



B R I E F L Y

A study published in the Federal Reserve Bank of Boston's *New England Economic Review* confirms that Washington's unemployment insurance system levies unusually high taxes in order to fund unusually high benefits.

How Washington Compares on Unemployment Insurance

Washington provides more generous benefits to recipients of unemployment insurance (UI), at a higher cost to taxpayers, than do most other states. This is the conclusion of a thorough analysis of UI programs by Robert Tannenwald, Christopher O'Leary and Wei-Jang Huang.¹ Their analysis, published in the *New England Economic Review*, shows that Washington ranks in the top four states in both tax burden and benefit generosity.

Taxes

A simple approach to tax analysis would be to look at the tax rate. However, different states have different tax bases as well as tax rates. For instance, Washington's average tax rate (using 1996 data) is 2.0%, which looks lower than Ohio's rate of 2.6%.² Washington's rate, however, applies to the first \$21,300 of wages, while Ohio's tax only applies to the first \$9,000 of wages. As a percentage of total wages, Washington's tax rate is actually higher by a third than Ohio's.

Using as a measure of taxation total UI taxes as a percentage of total wages, Washington has the 7th highest tax rate in the country. However, the point of the Tannenwald team's analysis is that the simple measures are not always accurate. The actual tax rate in a state reflects not only current public policy toward the UI system, but also the history of UI in the state. When a state has had a bout of high unemployment, its UI trust funds are run down. In extreme cases, the state may need to borrow from the federal government. All states have automatic tax adjustment mechanisms that raise tax rates when trust fund balances are low. So if we observe a state with a high tax rate, we don't know immediately if the state has a policy of high taxes, or if the state is just coming off of some bad years. In fact, a state could have a very lean tax schedule, but show a high tax collection rate if it were coming out of particularly nasty local recession.

Tannenwald et al. worked to separate out pure tax policy from economic history by conducting a series of runs with a microsimulation model. This computer model uses standardized assumptions about firms, and actual state legislation, to compute a standardized measure of the tax rate. However, the actual taxes vary depending on the assumptions, such as average wage level and how severe a recession is. The research team addressed this problem by computing six different cases, covering a wide range of assumptions. When a particular's state's ranking is sensitive to the assumptions used, the results should be treated with caution. However, if a state's ranking is high across most of the simulations, it is safe to say that it has a relatively high tax rate.

Washington's ranking in the six different simulations is 3rd, 2nd, 2nd, 1st, 2nd, and 1st, out of 28 states for which the microsimulations were performed. It is clear that Washington is a high tax state. The first and third simulations (3rd and 2nd place) used income levels that most closely approximate Washington's, leading us to say that if all states were pretty much like Washington in terms of average wage rate, Washington's taxes would be 2nd or 3rd highest out of 28.

Tannenwald et al. do not combine their six simulations into a composite, but it isn't hard to develop a rough overall estimate. Taking all six simulations and

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A Primer on Unemployment Insurance

UI benefits are paid to workers who lose their jobs, except generally for good cause firings, though there are many details and exceptions from state to state. The benefit that an unemployed person receives depends on the person's employment and wage history. States have differing benefit formulas, minimum and maximum benefit levels, past earning requirements and number of weeks of eligibility.

Employers pay two taxes to fund the UI system. First, they pay a federal tax of 0.8 percent on the first \$7,000 paid to each employee. That tax, uniform across the country, pays the cost of administering the UI system both federally and in the states. A separate state tax is also levied to fund benefits, and the tax rate and wage base it applies to vary across the states. Within a state, the tax rate depends on the employer's history of employees collecting UI benefits, as well as the condition of the state's UI trust fund. The formulas that determine a tax rate also vary from state to state.

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giving them equal weight, Washington has the highest average rank of the 28 states.

Our conclusion is straightforward: Washington is one the three highest taxing states of 28 states by the new methodologies, or 7th out of 53 states and territories using the old methodology.

Benefits

Washington's benefits are, like its taxes, among the highest in the country.

The easiest measure is the weekly benefit amount. Washington's 1996 average was \$209, a fairly-high 11th out of 53 states and territories. However, the state's average duration of unemployment ranked 2nd highest, so the product of weekly benefits and weeks paid ranks 6th out of 53. That's pretty high, though not quite so high as our tax rate would suggest. The last traditional measure of benefits is the wage replacement ratio, which considers how the benefit amount compares to the wage earned before unemployment. Tannenwald et al. compute that Washington ranks 2nd out of 28 states by this gauge.

These simple measures of benefits can be misleading, however, because they reflect the particular people who are unemployed in the time period measured. During times of strong economic activity, unemployed people tend to be lower wage earners, who qualify for relatively low UI benefits. But during a recession, construction and manufacturing workers are laid off. These higher paid people qualify for higher benefits. Thus, the average benefits paid in a year is a measure not only of benefit generosity, but also a measure of who happens to be unemployed in the year.

The House Ways and Means Committee publishes benefits based on four hypothetical workers as a way to compare the different states based on identical people. In their four cases, Washington ranks 2nd, 2nd, 2nd and 3rd out of 52 states and territories. Averaging these ranks suggests that Washington is the 2nd most generous state in the union.

Tannenwald and his team also used their microsimulation of 28 states to compute benefits and rankings. For their six hypothetical cases, Washington ranks 5th, 12th, 5th, 2nd, 12th, and 2nd. The two fifth place rankings use hypothetical wage levels closest to Washington's average. Again we form Tannenwald's results into our own composite. Taking all six cases into consideration and giving the rankings equal weight, Washington ranks as the 4th most generous of the 28 states evaluated.

Washington's benefit generosity is unmistakable, whether one uses the traditional measures or the cycle-neutral analyses.

Conclusion

Washington's unemployment insurance system levies unusually high taxes in order to fund unusually high benefits.

Notes

¹ Robert Tannenwald, Christopher J. O'Leary, and Wei-Jang Huang, "New Ways of Evaluating State Unemployment Insurance," *New England Economic Review*, March/April 1999.

² Committee on Ways and Means, U. S. House of Representatives, *1998 Green Book*, Section 4.