

# **EMPLOYMENT SECURITY FINANCING: PROPOSAL FOR REFORM**

## **1. INTRODUCTION**

### ***What this proposal is about***

For over 60 years, payroll taxes paid by employers have funded programs collectively known as the Employment Security System. These programs provide unemployment insurance, employment services, labor market information, and employment services to veterans through a Federal-State partnership. The Federal government establishes the overall legal framework, collects and allocates funds for administration, and provides oversight and technical assistance. States provide services to customers and establish law for the collection of state unemployment taxes and payment of benefits.

The Employment Security System is founded on a “compact” by employers, workers and the State and Federal government, through which employers provide financing through payroll taxes, and workers receive unemployment benefits along with re-employment services to shorten their spells of unemployment. Employers also receive services to assist them in meeting their needs for skilled workers.

The Employment Security “compact”, financed through payroll taxes, served the Nation well until the advent of large federal budget deficits beginning in the mid-1980’s. Budget deficits have undermined the Federal government’s bargain with employers and workers. Although the federal budget is now claimed to be balanced, the balance is created through the use of offsetting balances in trust funds, including those within the employment security system. As a result, it is now clear that employer payroll taxes are underwriting the deficit in federal general revenue and providing funds for domestic spending unrelated to employment security. Workers and employers are being shortchanged in services they need and for which employers have already paid. States, on the front line providing services, are caught between demands and needs of employers and workers, and lack of resources from their Federal partner.

### ***Why this proposal is needed***

This proposal will restore the “compact.” It will shift responsibility, resources and control to the States, where services can be restored and improved. It will ease burdens on employers. It will accomplish these goals by reforming the Employment Security financing structure.

### ***Who is making this proposal***

This proposal is being made by the Coalition for Employment Security Financing Reform - a coalition of states and organizations that includes Alabama, Alaska, Arkansas, Florida, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Mississippi, Montana, New Hampshire, New Mexico, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Wisconsin, Wyoming, UWC-- Strategic Services on Unemployment & Workers’ Compensation (UWC), the U.S. Chamber of Commerce, the National Association of Manufacturers, the American Payroll Association, the National Restaurant Association, the National Association for Alternative Staffing, the Association of Unemployment Tax Organizations, and state and local employer organizations representing hundreds of thousands of employers. Organizations interested in joining the

Coalition in support of the proposal should contact Douglas J. Holmes, Ohio Bureau of Employment Services, at 614-644-9178, or Eric Oxfeld, UWC – Strategic Services on Unemployment & Workers’ Compensation, at 202-682-1515.

***Who will benefit from enactment of this proposal***

*Workers and job seekers* will benefit through better access to employment and unemployment services, including job search assistance and referral, unemployment insurance, and labor market information.

*Employers* will benefit through elimination of the “temporary” surtax on their federal unemployment taxes, by simpler tax reporting, reduced state UI benefit taxes through better administration of the unemployment system and more rapid re-employment of unemployment claimants, improved employment services to help them meet their workforce needs, and elimination of special state taxes added on in recent years to make up for shortfalls in federal appropriations.

*States* will benefit through more control over administrative financing of the services they deliver, and relief on state budgets.

The *Federal government* will also benefit through improved tax administration of the federal unemployment tax.

**2. EMPLOYMENT SECURITY TODAY: PROGRAMS AND FINANCING**

Today’s Employment Security System includes four major programs, operated by State Employment Security Agencies (SESAs) using federal grants financed from the federal payroll tax on employers. In addition, states collect a separate state payroll tax to finance unemployment insurance benefit payments. These programs are:

- \*Unemployment Insurance,
- \*Employment Services,
- \*Veterans’ Employment Services, and
- \*Labor Market Information.

An overview of each of these programs and the current structure for financing them follows.

**A. Employment Security Programs: What Employers’ Taxes Should Buy**

***Unemployment Insurance***

The unemployment insurance system, created by the Social Security Act of 1935, is administered by each State, the District of Columbia, Puerto Rico, and the Virgin Islands under the oversight of the U.S. Department of Labor (DOL). These 53 jurisdictions determine requirements related to eligibility, benefit levels and state tax rates, in conformance with federal requirements.

The Unemployment Insurance system has broad objectives:

- \*Alleviate hardship for the unemployed,
- \*Prevent unemployment,
- \*Stabilize the economy and help businesses remain solvent during economic recessions by providing counter-cyclical benefit payments, and
- \*Promote reemployment.

Alleviating hardship, the system's principal aim, is accomplished by partially replacing the loss of wages for unemployed individuals who have a demonstrated attachment to the workforce.

According to DOL, an estimated 7.1 million American workers will receive unemployment checks in FY 1998, totaling more than \$20.3 billion in benefits. On the average, workers will receive benefits for just over 14.6 weeks.

The Unemployment Insurance program also includes the Extended Benefits (EB) program, which extends benefit payments beyond the regular 26 week benefit periods in States where unemployment is high. Extended Benefits come into effect when a State reaches a "trigger" based on the state's level of unemployment. Benefit costs are shared equally between the federal government and the State. There are also special unemployment benefit programs for federal workers and recently separated military personnel.

### ***The Employment Service***

The Employment Service (or Job Service), established by the Wagner-Peyser Act of 1933, provides job search assistance to unemployment insurance claimants and other individuals, and recruiting and referral services to employers.

Services available to workers in more than 1,800 Employment Service offices nationwide include job referral and placement, skill assessment and counseling, referral to training, and job search skill-building activities. The Employment Service assists employers by screening and referring applicants for job vacancies, and providing critical labor market information for business and economic planning.

More than 18 million individuals received job search assistance from the Employment Service last year, with 8 million referred to jobs. Over 3 million individuals were employed or reemployed after receiving ES services at a cost to the program of under \$250 each.

Other programs administered by Employment Service in most states include Alien Labor Certification, Federal Bonding, Migrant and Seasonal Farm worker services, the Workforce Opportunity Tax Credit and Trade Adjustment Assistance/NAFTA assistance to workers impacted by foreign trade. In some states, the Employment Service also provides services under contract for Job Training Partnership Act dislocated worker program and welfare to work programs.

### ***Veterans' Employment Services***

Services to veterans of the Armed Services are provided by Disabled Veterans' Outreach Program (DVOP) and Local Veterans' Employment Representatives (LVER) staff, who may only assist

individuals who have served in the military and eligible spouses and dependents. By law, veterans also receive priority for services from the Employment Service program.

DVOP staff maximize employment opportunities primarily for disabled veterans, and help those who are about to leave military service by conducting Transition Assistance Program workshops.

LVERs provide job placement and supportive services to veterans, and ensure local office compliance with federal performance standards for veterans' services.

### ***Labor Market Information***

Our nation's labor market information system provides essential information about employment and unemployment trends, jobs, and workers to a wide range of users. Most of this information is produced by SESAs in cooperation with the Bureau of Labor Statistics (BLS) and other federal agencies.

States collect, analyze, and disseminate data relating to employment, unemployment, and labor demand and supply, including monthly unemployment rates, quarterly wages, monthly estimates of total nonagricultural employment, average hourly and weekly wages, monthly estimates of the labor force, and occupational trends.

Labor market information is used by public policy makers, including the Federal Reserve, Congress and others at all levels of government, and by employers, students and counselors, job seekers, policy makers and analysts, economic developers, economists, planners and many others.

## **B. Financing the Employment Security System**

### ***Federal and State Taxes***

The employment security system is financed by two separate payroll taxes paid by employers, one to the Federal government and one to the states. The Federal tax proceeds are to be used principally for program administration, while the state tax proceeds may be used only for unemployment insurance benefit payments. Federal authority for these taxes is in the Federal Unemployment Tax Act (FUTA).

The Federal Tax. FUTA requires employers to pay a federal payroll tax of 6.2 percent (0.2 of which is temporary) on the first \$7,000 paid to each employee each year. This tax is currently paid on a quarterly basis. However, if state laws conform with federal requirements, employers in the state are eligible for a tax credit of up to 5.4 percentage points (90% of the 6.0 base tax rate). Employers in all States currently receive this "offset credit." The net tax is 0.8 percent, or a maximum of \$56 per employee.

The 0.2 percent "temporary" surtax was added by Congress in 1976 to pay a debt arising from repeated supplemental extensions of unemployment benefits. This "temporary" tax has been extended several times and is now scheduled to end December 31, 2007.

FUTA revenues finance the administration of the employment security system, paying for state and local offices which take claims, pay unemployment benefits, collect taxes from employers, handle appeals, provide employment services to unemployment insurance claimants and others, and services to veterans, and collect and disseminate labor market information.

FUTA funds also go to the DOL to pay for its oversight activities and certain Bureau of Labor Statistics programs. The Internal Revenue Service (IRS) also receives FUTA funds to pay for collection of the tax,

including about \$100 million in FY 1995. The Federal government's one-half share of extended benefits is paid from the Extended Unemployment Compensation Account, which is funded from FUTA revenue. Loans to insolvent state unemployment accounts are provided from the Federal Unemployment Account, which is also funded by FUTA.

FUTA collections were \$6.24 billion in FY 1998. Of this sum, \$3.60 billion was appropriated by Congress for federal and State administration.

The FUTA tax provides a means of enforcing state conformance to federal requirements in the Unemployment Insurance program. The Federal government may reduce the "offset credit" on FUTA taxes paid by employers should the state be out of conformance, increasing the effective tax rate from 0.6 percent to 6.2 percent of taxable wages.

FUTA also provides a means for the federal government to ensure that the Employment Security system meets other federal requirements, such as providing information to state and federal agencies for child support enforcement, welfare fraud reduction, and other purposes. Failure by a state to meet these requirements can result in reduction of the state's "offset credit" and an increase in the FUTA tax rate on the state's employers.

The State Tax. Employers also pay a payroll tax to the state. These taxes are held in the U.S. Treasury and are dedicated to unemployment benefit payments. The state taxes are based on "experience-rated systems" so that employers who lay off few or no workers typically have the lowest tax rates. State legislatures determine the tax rate and taxable wage base, subject to certain federal minimums. While eleven States limit taxable wages to the federal minimum of \$7,000, others have ceilings ranging from \$7700 to \$26,400. These state taxes are normally paid quarterly.

In FY 1998, states collected \$21.63 billion and paid \$20.29 billion in benefits.

### ***The Tax Accounts.***

Revenues from federal and state taxes are deposited in separate accounts in the Federal Unemployment Trust Fund (UTF), held by the U.S. Treasury, where they are invested in government securities. These funds can be used only for administering the employment security system and paying unemployment benefits.

The UTF has 59 separate accounts: 6 federal accounts, and 53 state accounts. Three of the federal accounts are relevant to this proposal.

Federal Accounts. The three relevant federal accounts have been established to serve specific purposes.

*Employment Security Administration Account (ESAA).* Appropriations are made by Congress from ESAA for Federal and state administration of unemployment insurance, employment services, veterans' employment services, and for certain Bureau of Labor Statistics programs. By law, 80 percent of FUTA receipts are deposited in the ESAA. In FY 1998, \$5.0 billion went into the ESAA and \$3.6 billion was appropriated for federal and state administration.

The *Extended Unemployment Compensation Account (EUCA)* is used to finance the federal share (half) of Extended Benefits, which are available during times of high unemployment. EUCA receives 20 percent

of FUTA collections, or \$1.25 billion in FY 1998. Expenditures from EUCA were less than \$20 million in FY 1998, less than two tenths of one percent of the total funds in the account.

The *Federal Unemployment Account (FUA)* is used to finance loans to insolvent state unemployment accounts. No loans are expected over the next two fiscal years given low unemployment and solvent state trust funds across the nation.

*Account Ceilings and Funding Flows.* Federal law provides for fund flows among the UTF accounts to maintain needed balances and to deal with excesses and shortfalls. The ESAA, EUCA and FUA accounts all have ceilings established by law. Congress has occasionally legislated changes in ceilings for various funds. For example, an increase in the FUA ceiling was enacted as part of in the FY 1998 federal budget.

The balance in ESAA may not exceed forty percent of the amount previously appropriated for program administration. The 1998 ceiling is \$1.42 billion. Should the ESAA balance exceed this ceiling, the excess funds are transferred to the EUCA account.

The EUCA balance may not exceed 0.5 percent of total payroll of all employers covered by the unemployment insurance program. The 1998 ceiling is \$14.4 billion. Should the EUCA balance exceed its ceiling, the excess funds are transferred to the FUA account.

The FUA ceiling was recently raised from .25 % to 0.5% effective in 2002 as part of the Balanced Budget Act of 1997. Although the ceiling was not raised until 2002, the legislation limited Reed Act funding distributions in order to maintain greater balances in the FUA to offset the federal deficit and spending in other domestic programs. Effective in 2002, the account may not exceed 0.5 percent of total payroll of all employers covered by the unemployment insurance program. The 1998 ceiling is \$7.2 billion and will be increased to an estimated \$17.4 billion in 2002 with the newly raised ceiling. Should the FUA balance exceed its ceiling, the excess funds are transferred first to ESAA, if it is not at its ceiling. Any remaining excess funds are then distributed to State Trust Fund accounts, if all of the federal accounts are at their ceilings.

At the end of FY 1998 it was discovered that the economy had performed so well in increasing FUTA revenue that all three accounts overflowed and a distribution to states of \$15.9 million was made. A much larger distribution would have been projected for the end of FY 1999 but for the action taken by the Administration and Congress to limit distributions beginning in 1999 and raising the ceiling in 2002.

*Reed Act.* The UTF also includes the Reed Act account, a special revolving fund. The Reed Act account receives overflows from the ESAA, EUCA and FUA accounts when all of these accounts are at their ceilings. While Reed Act funds may be used by states for administration, historically they have been used for financing capital investments, primarily in real property. The law provides that property financed with Reed Act funds may be used only for purposes of employment security, and that the federal government retains ownership of the property.

*Federal Account Trends.* Over the last two decades, funding levels in the various UTF accounts have fluctuated with changes in the economy, responding to the need for benefit payments and state trust fund loans. Beginning in the mid-1980's, fund balances began to build as the federal deficit put pressure on appropriations for administration, and the "temporary" 0.2 percent surtax added to FUTA revenue.

Since 1986 the total balance for the ESAA, FUA, and EUCA funds has grown from \$2.8 billion to \$23.09 billion in 1998. The Federal government has hoarded \$20 billion that should be available for employer tax reduction and delivering services for which employers have already paid.

State Accounts. The taxes collected by the States are deposited with the U.S. Treasury and credited to the 53 individual State Trust Fund accounts in the UTF. These funds may be used only for benefit payments by the State, including regular benefits and the State's share (half) of extended benefits. If a State's Trust Fund is insolvent it may obtain a loan for benefit payments from the Federal Unemployment Account (FUA).

States also have "Penalty and Interest" accounts, held at the state level. These accounts contain employer penalty payments for delinquencies in taxes and reporting, and the interest earned on the fund balances. "Penalty and Interest" Funds are used by the states in a variety of ways, as governed by state law, including purposes not related to Employment Security. In recent years a large portion of these funds also has gone toward administration, supplementing the insufficient funding levels provided by the federal government.

There is no information available nationally on the total amount in state Penalty and Interest funds or the amounts collected each year. We estimate the collections at about 1 percent of state payroll tax collections, or about \$216 million in FY 1998.

### ***Funding Employment Security Programs***

Funds appropriated by Congress from the ESAA for the operation of Employment Security Programs are allocated to states using various formulas. The most complex and controversial is the formula for the Unemployment Insurance program.

Unemployment Insurance. Funds for administration of the unemployment insurance program are allocated to the States by DOL using complex and controversial formulas based on state "workload." Workload includes items such as the number of claims processed and the number of employer tax accounts administered. The formula also includes staff costs (average cost per position) and amount of staff time required to perform each workload item.

DOL determines the formula by first establishing a "budgeted national workload base" using assumptions about the expected level of unemployment. DOL then projects the workload for each State based on the workload the previous year and adjusting to the budgeted national workload base. The staff level required to process each State's projected workload is estimated, using the staff time per workload information. These staff-year estimates are multiplied by a designated cost per staff year to arrive at dollar funding levels. Finally, amounts are allocated for overhead.

This system has not worked fairly for a number of reasons. Congress has not appropriated enough funds to cover the total workload cost of all states, and the information in the workload formula is not current and accurate.

For many years, Congress has failed to provide enough funds to cover the total national workload. DOL has therefore revised the allocation process to reduce funding to each state across the board. For example, if the appropriation is 10 percent less than the amount needed to fund the total national workload, each state's allocation is reduced by 10 percent. Thus, every state is under funded.

The staff effort information used in the formula has not been updated since the early 1980's. Thus, the funding formula does not recognize the shift in the cost structure of the programs which have taken place over the last two decades as states have greatly expanded their use of information technology and decreased the number of staff.

Employment Service. The amount appropriated is allocated to states using a formula established in the Wagner-Peyser Act. The formula is based on a State's share of the nation's civilian labor force and number of unemployed individuals.

Veterans' Programs. Appropriations for the veterans' programs are distributed among states using a formula to allocate the required staffing level among states based on the number of veterans residing in the state.

Labor Market Information. Funds are provided to states through cooperative agreements with the Bureau of Labor Statistics, and formula distributions from the Employment and Training Administration.

### **C. The Unemployment Trust Fund and the Federal Budget**

The accounts in the Unemployment Trust Fund (UTF) are included in the Unified Federal Budget. For federal budget purposes, deposits to the trust fund are treated as revenue and expenditures for administration and benefit payment are treated as outlays.

The consequences of this budget arrangement are that Congress has worked to maintain as high a level of reserve in the UTF as possible, so as to make the deficit in federal general revenue appear lower and to offset domestic spending for other programs. Congress has maximized the revenue to the UTF by continuing the 0.2 percent "temporary" tax for many years past its original purpose. Congress has also minimized appropriations by failing to fund the actual cost of the unemployment insurance workload and by reducing appropriations for other employment security programs, particularly the Employment Service.

The result for states has been the reduction in services through closing of local employment offices and decreases in staff. To avoid more drastic service reductions, states have scrambled to supplement federal funds with alternative resources. A recent study by the Interstate Conference of Employment Security Agencies (ICESA) showed that in FY 1996, \$179 million in funds from Penalty and Interest accounts (\$105 million), state general revenue (\$8 million), state payroll tax surtaxes (\$64 million) and other sources (\$2 million) was spent on making up the shortfall in federal funds for Employment Security programs. The amount for FY 1997 was estimated to be \$208 million.

## **3. WHY REFORM IS IMPERATIVE**

### **A. The Employment Security Compact has been broken by the Federal Government.**

*Employers and workers are not getting the services they need and employers have paid for. Instead, the funds dedicated to these services are being hoarded to make the federal deficit appear smaller and to finance spending for other domestic programs.*

Although funds are available, not enough has been appropriated by Congress to underwrite the employment security system. In FY 98, \$3.6 billion of the \$6.24 billion in FUTA collected was appropriated for state administration. Employers in most States are continuing to pay more in FUTA taxes than they get back under the federal formula for allocating administrative funds, even though the ESAA is at its statutory ceiling.

Dedicated unemployment insurance tax revenues are accumulated in the trust fund to make the national budget deficit look smaller and provide funds for other domestic spending, rather than being spent to help get people back to work. Unless action is taken, this inequity will be even greater in future years.

Further, spending from the UTF for administration is subject to the domestic discretionary caps. During recessions, additional funds are needed to handle increased claims for unemployment benefits. The demand for employment assistance also varies with the economy. Discretionary budget caps make it difficult to secure sufficient funds during bad times and good.

*Access to services and the level of services has declined because of shortfalls in administrative financing.*

The number of local employment offices -- the primary point of access for services -- and the number of employment security staff available to assist employer and worker customers have declined significantly over the last decade. States are struggling to maintain services through innovations in self-services for customers who can get what they need without staff assistance, using touch screen kiosks, the Internet, and other technologies. Many states are moving to telephone claim taking and appeals systems for unemployment insurance. States are also developing "one-stop" service delivery systems in partnership with other workforce development programs and will be implementing the provisions of the Workforce Investment Act of 1998 in 1999 and 2000. These innovations carry their own costs, particularly costs related to telecommunications, purchase and support of complex computer technology, and staff training. These approaches still require skilled staff, and do not meet the needs of some customers who need individual personal attention to deal with complex labor market problems.

*Inadequate administrative funding leads to higher costs for the Unemployment Insurance program.*

Under-funding of employment security administration is penny wise and pound foolish. Lack of resources for staff and supporting information systems leads to increased benefit payments and employer taxes. States are less able to provide the needed employment services to assist unemployment claimants in getting back to work, increasing the length of their unemployment and the amount of benefits they receive.

Research conducted by the U.S. Department of Labor and the New Jersey Department of Labor and evaluated by Mathematica Policy Research, Inc., has shown that intensive job search assistance to unemployment insurance beneficiaries reduced receipt of benefits by an average of three-quarters of a week. Follow-up studies showed that the reductions carried over into following years. Based on this research, we estimate that job search assistance services will result in a reduction of \$2.43 in benefit costs for each \$1.00 spent on job search assistance. Actual trust fund savings under the proposal would depend on the amount of additional resources available for job search assistance activities.

Additional savings will come from reduced errors and more accurate benefit payments, as well as reduced fraud. States will also do a better job of state and FUTA payroll tax collection.

## **B. Employers Are Bearing Unnecessary Burdens**

*The “temporary” 0.2 percent surtax, which amounts to \$1.5 billion annually, was enacted by Congress in 1976 to pay a debt incurred by repeated extensions of unemployment benefits, continues long after the debt has been repaid.*

While the debt was paid in 1987 -- twelve years ago -- the tax has been extended several times to offset federal expenditures unrelated to unemployment insurance even though the money cannot be spent for other purposes. The Balanced Budget Act of 1997 extended the surtax through the year 2007.

This tax costs each employer \$14 per employee each year. The surtax is a drag on the economy which suppresses job growth and economic development.

*Employers in some states are taxed twice for Employment Security administration.* The ICESA study mentioned earlier indicated that in FY 1996, fourteen states had imposed additional state payroll taxes to raise funds to supplement the insufficient federal funding for administration. Employers are thus taxed twice for this purpose, once by the federal government through the FUTA tax, and once by the state, to make up for the federal government’s withholding of FUTA revenues intended for administration costs.

*Employers are burdened by having to make reports and pay separate taxes to two government entities, one to the IRS and one to the State.* According to IRS estimates, it takes employers an average of 12 hours and 31 minutes to complete and file Form 940, the FUTA tax return. At a conservatively estimated hourly rate of \$14, the nation’s 6.4 million FUTA-paying employers spend in excess of \$1.1 billion annually to comply with FUTA reporting requirements.

## **C. States Are Bearing Unnecessary Burdens**

*States lack the flexibility to operate an efficient employment security system that meets the needs of their workforces. The federal government determines the level of resources available to each State and also maintains program authority.* Federal control of the system has increased over the years, resulting in restrictive administrative requirements and rigid procedures, which have left States less able to respond to the needs of their employers and workforces. Federal limitations on the use of FUTA funds among FUTA programs have led to unnecessary expenditures. Consequently, States often have been unable to achieve efficiencies.

The federal role should be limited to:

- \*Ensuring conformity of state laws and federal law,
- \*Establishing performance standards,
- \*Monitoring state performance,
- \*Setting broad guidelines for program administration,
- \*Ensuring that state operations comply with federal requirements, and
- \*Conducting research.

*States have been forced to assume administrative costs that should be paid from FUTA receipts.* The ICESA study already mentioned indicates that a large majority of states -- thirty-nine -- used Penalty and Interest funds to help make up the shortfall in federal funding for administration. This action diverts these funds from other state purposes. In addition, general revenue funds have been appropriated by state legislatures in eight states in FY 1996, and state legislatures have had to resort to imposing additional employer taxes in fourteen states to make up for the shortfall in federal funding for administration.

*DOL accounting and reporting requirements are numerous and cumbersome.* DOL requires many reports on program activity and financial transactions, imposing unnecessary burdens on the states. States are also required to segregate the funds for each of the Employment Security programs (unemployment insurance, employment services, labor market information, and veterans' services) so that funds for each program may be used only for the activities defined by law for that program. This segregation imposes significant accounting burdens, and makes service delivery of closely related services unnecessarily difficult.

*DOL retains control of funds and rules used to construct buildings and buy real property.* DOL rules control the use of Reed Act funds for purchase or investment in real property. If this property is sold by the state, DOL approval is required and the proceeds must be reinvested in another federally "approved" project or returned to the UTF.

DOL also has similar control over administrative funds used to pay for office buildings and land. When a State sells property purchased with administrative funds, the proceeds must be reinvested in real estate or the federal funds must be repaid along with a proportionate share of the equity.

Also, federal rules related to real property use and support are counter-productive to the Employment Security mission and one stop career center initiatives. For example, when Reed Act funded real property is used jointly by employment security programs and other workforce development programs in a one-stop system, accounting and payment by the non-employment security personnel for the portion of the property they use is required.

#### **D. Federal Tax Collection is Inefficient and Expensive**

IRS transfers to the UTF accounts are based on estimates of FUTA revenue, not a full accounting. This inaccuracy means the UTF may not be receiving all that it should. The IRS is inefficient in collecting the FUTA payroll tax, especially compared with state unemployment tax collection operations. IRS collects FUTA along with many other types of taxes. The states collect only unemployment payroll taxes, and they are much closer to the employer community in their states. States can do a better job of unemployment tax collection and provide better service to employers. Also, states are more likely to collect FUTA accurately and in full if both taxes are collected on one form.

For its inefficient FUTA tax collection effort, the IRS charges the Department of Labor about \$100 million per year. These funds can be better used for service delivery. State FUTA tax collection will be far less expensive, as States already have payroll tax systems in place.

## **E. Welfare Reform Requires Strengthening Employment Security**

In 1996, the Congress passed the Personal Responsibility and Work Opportunity Reconciliation Act, reforming the nation's welfare programs to focus on "work first." States individually have developed programs with a work component at the core. In many States the welfare agencies are working with the Employment Service to provide placement and work search services for their clients. Continuing reductions in funding for the Employment Service is counter to the national and state priority now placed on "work first" for welfare recipients.

As more and more welfare recipients transition from public assistance to work, their safety net will change from welfare benefits to unemployment benefits. Like most new entrants and re-entrants to the workforce, these individuals will be the first affected by negative changes in the economy. Without a strong public employment service to assist them in getting new jobs, many will fall back on public assistance after they exhaust their UC benefits. With continued cuts to the Employment Service these claimants, as well as regular UC claimants, will remain unemployed for longer periods of time exacerbating budget problems. Additionally, some State and county welfare agencies are developing employment service programs of their own, even though the Congress has expressed concern about the plethora of duplicative federally funded employment and training programs.

Simply put, it makes no sense to impose new work search requirements on a large population, such as the welfare recipients, while cutting resources for the nation's largest and most effective public job placement system, the Employment Service.

## **4. THE PROPOSAL**

*This proposal to reform Employment Security Financing, which was first introduced in the 105<sup>th</sup> Congress in the House of Representatives as H.R. 3684, and in the Senate as S. 2556. The proposal is being reintroduced by Senator DeWine in 1999 as S. 462.*

The proposal includes fundamental changes in the unemployment insurance tax system. It restructures the Unemployment Trust Fund accounts and their flow of funds. It also fundamentally changes how funds are provided for program operation, allowing states to provide the services employers have paid for and which employers and workers need.

Finally, the proposal redefines the respective roles of the states and the federal government in the Employment Security system.

### **A. Tax Components of the Proposal**

*Repeal the "temporary" 0.2 percent FUTA surtax.* This tax, which was due to expire in 1998 but was extended to the year 2007 as part of the Balanced Budget Act of 1997, should be repealed as soon as possible. S. 462 would repeal the surtax effective for calendar year 2000. Once repealed, this will return over \$1.6 billion each year to employers providing resources for business investment and stimulation of economic and employment growth.

*Transfer collection of the FUTA tax to the States.* Transfer the responsibility for collecting the FUTA tax from the federal government (IRS) to the States effective for calendar year 2001 and thereafter.

This change will save the \$100 million charged by the IRS for collection services. The States will increase collections because the tax is a primary tax for the State compared to FUTA being a tertiary tax for the IRS. The estimated \$60 million in penalty and interest the IRS collects related to delinquent FUTA tax reporting will be collected by the States and deposited in the new State Administration Accounts.

*Consolidate employer FUTA reporting with state tax reporting and payment.* Employers will save hundreds of millions of dollars in reporting costs as a result of this change. Errors will be reduced resulting in administrative savings.

## **B. Restructuring the Unemployment Trust Fund**

The proposal will restructure the Unemployment Trust Fund by changing the account structure and the flow of funds among accounts.

### ***The Accounts***

The accounts in the Unemployment Trust Fund will be restructured by modifying some existing accounts and creating new accounts. All UTF accounts will continue to be held by the U.S. Treasury and remain as part of the unified federal budget. The legislation drafted to enact the proposal provides for a separate series of accounts through which to fund specific employment security functions designed to return claimants back to work. These accounts and the procedure by which funds are to be appropriated will be used in transition until the ESAA is permanently replaced by individual state accounts.

Federal Accounts. The three relevant federal accounts in the UTF will be restructured in the following manner:

*Employment Security Administration Account (ESAA)* will be restructured into a *State Employment Security Administration Account* for each State, a *Secretary of Labor Employment Security Administration Account*, and a *Supplemental Employment Security Administration Account*.

Starting in 2004, states will be required to immediately deposit FUTA receipts into their *State Administration Account*. The deposit of these receipts in the account held by the U.S. Treasury is required because FUTA receipts will continue to be counted as revenue in the Federal Unified Budget. Additionally, separate accounting for each State fund is required for the change in procedures authorizing State legislatures to make appropriations.

Similar to the current ESAA, each State Administration Account will be capped at forty percent of the previous year's appropriation (i.e. at year end the fund may only carryover 40%). Annual surpluses in a state's Administrative Account will flow directly to that state's benefit Trust Fund. Any excess in the FUA and EUCA account will also be transferred to the State Administrative Accounts based upon each State's relative share of FUTA taxable wages.

States with insolvent administrative accounts may borrow administrative funds from the Federal Unemployment Account (FUA), similar to loans currently available for States with insolvent benefit accounts.

The *Secretary of Labor Administration Account* will receive two percent of each State's annual FUTA collections. This fund will be available to Congress for appropriations for federal administration and for the Bureau of Labor Statistics programs currently funded from ESAA. This account will have a ceiling set at forty percent of the previous year's appropriation, with surpluses returning to the State Administrative Accounts.

The *Supplemental Administration Account* will receive two percent of each State's annual FUTA collections. The purpose of this Account is to provide supplemental funds to those states with employment levels too small to adequately fund Employment Security programs. Funds from this account will be allocated by a newly established "Council of States with Lesser Populations" and appropriated by state legislatures.

The current *Extended Unemployment Account (EUCA)* will be modified. The ceiling for the account will be lowered to the greater of \$14.4 billion or 0.25% of covered wages. In addition, excesses in the account above the newly established ceiling will be transferred to the state administrative accounts each year using the Reed Act distribution formula. The extended benefit program will be continued as a national program. However, weekly eligibility criteria will follow state law. States will be responsible for paying 50 percent of extended benefits as they pay now.

The *Federal Unemployment Account* will remain as it is currently structured, except that there will be no flows of funds into it other than loan repayments, interest earnings, and the annual distribution of the excess in the account to the state administrative accounts. FUA will thus function as a revolving account.

The FUA account ceiling was increased to 0.5%, including receivables, as part of the Balanced Budget Act of 1997. The proposal caps the FUA account ceiling at the former cap of .25 % of wages in covered employment paid by taxable employers in the preceding calendar year. Any surplus at the end of the year, including interest, will automatically flow to the State Administrative Accounts based upon each State's relative share of FUTA taxable wages.

State Accounts. States will continue to maintain their existing State Trust Fund accounts with the U.S. Treasury, and deposit state unemployment tax revenue in these accounts.

### ***Disposition of Existing Account Balances***

*Employment Security Administration Account (ESAA).* On October 1, 2004, two percent of the current ESAA balance will be transferred to the Secretary of Labor Employment Security Administration Account, and two percent will be transferred to the Supplement Employment Security Administration Account. The remaining balance will be distributed to the State Employment Security Administration Accounts based upon each State's relative share of wages taxable under FUTA.

The transition and implementation of the new financing system will be funded through a special distribution from the ESAA account balance for FY 2001 through 2004. This distribution will be made to state employment security administration accounts created for this purpose. Until full implementation of

the proposal in 2004, these funds will be used to 1) pay for the cost of FUTA collection by the states, 2) provide job search and placement services to claimants and other job seekers, 3) provide appropriate recruitment services and special technical services for employers, and 4) determine whether claimants are available for suitable work. This mandatory spending for transition and implementation leading up to 2004 will supplement the existing discretionary spending appropriations process.

The *Extended Unemployment Compensation Account (EUCA)*. The EUCA excess will be transferred to the State Administrative Accounts in 2004 based upon each State's relative share of taxable wages under FUTA. There will be no real impact on the balance in the federal unified budget because the State Administrative Accounts, like EUCA, are included within the federal unified budget.

### ***Appropriation of funds for state administration***

State Legislatures Appropriate from State Administration Accounts. Appropriations from the State Employment Security Administration Accounts will be made for the transition and implementation costs prior to October 1, 2004, by each State's legislature. The same process will be used for the funding of the full proposal beginning on October 1, 2004, to provide funding for operation of Employment Security programs, including unemployment insurance (including FUTA tax collection), employment services, veterans' programs, and labor market information activities other than Bureau of Labor Statistics programs.

State legislatures will be allowed to appropriate an amount up to one hundred and forty percent of the previous year's appropriation. Also, as noted earlier, each State Administration Account will be capped at forty percent of the previous year's appropriation, and any excess will be transferred to the State Trust Fund. Because of these provisions, state legislatures will be frugal in their appropriations. Transfers to the Trust Fund reduce the need for state unemployment taxes to maintain solvency.

Small States Supplement: Small States (civilian labor force of less than one million) may have insufficient tax bases to fund the proper and efficient administration of their state program. These States will receive supplemental funding from the Supplemental Employment Security Administration Account during the transition period and when the proposal is fully implemented. These funds will be allocated among states with civilian labor force populations of less than one million by the newly established "Council of States with Lesser Populations."

### ***Appropriation of funds for federal administration***

Congress will appropriate funds from the Secretary of Labor Employment Security Administration Account beginning in FY 2005 for federal administration costs, including the Bureau of Labor Statistics programs currently funded from the ESAA. The current processes for allocating funds to states for the BLS programs are expected to continue.

## **C. Programs and Federal/State Roles**

*Amend FUTA regarding Employment Services.* The FUTA law will be amended to require States to provide public employment services specifically to individuals claiming unemployment benefits as well as to a universal population. The proposal will provide States with flexibility regarding the methods for receiving and processing claims, so use of phone claims systems and other innovations will not be precluded.

To establish accountability of the States relative to re-employment services for UI claimants, States will submit annual reports, at the state level, providing information on services and outcomes including:

- \*the proportion of the claimant population using re-employment services,
- \*the proportion of employers using employment services,
- \*information regarding referrals and placements, and
- \*information on other services such as counseling and testing.

States will have the authority and flexibility to develop performance measures with benchmarks that best serve their customers while reporting on performance outcomes needed by employers and others interested in the program.

This change will ensure the future of the public employment service by tying it more closely to the UI system as a conformity requirement while giving the States greater flexibility in determining the process by which employment services will be provided.

*Repeal most of the Wagner Peyser Act.* The amendment to FUTA would repeal all but the specific provision of the Wagner Peyser Act which describes the employment services allowed with FUTA funds and the newly enacted provisions of the Workforce Investment Act of 1998.

*Limit the federal role in UI and ES.* The Federal/State partnership will continue. However, the federal role will be limited to:

- \*Ensuring conformity of state laws with federal laws,
- \*Establishing UI performance standards,
- \*Monitoring state performance,
- \*Auditing the use of FUTA resources for FUTA related services,
- \*Ensuring state operations comply with minimum federal requirements, and
- \*Conducting research.

Reporting requirements would be limited by the reduced role of the U.S. DOL

The appropriate role of the U.S. DOL is to ensure States run proper and efficient programs, that worker and employer rights are protected and that the programs meet their objectives. Removing the funding and allocation authority from the U.S. DOL will reduce its tendency to micro manage the state programs and allow it to focus on its original mission of supporting States and maintaining the integrity of the Employment Security system.

*Maintain the Veterans' Programs.* The Local Veterans Employment Representative (LVER) and Disabled Veteran Outreach (DVOP) programs will be maintained as required by Title 38 of the U.S.

Code. Funds for the Veterans' Programs will be appropriated by state legislatures from the State Employment Security Administration Accounts.

*Maintain the Labor Market Information Programs.* Congress will continue to appropriate funds to the U.S. DOL and the BLS for the programs currently funded from the Employment Security Administration Account. These appropriations will now be made from the Secretary of Labor Employment Security Administration Account.

*DOL will relinquish control of states' real property.* Other than retaining its equity in state real property, DOL will relinquish all rules relative to the use of the state real property. The States will determine the use of capital equipment and local facilities that will best serve the customer.

#### **D. Impact on Federal Budget**

The proposal retains all current funds related to financing Employment Security programs as part of the federal unified budget, decreasing costs in some areas, and bringing new revenue within the calculation of the federal budget. These features offset the expected increase in funding to states for administration

All funds remain in the Unified Federal Budget. The funds that will be moved from existing accounts (ESAA, EUCA and FUA) will be transferred to new accounts within the U.S. Treasury and will therefore continue to be part of the federal unified budget.

*FUTA revenue will increase through more effective tax collection by states than currently provided by the IRS.* The state agencies charged with UI tax administration are familiar in detail with the employers in the state and changes in the state's economy. They will be better able to identify covered employers, be sure taxes are collected, and follow up on delinquencies and collections.

*Cost of tax collection will decrease as the function is shifted from the IRS to the more efficient tax systems operated by the states.* States already have payroll tax collection systems in place and experienced staff familiar with the employers in their state. These staff are dedicated solely to payroll tax collection. State tax operations will be more efficient than those of the IRS which must collect a variety of different taxes and do not have the familiarity with employers present in the states.

*Benefit payments will be reduced as administrative funding allows re-employment services to be provided to more claimants.* As already detailed, research has shown that increased investment in job search assistance for unemployed claimants returns nearly \$2.50 in unemployment benefit savings for each \$1 expended. Providing targeted services to unemployed claimants will result in savings to the unemployment trust fund and the federal unified budget.

*Federal Administration costs will decrease.* The more limited role of DOL in administering the Employment Security programs will result in savings in federal costs of at least \$25 million per year.

### **5. BENEFITS OF THE PROPOSAL**

*A. States will have sufficient funding to deliver services and maintain program integrity.* States generally can expect increased resources for program administration resulting from efficiencies

generated by this proposal. States will be able to focus on improving services, rather than reducing services and scrambling for alternative funds.

- B. *FUTA revenue will be used for the purpose for which it is intended.* Federal trust fund excesses will flow directly to State Administrative Accounts where they will be used for program administration and potentially to reduce employers' state UI taxes.
- C. *Integrity of the UI system will be better protected.* With adequate administrative resources, states will be able to do a better job of benefits and tax administration, reducing fraud and overpayments, and collecting the correct amounts from all covered employers.
- D. *The length of unemployment will be reduced for many unemployment claimants.* With better capacity to provide job search assistance, the Employment Security system will help more claimants return to work sooner, saving millions in benefit payments.
- E. *The Employment Security system will be better positioned to contribute toward welfare reform.* The Employment Service will have the capacity to better assist job seekers who are currently welfare recipients.
- F. *Employer burdens will be reduced.* Employers will no longer pay the "temporary" 0.2 percent surtax, saving them money for investment in productive activities, stimulating employment and local economies. Special state taxes added to fund administration should not be necessary.

Employers will deal with one tax collection agency -- the state, not the IRS -- regarding unemployment taxes and reporting, with fewer errors and improved service and saving employers hundreds of millions of dollars. Further, States will have the opportunity to "harmonize" their wage laws with FUTA to enable a single and simpler tax collection and reporting process for employers. The IRS will be replaced by state tax collectors who are more familiar with local employers and more responsive to their needs.

Finally, the reduced duration of unemployment benefits through stronger re-employment services, and the overflow of funds to the state unemployment trust funds, will lead to lower employer taxes at the state level.

- G. *State burdens will be reduced.* State Employment Security Agencies will have more flexibility to deliver services as best meet the needs of their states and communities, and which promotes one-stop services.
- H. *DOL Accounting and Reporting requirements will be reduced.* Burdensome federal mandates which cause inefficiencies and impose increased costs will be eliminated. Time consuming and costly reports will be minimized.
- I. *States will have flexibility in the use of Real Property.* Flexibility in the use of capital equipment and facilities will improve customer service and a full use of the resource.
- J. *Small States will be protected.* States with small tax bases will have the resources to deliver employment security services.

- K. The Federal/State partnership will be more focused on program integrity and program efficiency.* Fewer resources will be needed for federal administration in UI and ES. The Federal/State partnership will be maintained with the U.S. DOL more focused on program integrity and program efficiencies than steering States through the funding lever in a direction not consistent with the States' needs.
- L. Administrative costs will be reduced.* A reduced federal role will result in more resources for service at the State level if needed or a transfer of those resources to the benefit accounts.
- M. Tax collection will be less expensive.* The proposed reform will save money and increase tax collection effectiveness.
- N. The Employment Security System will be more efficient:* A more efficient program will produce trust fund savings by using an effective employment service to help reduce unemployment duration, by maintaining an appropriate level of fraud detection and improving benefit and FUTA tax collections.
- O. The proposal is budget neutral.* Although current "pay-go" rules would result in the proposal being scored as an increase in mandatory spending without offsets, the coalition believes that the proposal would not result in a net increase in federal outlays.