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Testimony before House Committee on Commerce, Labor, and Economic Development

Senate Bill 154

Chairman Hutton and Honorable members of the Committee:

Thank you for another opportunity to address the Committee on the important topic of unemployment insurance financing. Before you is a major piece of legislation that brings dramatic reform to the current financing set-up. Senate Bill 154 overhauls the Kansas employment security law's current arrayed system for taxing employers and moves to a "fixed" system. While the Department of Labor supports moving to a fixed system, the agency has some concerns about the bill as drafted and urges the Committee to consider carefully the points raised herein, as well as an amendment to make this a piece of legislation that provides needed reform to our current system of financing while maintaining protections to ensure the unemployment trust fund achieves solvency in order to provide for payment of benefits when due.

Goals for the Unemployment Trust Fund

The Kansas employment security law (KESL) is exceptional in that the public policy behind the act is set forth clearly in statute. Two key clauses found in K.S.A. 44-702 guide the application of the KESL. First, the legislature pronounced that the achievement of social security requires protection against the greatest hazard of economic life, i.e., the menacing effects of involuntary unemployment, and that "[t]his can be provided by encouraging employers to **provide more stable employment** and by the **systematic accumulation of funds** during periods of employment to provide benefits for periods of unemployment." Second, the legislature declared "the public good and the general welfare of the citizens of this state require the enactment of this measure … for the compulsory setting aside of unemployment reserves to be used for the benefit of persons unemployed."

To that end, KDOL strongly urges the Committee to consider the principles of encouraging stable employment as well as a systematic accumulation of unemployment reserves to be used for the benefit of persons involuntarily unemployed. These principles require the Committee to consider the adequacy of the unemployment trust fund while as well as protecting the integrity of the experience rating system that encourages stable employment.

Encouraging Stable Employment

The KESL, both in its current form and in the proposed reforms in SB 154, encourages responsible use of the system by employers by taxing employers based on the individual employer's experience, i.e., risk, as described by the employer's **reserve ratio**.[1] A higher reserve ratio reflects a better experience or less risk. Under current law, positive balance employers are arrayed among 51 rate groups. The array method requires that employers comprising approximately 1.96% of taxable payroll are placed into each rate group. This means that from year to year, reserve ratios fit into different rate groups, and employers' experience ratings reflect risk on a relative basis instead of an individual employer's merit basis.

An important consideration when setting the reserve ratio limits for fixed rates is that the KESL still is an insurance system. Risk, therefore, should be spread among all potential users, i.e., all contributing employers. Thus, any fixed system should still ensure a reasonable distribution of employers among the rate groups, avoiding a scenario wherein the worst reserve ratio employers pay too much, and wherein too many employers are bundled at the top of the rate table. A system designed like SB 154 that has more than 70% of employers in the lowest rate group, is untenable and does not adequately represent the relevant risk of Kansas employers. Further, a reserve ratio threshold too low would create an incentive for employers to spend down reserves, e.g, by not contesting benefit charges or by using the system as a subsidy for operations, that would frustrate one of the primary purposes of the KESL – to maintain stable employment.

KDOL recommends that the Committee consider a distribution of employers based upon Kansas historical data, and refrain from comparing tax structures among states based merely upon reserve ratios, as the distribution of employers among reserve ratios in those states has not been shown.

Trust fund adequacy

The public policy of the state should be an adequate unemployment trust fund. Trust fund adequacy is measured by the average high cost multiple. The average high cost multiple is the trust fund's **reserve fund ratio**[2] divided by the

[1] An employer's reserve ratio is the employer's UI account balance divided by the employer's three-year average taxable payroll.

[2] The reserve fund ratio is the trust fund balance on July 31 divided by total payrolls for contributing employers for the preceding fiscal year which ended June 30. For rate year 2015, the reserve fund ratio was 0.541% based upon a July 31, 2014 trust fund balance of $241,332,201 and total payrolls ending June 30 of 44,624,612,033.

average high benefit cost rate.[3] In layman's terms, the average high cost multiple describes the capacity of the trust fund to pay benefits during a significant recession. The most recent average high cost multiple is 0.353. This means that as of July 31, 2014, the trust fund had 35.3% of the balance needed in order to cover benefits if Kansas was to experience a similar recession.[4] Kansas' goal should be an AHCM of 1.0 or above.

Having an adequate trust fund protects against the need to dramatically increase contributions during a period of increasing benefit payments. In the event Kansas does not maintain an adequate trust fund, there would be consequences for all Kansas employers during the next recession. Particularly, there would be an increased risk of having to borrow money from the Federal government to cover benefit payments, and a reduction in employers' Federal unemployment tax credit. Kansas, if it does not progress toward solvency, also runs the risk of losing its ability to borrow interest free. Payment of interest cannot come from the unemployment trust fund, so an additional interest surcharge would be required to be enacted in statute.

These consequences are real. As of March 10, 2015, 10 states or territories had more than $14.2 billion in outstanding loans, including California at $8.8 billion. Connecticut's failure to pay its loans has resulted in a 1.7% FUTA credit reduction, which translates to an additional $119 per employee in unemployment taxes. Kansas should avoid a financing mechanism that increases the risk of these consequences.

KDOL supports the concept of moving from an arrayed to a fixed tax system. The structure of SB 154 is appealing, but the reserve ratio limits in the Standard Rate Schedule on pages 15 and 16 of the bill should be adjusted to ensure an adequate, solvent trust fund. KDOL looks forward to working with the committee on amending the bill to meet those goals.

Respectfully submitted,

Justin McFarland

[3] The average high cost benefit rate is the average of the three highest ratios of benefits paid to total wages in the most recent 20 years. The average high benefit cost rate for the most recent 20 years is 1.532%. More simply, during the recent recession, benefits paid were about 1.5% of total wages paid.
[4] To reach an AHCM of 1.0 using current wage levels, Kansas would need a trust fund balance of approximately $684 million.