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# **The Whole Truth: Employer Fraud and Error in the UI System**

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A Special Report by the  
National Employment Law Project  
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## About the Authors

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### **National Employment Law Project**

NELP is a non-profit policy and legal organization based in New York City. NELP has advocated on behalf of low-wage and unemployed workers for over 30 years, and is particularly concerned with assisting these workers in overcoming barriers to employment and government systems of support. For further information about NELP, visit our website at [www.nelp.org](http://www.nelp.org).

NELP's Unemployment Insurance Safety Net Project supports state unemployment insurance reform efforts, especially those directed at expanding UI eligibility for low-wage, women, and part-time workers. To carry out this work, NELP provides technical assistance and advice to legislators and their staff, advocates, unions, and other policy makers involved in state-level unemployment insurance (UI) reform efforts, and monitors federal UI legislative and administrative developments. For copies of other reports and materials on unemployment insurance and related NELP projects, visit our website's publications page at [www.nelp.org](http://www.nelp.org).

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## Executive Summary

Since the mid 1930's, unemployment insurance has kept unemployed workers attached to the labor force and out of poverty while they search for new work. Just as in other social insurance programs, the program must be monitored in order to ensure that those who are entitled to its benefits are receiving them, and that the system is collecting taxes due from employers. This means that both erroneous overpayments—payments made to workers who are not entitled to receive them—and erroneous underpayments and mistaken denials should be tracked and corrected. Unfortunately, the Department of Labor places a much higher priority on erroneous overpayments than it does on workers who are mistakenly denied benefits. This report tells the whole truth about program integrity, and makes suggestions about how DOL and the states can create true program integrity. Among our key findings:

- DOL statistics show \$888 million annually in UI overpayments that are attributed to fraud on the part of workers.
- Far more erroneous underpayments occur in the system annually. In 2002, DOL reports \$268 million underpaid (that is, paid but not at the proper amount). NELP estimates \$1.03 billion in benefits wrongfully denied. These underpayments thus total \$1.3 billion, or about 3.2% of all UI benefits paid in 2002.
- In its first-ever nationwide report of denied claims, released in 2003, DOL found a 14.7% error rate in workers denied benefits for reasons of monetary eligibility, 7.6% error rate in workers denied benefits because of reasons for unemployment rules (separation), and an 11.8% error rate in workers denied benefits because of continued eligibility rules (non-separation.) Even after adjusting for efforts by workers and agencies to correct these errors, there was a 9.4% monetary denial error rate, a 5.7% separation denial error rate, and a 9.2% nonseparation denial error rate.
- A DOL commissioned report in 2000 found that 80,000 workers annually are denied benefits because employers wrongly call them “independent contractors” instead of “employees.”
- Recent DOL-reported audit data, representing only audited firms (less than 2% of employers), found 30,135 workers misclassified as independent contractors in the 4<sup>th</sup> quarter of 2002, an increase of 42% over the previous year. The same audit found \$436 million in underreported wages.
- According to a General Accounting Office (GAO) survey conducted between March 2003 and June 2003, 14 states reported that they had identified particular employer fraud schemes, called “SUTA dumping” cases, in the past three years. Tax losses exceeded \$120 million. A five-year audit of six companies in the state of Georgia found a loss of over \$1.6 million to that state's UI system caused by employers' SUTA dumping schemes.

Despite these statistics, and the recommendations of at least two reports on the subject, DOL has paid little attention to detecting and remedying mistaken denials and employer fraud. Although it has collected overpayment data annually since 1987, it was not until this year that data was published on mistaken denials. Over the last two years, it has developed new accuracy and integrity measures focused entirely on

overpayments, but no new initiatives focusing on correcting mistaken denials. It has issued grants totaling \$4.8 million to states for improved overpayment detection, but no grants have been made to states to help detect underpayments. It has implemented five different systems of cross-matching social security, wage and work search data in order to detect erroneous and fraudulent overpayments, but no new systems to detect underpayments or mistaken denials.

DOL is to be applauded for backing newly-proposed legislation (the bipartisan bill H.R. 3463) to combat employer schemes to underpay taxes, its “SUTA dumping” proposal. However, DOL could do more to distribute the estimated \$1.3 billion dollars in mistaken denials to eligible unemployed workers. It could do more to recover the estimated \$200 million dollars in taxes lost to the UI system per year since the 1990s. For example, DOL can use some of the same methods for detecting employer fraud that it has used to detect claimant overpayments. It should give grants to states to track down employers who are cheating. It should give states more tools to detect fraud on the part of employers and their accounting firms, including detection of employer misclassification of workers as independent contractors. Model legislation should include stiff penalties for employers who underpay their taxes by misclassifying workers or by any other means. Program integrity means both workers and employers should have integrity.

## Introduction

**“We want to make sure when we spend money, that it meets needs. . . . that’s what the American taxpayer expects. They expect results and I expect results.” President George W. Bush April 9, 2002**

President Bush’s statement above refers to the increasing focus on measuring the performance of public programs. But the Bush Administration, and others before it, have prioritized overpayments in the unemployment insurance system, and have largely neglected erroneous underpayments and failures to pay UI benefits to those who are entitled to them. This paper focuses on telling the whole truth: that employer fraud, and errors that deny workers benefits to which they are entitled, are a huge problem that must be addressed by policymakers.

When it comes to a social insurance program like unemployment insurance, the most fundamental question is whether payments made by the system are proper. Within unemployment insurance, most of the attention has been focused on unemployed workers who receive more in UI than their state law allows – known as overpayments. But the program also makes “erroneous payments” when qualified jobless workers who apply for benefits are paid too little or not at all. Employers are also obliged to participate in the UI system, by accurately reporting their wages and paying their share in unemployment costs. When employers shirk their responsibilities and workers go without benefits, the UI system is fundamentally damaged.

Within UI, concerns about accurate payments have come to be known as “program integrity.” The U.S. Department of Labor has focused most of its “program integrity” attention on overpayments. Overpayments have been equated with claimant fraud in the public eye, even though only a tiny proportion of overpayments are caused by claimant fraud. Congressional hearings and even grants to states for enforcement have understood “program integrity” to involve primarily the integrity of workers, not employers.

In contrast, little attention has been paid to underpayments and employer fraud. While overpayments have been fully tracked since 1987, until this year only a fraction of underpayments were analyzed. The analysis thus made it appear that underpayments represented only a small fraction of the “program integrity” problem.

New data and research carried out over the last several years now presents a more coherent picture of this side of “program integrity.” This paper is intended to put the overpayment question into context by analyzing recent data on underpayments and on two related forms of employer tax evasion: employer misclassification of workers as independent contractors and employer SUTA dumping.

The Federal government and states are beginning to recognize that substantial numbers of workers are underpaid UI benefits and that significant amounts of revenue due to the system go uncollected. Legislative proposals at both the state and federal level are beginning to take on the manipulative SUTA dumping practice by employers. These are critical issues as policy makers consider ways to preserve a strong UI safety net during the continued labor market slump.

### Program Integrity: A guide to terms

As described by a UI expert to a congressional panel, "Program Integrity in the unemployment insurance system has three components: whether workers are overpaid, whether they are underpaid, and whether employers are paying the taxes that they owe."

**Underpayment:** The amount of a UI check that is below what a worker should be legally entitled to or the amount of UI benefits an unemployed worker would have received if he or she were improperly denied benefits.

**Employer misclassification:** The practice of considering workers who are legally employees (and eligible for UI benefits and liable for UI taxes) as independent contractors (ineligible for benefits and not taxed.)

**SUTA dumping:** Schemes under which companies pay less UI taxes than they owe by manipulating tax systems. Under this scheme, employers transfer their employees to corporations that qualify for a lower rate or for the lower "new employer" rate.

**Claimant Fraud:** A UI payment made to worker when s/he is not eligible because s/he knowingly makes a false statement or misrepresentation of facts to receive benefits to which s/he is not entitled.<sup>1</sup>

**Overpayment:** A partial or total UI payment beyond that to which a worker is legally entitled, for any reason, including errors or fraud committed by the claimant, the state agency or employers.

### Underpayments: Denied Claims Cost Claimants More than a Billion per Year

Laid off workers can be denied UI at three points in the UI system process. First, when a worker applies for benefits she can be told she has not earned enough money, worked sufficient numbers of hours, or earned wages in the wrong quarters to qualify for UI. This is called a monetary denial. Second, even if she is found to have earned a sufficient amount of money in the correct quarters, the agency can declare that she became unemployed for an unacceptable reason. In these cases, the state rules a worker has quit her job for reasons that are not considered 'good cause' or has been fired for misconduct. Third, after initially receiving UI, a worker can be cut off if she is found to have stopped looking for work or is no longer "able and available" to take a job.

In 2002, there were 1.7 million occasions when workers were denied benefits for monetary reasons and 2.3 million occasions when workers were denied benefits for job separation reasons. Workers who initially qualified for UI were denied one or more weeks of UI benefits for job search reasons 2.6 million times last year. In August, 2003, the U.S. Department of Labor released a first-ever annual audit of these denials, and found that a substantial number of these workers were wrongfully denied. The Denied Claims Accuracy project found 14.7% of monetary denials, 7.6% of separation denials and 11.8% of non-separation denials were improper. Even after such wrongful denials were adjusted by appeals or by a subsequent correction, 9.4% for monetary denials, 9.2% of nonseparation denials and 5.7% of separation denials were issued in error. (U.S. Department of Labor, August 2003)

These denial rates translate into a total of 528,000 wrongful denials in CY 2002, even after corrections are made.<sup>2</sup> To put that in perspective, these denials represent 5% of the slightly more than 10 million workers who received UI payments in 2002.

<sup>1</sup> Fraud definitions vary from state to state. This definition is taken from New Jersey law, N.J. 43-9-21-16(a).

<sup>2</sup> Because of the evolving nature of the DCA sample (3 states including California did not report data in 2003), the population for the sample does not cover the entire nation. For the purpose of our analysis, which is to compare to overpayments, we assume that the rates discovered by DCA would hold for the entire population of denied claims.

The U.S. Department of Labor does not put a dollar figure on the amount of benefits lost. However, researchers Stephen Woodbury and Wayne Vroman (2000) came up with several methods to estimate the amount represented by these underpayments. **Following such a methodology, NELP estimates approximately \$1.03 billion was lost to claimants in 2002 due to improper denials nationally.**

The U.S. Department of Labor does estimate dollar figures for underpayments made on paid UI claims. In these cases, workers are paid UI benefits, but are erroneously granted less money than that for which they are eligible. Such underpayments (tracked through the Benefit Accuracy Management system) totaled \$268.5 million in 2002, or .66 percent of total UI benefits paid. **Taken together, these represent a total of \$1.3 billion dollar in underpayments, 3.2% percent of the \$40 billion in UI payments made in 2002.**<sup>3</sup>

Table 1 – UI Underpayments

Type of Underpayment	Total Underpayments
Improper Monetary Denial	\$459,701,942
Improper Non-Separation Denial	\$187,233,990
Improper Separation Denial	\$384,395,264
Underpayments on Paid Claims	\$268,500,000
<b>Total</b>	<b>\$1,299,831,196</b>

Source: Benefit Accuracy Measurement Data 2002 (U.S. Department of Labor, August 2003). NELP Calculations of Denied Claims Accuracy Data 2002 from the same report (see Appendix)

These erroneous underpayments represent a real loss of benefits by considerable numbers of unemployed workers, benefits that are especially needed by unemployed workers during an economic downturn. Yet DOL has placed little emphasis on properly awarding desperately needed UI benefits to unemployed workers. Indeed, a 2000 DOL-commissioned follow up report on denied claims concluded “agencies place a higher priority on avoiding overpayments to ineligible claimants than on improperly denying benefits to eligible claimants.”<sup>4</sup>

*Who is responsible for UI underpayments?*

Employers are to blame for more than half of wrongful monetary denials (60%), errors equivalent to 83,000 workers nationally in 2002. These errors occur when employers underreport or misreport wages. These errors can relate to late reporting, benign miscalculations or outright efforts to conceal wages and thus avoid UI costs.<sup>5</sup>

Agencies are responsible for the vast majority of incorrect separation and nonseparation denials, which require the judgment of agency personnel. Agencies are most likely to have taken incorrect action in the area of separation denials; they correctly identify the case as one relating to misconduct or quit, but they misapply state law and regulations. Employers are also involved in about one in five improper separation denials, such as when they misreport the reason a worker was fired.

<sup>3</sup> Same base of UI payments used for the overpayment data

<sup>4</sup> Woodbury and Vroman (2000), Denied Claims Accuracy Pilot Project: Follow Up Report, Prepared for Division of Performance Review, Office of Workforce Security, US Department of Labor.

<sup>5</sup> Personal correspondence with U.S. Department of Labor staff.

## UI Overpayments in Perspective: Underpayments Exceed Fraudulent Overpayments

The U.S. Department of Labor's Benefit Accuracy Management has been tracking overpayments since 1987, providing data for the states as well. The program has found a steady overpayment rate of between 8.0 and 9.0%, with total overpayments equaling \$3.68 billion in 2002.

Several factors put these total overpayments in context. Overpayments are a catch all for a wide array of incorrect agency decisions. Many of these overpayments are "partial" overpayments, meaning that workers are eligible for UI but receive checks that are too high (often because workers fail to report part-time earnings or receipt of Social Security retirement benefits.) Other overpayments are technical, such as when auditors find that a worker was not listed as registered on the state's official registry of unemployed workers (the job service). Job Service registration errors represented \$300 million of the overpayments in 2002. (U.S. Department of Labor, August 2003)

Indeed, the states and the U.S. Department of Labor have agreed that the definition of total overpayments is so broad that it cannot be used as a standard of performance accountability. So, the BAM overpayment system has developed a separate "Government and Performance Results Act Overpayment Rate". This rate includes all of the overpayments that states could be expected to collect under a qualify control operation. Under this definition, the overpayment rate drops from 9.1% to 5.0%. (U.S. Department of Labor, August 2003).

**Few overpayments are fraudulent.** Only 2.2% of the benefits paid in CY 2002 were overpayments caused by claimant fraud, a total of about \$888 million. So, while the overall overpayment rate is higher than the underpayment rate, underpayments are comparable or greater to key components of overpayments. As displayed in the graph below, the total UI underpayment rate of 3.2% is on par with the rate of "recoverable and detectable" overpayments of 5.0%. The underpayment rate exceeds the UI fraud rate of 2.2%, the willful cases that attract most of the attention of lawmakers and the media.

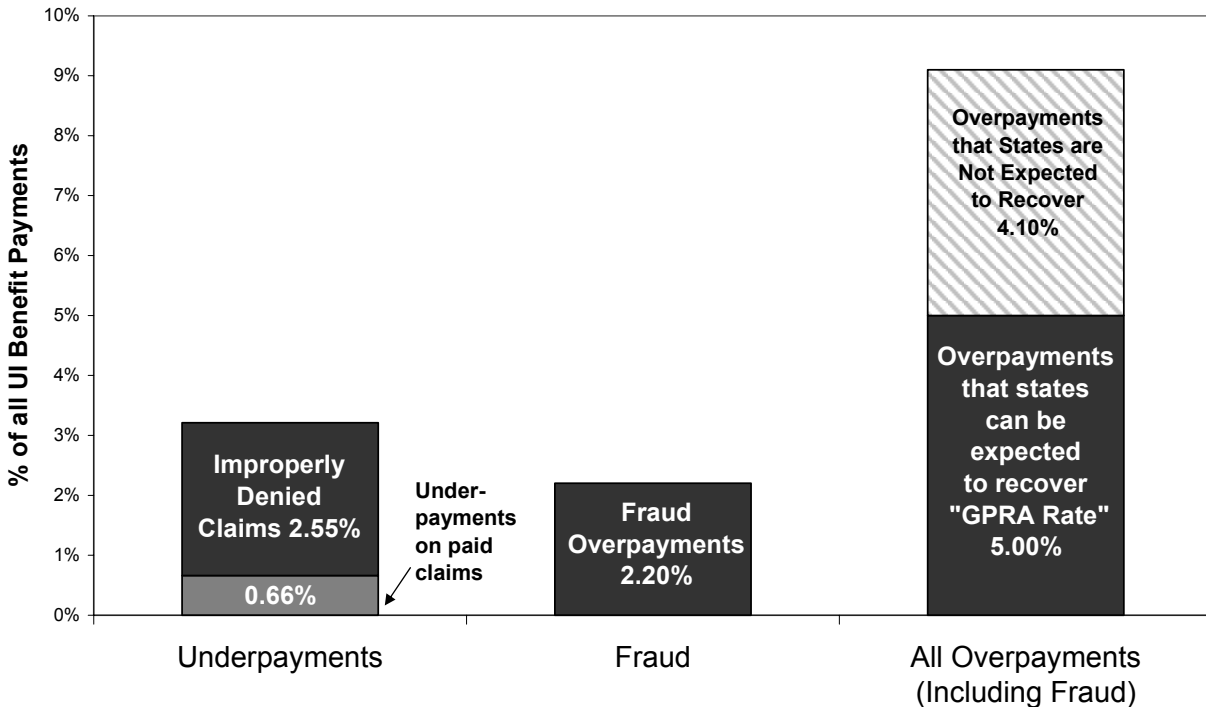
Several additional facts point out that underpayments are more damaging to UI program integrity than overpayments.

Overpayments are almost always recoverable against the claimant, no matter what the cause. In a recent case in New Jersey, the state miscalculated a worker's benefits and he was overpaid. The worker will be obligated to repay the state even though the overpayment was the agency's fault, not the worker's. Even innocent mistakes that cause overpayments mean that the worker must repay the benefits. In a second recent case, a telecommuter was assessed an overpayment after she listed her place of business as the employer's New York address, rather than her personal Florida address, on her application form. States recover millions of dollars in benefits in overpayments each year, while few wrongfully denied workers successfully appeal their cases and receive benefits.

Second, almost all denied claims result in a total underpayment, meaning workers lose a full week of benefits; by contrast, many overpayments are only partial – meaning that the worker qualified for benefits, but the weekly benefit amount paid him or her was too much. (Vroman and Woodbury, 2000)



## Underpayments vs. Overpayments, 2002



Source: U.S. Department of Labor, Benefit Accuracy Measurement Data 2002 (US Department of Labor, August 2003). NELP Calculations of Denied Claims Accuracy Data 2002 from the above report.

### Employer Misclassification of Workers to Evade Taxes and Benefits Costs States Over \$200 Million Annually

Genuine independent contractors constitute a small proportion of the American workforce, hiring out their special skills to various companies. Because independent contractors are thought of as being in business on their own, employers are not required to pay a variety of payroll taxes (social security and unemployment insurance) and they are not fully protected under employment laws. Because of these advantages, employers often misclassify employees (whose work is controlled by their employer) as independent contractors. (Regular employees receive a W-2 form at the end of the year showing what taxes have been withheld on their behalf, while independent contractors receive a 1099). Employer misclassification is a major tax evasion issue that has drawn the attention of the IRS.

This issue is also a serious and growing problem for the UI system, as employers pay their UI taxes based on their payroll. Employers can avoid paying UI taxes by calling workers "independent contractors" and by failing to include those workers' wages on the employer's tax report. State agencies catch only a small portion of these errors through audits or complaints by workers.

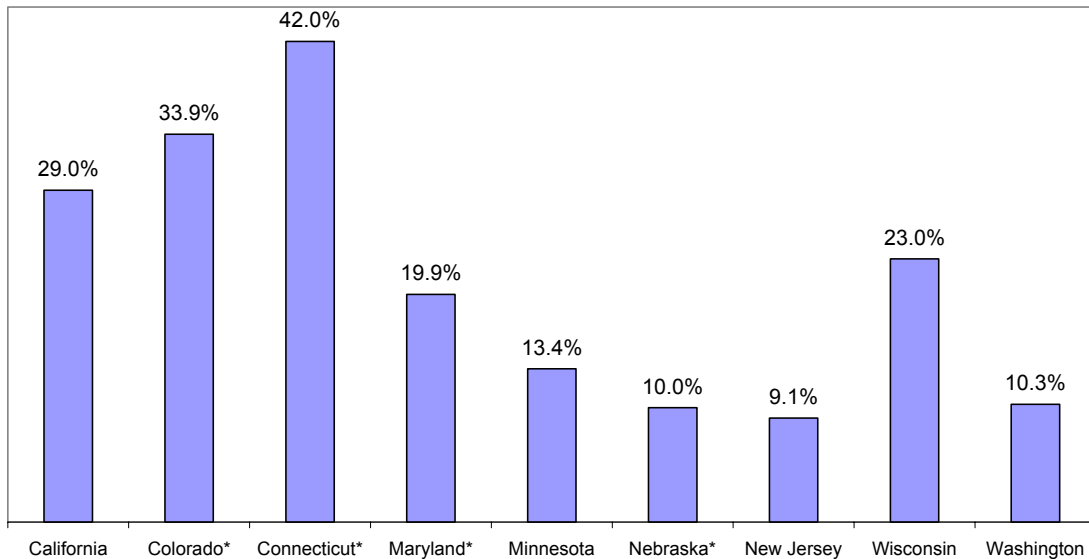
Such misclassification undermines the UI system on several fronts. Firms that misclassify workers as independent contractors pay no employment taxes on those workers. When misclassified workers apply for UI after a layoff, they are denied benefits because there is no record of them having worked. The firm saves additional money because the layoff is not charged to their unemployment insurance account. Firms

that fail to disclose their taxable obligations gain a competitive advantage over those that do. In the process, they cheat the states out of taxes and workers out of their UI benefits.

While there has not yet been a system wide effort to track this problem, research has identified the extent of the impact of misclassification on the UI system. An early study suggested that employers might have evaded three-quarters of a billion dollars in UI taxes nationally in the year 1987 alone through unreported wages (Blakemore et al., 1996). Based on a study done in Illinois, the report concluded that nearly half of employers made reporting errors.

More recently, US DOL commissioned a study of employer tax evasion that found lost benefits to 80,000 workers annually from employer misclassification of workers as independent contractors. (Planmatics, 2000) Nine states were audited in the study. The percentage of employers that had misclassified some of their workforce ranged from a low of 9.15% in New Jersey to a high of 42% in Connecticut.

### Percent of Randomly Audited Employers with Misclassified Workers (1998)



\* Only partial data was provided. Estimated figures.

Source: (Planmatics, 2000)

The study found that misclassification could have a significant impact on UI tax revenues, as much as 9.9% of all UI taxes paid in New Jersey. **The study concludes that there was nearly \$200 million in lost UI tax revenue per year through the 1990s. Taking these results forward to 2002, the annual total exceeds \$212 million.**

The U.S. Department of Labor does recommend that states audit 2% of their employers annually. Recent US DOL audits have identified a large increase in employer misclassification. In the fourth quarter 2002, DOL's quarterly audits found 30,135 workers misclassified. This number represented an increase of 42% from the prior year. DOL also identified, in that quarter, \$436 million in wages under-reported into the state UI systems. These data are from audited firms only, not the entire nation. (U.S. Department of Labor, December 2003)

When employers misclassify workers, their actions have several effects on the UI system: first, taxes go unpaid. Second, workers who are eligible for benefits may be excluded from the system. Finally, where workers do receive benefits, but the employer cannot be held accountable, other employers may be subsidizing those that fail to pay into the UI fund.

## **SUTA Dumping: Employer Tax Evasion Cheats the State and Law-Abiding Employers**

Over the last several years, through a new intentional UI tax evasion scheme known as SUTA (State Unemployment Tax Act) dumping has emerged. Through this scheme, employers pay a lower tax rate than their history of layoffs normally require. The issue has attracted the attention of the U.S. Department of Labor (which has issued an advisory to states about the issue) and the U.S. Congress, in which legislation has recently been introduced on the subject.

Unemployment Insurance is funded through an “experience-rated” tax. Employers who lay off more workers pay higher tax rates than employers who do not. The system is designed this way in order to discourage layoffs and to have employers cover their fair share of unemployment costs.

### **How SUTA Dumping Works**

Through the experience rating system described above, each employer is assigned a tax rate based on its history of layoffs. Through SUTA dumping, employers try to dump their higher tax rate onto a different company that has a lower tax rate even though their business has not changed.

Under SUTA dumping schemes, employers try to lower their taxes in two main ways.

*1) Purchased Shell Transactions.* A newly formed company buys an existing business that has a low experience rating and, therefore, a low tax rate. The company is purchased not for the business value, but for its lower tax rate. The new company gets a new, low, tax rate and transfers all of its employees to the business with the lower tax rate.

*2) Affiliated Shell Transactions.* An existing business with high taxes forms a number of additional corporations with new tax identification numbers. Then, they transfer a portion of their employees (such as administrative employees that are rarely laid off) to those corporations in order to get a more favorable tax rate. Under unemployment insurance laws, all new corporations get a “new employer” rate that tends to be in the middle of state’s tax schedule and is thus lower than the high rates paid by high layoff industries and companies.

SUTA dumping occurs most commonly in employee leasing and in industries that tend to have a high turnover of staff and high unemployment insurance taxes, like temporary help, construction, and the hospitality industry. But these employers have not come up with this scheme on their own. A group of HR consulting firms have openly promoted this practice to clients coming to them for advice about how to lower their taxes.

To demonstrate the role of these consultants, the General Accounting Office had an auditor pose as a construction company and call four consulting companies. Three of the companies advised the auditor on

ways to do SUTA dumping, with one suggesting that the employer “move your employees on paper into another type of organization to obtain more favorable rates.” (General Accounting Office, June 2003)

**Consequences and Costs of SUTA Dumping.** SUTA dumping disrupts the experience rating system, balanced to collect fair shares of revenue from different employers and to discourage layoffs. Employers that play by the rules will have to pick up the tab for the benefits of the high-layoff firms avoiding taxes they owe.

The exact cost of SUTA dumping schemes to the states is not known because the violations are difficult to track, and enforcement is just beginning. According to the General Accounting Office (GAO) survey conducted between March and June 2003, 14 states reported that they had identified SUTA dumping cases in the past three years, with tax losses exceeding \$120 million.<sup>6</sup> A five-year audit of six leasing companies in the state of Georgia found a loss of over \$1.6 million to that state’s UI system caused by employers’ “shell” transactions. This only accounts for the cases that were actually detected – with the total losses potentially much higher. (Georgia Department of Labor, 1998)

### **The Major Costs of SUTA Dumping**

According to Mike Durik, Vice President of Human Resources for **Kelly Services** (one of the nation’s largest temporary help firms), every major accounting firm in the United States has solicited his company to engage in SUTA dumping. One major accounting firm soliciting Kelly’s business estimated that the company could save \$5 million in unemployment taxes in 2000 alone, and double that amount in another year, if it engaged in SUTA dumping. At a recent presentation before the national gathering of state unemployment insurance directors, Mr. Durik vigorously supported federal anti-SUTA dumping legislation and urged much stronger state enforcement under current laws.

Several states have begun to more actively identify and prosecute cases of SUTA dumping.

- In **Texas**, 30 cases were identified in 2002, and the state is seeking to recover \$20 million in fraud from one of the largest leasing firms in the state.
- **North Carolina** is pursuing the first of 17 corporate prosecutions, totaling \$57 million in fraud.
- **California** has identified at least 29 companies with payrolls of between \$10 million and \$1.6 billion that appear to have engaged in SUTA dumping. Initial estimates of the potential underpayments to the states unemployment fund are in excess of \$100 million.

Sources: Presentations at 2003 National UI Directors’ Conference and Legal Issues Forum (October 20-23, 2003, Savannah, Georgia); California AB 444 Committee, Responses to Data Request, Employment Development Department (November 20, 2003).

### **State and federal action against SUTA dumping.**

In the past year, four states (Arkansas, Maine, North Carolina and Washington) have enacted legislation that specifically addresses SUTA dumping. The North Carolina and Washington statutes apply to any employer that practices SUTA dumping, as well as any company that advises another to engage in SUTA dumping. The state laws impose monetary penalties and criminal charges. The DOL recommends that state law require assigning the maximum tax rate under state law for a specified period of time. Washington

<sup>6</sup> The GAO survey was sent to the unemployment insurance administrators in the 50 states, District of Columbia, Puerto Rico and the U.S. Virgin Islands. Fifty administrators responded to the survey.

adopted this measure as a possible punishment for tax evading companies.

There is clearly a need for more states to follow the lead of these four. Administrators in 21 states told the GAO that they have no laws specifically addressing SUTA dumping practices. The remaining 29 state administrators indicated that they have laws addressing SUTA dumping, but 7 of them felt that those laws were inadequate.

States need solid information on SUTA dumping to enforce existing or new laws. While there is no federal model of detection, the North Carolina Employment Security Commission has developed a computerized tax analysis program to detect SUTA dumping. It includes a voluntary contribution report that detects lowered rates beyond ordinary parameters, a management report charting the movement of workforces from overdrawn negative accounts to newly established positive accounts, and a management report that shows a lack of filing from corporate taxpayers.

Meanwhile, after hearings held in June, 2003, legislation has been introduced in Congress that would require states to enact SUTA dumping laws. H.R. 3463 was introduced on November 6, 2003. It is a bipartisan bill, sponsored by ten members of the House. It requires states to pass laws that would outlaw some forms of SUTA dumping, and would require them to impose civil and criminal penalties on persons that knowingly violate the law. It also includes studying and reporting requirements. While the proposal does not prohibit SUTA dumping activities as broadly as the Washington or North Carolina statutes, it includes civil and criminal penalties against SUTA dumping employers and the consulting companies that advise them to engage in illegal activities.

### **Solutions: The Need for a Balanced Approach to Program Integrity**

DOL has placed intensive emphasis on overpayment detection and recovery in the past, but very little attention on detecting mistaken denials and employer fraud. As noted above, it has collected overpayment data annually since 1987. Over the last two years, it has developed new accuracy and integrity measures focused entirely on overpayments. It has issued grants to states for improved overpayment detection. It has implemented five different systems of cross-matching social security, wage and work search data in order to detect erroneous and fraudulent overpayments.

By contrast, DOL's efforts to capture underpayments and employer fraud have been more recent and less aggressive. DOL issued its first-ever report on mistaken denials of UI benefits only this year. Anti-SUTA dumping legislation has also just recently been proposed. States engage in quarterly audits of small numbers of employers who misclassify workers.

DOL could do more to distribute the 1.36 billion dollars in mistaken denials to eligible unemployed workers. It could do more to recover the estimated 200 million dollars in taxes lost per year to the UI system since the 1990s. For example, DOL can use some of the same methods for detecting employer fraud that it has used to detect claimant overpayments. It should give grants to states to track down employers who are cheating. It should give states more tools to detect fraud on the part of employers, including employer misclassification. Model legislation should include stiff penalties for employers who underpay their taxes by misclassifying workers or by any other means. Program integrity means both workers and employers should have integrity.

**Underpayment detection:**

- DOL should set performance goals in the area of denied claims accuracy to go along with timeliness and overpayment performance standards.
- Congress should increase UI administrative funding to improve the overall quality of UI administration.
- States should use some of the eight billion dollars in Reed Act funding, distributed in March 2002, to develop better systems to track and remedy underpayments and to locate employers who cheat on their payroll taxes and fail to report wages.
- State programs supporting legal services for representation of workers denied UI claims and improved UI appeals systems also will reduce improper denial rates.

**Misclassification:**

- DOL should develop statistical models, as it has for claimant profiling, which would help states target industries that are likely to engage in misclassification and other forms of tax evasion.
- DOL should mandate that states investigate the extent of misclassification problems within a state, mandating that all states perform targeted audits in industries most susceptible to employer misclassification.
- In recent years, Rhode Island and North Carolina have enacted laws that require comprehensive studies of nonstandard work. State commissions established in New Hampshire and Maine held hearings and submitted recommendations for legislation to address nonstandard work in the unemployment insurance program specifically. A special investigation in New Jersey documented abuses in the contract labor system. More states should analyze the extent to which misclassification has cheated workers and the UI tax system.
- DOL should take a leadership role in forging a strong relationship between the IRS and SESAs to routinely share 1099 data. (Recommended in Planmatics, 2000)
- DOL should investigate new technologies (e.g. intelligent collection systems, pattern recognition) that can be used to track “independent contractors” and their employers. (Planmatics 2000)
- DOL should develop a repository of information on independent contractor issues, best practices, new initiatives, and legislative measures. This information should be updated frequently and publicized, and its contents made accessible to agencies dealing with independent contractors. (Planmatics 2000)
- DOL should also develop “best practices” for efficient use of appeals process in ways that correct more errors, and develop information and best practices on techniques that reduce underpayments due to administrative error.

- DOL should sponsor federal legislation to remove the “safe harbor” provisions from Section 530 of the Revenue Act of 1978, which unnecessarily protects employers who misclassify workers. (Recommended by the Advisory Council on Unemployment Insurance in 1995).

**SUTA dumping:**

- Congress should quickly approve the anti-SUTA dumping legislation, including the requirement for civil and criminal penalties against employers and the advisors who encourage SUTA dumping.
- States should coordinate enforcement activities against accounting firms and employers who engage in SUTA dumping across state lines.
- DOL should give grants to the states to develop techniques for investigating employer fraud, just as they now give grants to states to develop techniques to investigate employee fraud.
- DOL and the states should increased penalties for employers who underpay their state UI taxes or who pay late.

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## Appendix – Lost Benefits Calculations

We applied the methodology and data from Vroman and Woodbury, 2000, to find a rough estimate of the amount of benefits lost through denied claims. The losses must be estimated because the workers have not actually received a UI check.

Coming up with such an estimate requires summing up the benefits lost for three different types of denials: monetary, separation and nonseparation. In each category, the cost of the improper denial is the average weekly benefit amount times the average weeks of benefits that would be received times the number of improperly denied claims (based on the DCA estimates)

In the pilot study, denied claimants were found to have below average potential weekly benefit amounts based on their prior earnings. Workers erroneously denied benefits for monetary reasons would have qualified for a benefit rate that was 0.859 of the AWBA. For separation denials, the number is 0.866, for nonseparations its 0.909. We apply these numbers to the 2002 nationwide average weekly benefit amount of \$256.77.

The average duration of benefits depends on the type of denial. Workers denied for monetary reasons will lose an entire claim of benefits—so we assume that they would have the same duration as the U.S. 2002 average—16.5 weeks. Separation denials can be made on an initial claim or on an additional initial claim. Additional initial claims occur after a break in a worker’s unemployment benefits. In 2002, 60% of initial claims were new and 40% were additional claims. Following Vroman’s methodology we assume that 60% of separation denials would be on new initial claims and be for full duration and 40% would be on additional initial claims. We adjust the duration for separation denials to be  $(P_{new} * 16.5) + ((1 - P_{new}) * (16.5/2)) = 13.2$  weeks. Finally, all nonseparation denials would occur after worker first receives benefits. Vroman finds that 57.7% of nonseparation violations have a penalty that equals a full loss of benefits and for the rest it is a single week. We assume that a violation would occur at the midpoint of the spell and thus the duration would be half as long. Applying the adjustment to take into account additional and initial claims, we reduce this amount by 80%:  $(P_{new}) + ((1 - P_{new}) * (0.5))$ , with  $P_{new}$  equaling 0.6. Thus the total average duration of nonseparation denials is  $\{[(.80) * (AvgDur/2) * (P_{multi-week})] + (P_{single-week} * 1)\}$  or  $(0.8 * 8.25 * 0.42) + (0.57 * 1)$ , which is equal to 3.3 weeks.

We apply the adjusted DCA estimates to the entire population of US denied claims, in order to make a comparison with the BAM data. The adjusted denial rates are 9.4% for monetary denials, 5.7% for separation denials and 9.2% for nonseparation denials. Using these rates produces a conservative estimate. The populations for these denials are 1.68 million monetary denials, 2.29 million separation denials and 2.60 million nonseparation denials. Also, not all workers who receive an affirmative monetary determination actually receive benefits, as some are then denied for separation reasons. For the cost estimate, we apply a 20% reduction factor to monetary denials based on the ratio of first payments to monetarily eligible claimants.

The data for this section come from ETA forms 207 and 218, submitted by the states to the US Department of Labor. The calculations are listed below.

Table 2 – Calculations For Denied Claims Lost Benefit Analysis

	Estimated Average Weekly Benefit Amount	Estimated Average Duration (Weeks)	# of Improperly Denied Claims (2002)	Total Underpayments on Denied Claims
Monetary	\$220.82	16.5	126,168	\$459,701,942
Non Separation	\$233.40	3.3	240,033	\$187,233,990
Separation	\$222.36	13.2	130,797	\$384,395,264
Total Denied Claims				\$1,031,331,196