

Federal Income Taxation of Unemployment Insurance: Re-examining a Flawed Policy

By National Employment Law Project

Background: Congress began partial income taxation of UI benefits in 1979 and began taxing all UI benefits in 1987, reversing a 1938 IRS tax policy exempting state unemployment insurance (UI) benefits from federal income taxation. This change arose mainly from intense federal budgetary pressures that no longer apply with today's budget surpluses. With unemployment rising, and growing concern about an economic downturn motivating broad income tax cut proposals, policy and fairness dictate re-examination of the federal income taxation of UI benefits. These modest income tax cuts could take effect immediately and provide economic stimulus in affected communities by putting more money in the pockets of unemployed workers.

Unified Federal Budget and UI Trust Funds: UI is financed by two separate payroll taxes. Each state imposes experience-rated state UI payroll taxes that are collected by states and then deposited in trust funds maintained in the U.S. Treasury. All covered employers also pay a federal FUTA payroll tax that funds UI administration by both the U.S. Department of Labor and state employment security agencies. In addition, FUTA revenues not used for current UI administration are kept in federal UI trust funds to finance the federal share of extended benefits and provide temporary loans to state trust funds unable to pay UI benefits during recessions. All UI trust fund balances consist of state and federal UI payroll tax revenues that are dedicated exclusively to payment of UI benefits and related administrative costs.

UI Goals Undercut by Federal Taxation of UI Benefits: The related goals of UI are to maintain consumer spending and provide a boost to the economy by partially replacing lost wages for laid off workers. Undercutting these safety net goals, federal income taxation of UI benefits effectively reduces weekly benefit amounts. The impact on UI benefit payments is sizable. The 1998 Green Book estimated the impact of federal UI taxation at 18.3% of overall UI benefits. State income taxation increases the impact because many states' income tax systems are based upon federal taxable income.

Repeal of Income Tax As a Targeted Boost To Economy: In effect, federal taxation of UI benefits has acted as a federally imposed state UI benefit reduction, since no state raised UI benefit amounts to offset their taxation. State UI benefits replace only about 40% of pre-layoff incomes. A 1999 study commissioned by the U.S. Department of Labor concluded that each \$1 of UI benefits boosts GDP by \$2.15. Repeal of federal income taxation of UI benefits will support the goals of UI policy and assist laid-off workers.

Other Impacts of Taxation: UI trust funds use payroll taxes built up during economic good times to pay UI benefits during economic downturns. Taxing UI benefits effectively turns dedicated state UI payroll taxes into federal income tax revenues, rather than state UI benefits. Taxing UI benefits contributes to cynicism about our UI trust funds' security and raises doubts about the federal government's support for the goals of UI. Income taxation of UI benefits also creates practical difficulties for UI claimants and state UI agencies. Most claimants don't save a portion of UI benefits to later pay taxes and many don't exercise an option to have 10% of their UI benefits withheld to pay taxes. This creates financial hardship when April 15 comes and income tax payments are due. In

National Employment Law Project, Inc.

55 John Street, 7th Floor • New York, NY 10038

(212) 285-3025 • (212) 285-3044 (fax)

www.nelp.org • nelp@nelp.org

addition, state administration of UI is complicated by the need to provide 1099s for all UI recipients and to offer the tax withholding option to UI claimants—all of which is paid for with FUTA administrative funds collected from federal UI payroll taxes. Essentially, this dog is chasing its own tail.

Costs of Repeal Modest: Although income taxation of benefits has significant impact on UI benefits levels, it does not provide significant federal revenues in the context of today's budget surpluses. The 1998 Green Book roughly estimated revenues at \$4.041 billion. Just over \$20 billion in UI benefits were paid in FY 2000, as compared to nearly \$23 in calendar year 1998 (used for the Green Book estimates). If unemployment rises further these figures will rise, but in light of the overall scope of current income tax proposals, costs of repeal of UI benefit taxation are quite modest, especially when balanced by the immediate benefits to working families and the economy.

What Experts Have Said About Income Taxation of UI Benefits: Both the Advisory Council on Unemployment Compensation (1995) and the National Commission on Unemployment Compensation (1980) advised Congress to repeal the federal income taxation of UI benefits. Both groups included a broad range of UI experts and representatives of important UI constituencies. Given projected budget surpluses and the scope of proposed income tax reductions, now is the time to re-examine the income taxation of UI benefits.

How Can I Get More Information? On income taxation of UI, contact NELP Staff Attorney Rick McHugh at (734) 426-6773 or e-mail rmchugh@nelp.org. NELP's Unemployment Insurance Safety Net Project provides information, advice, and assistance to policymakers and advocates concerned with making unemployment insurance more relevant to today's working family and our economy. For more information, including fact sheets and briefing papers on UI and issues affecting working families, visit NELP's website at www.nelp.org.

References

Advisory Council on Unemployment Compensation, UNEMPLOYMENT INSURANCE IN THE UNITED STATES: BENEFITS, FINANCING, COVERAGE (1995), 20-21.

National Commission on Unemployment Compensation, UNEMPLOYMENT COMPENSATION: FINAL REPORT (1980), 52-54.

U.S. Congress, House Ways and Means Committee, BACKGROUND MATERIAL AND DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS (1998 GREEN BOOK), 338-339 and Table 4-4.

U.S. Department of Labor, Employment and Training Administration, UNEMPLOYMENT INSURANCE AS AN AUTOMATIC STABILIZER: EVIDENCE OF EFFECTIVENESS OVER THREE DECADES (UI Occasional Paper 99-8, July 1999), 84.

Wayne Vroman, "Taxing Unemployment Compensation," UNEMPLOYMENT COMPENSATION: STUDIES AND RESEARCH (Washington, D.C., National Commission on Unemployment Compensation, 1980), 95-108.