New Employer Rate Study
Final Report

Presented by Beth Zander
Job Service North Dakota

To the

Interim Legislative Committee on Industry, Business and Labor
Senator Karen Krebsbach, Chair
July 18, 2006

Madam Chair, members of the Interim Industry, Business and Labor Committee, I am Beth Zander, representing the Unemployment Insurance Area of Job Service North Dakota. I'm here today to provide you with the final report on the study of new employer rates as directed in HCR 3040. I have provided you with a copy of our full report, and my testimony today summarizes that report.

HCR 3040 was created after House Bill 1425 failed to pass during the 2005 legislative session. HB 1425 proposed to amend UI law as it relates to assigning tax rates for new employers classified as 'new homebuilders'. Because the Resolution came as a result of HB 1425, the study team focused on rates assigned to new *construction* employers and more specifically, *new homebuilders*.

Current law (NDCC 52-04-05) requires that new employers identified as construction employers are assigned the negative employer maximum rate until they meet requirements to be experience-rated. Construction employers are considered new until they have approximately three years of coverage. By comparison, new non-construction employers are assigned 150% of the positive employer maximum rate until they meet requirements to be experience-rated, which for non-construction employers is approximately two years coverage. For calendar year 2006, the negative employer maximum rate is 9.44%. The 2006 positive employer maximum rate is 1.25%, so at 150% of that, new non-construction employers pay at a rate of 1.87%. The 2006 negative employer rate ranges from 6.05% to 9.44%. The positive employer rate ranges from .40% to 1.25%.

Job Service North Dakota identifies any businesses coded with the first two NAICS code digits of 23 as being construction. Within the 23 series, exist subgroups of 236 (Construction of Buildings), 237 (Heavy and Civil Engineering Construction) and 238 (Specialty Trade Contractors). When reviewing statistical information, we focused on the three-digit groupings, since it gave us a finer breakdown of industry information.

The study team consisted of Doreen Riedman from the North Dakota Association of Builders, Job Service Labor Market Analyst Mark Backman, Job Service North Dakota Tax Chief Bob Olson, and me.

Study data was gathered to obtain trends, cyclical impact, industry comparisons, costs and other related factors. The following statistical data was reviewed:

1) **Comparison of ratios of benefits paid to taxable wages from FY 1996 – 2005.** This data shows us that the construction industry has a history of higher payout of benefits in comparison to taxable wages than employers overall.

2) **North Dakota building permit data from 1999 – 2005.** This data shows growth trends in the housing industry over recent years.

3) **Comparison of 6-year reserve ratios.** This data shows us that construction industry reserve ratios are regularly lower than the overall levels. The reserve ratio is the employer's most recent 6-year contributions minus most recent 6-year benefits paid to its most recent 3-year taxable payroll. A lower reserve ratio indicates a higher level of risk to the unemployment insurance trust fund, due to a substantial increase in payroll or a recent history of high benefit payouts, and results in a higher tax rate assignment.

4) **Tax rate comparisons for 2006.** This data shows us how construction employers have fared after they become rated based on their reserve ratio, in relation to overall employers. Determination of *negatively* vs. *positively* rated is based on the lifetime difference between contributions minus benefits charged. Our data shows that 79.2% of employers classified in *Construction of Buildings* are positively rated in 2006. 72.5% of Specialty Trade Contractors and 45.2% of Heavy and Civil Engineering Construction employers are positively rated in 2006. These levels of positive ratings are due in part to employers making voluntary contributions to move from the negative rate schedule to the positive schedule; improved ratios imposed by trust fund building; and because the higher rate currently being applied moves employers in a positive direction quickly when they do not have a high numbers of claims. 91.4% of total employers are positively rated.

5) **Quarterly wage comparisons for 2001 through 2004.** This type of data may reflect industry seasonality by reported wage levels. The three construction industry subgroups showed stronger seasonal fluctuations by wage in comparison to overall employers.

6) **Cost estimates and projections.** Cost estimates for staffing, Management Information Systems (MIS) changes and impact to the trust fund were gathered for use in the final recommendation. MIS modification costs are estimated at $20,000 and an additional 1 FTE in staff need is projected. Projected impact to JSND can be found on page four of the study report.

Trust fund impact is passed on to employers and varies depending on how statute is changed. Our projected cost to the trust fund is based on two scenarios: moving the new construction employer rate from the maximum negative rate to the average negative rate, for which an impact of $458,058 is projected, based on current rates; or moving the new construction employer rate from the maximum negative rate to the minimum negative rate, for which an impact of $918,827 is projected, based on current rates. Costs to the trust fund are passed to all employers. The rule of thumb for costs to trust fund: Every $400,000 in costs to the fund means the average tax rate for every employer must be raised by 1/100th of a percent. Example – for each $10,000 in taxable wages, employers would pay an additional $1.00 in taxes each year.

7) **North Dakota Association of Builders.** A notable factor in our study results is the limited interest in this issue by members of the North Dakota Association of Builders. This issue was presented to the North Dakota Association of Builders at their spring meeting and the group indicated that it was not of high concern. Within the group, some individuals sought clarification of the process to fully understand that the *new employer*

rate applies only during first three years from the point of becoming a liable employer, after which experience rating applies.

8) **History and Projections**. Factors including declining homebuilding projections nationwide, recent unseasonably warm winters and high growth years, as well as the affect of trust fund building influenced our decision as well. Because we've been building the UI Trust Fund since 2000, all employers' reserve ratios look better than they would otherwise. Because we're now approaching our target balance, we are returning to 'maintenance mode', which will affect future trends.

The team concluded that current law regarding assignment of rates to new employers is sound. An evolution of the tax rating system in North Dakota has included moves to address inequities between experience rated employers and new employers. Historically, the construction industry in North Dakota experiences a high relative volume of layoffs, due to the seasonal nature of the work and the industry's sensitivity to economic fluctuations. This impacts the trust fund.

Furthermore, if legislation were enacted to reduce or eliminate the new construction employer rates, out-of-state competitors could actually pay at lower rates than in-state employers because they would not have the benefit payout history that affects North Dakota's experience rated employers.

While short term influences may give some support to modification to existing statute, factors influencing such a decision, such as strong economic times and warm winters, will ultimately shift. We recommend that current statute not be changed.

I want to give special thanks to Doreen Riedman of the North Dakota Association of Builders for taking the time to participate in this effort.

Madam Chair, members of the Interim Industry, Business and Labor Committee, I would be happy to respond to your questions.

Unemployment Insurance (UI) New Employer Tax Rates

I. Study Overview

House Bill 1425 (2005) addressed the assignment of unemployment insurance tax rates to new employers. The bill identified five specific sub industries within the overall construction industry, as classified according to the North American Industry Classification System (NAICS) that would be exempt from paying the *new construction employer rate* currently assigned to within the industry. Those sub industries included:

236115 New single-family housing contractors
236116 New multifamily housing contractors
236117 New housing operative builders
236118 Residential remodelers
236220 Commercial building construction.

HB 1425 failed to pass in the House; however HCR 3040 was enacted to mandate a study of the tax rate assigned to new employers. Because the Resolution was the result of HB 1425, this team focused on rates assigned to new *construction* employers and more specifically, *new homebuilders.*

Current law (NDCC 52-04-05) requires that new employers be classified using the North American Industry Classification System (NAICS). Those identified as construction employers are assigned the negative employer maximum rate until they meet requirements to be experience-rated, or no longer 'new'. Construction employers are considered new until they have ten quarters of coverage (approximately their first three years). By comparison, new non-construction employers are assigned 150% of the positive employer maximum rate until they meet requirements to be experience-rated, which for non-construction employers is six quarters of coverage (approximately their first two years). For calendar year 2006, the negative employer maximum rate is 9.44%. The 2006 positive employer maximum rate is 1.25%, so at 150% of that, new non-construction employers pay at a rate of 1.87%.

Employers are assigned a NAICS code based on a percentage of sales volume or receipts from their business activity. The NAICS system progressively refines groupings to detail down within major industry areas. A 2- or 3-digit code identifies a higher classification level and the 6-digit code is the most specific level. Current law is applied by identifying any businesses coded with the first two digits of 23 as being construction. Within the 23 series, exist three-digit NAICS subgroups of 236 (Construction of Buildings), 237 (Heavy and Civil Engineering Construction) and 238 (Specialty Trade Contractors). Within the 236 grouping, the five industries identified in HB 1425 exist, as does 236210, Industrial Building Construction. The 237 subgroup contains 6 six-digit breakouts and the 238 subgroup contains 27 six-digit breakouts.

II. Study Data

A variety of data were gathered for the study. This data was intended to assist us in analyzing factors such as the cyclical nature of the construction industry and its subgroups; industry subjectivity to economic fluctuations; comparisons of experience among industries; and the cost of changing current law. This study focused on data and factors as they related to the three-digit NAICS industry codes. It was felt this gave the fairest representation of breakouts within the industry. Data included:

1. Comparisons of ratios of benefits to taxable wages (FY 1996 – 2005)
Use: Review of cyclical economic trends and comparisons of trends by industry.

Limitations: Availability of data (1996-forward) and insignificant changes from year to year resulted in determination that it could not be used to track cyclical patterns. Use of the data changed from our original intent. While we felt we could not use it to definitively determine cyclical trends, we determined that it could be used to compare the gap in ratios for specific groups to all industries. These gaps give an idea of whether the industries in question deviate far enough from the norm to support the higher new employer rate.

Observations: A comparison of the 236 industry group to all industry (referred to in this report as 'Total') reveals significant differences in the ratios, with the 236 being higher than the Total. Code 238, Specialty Trade Contractors (drywall, framing, masonry, electrical, roofing, etc) varies from Total as well. Heavy and Civil Engineering Construction (code 237) shows wider gaps in ratios, as was expected due to the highly seasonal nature of the work. Charts of these comparisons are shown in **Attachment I.**

A scan of other industries commonly thought to be seasonal revealed similar gaps by percentage from the Total. Examples include 115 Agriculture and Forestry Support Activities, 111 Crop Production, and 113 Forestry and Logging. However, the total numbers in benefits paid and taxable wages are significantly smaller for these industries than for the construction industries.

2. North Dakota Building Permit Data (1999 – 2005)
Use: Trend information.

Limitations: Not all data is alike, due to additions of geographic areas and varied reporting by area. This includes all building permits, rather than just homebuilder data.

Observations: Records show a gradual growth throughout the time span in numbers of permits and valuation.

3. Comparison of 6-Year Reserve (1996 - 2002 through 1999 – 2005)
Use: Comparison of rated employers in construction industry breakouts to rated employers in the Total grouping.

Limitations: None identified.

Observations: The reserve ratios in the construction industry (NAICS Code 23) improved, 236 and 238 more than 237. However reserve ratios improved for the Total as well. This improvement reflects the factoring in of the trust fund target in our rate calculations. A growing economy and warm winters are likely reflected here as well. In 2004, all 3 construction groupings fare worse than the Total reserve rate of 1.35%: Construction of Buildings at negative .42%, Heavy Construction at negative 19.25% and Specialty Trade Contractors at negative 1.85%.

4. 2006 Tax Rate Comparison by NAICS
Use: Comparison of experience ratings after employers they become rated (six quarters non-construction, ten quarters construction).

Limitations: None identified.

Observations: Within Construction of Buildings (NAICS 236), 79.2% (545/688) ended up positive when rated. Specialty Trade Contractors (NAICS 238) are at 72.5% (971/1,340) and Heavy and Civil Engineering Construction (NAICS 237) at 45.2% (127/281). This is due in part to the artificial growth in contributions imposed by the new employer tax rate. If a new construction employer maintains a reasonable history for those first 10 quarters, the new construction employer tax rate will have brought him to a strong positive position when he becomes rated. For graphic information on this data, see **Attachment II**.

5. Comparison of Quarterly Wage Records by NAICS (Q 2002-1 through 2004-4)
Use: Comparison of seasonal cyclical impact on construction industries in relation to industry total.

Limitations: Data only available back to 2002.

Observations: Seasonality patterns are present for the three key construction industry groups – 236, 237, 238 and more prevalent than for the Total of all industries. Patterns for Heavy Construction (237) are clearly more impacted by seasonal fluctuations. Seasonality patterns do result in a recurrence of a draw on the trust fund, which causes a lower reserve and higher rate, and if not absorbed by the impacted employer, is then absorbed by all employers. Graphic comparisons of these data are available in **Attachment III.**

6. Cost Data

Use: Identify the affects on UI Trust Fund (passed on to employers) and JSND of changes to current law.

Limitations: These are projections and estimates only.

Cost Breakouts:

A. MIS Modifications - $20,000 for any option. Multiple options were provided, in order to determine cost variables.

B. Cost to Trust Fund, varied scenarios including three-digit NAICS codes 236, 237 and 238.

- Maximum to average negative rate (from 9.44% to 7.75%): $458,058.
- Maximum to minimum negative (from 9.44% to 6.05%): $918,827.

C. Staff costs

We have estimated that one full time equivalent (FTE) program administrator would be needed to complete the extra work associated with assigning new construction rates by 3-digit NAICS code or higher, vs. the current 2-digit NAICS. The work includes two events: 1) new construction employers just starting as the rate is applied; 2) existing construction employers still in the *new employer* category facing continued application of the new employer rate for the remainder of their 10-quarter period. The midpoint salary for a Program Administrator I is just below $40,000 annually.

Factors involved in the estimate include:

- Currently our **UI Tax staff** makes a preliminary classification as to "construction" vs. "non-construction" and assign tax rates accordingly. The information is then passed on to our **Labor Market Information staff** for assignment of a full six-digit NAICS classification. An effort to further define the construction industry (code 23) down to a more specific grouping prior to assigning a tax rate will involve further investigation and additional contact with the employer to ensure the code is correctly assigned. This will do one of two things, 1) increase the amount of time needed to make determination causing a decrease in customer service or 2) require significantly more information gathering by our UI Tax staff. These determinations frequently involve employers that do both types of business – homebuilding (code 236) and the specialty construction work (code 238) needed to complete the structure. The determination may be difficult and may be come contentious.

- Employer appeals of their industry classification will increase because they will seek to be coded in a manner that more favorably affects their tax rates (i.e. 236 – homebuilders, vs. 238 specialty contractors). Workers from Appeals, Tax and LMI units are involved in this process.

Notes:

- MIS modification and staff costs present a significant impact to Job Service North Dakota.
- Costs to the trust fund are passed to all employers. The rule of thumb for costs to trust fund: Every $400,000 in costs to the fund means the average tax rate for every employer must be raised by 1/100th of a percent. Example – for each $10,000 in taxable wages, employers would pay an additional $1.00 in taxes each year.

III. Additional Key Factors

- This issue was presented to the North Dakota Association of Builders at their spring meeting and the group indicated that it was not of high concern. Within the group, some individuals sought clarification of the process to fully understand that the *new employer rate* applies only during first three years from the point of becoming a liable employer, after which experience rating applies. However, little concern was expressed over the use of new employer rates.

- The time frame covered in our available data has involved unseasonably warm winters and a growing economy, and true cyclical effects are not reflected.

- Industry economists nationwide express indicators that housing growth is off and will be now in decline. Housing sales data support this. Shifts in trends could force us to revisit this issue if we change it now.

- Because we've been building the UI Trust Fund since 2000, all employers' reserve ratios look better than they would otherwise. Because we're now approaching our target balance, we are returning to 'maintenance mode', which will affect future trends.

- HB 1425 isolated specific industries within the home building industry, coded as the 236 subgroup of construction NAICS codes. However, data reflects that the characteristics of subgroup of 238 (Specialty Trade Contractors) are similar. Within 238, lie numerous examples of trades that also occur in 236, such as residential and nonresidential finish carpentry contractors, residential and nonresidential flooring contractors, residential and nonresidential roofing contractors, etc. As with the isolation of 236210 from the new homebuilder codes identified in HB 1425, the 238 group has specific industries at the six-digit level that either positively or negatively affect the overall picture of the construction industry. However, unlike the possibly manageable six subgroups within 236, there are 27 digit subgroups within the 238 category.

- A law change to exclude certain homebuilders from the assignment of the new construction employer rate, may lead to additional modifications in the future, such as changes to exclude the 238 code (Specialty Trade Contractors), or to change the method in which taxes are assigned to other industries completely.

IV. Conclusions

We recommend that statute *not* be changed to alter the current method of assigning new employer tax rates.

An evolution of the tax rating system in North Dakota has included moves to address inequities between experience rated employers and new employers. Historically, the construction industry in North Dakota experiences a high relative volume of layoffs, due to the seasonal nature of the work and the industry's sensitivity to economic fluctuations. The current mechanism reflects a sound method of equitably distributing UI tax responsibility.

While short term influences may appear to substantiate modification to existing statute, factors influencing a decision to re-categorize subgroups of new construction employers, such as recent market growth and warm winters, will ultimately shift.

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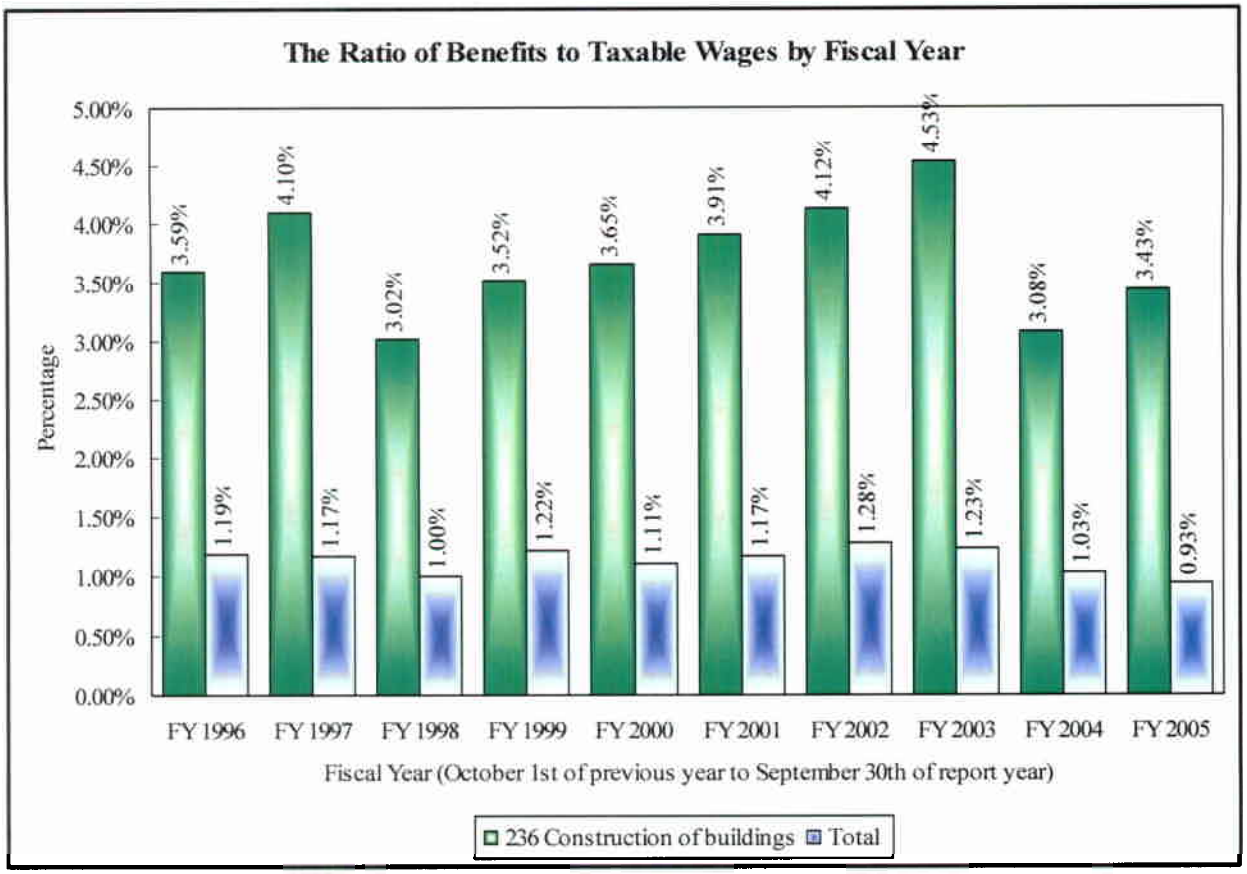
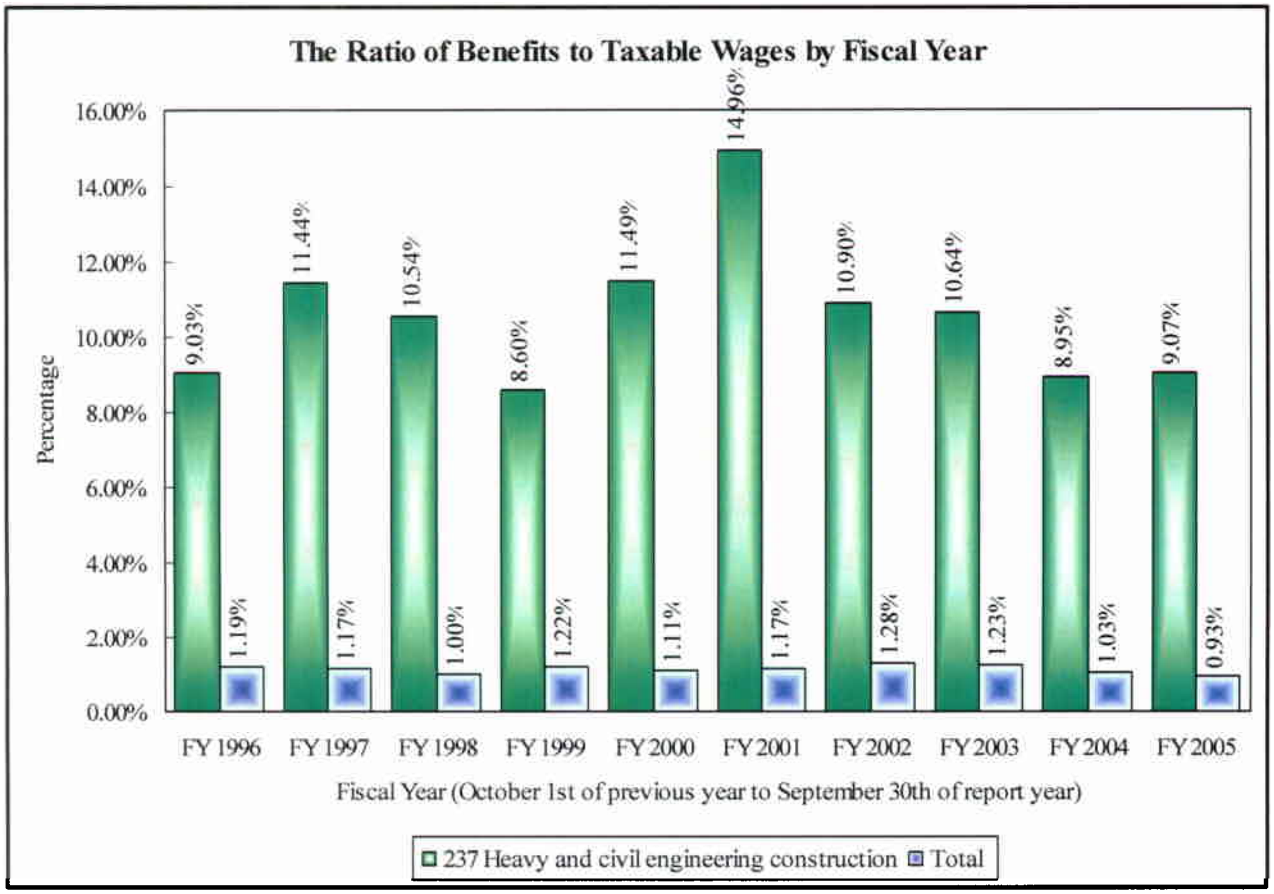
HCR 3040 Rate Study
Attachment I: Comparisons of ratios of benefits to taxable wages (FY 1996 – 2005)

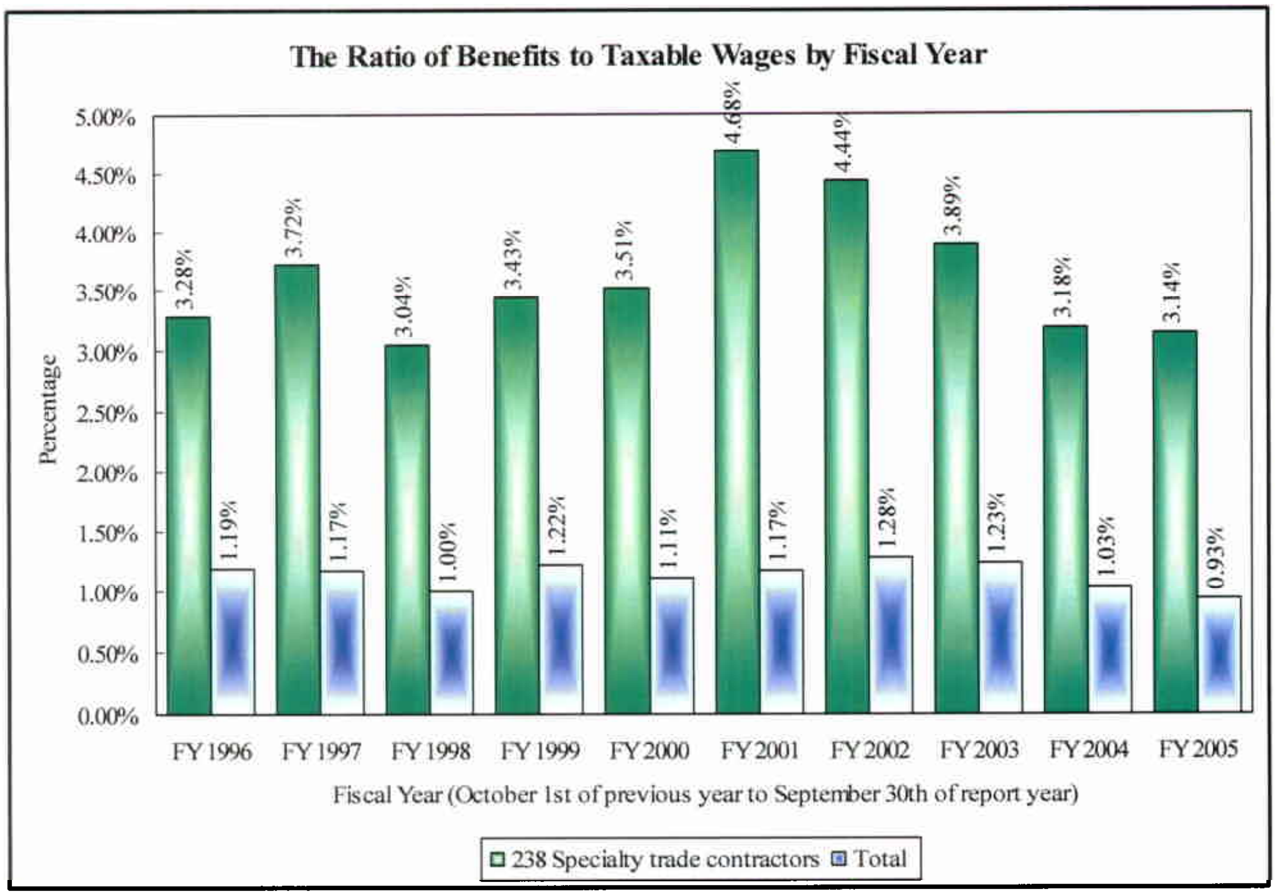
Graph 1: NAICS 236 Construction of Buildings to Total (all industries)



Attachment I
Graph 2: NAICS 237 Heavy and Civil Engineering Construction to Total (all industries)



Attachment I
Graph 3: NAICS 238 Specialty Trade Contractors to Total (all industries)



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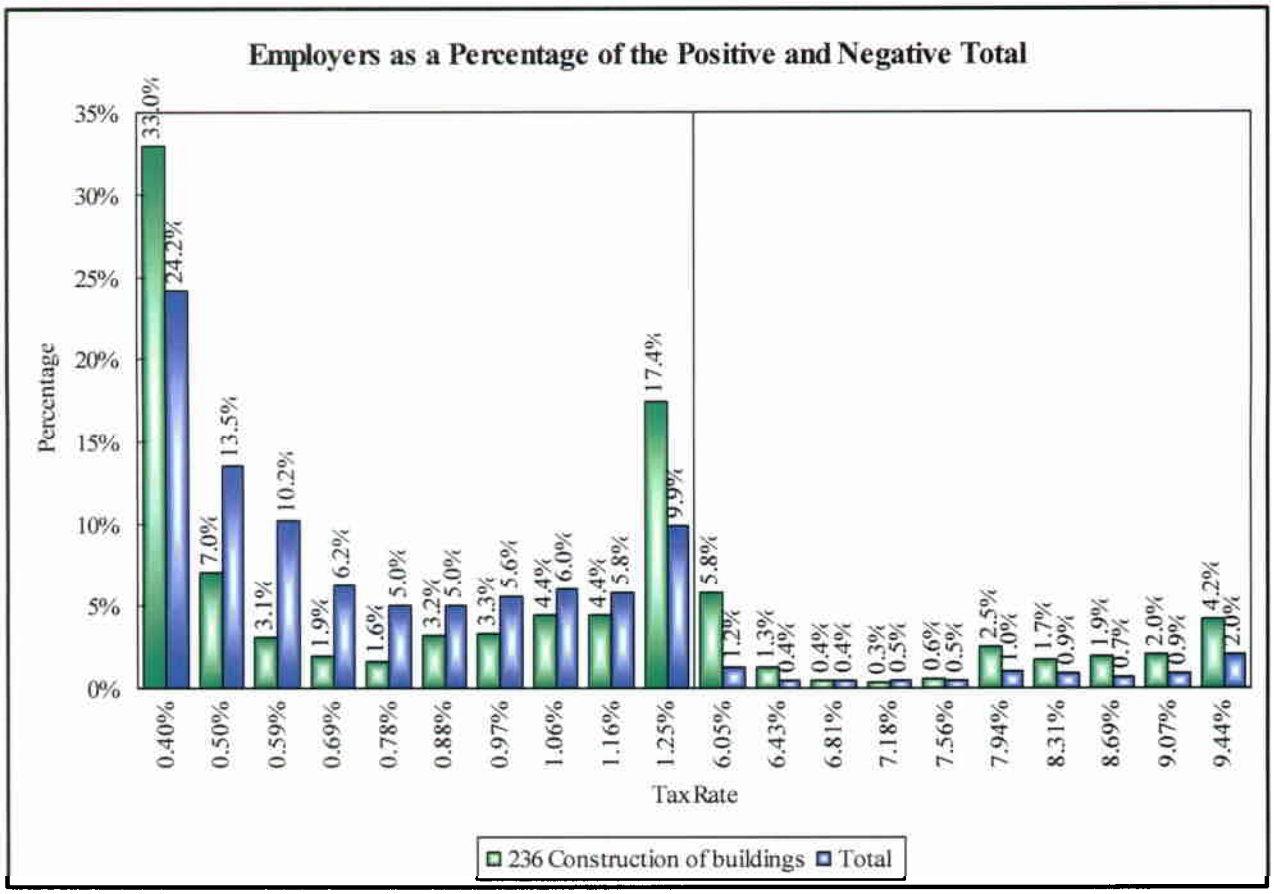
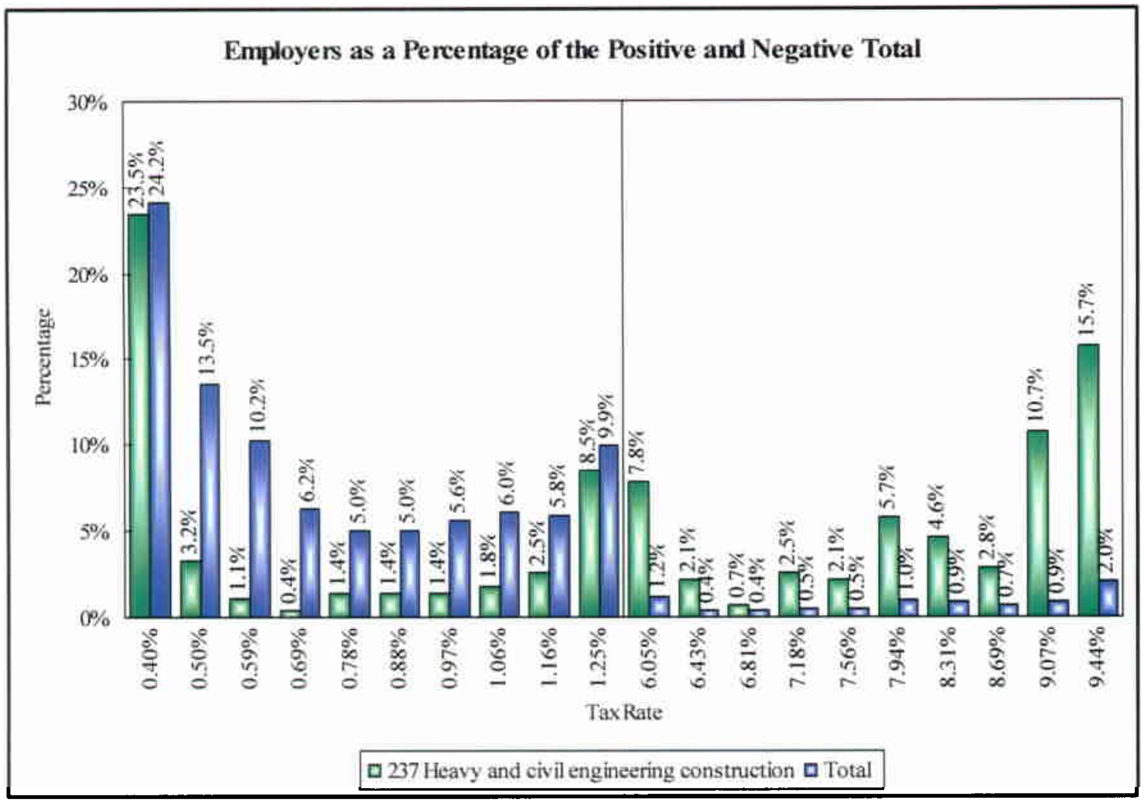
Attachment II: 2006 Tax Rate Comparisons by NAICS

Graph 1: NAICS 236 Construction of Buildings to Total (all industries)



Attachment II

Graph 2: NAICS 237 Heavy and Civil Engineering Construction to Total (all industries)



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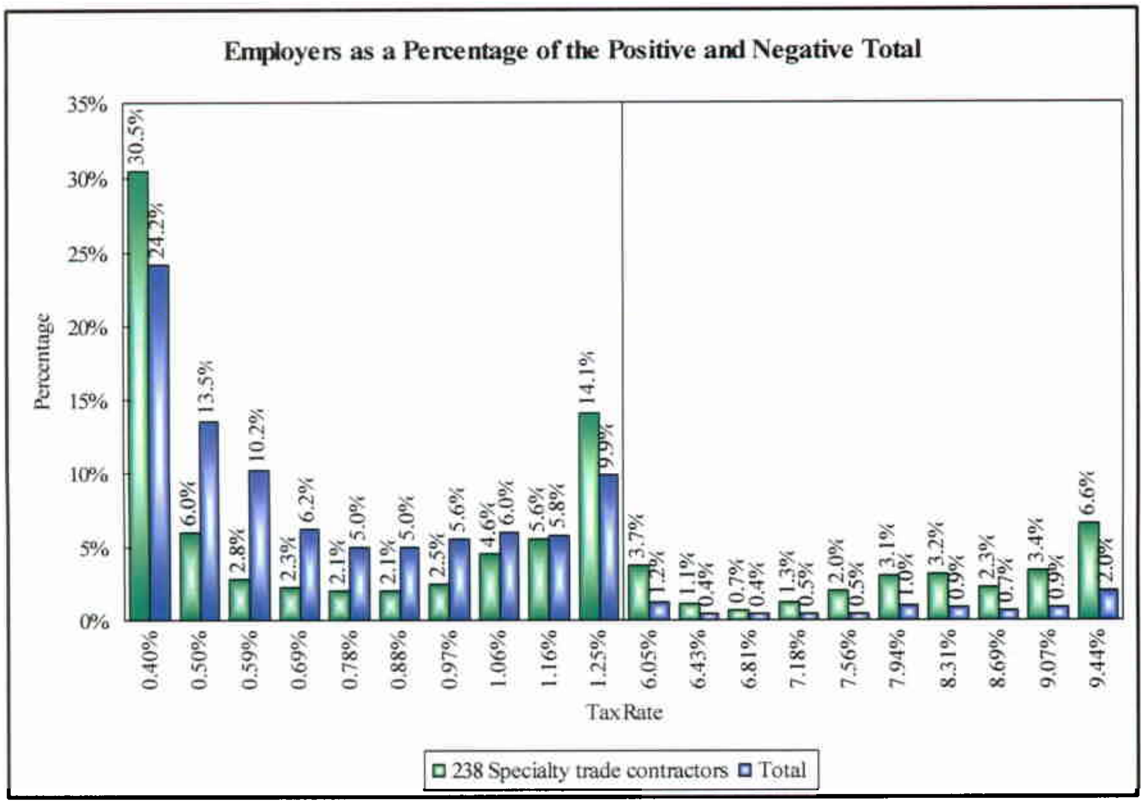
Graph 3: NAICS 238 Specialty Trade Contractors to Total (all industries)



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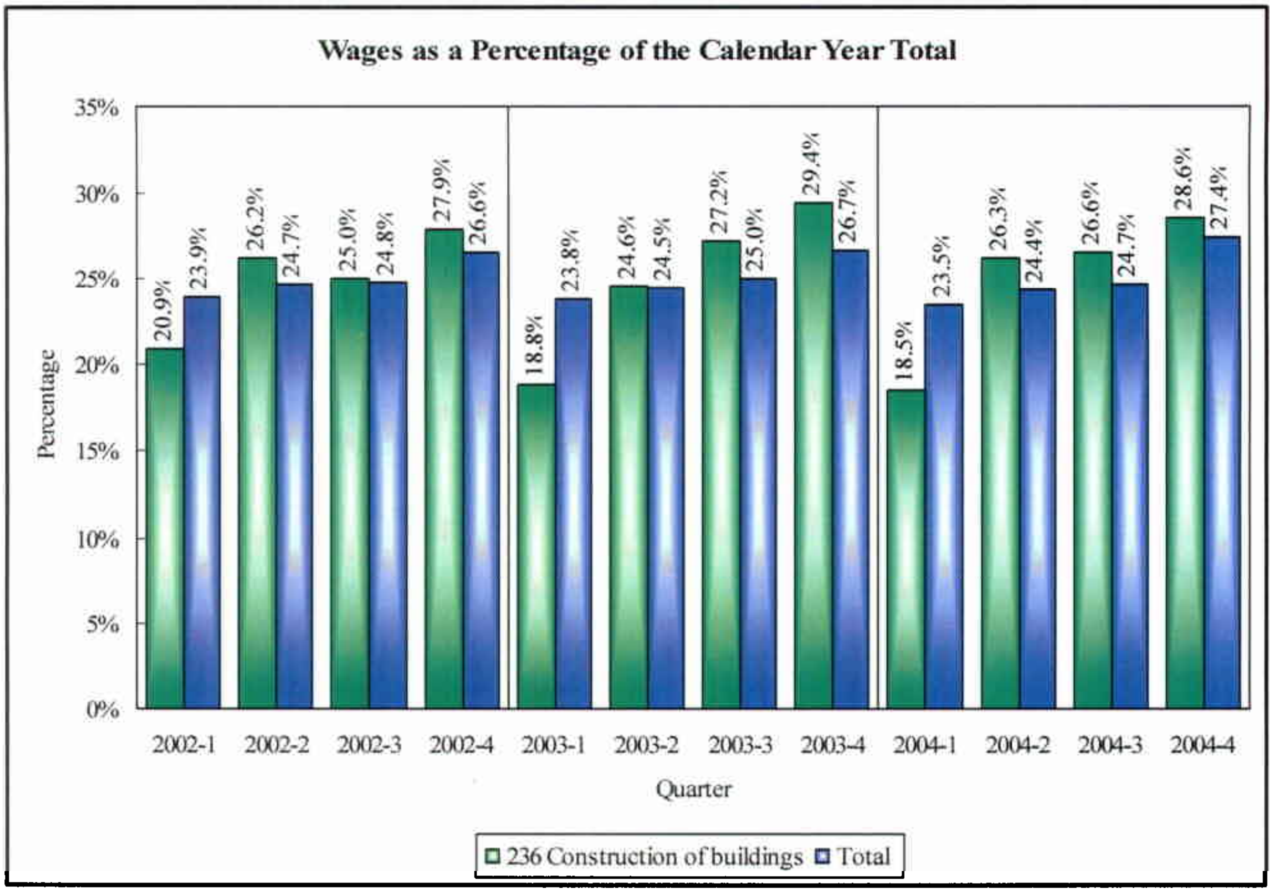
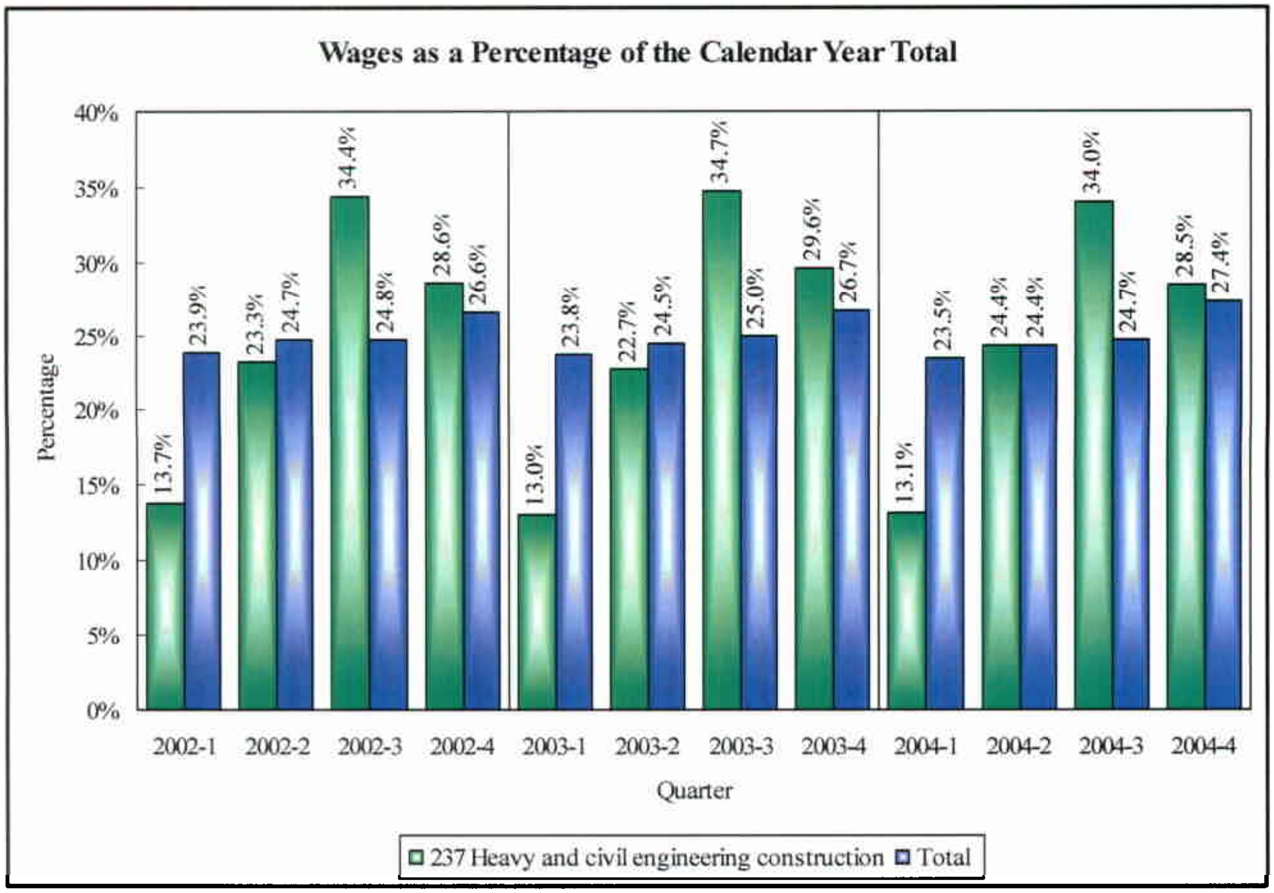
Attachment III: Comparison of Quarterly Wage Records by NAICS (Q 2002-1 through 2004-4)

Graph 1: NAICS 236 Construction of Buildings to Total (all industries)



Attachment III
Graph 2: NAICS 237 Heavy and Civil Engineering Construction to Total (all industries)



Attachment III
Graph 3: NAICS 238 Specialty Trade Contractors to Total (all industries)