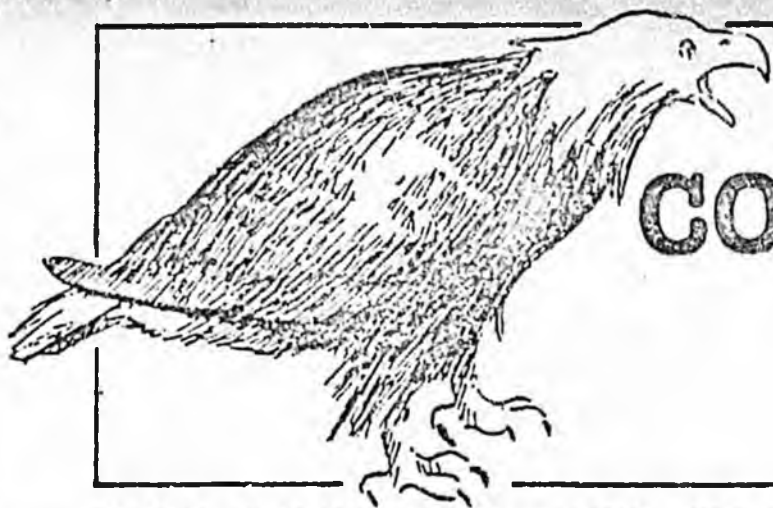


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ISSUES & COMMENTARY

ALASKA DEPARTMENT OF LABOR, RESEARCH AND ANALYSIS SECTION

APRIL 1981

SHOULD ALASKA OPT OUT OF THE FEDERAL/STATE UNEMPLOYMENT INSURANCE SYSTEM?

By Scott T. Hannigan

The Social Security Act of 1935 established an Unemployment Insurance (UI) program in the United States under joint federal/state management. The major role of the federal partner was administration of a uniform employer tax to fund the program. States were encouraged by the Act to pass local UI legislation with the reserved right to set qualifications and standards for the payment of unemployment compensation. The Act contained provisions for employers to receive credit against the federal tax for contributions to a state UI plan and for states to receive grants to administer their programs. The availability of employer tax credits and state administrative grants were made contingent upon states' compliance with certain features in the Social Security Act. These features were generally found acceptable to the states and a nationwide federal/state UI program was in full effect by 1937. Over the ensuing years, however, numerous amendments to the Act and additional UI legislation by Congress (requiring conforming state legislation) has led to conflicts in the federal/state partnership. The federal government has generally held the upper hand in these conflicts by virtue of the enormous financial clout provided by the tax credits and administrative grants provisions of the Social Security Act. This paper will review the historical beginnings of the federal/state UI program, some of the conformity issues facing the states, and the possibility of future changes including complete separation of the federal and state systems.

Prior to 1935, states had no programs to provide assistance to the unemployed, with the notable exception of Wisconsin, which legislated a comprehensive UI law in 1934. The major obstacle to enactment of UI laws at the state level was directly related to taxes. Specifically, it was felt that a new tax burden on employers would have a detrimental effect on interstate competition. Congress eliminated this obstacle by passing (as part of the Social Security Act) Title IX, which levied a uniform tax on all employers in the country. Title IX allowed employers a 90 percent credit against the tax if they contributed to an approved state UI program. The remaining ten percent of the tax assessment was returned to the states in the form of administrative grants. These financial incentives in Title IX plus the deepening crisis of the 1930's depression strongly encouraged enactment of state UI laws and all states had unemployment insurance programs in operation by 1937. Provisions of Title IX were removed from the Social Security Act and were placed in the Internal Revenue Code by the Federal Unemployment Tax Act of 1939 (FUTA).

Original proponents of the Social Security Act vigorously debated the type of UI program to be recommended--a wholly federal system or a federal/state plan. Arguments for a national system included, among others, that a national system would provide uniform protection from the risks of unemployment, protect the interests of multi-state employers and workers, provide for a national pooling of reserves, and streamline reporting requirements and the payment of taxes. Those who favored a federal/state program argued that a national system would be cumbersome to operate, that centralization would tend to paralyze action, that controversial issues would not receive proper debate and discussion by the states, and that a federal/state system would allow states to tailor the program to fit their needs and would allow wide latitude for experimentation by the states and so aid in producing a better system.^{1/} The federal/state plan was the one that finally emerged.

The issues of conformity have existed since the very start of the unemployment insurance program. The Social Security Act contained several provisions that the states were to comply with. Titles III and IX of the Act required state UI laws to include the following major provisions: (1) payment of UI benefits solely through public employment offices or other approved agencies, (2) opportunity for a fair hearing on denied claims, (3) payment of all tax monies collected to the U.S. Treasury (Unemployment Trust Fund), (4) expenditure of all money requisitioned from the Trust Fund for UI benefits only, (5) no benefits to be paid until two years after commencement of tax collections, and (6) several provisions protecting conditions of work acceptance by claimants. Other provisions refer to administrative and reporting requirements. To enforce state conformity to these provisions, the Social Security Act allows for the denial of all employer tax credits and the suspension of state administrative grants. On numerous occasions since the inception of unemployment insurance, Congress has passed amendments to the Act necessitating conforming legislation at the state level. A major example has been amendments that have extensively increased UI coverage to such worker groups as state and local government employees and employees of non-profit institutes.

More recent conformity issues have included pension offset provisions (P.L. 95-364) and provisions of the 1980 Omnibus Reconciliation Act (P.L. 96-499). The pension offset provision requires a reduction of a claimant's weekly benefit by the amount of any pension (attributable to a base period employer) received by the claimant. The Reconciliation Act requires conforming state legislation to deny the payment of extended benefits for voluntary quits and discharges for misconduct regardless of applicable state law for regular benefits (i.e., if state law reinstates benefit entitlement for regular benefits after a penalty period, the entitlement would be cancelled for extended benefits). Failure to accept suitable work (as defined by federal law) or failure to seek work also results in denial of extended benefits.

Even further encroachment by the federal government will occur if recent proposals of the Reagan Administration are adopted. These include (1) changes in the extended benefits program to eliminate the national trigger and to revise the methods of calculating state triggers (both of which determine when extended benefits are to be paid); (2) requirements that unemployed workers who have collected 13 weeks of state UI accept any job that meets minimum wage and safety standards if the wages are equal to or greater than their UI benefits; and (3) eliminate UI for those who leave the military voluntarily.

The rising spectre of federalism in unemployment insurance has caused concern in

^{1/} William Haber and Merrill G. Murray, Unemployment Insurance in the American Economy, Richard D. Irwin, Inc. 1966.

Alaska and many other states. In most conformity issues, the states have grudgingly complied with federal legislation because they fear to lose tax credits for their employers and administrative grants for their programs. The mere threat of sanctions has kept states in line and the sanctions have never been fully applied. A specific instance where Alaska has run headlong against the federal government has been on the issue of interstate benefits. In 1955 and again 1960 Alaska reduced the maximum weekly benefit amount to out-of-state claimants in order to curtail the amount of UI dollars leaving the state.* The state was required to retreat from this position in 1972 when Congress decided the practice was discriminatory to the rights of workers to move from state to state seeking employment. This interstate question has become a point of concern in recent years as Alaska has seen one-third of all its UI dollars pouring out of the state, aiding the economies of other states instead of our own. An even larger problem looms in the future amid talk of federal benefit standards requiring a maximum benefit equal to 2/3 of a state's average weekly wages. Alaska traditionally pays more benefits per dollar of total wages than any other state. This standard would put employer costs through the ceiling and could possibly drain the state's trust fund.

Potential solutions to the partnership problem are varied and complex. Many people over the years have advocated complete federalization of unemployment insurance. Most states, however, take a dim view of this type of encroachment on their rights. Another course would be to maintain the present system with some sort of systematic court review of conformity sanctions.^{2/} The most extreme solution would be for a state to permanently refuse to comply with federal legislation.

The remainder of this paper discusses ramifications if Alaska chooses to remove itself from the federal/state system. The most direct effect would be monetary. Shown below are cost estimates for Alaska's UI program in 1982 comparing an out of conformity situation with a conforming one.

	Estimated Costs for 1982	
	<u>In Conformity</u>	<u>Out of Conformity</u>
State Taxes	\$63.6 million	\$63.6 million
FUTA Taxes	7.0 million	34.0 million
UI Administration	Federal Grants (From FUTA Taxes)	11.5 million
ES Administration	Federal Grants (From FUTA Taxes)	7.9 million
Extended Benefits (50% Federal)	Federal Reimbursements (From FUTA Taxes)	4.5 million
TOTAL	\$70.6 million	\$121.5 million

*Ch. 5, ESLA 1955 and Ch. 60, SLA 1960.

^{2/} Ibid.

The comparison shows that operating the current program while failing to conform to federal requirements would result in additional costs of \$50.9 million. Most of the cost (\$27 million) would be levied on employers as a result of lost FUTA tax credits. Employers might also be expected to pay administrative costs as well as funding full benefit outlays. If that were the case, employer costs would increase by approximately seventy percent. This burden could be reduced if employee contributions were increased and/or the state absorbed administrative costs.

One major question of the conformity issue concerns federal responsibility if employers opt to pay the full FUTA tax. The system was designed to pay benefits equal to 2.7 percent of taxable wages. Of the three percent FUTA tax, this 2.7 percent was to be dropped if employers contributed to the benefit fund of an approved state program. The implication is clearly that the 2.7 percent was to be used for paying benefits. Further, if employers opt to pay the full FUTA tax, the implication is that no state taxes would be necessary because the federal partner should be responsible for benefits.

The system was not--at least, should not have been--designed to coerce states into setting up their own unemployment insurance programs. Since costs would be three percent of taxable wages under a state or federal system, states would obviously find it attractive to design systems to fit their own social and economic conditions rather than accept standards determined in Washington. This "logical interpretation" does not coincide with the "legal interpretation." According to an unofficial opinion of the Solicitor General, the federal government has no power to implement an unemployment insurance program in any state. In other words, the system was designed to force states to implement unemployment insurance programs via making them pay for one whether they have one or not.

Failure to maintain an approved program would result in the 2.7 percent "credit" flowing into the federal administrative account rather than a benefit account, with the state receiving no funds in return. No state has informed the federal partner that it intends to drop its own program in favor of federalization and so the position remains unchallenged. It is conceivable that the "back door" federalization now in progress will change this situation in the future. The issue is not a simple one and raises a host of questions about the federal/state relationship. Some alternative relationships that might be considered for the operation of an unemployment insurance program in Alaska are discussed below.

The discussion centers on estimates of the average employer cost per worker (with annual earnings at or above the taxable wage base of \$13,300) and includes the current system for comparison purposes.

CURRENT SYSTEM

FUTA Tax (0.7% of first \$6,000)†	=	\$ 42
State Tax (3.3% of first \$13,300)	=	439
TOTAL TAX	=	<u>\$481</u>

One (untested) alternative is to drop the state system in favor of a federal program funded from the maximum FUTA tax. Employers would then pay the full FUTA tax of \$204 per employee and all program provisions would be determined in Washington.

FEDERAL SYSTEM

FUTA Tax (3.4% of first \$6,000)†	=	\$204
TOTAL TAX	=	<u>\$204</u>

A second alternative would supplement a federal system with a separate state system. Costs would be dependent on the level of benefits the state wishes to provide. The state system would also require administrative funds of approximately \$19 million.

An independent state program is a third alternative. The cost figures below assume that the full FUTA tax is paid and that the state receives no funds in return. Obviously the combined cost of running a state system and paying penalty FUTA taxes could exceed the capabilities of many employers to pay. Some form of state assistance may be necessary (especially in light of expected increases in the taxable wage base for FUTA which will probably become effective in 1983 or 1984). The most plausible forms of state assistance are assumption of the liability for FUTA taxes and/or administrative costs and state support of benefits through appropriations to the UI Trust Fund.

INDEPENDENT STATE SYSTEM

State Tax (3.3% of first \$13,300)	=	\$439
FUTA Tax (3.4% of first \$6,000)	=	\$204
Administrative Costs		<u>\$120</u>
TOTAL TAX	=	\$703

There are a number of areas where Alaska could effect some cost savings if the state were running an independent UI program. Some cost saving areas and approximate dollar amounts are listed below:

†The FUTA tax is set at 3.0 percent of the first \$6,000 of each employees wages. The rate was temporarily increased to 3.4% to reduce the national debt in the FUTA account. If a state's UI law is in conformity with federal law, then employers receive a 90 percent credit on their FUTA taxes and pay in effect 0.7 percent (10% of 3.0% = 0.3 + 0.4 added tax = 0.7%).

Potential Cost Savings

(Projected on basis of Alaska's 1980 UI law)

- | | |
|---|----------------|
| 1. Eliminate dependents benefits for out-of-state claimants (140,000 interstate payments X \$8.55 [average interstate dependent payment]) | \$1.2 million |
| 2. Eliminate extended benefits for out-of-state claimants (assuming Washington, Oregon and California still triggered on) 25% of estimated EB payments of \$4.75 million state share) | \$1.2 million |
| 3. Reduce interstate benefit to 50 percent of calculated WBA (140,000 interstate payments X \$116 [average interstate payment X 50%]) (excludes amount in #1) | \$8.1 million |
| 4. Eliminate interstate benefits entirely (140,000 interstate payments X \$124.50 [average interstate payment] (includes amount in #1) | \$17.4 million |
| 5. Withdraw from interstate wage combining plan (net figure from 1980) | \$0.3 million |
| 6. Withdraw from unemployment compensation plan for ex-federal employees and ex-servicemen (5% of administrative costs) | \$0.8 million |

As indicated, some of these savings overlap. The maximum savings would be about \$18.5 million, which is approximately equal to expected administrative costs. The possibilities are limitless in creating an independent state UI system. No state UI program (with the exception of the original Wisconsin plan) has existed outside the federal/state system, so no previous experience is available to formulate such a program. Opportunities exist for Alaska to tailor a UI program to the unique conditions of the state. Alaska's concerns with chronic unemployment, high wages, seasonal jobs, an itinerant labor force, and undiversified industries have not been satisfactorily addressed under the federal/state UI system.

Many legal and political questions arise in relation to separating the state's UI program from the federal/state structure. Would (and can) the federal government permit the state to break away? Would the national system disintegrate if other states wanted to drop out? Is the nature of unemployment beyond the capabilities of any one state to cope? Would the courts become involved in issues of "equal protection" and "due process" on behalf of denied out-of-state claimants? These and a host of other questions can only be answered by the legislature and the courts and are beyond the scope of this paper.

Opting out of the system is an issue that has gained prominence due to recent expansion of the federal partner's role in this cooperative system. It is a radical step and is likely to be accompanied by high costs and by legal battles.

Discussion of opting out is often the result of frustration with the expanding role of the federal partner and of a realization that this expansion cannot be successfully countered by piecemeal resistance to individual intrusions on state prerogatives.

Before taking a radical step, alternatives should be considered. The level of interference by the federal partner has increased substantially since the unemployment insurance trust funds were placed in the federal unified budget in 1969. In attempts to reduce budget deficits, Congress has enacted several changes to the UI system. Although the changes may have been proposed primarily for their budgetary effect, they have had profound impact on the program and on the nature of the federal/state cooperative arrangement. The key to a return to true partnership may lie in removal of state trust funds from the federal unified budget. Alleviating budgetary pressure may accomplish many of the desirable goals of opting out without some of the negative aspects. That is, removal of the trust funds from the budget could reverse the tendency toward federal intervention and would not carry the potential to destroy the existing federal/state partnership.

REMOVAL OF STATE UNEMPLOYMENT INSURANCE TRUST FUNDS FROM
THE FEDERAL UNIFIED BUDGET, STATE RETENTION OF TRUST
FUNDS, AND STATE COLLECTION/RETENTION OF FUTA TAXES:
A REPORT OF THE EMPLOYMENT AND TRAINING SUBCOMMITTEE
OF THE NATIONAL GOVERNORS' ASSOCIATION

July 1980

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Introduction

The unemployment insurance policy position to be discussed by the Governors' Human Resources Committee contains the recommendation that "immediate action be taken to remove state trust funds from the unified federal budget." In the process of formulating that recommendation, several issues were raised which led to a request for a discussion paper. This paper is intended to promote discussion of the specific policy recommendation and to briefly explore the ramifications of altering the existing methods of administering state trust funds and collecting FUTA (Federal Unemployment Tax Act) contributions.

Exclusion of state unemployment insurance trust funds from the federal unified budget is an important issue because of the impact of efforts to balance the budget. Federal budget considerations affect the unemployment insurance system because inclusion of state trust funds in the unified budget causes all unemployment compensation--including benefits paid completely from state funds--to appear as federal outlays. It is possible that reducing motivation for federal intervention by excluding state trust funds from the unified budget would be an attractive alternative to facing continuous struggle against a series of changes affecting the state portion of the program proposed primarily for their impact on the federal budget.

The decision to include the trust funds in the unified budget was a fairly recent administrative one (funds have been included since 1969). The quickest and simplest means of removal is administrative action.

Although the recent trend has been to expand budget coverage, the potential for the cyclical nature of unemployment insurance to unjustifiably influence government spending in other areas may persuade the Office of Management and Budget (OMB) that state unemployment insurance trust funds should be off budget.

Removal does not necessarily imply a recommendation to place those funds under state control. U.S. Treasury maintenance and administration may not maximize investment return on the funds, but there are other problems that could accompany state control of funds. If state budgets were to include these dedicated trust funds, budgetary pressures might increase within states that are geared toward a balanced budget. The recommendation for removal is in recognition of the unique nature of unemployment insurance, and the reasons for off budget treatment apply equally to state budgets.

In reviewing this paper, the reader should be aware that the options presented were for discussion and were not intended as recommendations. The paper does not attempt to answer all the questions it raises; its purpose is to focus attention on the range of alternatives to existing procedures in the unemployment insurance system. Some options would require considerable study and deliberation before recommendations could be made.

Background: Inclusion of State Trust Funds in the Federal Unified Budget

The Social Security Act of 1935 established an unemployment compensation system as a federal-state cooperative program in order to avoid the constitutional barriers imposed by the U.S. Supreme Court. Since each state's program provided for employer contributions to be used for the sole purpose of paying benefits, the funds had to be separated from other revenues and carefully administered. To ensure these ends, the original legislation required that states deposit receipts from employers in individual trust funds to be maintained at and administered by the U.S. Treasury. Unemployment insurance funds, as well as a growing number of other trust funds, were omitted from the annual budget of the federal government because trust fund receipts were available only for the purposes for which the trusts were established and could not be used for the general purposes of the government. Although all trust fund activity was reflected in what became known as the "consolidated cash budget," omission from the administrative budget led to confusion and to criticism that the administrative budget was deficient in reflecting overall federal receipts and expenditures.

A commission appointed by President Lyndon B. Johnson in 1967 recommended that receipts and expenditures of several trust funds be included in a unified federal budget because of federal responsibility for administration of trust fund programs and because:

"With the passage of time, trust fund activities have loomed larger in both absolute and relative magnitude in the total picture of Federal Government receipts and expenditures. Receipts, expenditures, and the surplus or deficit in federally owned funds, therefore, have correspondingly less significance. It is clear to the Commission that the current surpluses of trust funds must be considered in calculating the effect of federal government activities on the level

of income and employment, in managing treasury cash balances, in deciding on treasury cash borrowing needs, and in program evaluation."*

Despite the strong element of state participation in the unemployment insurance system, there was no special attention or discussion of special treatment of unemployment insurance trust funds. The Commission's recommendations were followed and several trust funds became part of a unified federal budget in fiscal year 1969. By including trust funds in a unified budget, increases in fund balances appeared as income and could be used to offset deficits in other areas. In addition, the fund balances themselves (although dedicated) could be used as a source of borrowed funds for other purposes.

Receipts of all trust funds included in the unified federal budget are expected to total about \$222 billion in fiscal year 1980 against approximately \$204 billion in outlays. These figures comprise roughly 42 percent of total receipts and 36 percent of total expenditures in the FY 80 budget. The trust funds as a whole are estimated to report a surplus of \$18 billion compared to a \$58 billion deficit for the rest of the unified budget.

Unemployment insurance trust funds are treated as a consolidated account rather than as independent accounts devoted to individual purposes. Individual trust funds within that account include:

- 53 state accounts (each state plus Washington, D.C., Puerto Rico, and the Virgin Islands);
- an administrative account with receipts from the federal payroll tax of 0.45 percent of the first \$6,000 of each employee's annual earnings;

*Report of the President's Commission on Budget Concepts, p. 26-27 as quoted in "Unemployment Insurance and the Federal Budget," a paper prepared by Peter Henle for the National Commission on Unemployment Compensation, February, 1980. Mr. Henle's paper also contains more detailed background than is presented here and was a primary source of information for this paper.

- an extended benefit account with receipts from the federal payroll tax of 0.25 percent of the first \$6,000 of each employee's annual earnings--this and the administrative account are funded by the 0.7 percent FUTA tax paid by employers;
- a federal account which receives advances from the Treasury and provides loans to state accounts when they are unable to meet their obligations.

The unemployment insurance trust funds as a group rank fourth in size behind the social security retirement trust funds, the health insurance trust funds, and the federal employees retirement trust fund. In the years of the unified budget, the unemployment insurance funds have increased in receipts from \$3.3 billion to \$16 billion and in expenditures from \$2.6 billion to \$17 billion.

Implications of Inclusion of State Trust Funds in the Federal Unified Budget

This discussion of possible changes in the treatment of the unemployment compensation trust funds in the budget focuses exclusively on the individual state trust fund accounts. There is general agreement that the other accounts financed either by the federal unemployment tax (FUTA) or through general revenues would continue (except under a major transformation of the federal-state system) to be included in the federal unified budget.

The "bottom line" impact of inclusion of state trust funds in the unified budget is that all unemployment compensation--including benefits paid completely from state funds--appear as federal outlays. This factor plus the stronger institutional support for closer scrutiny of the federal budget, because of both public attention and the Congressional Budget Reform Act of 1974, make the unemployment insurance system a target for budget-balancing proposals such as a taxation of benefits, pension offsets, removal of extended benefit claims from the computation of trigger rates, and other "cost-cutting" proposals.

The current recession will simultaneously increase outlays from state trust funds and reduce both federal general revenues and unemployment insurance trust fund receipts, making it increasingly difficult to balance the budget and potentially increasing the pressure in Congress to reduce the net outlays of the unemployment insurance system.

Clearly budget considerations lend greater support and credibility to proposals for reducing the program's net outflow, but there is danger in adopting proposals for their effect on the budget rather than for their intrinsic value. As budget and program considerations become increasingly interwoven, it becomes more important to analyze the rationale for inclusion of the unemployment insurance trust funds in the unified budget. The following points support the current arrangement:

- Federal Payroll Tax. This employer tax underlies all state programs and is the key to nationwide cooperation.
- Treasury Involvement. The Treasury maintains individual accounts for all states and provides services including assured security, investment in U.S. securities, payment of interest, and interest-free loans.
- General Revenue Support. The federal government is committed to support state programs with general revenues in the event that state funds become inadequate to meet benefit payments.
- Program Review. The federal unified budget provides an opportunity for a legislative body to review the program budget.
- Cash Outlay. While it may appear that budget balancing considerations would lend support to removal (since trust funds are likely to decline throughout the current recession), net flow is not the only factor involved in the decision. The balances can be borrowed but are dedicated funds and must be fully replaced. Removal from the budget may therefore require a large cash outlay in order to replace trust fund balances used for other purposes. This would hinder rather than help budget balancing efforts.

Valid arguments can also be advanced for removing the funds from the unified

budget:

- Federal Payroll Tax. The majority of the federal tax is not collected from employers, but is credited if employers participate in an approved state program and are subject to contribution rates set by the state.
- Treasury Involvement. The operations of the Treasury do not require that the accounts be included in the unified budget. The Treasury currently handles accounts for several "off-budget" agencies.
- General Revenue Support. When and if federal funds are advanced, these should be reflected in the budget; however, the commitment to support the program does not require the placement of state funds in the federal budget.
- Program Review. Although state unemployment insurance trust funds are not included in state budgets, basic program decisions--level and duration of benefits, contribution mechanisms, eligibility, and many administrative functions--are almost entirely in the hands of state legislators. States currently review programs for fiscal soundness even though the funds are not included in state budgets. There is no reason to believe that removal of state trust funds from the unified budget would encourage less responsible behavior.
- Unique Treatment. The unified budget reflects several types of federal-state cooperative programs, but includes only the federal grants. No other program whose expenditures are so dependent on state policy (and state revenues) are included in the budget.
- Federal Expenditure Limit. If federal expenditures become limited to a certain percentage of gross national product, some lawmakers might be interested in removing certain programs--such as unemployment insurance trust funds--from the budget in order to increase available funds in other areas.
- Potential Distortion. Unemployment insurance programs are inherently cyclical in nature. Economic downturns increase benefit outlays and reduce contributions while in more prosperous years surplus contributions build trust fund balances. A surplus in the unemployment insurance system may encourage federal spending in other areas even though the trust funds themselves can be used only for unemployment insurance. Similarly, a deficit in the system (which can be expected to occur during economic downturn) may make a unified budget deficit appear larger and therefore result in reduced spending in other areas.
- Projected Deficit. If any change in budget consideration is forthcoming, its probability is greatly enhanced during years when the program is operating with a deficit. Removal of the program at such a time would reduce the federal deficit. A deficit can be expected during 1980 and 1981.

In addition to these issues, several considerations of a more speculative nature should be addressed. Will the unemployment insurance system once again be used to funnel funds into a slumping economy? If so, does it make sense to be concerned about budget-balancing proposals at a time when program dollar flows are expected to increase? Is it right to sacrifice equity for budget considerations? Will removal affect the probability of implementation of a reinsurance system? Where is the support for removal? Do employers support it? Do employee groups support it? Did inclusion in the unified budget allow (or at least facilitate) borrowing from federal general revenues during the last recession? Will inclusion mean continuous struggling to retain state flexibility? Is the struggle worth the benefits of inclusion? Would federal services be cut back as federal involvement decreased? Can states emphasize solvency or help themselves (as through reinsurance) so that federal dependence can be reduced?

Recommendation: Remove State Unemployment Insurance Trust Funds From the Unified Federal Budget

The Human Resources Committee believes the preceding discussion provides ample rationale for removing state trust funds from the unified budget. Removal can be accomplished either by administrative change instituted by the Office of Management and Budget (OMB) or by Congressional action. Administrative action brought the funds in and working through OMB would probably be the most efficient means of returning to off budget treatment.

Treatment of funds after removal is extremely important. If trust funds were to be reflected in state budgets, budget-balancing considerations might gain even more influence at the state level than is present at the national level. The policy recommendation does not advocate state control of funds (as discussed later), it advocates off-budget treatment of funds. The U.S.

Treasury currently maintains several off-budget accounts (the Federal Financing Bank, the Federal National Mortgage Association, and the Pension Guaranty Corporation, for example) and could continue to administer state unemployment insurance trust funds if they were removed from the federal unified budget.

The remainder of the issues presented in this paper are not natural consequences of removal of state trust funds from the unified budget, but represent several options that arise on a continuum of possible arrangements. They are presented because they were discussed in the process of formulating policy recommendations, and as discussion topics they should not be interpreted as recommendations.

I. State Collection of FUTA Taxes

Federal Unemployment Tax Act (FUTA) taxes are those contributions which employers pay to federal accounts used for program administration and to pay extended benefits. The funds should not be confused with state trust funds, which can be used only to pay unemployment compensation and which were the subject of the preceding discussion.

A study by the California Employment Development Department (attached) estimates that state collection of FUTA contributions could increase revenues by about 10 percent, or over \$200 million per year, while reducing the costs of collection. The basis for this more efficient, more effective, collection is the use of existing mechanisms within state employment security agencies.

If such a transfer of responsibility was to be considered, a constitutional issue might arise since states would be collecting federal taxes. One (strictly non-legal) opinion on this subject is that collection would be handled by contract and would not involve a transfer of authority. The issue is similar to the present situation of employers withholding federal

income tax from employee earnings.

This proposal would not require significant program changes since all funds would be immediately forwarded to FUTA accounts. Additional collections and reduced costs could justify reduced tax rates or be used to fund a reinsurance program or to increase the balance of FUTA accounts.

II. Partial State Retention of FUTA Contributions

This option would be available either by partial state retention of state-collected FUTA taxes or by crediting a portion of federally-collected receipts to state-specific administrative trust funds. The following page from a Macro-Systems study for the National Commission on Unemployment Compensation discusses some of the details of the option, and the study noted further that:

"...there are a number of states which consistently over a several year period do not generate sufficient FUTA receipts (even at a 10% funding level) to cover their annual operating costs.... These states face the real potential of either reducing services, being more efficient, perhaps at the cost of quality, or soliciting additional revenues from the state general funds or employer community."

As the following table shows, full state retention of administrative funds would increase net receipts for some states, while others would face a shortage of administrative funds that would have to be generated within the state.

III. State Investment of State Trust Funds

This issue involves state retention of employer taxes paid to the state funds and is an issue independent of FUTA (federal tax) collections. The primary concerns associated with this discussion topic are interest earnings and use of funds. Several states have compared the interest rate on other state monies and the interest earnings on federally-held unemployment insurance trust funds and claim that trust fund earnings would increase if states were allowed to invest the funds on their own. The table below

National Commission on Employment Compensation

UI—FEDERAL REIMBURSEMENT ALTERNATIVE

UI—FEDERAL REIMBURSEMENT ALTERNATIVE

FUND SOURCE

Federal Trust Fund/State Trust Funds—The primary source of funds would continue to be FUTA with the existing FUTA taxing structure left intact. However, a portion of the tax receipts generated by each State would be credited to State-specific UI administrative trust funds, with the remaining portion of receipts pooled in ESAA, thus giving each State its own administrative trust fund for purposes of meeting its share of administrative costs. Federal reimbursement would pay for a standard cost of workload accomplished.

Options:

- Federal reimbursement could provide (1) a minimum cost for all functions, (2) an average cost for all functions, (3) a full cost of specified functions, (4) some combination of the above.
- Cost standards could be based upon national average cost or State-specific cost levels.
- States could earn a higher level of Federal reimbursement by maintaining specified levels of quality and performance.
- States could borrow from a Federal trust fund reserve if State trust funds were inadequate to cover the added cost of program operations.

BUL AT JUSTIFICATION

Productivity And Forecasted Work Load—The Federal budget would be based on national cost standards applied to forecasted work loads. The current model could be used to develop a range of unit cost minimum costs (or staff requirements). Such standards in conjunction with estimated work load would determine the budget amount. Concepts of base and contingency funding would no longer be necessary. States would be reimbursed for all work load accomplished at the standard reimbursement rate; reimbursement would be at less than full cost and States would supplement incrementals above the reimbursed amount through their State trust fund or through State general revenue if necessary.

RESOURCE ALLOCATION

Strict Reimbursement—Since standard reimbursements are established during budget formulation, allocation is based on experienced work load funded at the reimbursement rate.

PROGRAM OPERATION

State/Federal—The Federal role would become significantly less concerned with program operations because of the standard reimbursement nature of the program. The States would be afforded increased program flexibility and would become increasingly accountable to their Governor and State legislature to justify program costs in excess of the Federal standards.

FUTA Administrative Contributions Less Administrative Funds Returned, by State, 1979

<u>STATE</u>	<u>\$ MILLIONS</u>
Alabama	5.5
Alaska	-11.8
Arizona	5.2
Arkansas	- .7
California	24.5
Colorado	7.1
Connecticut	15.0
Delaware	.7
District of Columbia	- 3.5
Florida	38.3
Georgia	13.3
Hawaii	- 1.9
Idaho	- 2.5
Illinois	35.6
Indiana	23.3
Iowa	2.5
Kansas	6.1
Kentucky	8.3
Louisiana	18.4
Maine	- .7
Maryland	9.1
Massachusetts	22.3
Michigan	.5
Minnesota	7.8
Mississippi	1.9
Missouri	6.2
Montana	- 2.4
Nebraska	2.1
Nevada	- 3.6
New Hampshire	2.7
New Jersey	6.4
New Mexico	- .7
New York	-13.2
North Carolina	31.6
North Dakota	- 3.7
Ohio	43.6
Oklahoma	3.4
Oregon	10.2
Pennsylvania	8.6
Puerto Rico	0.0
Rhode Island	- 2.8
South Carolina	8.7
South Dakota	- 3.8
Tennessee	18.1
Texas	64.3
Utah	- 8.5
Vermont	- .9
Virginia	25.7
Washington	- 4.5
West Virginia	3.0
Wisconsin	7.2
Wyoming	- .6

6

compares Wisconsin's unemployment insurance trust fund earnings with earnings of the Wisconsin state investment fund.

The table shows four instances of trust fund earnings at or above the rate earned on state funds. Wisconsin estimates that state investment of its trust funds (from 1972 through March 1980) would have produced an additional \$47.1 million, which is 36.2 percent above the amount actually earned.

There is some sentiment that wise use of funds may include investments which don't necessarily have a high direct monetary yield. For example, loans to prospective employers would encourage them to locate in a state and thus improve the economy in years ahead. The National Commission on Unemployment Compensation discussed state use of funds and voted to recommend that the Congress study the issue. A Commission discussion draft of the topic follows:

Investment of State Reserve Funds

The Commission has received testimony in favor of amending existing federal and state laws to permit states to invest part of their unemployment compensation reserves in state approved investments, other than obligations of the federal government. The Commission has studied this proposal. Because of the importance of state reserve funds being available to meet unforeseen demands the Commission believes it is essential for the reserve funds to be invested in obligations of the federal government which can be liquidated promptly without major adverse effects on the economy.

The Commission has recommended that each state pursue a prudent and conservative financial policy in the establishment of adequate reserves to meet the future obligations of the state unemployment insurance law. It might be possible, therefore, for a state reserve fund to be permitted to invest a small amount in non-federal obligations. For instance, an amount equal to ten percent of its average annual benefit disbursement in the prior 15 years could be invested in non-federal obligations. Such a policy might be authorized under regulations established by the Board of Trustees for an initial period of ten years, 1982-91. In addition, specific responsibility would be assigned to the Board and the next Commission to study and evaluate such experience and to recommend the continuation, amendment, or repeal of such authorization.

STATE INVESTMENT OF STATE UNEMPLOYMENT INSURANCE FUNDS

Comparison of Interest Rates on Unemployment Insurance
Trust Funds and Wisconsin State Investment Fund, 1972-1980*

<u>Year:</u>	<u>Quarter</u>	<u>Trust Fund Rate</u>	<u>State Investment Fund Rate</u>
1972:	1, 2	4.903	4.802
	3, 4	4.838	4.911
1973:	1, 2	4.952	6.499
	3, 4	5.493	8.946
1974:	1, 2	5.718	9.113
	3, 4	6.081	10.863
1975:	1, 2	5.904	7.816
	3, 4	5.056	5.639
1976:	1	5.395	7.424
	2	6.011	6.566
	3	5.490	7.893
	4	6.618	9.330
1977:	1	6.182	5.424
	2	6.104	4.799
	3	5.563	5.458
	4	5.560	5.657
1978:	1	5.654	7.137
	2	5.984	6.989
	3	6.153	7.959
	4	6.251	8.683
1979:	1	6.517	9.373
	2	6.874	9.449
	3	7.377	9.629
	4	7.165	11.350
1980:	1	7.536	12.679

*Source: Wisconsin Department of Industry, Labor and Human Relations. Data should be interpreted with caution. Liquidity of investments has not been considered nor should final judgement be made on the basis of one state's experience. Note, however, that California and Minnesota have reported similar results.

IV. State Retention of FUTA Taxes

This option is equivalent to elimination of FUTA taxes since state and federal funds would be indistinguishable. The result would be complete decentralization of the system into a series of state programs with no federal loan accounts and no federal sanctions.

INTRODUCTION

This study was initiated at the request of E. L. Sullivan, Deputy Director. The objective is to determine the estimated amount of Federal Unemployment Tax (FUTA) that would be collected if the States collected the FUTA tax instead of the Internal Revenue Service (IRS).

Study Methodology

The year 1978 was selected for use in the study as it was the most current year with complete national information. That revenue estimate was then updated to 1980 based upon available data for California alone.

The following information was obtained from the Department of Labor (DOL) for the year 1978 (figures do not include reimbursable employers):

1. Gross wages United States employers - \$830,005,987,000
2. Unemployment Insurance taxable wages for states with a \$6,000 wage base - \$351,967,424,000
3. Gross wages for states with a \$6,000 wage base - \$721,176,544,000
4. FUTA tax collected by IRS for year 1978 - \$2,642,014,000

The following assumptions were made:

1. The average FUTA tax rate after credit is .7% ($5.4\% - 2.7\% = .7\%$). This is the rate of tax for the vast majority of employers.
2. Taxable wages subject to FUTA and State Unemployment Insurance are essentially the same. By 1978 almost all wages subject to FUTA were subject to State UI. The largest group of wages becoming subject to UI and FUTA during 1978 were agricultural wages. Others, such as state and local governments and Non-Profits, are for the most part reimbursable type employers. The remaining wages not subject to both taxes are quite small.
3. FUTA tax per dollar of gross wage is the same for all states. The amount of tax collected per dollar of gross wage will average out throughout the nation.
4. The rate of increase in taxable wages in California from 1978 to 1980 approximated that of the nation as a whole.

Summary of Conclusions

The states would have collected \$222,086,152 more than the IRS for the year 1980, if the responsibility for FUTA tax collections has been delegated to them.

Findings

The estimated FUTA tax to be collected was calculated on the data given and assumptions made since current information on taxable FUTA wages was not available.

Step 1. Estimated FUTA Tax Due For States With a \$6,000 Wage Base (1978)

To determine the estimated FUTA tax due for States with a \$6,000 wage base we multiplied UI taxable wages for states with a \$6,000 wage base (\$351,967,424,000) by the average FUTA tax rate (.007) after credit. The result is the estimated FUTA tax due (\$2,463,771,968) for states with a \$6,000 wage base.

$$.007 \times 351,967,424,000 = 2,463,771,968$$

Step 2. Estimated FUTA Tax Due Per Dollar of Gross Wage For States With a \$6,000 Wage Base (1978)

To determine the estimated FUTA tax due per dollar of gross wages for states with a \$6,000 wage base we divide the estimated FUTA tax due (\$2,463,771,968) by the gross wages (\$721,176,544,000) for states with a \$6,000 wage base. The estimated FUTA tax due per dollar of gross wage is \$.003416.

$$2,463,771,968 \div 721,176,544,000 = .003416$$

Step 3. Estimated FUTA Tax Due From All United States Employers (1978)

We have assumed that the FUTA tax per dollar of gross wage is the same for all states. Therefore, by multiplying the total United States Gross Wage (\$830,005,987,000) by the estimated FUTA tax per dollar of gross wage (\$.003416) we can arrive at an estimated FUTA tax for the entire United States in 1978 (\$2,835,300,451).

$$830,005,987,000 \times .003416 = 2,835,300,451$$

Step 4. Comparison With FUTA Tax Actually Collected - (1978)

Estimated FUTA Tax Due	\$ 2,835,300,451
FUTA Tax Collected by IRS	<u>-2,642,014,000</u>
Estimated Uncollected FUTA Tax 1978	\$ 193,286,451

Step 5. Updated to 1980 based on Available Data For California Alone

It is estimated that the 1978 taxable UI wages \$45,265,000,000 will increase to \$52,052,000,000 an increase of 14.9%.

We assume this rate of increase in taxable UI wages from 1978 to 1980 to approximate the nation as a whole. Based on this, uncollected FUTA Tax would increase by 14.9% by the end of 1980. Therefore by multiplying the rate of