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Committee on Ways and Means

Subcommittee on Human Resources

Testimony of  
National Employment Law Project  
on

**U.S. Department of Labor's FY 2007 Budget  
For Unemployment Insurance**

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**I. Introduction**

The National Employment Law Project (NELP) thanks the Subcommittee for the opportunity to submit testimony on the U.S. Department of Labor's FY 2007 Budget request for Unemployment Insurance. National Employment Law Project is a nonprofit law and policy organization dedicated to research and advocacy on issues of concern to low wage and jobless workers, including unemployment compensation. For over 30 years, NELP has served as the leading voice of jobless workers, with an emphasis on policies and practices that impact low wage and part time workers. NELP research has identified and supported wider use of alternative base periods to qualify more low wage workers for unemployment benefits as well as policies that assist jobless workers facing work and family conflicts. NELP also serves other low wage workers, including immigrants, day laborers, and nonstandard workers.

**II. Background**

The FY 2007 budget includes a list of measures to improve the "program integrity" of the unemployment insurance system. Our testimony will focus on two of these: the use of private collection agencies to collect UI overpayment debts, and the collection of UI overpayments through federal tax returns. Since the actual language of the proposals themselves are not yet available, our analysis focuses on budget documents describing the proposals. Our analysis of the package of Program Integrity proposals finds them generally to continue, as in previous years, to equate all overpayments with the commission of fraud by the claimant, even though most are caused by simple errors on the part of claimants, employers and job service personnel. Further, the budget unfortunately proposes to continue a trend in reduced funding for adequate UI administration that could prevent overpayments before they happen, favoring instead a post-overpayment enforcement approach which may prove more cumbersome and expensive than simple adequate funding for UI administration, both on overpayments and underpayments, and both on taxes and benefits. Instead,

we believe the Administration should place more emphasis on assisting states in addressing what appears to be widespread practice of employer tax evasion and avoidance. Our testimony focuses on two of the proposals directed towards overpayments – the use of private collection agencies to collect UI overpayment debts and the collection of UI overpayments through federal tax refunds.

### **Fraud v. nonfraud overpayments**

The Administration's proposals on overpayments continue to equate all overpayments with fraud by claimants. Generally, an overpayment in the UI system is 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. Fraudulent payments are a subset of all overpayments, generally involving a knowingly false statement or misrepresentation of facts to receive benefits to which s/he is not entitled. In 2005, only 38% of all overpayments established by states (\$390 million) were due to fraud.<sup>1</sup> The rest are classified as non-fraud. Thus 60% of errors are caused by misunderstanding of program rules or some other cause that was not willful on the part of the claimants.<sup>2</sup>

Approximately 30% of overpayments are caused by errors on the part of the UI agency or employers, or some combination of factors – not solely due to the claimant's error. In fact, only half of non-fraud overpayments in calendar year 2005 were caused by claimants alone.<sup>3</sup> A significant proportion of overpayments come as a result of reversals. In these cases, front line DOL staff grant a worker their benefits but later decide to reverse the decision, usually after an employer objection that occurs after the fact, or even by an after-the-fact change in the interpretation of the state law. Nonfraud overpayments include contested areas of UI policy like downsizings that include early retirements where the law is evolving.

States are adept at overpayment recovery: in CY 2005, 51.6% of the overpayments established by states were recovered through the myriad methods of recovery currently available to

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<sup>1</sup> US Department of Labor, ETA 227 Data, written communication with the authors.

<sup>2</sup> See, Bush Administration FY 2007 Budget to Unfairly Penalize Jobless Workers (NELP, April 2006).

<sup>3</sup> Ibid.

the states.<sup>4</sup> In this context, the additional proposals in US DOL's budget are unnecessary. Two proposals are worthy of separate mention.

### **III. Specific Program Integrity Proposals in Budget**

#### **A. IRS Offset: Complicated, costly, and burdensome to working poor.**

The proposal to offset overpaid benefits from income tax returns was first made in the FY 2005 budget. While some changes have been made to the proposal since that time, it suffers from many of the same defects as it has in previous years. Above all, it can result in complicated offsets against the offset itself for taxes already paid on UI benefits received, it will have very limited use against employers who are underpaying taxes and will instead be focused on low-wage workers and their innocent spouses.

**Offsetting against the offset:** Using an IRS offset could have a cascade of retroactive consequences for an individual's past tax liability and could result in a cost to the federal government. This is because UI benefits are taxable income. Therefore, individuals subject to the offset may well be owed money as a refund on taxes they paid on the UI benefits.<sup>5</sup> If tax returns are subject to federal offset, the IRS would either need to refigure taxes and offset the tax overpayment against the benefit overpayment – a level of cost and complication that makes the proposal unworkable – or require individuals to file for a retroactive adjustment to their taxes, which would then need to be processed by the IRS. If taxes were not recalculated, these individuals would, in effect, be subject to a tax hike.

**Harm to the working poor:** The proposal would apply mainly to low-income individuals, who are already hard-pressed to meet necessary family needs. This is because tax refunds affect

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<sup>4</sup> US Department of Labor, ETA 227 Data.

<sup>5</sup> While some states already use an offset against state income tax refunds as a means to recoup overpayments, since UI benefits are only taxed at the federal level, this issue does not arise from state offsets.

the low-income far more than they do the wealthy. In fact, two-thirds of all taxpayers with incomes below \$30,000 receive an income tax refund, while only 7% of taxpayers with incomes over \$100,000 receive such a rebate. CPS data suggest that, among family heads with children, 41% of unemployment claimants in 2004 have incomes low enough to qualify for the Earned Income Tax Credit in tax year 2004 (i.e., filing by April 15, 2005), compared to only 24% of the general tax-paying population.<sup>6</sup> Thus, the offset would apply to deny a refund to families who need every dime to sustain themselves.

**Breadth of proposal can punish innocent.** Language available to date on the IRS offset proposal is not clear how the federal offset would correspond to a state insurance system which has its own laundry list of recovery provisions, as well as limits on recovery. First, it is not clear that current Treasury Offset Program (TOPS) procedures for “innocent spouses” to request a refund of money withheld through the acts of a spouse would apply. Second, the proposal does not appear limited to fraud overpayments, and could therefore sweep up innocent, low-wage taxpayers who are making an effort to repay their debt. Finally, it is unclear how the proposal might interact with the specific provisions in 37 states, which have laws allowing non-fraud overpayments to be waived, where the claimant is not at fault and is unable to repay because of economic hardship. Claimants (and their innocent spouses) may, for example, be subject to a tax offset for a waivable overpayment, simply because they have not yet submitted the overpayment request to the state agency. Claimants would then be required to file petitions for a full return, or a return of the spouse’s share of an offset, due to waiver of the overpayment. Since most states waive overpayments because of economic hardship, the IRS offset would mean these families would be forced to do without income that they have already demonstrated is needed for their families’ survival.

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<sup>6</sup> Center on Budget & Policy Priorities Calculations from the Current Population Survey.

**Limited use against employers who cheat:** The IRS offset will be of limited use against employers who have underpaid taxes. According to the proposal itself, “in many cases, this involved an individual who has been held liable by states for UC tax liabilities incurred while operating as a solely-owned corporation.”<sup>7</sup> Thus, the majority of businesses in this country -- those who are not solely-owned corporations – will apparently not be subject to the offset.

#### **B. Use of Collection Agencies: Ticket to harass.**

The proposal to allow states to turn over collection activities to collection agencies was made in FY 2006. States are already free to use collection agencies at this time, but FUTA and the Social Security Act both currently require that UI trust fund withdrawals are limited to benefit payments, and overpaid benefits have always been returned to the trust funds in the past. The FY 2007 proposal would allow collection agencies to retain a portion of the collected overpayments, as much as 25%, an amount which would then be taken directly from state trust funds.

**Most complained-about industry:** Private collection agencies remain the most complained-about industry in the nation with respect to unfair and abusive tactics. In fact, complaints about their non-compliance with the Fair Debt Collection Practices Act increased by 14% in one year, according to the Federal Trade Commission’s annual report.<sup>8</sup> The actions of debt collectors described in the FTC report include demanding a larger payment than is permitted by law; harassing the debtor or others; threatening ‘dire consequences’ if the consumer fails to pay; making impermissible calls to a consumer’s place of employment; revealing an alleged debt to third parties;

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<sup>7</sup> U S Department of Labor, Unemployment Insurance Performance Budget Issue Paper, *Unemployment Insurance Integrity and Reemployment*.

<sup>8</sup> FEDERAL TRADE COMMISSION ANNUAL REPORT 2006: FAIR DEBT COLLECTION PRACTICES ACT <http://ftc.gov/os/2006/04/P0648042006FDPCARreport.pdf> While

failing to verify disputed debts; continuing to contact consumers after receiving a “cease communication” notice; and others.

**Duplicating work at a cost to trust funds.** Payments to collection agencies would come directly from overpaid benefits, which would be diverted from state trust funds. While states may be required to use their own efforts to collect overpayments before turning to private collection agencies, the availability of collection agencies will discourage states from using their own mechanisms for UI debt collection. Because they work on contingency, collection agencies will either be tempted to engage in the abusive tactics noted above, or focus on the easiest, freshest, least complicated cases that state agencies are well-equipped to handle themselves. The proposal lacks any evidence that private collection agencies could beat the laudable success records of the state agencies in recovery of overpaid benefits.

**Lack of privacy controls.** Because the full language of the proposal is not yet available, it is unclear how states’ existing processes, including privacy controls, and their own recovery efforts via would interface with collection agencies’ often harsh tactics. For example, how would the state determine that the collection agency’s work resulted in payment, compared with the efforts of the state agency itself?<sup>9</sup> Because resolution of this issue has an effect on the trust fund, it would need to be resolved. How would the state agency ensure that the collection agency kept information private, and did not use information it received from the state agency to collect other debts? Even when privacy protections exist, private contractors have an abysmal record of protecting the confidentiality of taxpayer information.<sup>10</sup>

The IRS has taken a “go slow” approach to a similar law allowing it to use private collection agencies to collect tax debt. Congress in 2004 gave the IRS authority to contract debt collection to

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<sup>9</sup> Colorado has just passed a law limiting recovery by collection agencies in this circumstance, after testimony revealed abuses by collection agencies in the child support enforcement context. See, HB 06-1066.

<sup>10</sup> See, e.g., Office of the Inspector General, Social Security Administration, *Federal Agencies’ Control over the Access, Disclosure and Use of Social Security Numbers by External Entities*, February 2003.

private companies.<sup>11</sup> That program included safeguards to protect taxpayer privacy, as well as training and monitoring provisions. Protections include that work must be done in the United States, that collection agencies are subject to background checks, that collection agencies may not use information that they have received in order to collect other debts, and that they may be charged with a felony if taxpayer information is disclosed to others. A limited trial, with three debt collection companies, will begin this summer.<sup>12</sup> This proposal should, at the least, await the results of the IRS experiment.

**C. Funding UI administration adequately would do more to stave off overpayments.**

The shrinking of dollars used for state Administration of UI programs has been a challenge for state agencies for several years. In fact, the President's FY 2007 proposal brings UI Administration only slightly higher than it was in 2003, and far less than what is needed to administer programs. These shortfalls in UI administration severely hampers the efforts by states to make accurate initial determinations of eligibility, thus avoiding overpayments. US DOL's most recent report indicates that 33.5% of initial determinations nationwide did not meet federally-established quality standards.<sup>13</sup> In order to make more accurate initial decisions, and avoid costly overpayment recoupment activities, states need adequate administrative funding.

**D. Employer Tax collection efforts do not address larger employer fraud issues.**

The Administration's FY 2007 proposals respond in part to criticisms that its past Program Integrity measures have been one-sided. However, the proposals made for FY 2007 do not adequately address the very real problems of employer-dumping of UI tax rates and misclassification of workers as independent contractors. Continued reduction in UI Administration has meant that

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<sup>11</sup> Sec. 6306 of America's Jobs Creation Act.

<sup>12</sup> Amelia Bruger, *House votes to bar IRS from Outsourcing tax collection*, Daily Briefing govexec.com (September 15, 2004); IRS, US Department of the Treasury, *Private Debt Collection Imminent in IRS Future*, (June 30, 2005); *3 private debt collectors get IRS work*, USA Today, March 9, 2006, at [http://www.usatoday.com/money/perfi/taxes/2006-03-09-irs-debt-collectors\\_x.htm?csp=34](http://www.usatoday.com/money/perfi/taxes/2006-03-09-irs-debt-collectors_x.htm?csp=34).

<sup>13</sup> UI Performs, 2005.

states are struggling to adequately fund their program integrity efforts directed towards employers. The enforcement tools proposed in the FY 2007 budget are no substitute for adequate funding.

The FY 2007 proposal includes items involving collecting unpaid employer taxes as well as overpayments by deduction from federal income tax returns. The Administration's collection agency proposal would also allow private collection agencies to collect delinquent taxes. As noted, however, to the extent they are used against employers at all, the income tax and private collection agency provisions themselves lack adequate safeguards, and will result in a cumbersome process for all those subject to them, workers and employers alike.

The budget proposals with respect to employer taxes unfortunately miss the mark. The issue with respect to unpaid employer taxes is less one of **collecting** taxes than it is one of **detecting taxes that are owed**. In 2004, for the eighth year in a row, states audited only 1.7% of their employers, and focused their audits on small employers.<sup>14</sup> The USDOL recommended audit level is 2% of employers. Many states cite the continued reduction in administrative funding as a reason that these efforts fall short. Even though nearly half of these audits resulted in changes in the wages reported to the states, there has been no increase in the states' ability to audit more employers over these eight years. Cash-strapped state administrations are increasingly skimping on their audit functions, with the result that program integrity measures intended to recover unpaid taxes have been hampered.

The budget and policy documents would do well rather to focus on some unfinished business: In 2004, when federal SUTA dumping legislation was enacted, it completely ignored one of the most common and critical forms of tax evasion by employers: the transfer of employees from a company's direct payroll into the account of a professional employee organization (PEO), which lists itself as the nominal "employer" of workers, and promises to lower employers' tax rates by pooling their UI experience rating.<sup>15</sup> States that have taken their SUTA dumping responsibilities seriously are finding

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<sup>14</sup> UI Performs, p. 38.

<sup>15</sup> For more detail on this issue, see testimony submitted by Rick McHugh, NELP, to this Committee for its June 14, 2005 hearing on Implementation of the SUTA Dumping Prevention Act of 2004.

that the PEO scam is an important method of tax evasion: California estimates that half of the \$100 million that it loses in employer taxes each year comes from PEO schemes. Federal legislation should be drafted that requires states to address the PEO issue.

Second, states need additional resources in order to use the tools that the Internal Revenue Service has available for detection of SUTA dumping and misclassification of workers as independent contractors. With respect to SUTA dumping, while the Administration has made some funds available for implementation of SUTA Dumping Detection systems, these grants have not been sufficient for states to purchase the hardware that is necessary, train their staff to implement the programs, or provide the resources to investigate and prosecute SUTA dumping schemes by employers. The Administration's proposal to allow states to retain 5% of SUTA dumping taxes they have recouped for this purpose, while laudable, will increase recovery of unpaid taxes by less than \$3 million for these activities nationwide per year.<sup>16</sup>

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." A recent DOL Office of Inspector General Report indicates that while the IRS has several data sets available to states that would assist them in detecting underpaid taxes, only nine states are currently making use of that data.<sup>17</sup> Seven of the nine states reported that they identified 7,118 misclassified employees, recovered \$1,492,521 in underreported UI tax contributions, and adjusted for overreported UI tax contributions as well. Two-thirds of the audits resulted in changes in the employer's reports of taxes. At least one state, New Jersey, that uses the IRS process to target employers has an even higher success rate, of 70%.

Despite these success rates, states reported difficulties with their own IT processes, procedural difficulties in communicating with the IRS and meeting its safeguards, as well as "other priorities" as reasons that they were not using the IRS data sets.<sup>18</sup> Because the IRS data sets are so

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<sup>16</sup> US Department of Labor, *Unemployment Insurance Integrity and Reemployment*.

<sup>17</sup> US Department of Labor, Office of Inspector General, USE OF IRS FORM 1099 DATA TO IDENTIFY MISCLASSIFIED WORKERS (September 2005).

<sup>18</sup> *Id.*, p. 10.

large, states were required to load it on their mainframe computers. They also faced IT challenges in converting the tapes to documents that could be useful to auditors in the field. While OIG was satisfied that ETA, having convened a telephone conference call and presented this issue at its National UI Tax Conference, was meeting its obligations, there are many other activities, in provision of IT resources, training, and grants to states to help them prioritize use of this data, that can uncover additional tax cheating.

Finally, the Administration continues in its failure to devote significant resources to underpayment of UI benefits, as opposed to overpayments. To put this issue in perspective, in 2002, DOL statistics showed \$888 million annually in UI overpayments that are attributed to fraud on the part of workers. In that same year, NELP estimated \$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 CY 2004, the states' improperly decided 14.2 percent of monetary denials. Thus, 168,000 of 1.2 million denials in CY 2004 were improper. Certainly, overpayment of UI benefits is a serious matter that states must address. But the Administration could do far more to aid states in their detection and recovery of unreported and unpaid employer taxes through fraudulent misclassification of workers as independent contractors and dumping of their experience-rated tax charges.

### **Conclusion**

We thank the Committee for the opportunity to share our views of the Program Integrity initiatives in US DOL's FY 2007 budget. We look forward to answering any questions that the Committee may have, and may be contacted at the numbers listed on this document.