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Repeal the Federal Job Tax

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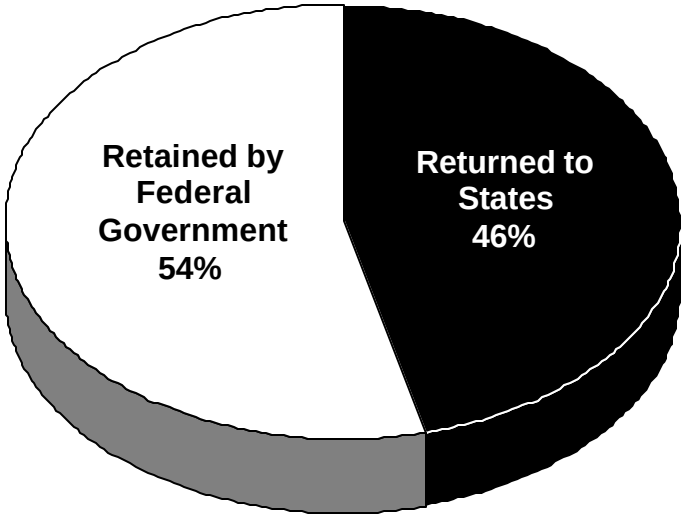
Employment has declined in most states, but the federal government continues to tax it. Employers in the 50 states will send an estimated $7.2 billion to Washington, D.C., in federal unemployment insurance taxes this year. The money will be credited to a "trust fund" from which it is supposed to be returned to the states to pay for administration of the unemployment insurance system and for other employment-related programs. Less than half is. Congress has spent roughly $30 billion of unemployment tax revenues on other programs, dropping IOUs into the trust fund as if they were real assets. Fortunately, the Bush administration has made some common-sense proposals to free up the employment tax revenue.

What Is the Federal Tax on Jobs? State unemployment insurance taxes pay cash benefits to workers, while the federal government collects an additional unemployment insurance tax (FUTA, after the Federal Unemployment Tax Act) from employers in every state. The basic FUTA tax is 0.6 percent on up to $7,000 of each employee's wages each year. After the 1973-75 recession, Congress added a 0.2 percent surtax, for a total tax rate of 0.8 percent. The surtax was supposed to replenish the federal unemployment trust fund that lends money to state programs that run short during periods of high unemployment. (Note that government trust funds are just accounting entries — promises to spend money for a designated purpose.) The replenishment was accomplished, and then some, but Congress maintains the surtax.

FIGURE I

Federal Unemployment Tax



Source: U.S. Department of Labor.

FUTA taxes are supposed to be returned to the states to pay administrative expenses, the "federal share" of extended unemployment benefits and for the aforementioned loans. However, as Figure I shows, only 46 percent of the dollars collected from the states were expended in 2000, the most recent year for which data are available. The states collected more than $20 billion in unemployment insurance taxes in 2000. The additional FUTA tax comprises nearly a third of the total funds that could be made available for state programs. [See Figure II.]

What's Wrong with the Federal Job Tax? There is some logic in taxing employment to administer the unemployment insurance system. There is no logic in collecting the tax but not spending the money for its intended purpose. FUTA is a payroll tax that is mostly passed on to workers, reducing their net income. Taxing jobs also raises the cost of employment and lowers the number of available jobs. The nation, states and cities have raised taxes on cigarettes and alcohol to reduce their consumption; if the FUTA tax has the same effect on employment, it is counterproductive.

Furthermore, the FUTA system stifles state efforts to help the unemployed. For instance:

- The formula for distributing administrative money to the states is based on the numbers of claims they process, appeals hearings they hold, checks they distribute and so forth; states that do a better job of getting people back to work lose funding.
- Some of the FUTA tax is credited to a trust fund that lends money to state unemployment insurance funds that run out of money; the interest rate on these loans

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is higher than the rate states pay to borrow on their own.

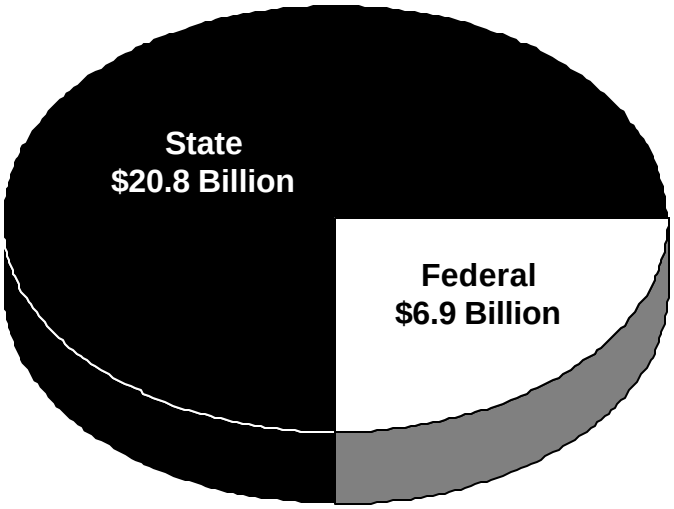
These perverse incentives discourage states from providing better services to the unemployed.

How to Return the Money to the States. The first step in returning the money to the states is for the federal government to stop collecting it. After the 0.8 percent federal tax is eliminated, states could cover their own administrative expenses with a tax averaging only 0.4 percent of wages. (The exact amount of the tax would vary from state to state.) Since the states already collect unemployment insurance taxes from employers, they could easily add the administrative tax.

Returning to the states the tax revenues that have not been spent on unemployment insurance is the second step. This amounts to about $30 billion, or nine times the annual administrative expenses the federal government pays. The states could use this money to bolster their state unemployment trust funds, and to delay the new administrative tax until the U.S. economy recovers from the recession.

FIGURE II

Unemployment Insurance Taxes, 2000



Source: U.S. Department of Labor.

To replace the loan fund, states could agree to borrow and lend among themselves. As an ultimate safety net, the federal government could lend the states money from general revenues.

Finally, with the federal government no longer taking money from employers, states could fund extended unemployment benefits themselves.

Benefits of Returning Tax Revenues to the States. Employment would likely increase in every state if the FUTA tax were eliminated. It is also possible that spending more to help the unemployed find jobs faster would save more than it costs; some job search seminars save more in benefits than they cost. Under current law, states cannot make trade-offs between administrative and benefit funds. Without FUTA, states could more rationally allocate resources to help the unemployed — and reduce the cost of unemployment insurance.

Finally, eliminating the FUTA tax would substantially reduce the administrative burden on employers, which hits small business especially hard. Employers today must file two unemployment insurance tax returns, one to the federal government and one to their state. The forms are different, and so are some of the filing deadlines.

Time to Change. The Bush administration's proposed reforms would gradually cut the FUTA tax from 0.8 percent to 0.2 percent of wages. States would finance their own administrative services. Some of the FUTA funds not previously spent on unemployment would be returned to the states to pay the costs of transition to the new system. The federal government would continue to lend money to states that run short.

Although not as thoroughgoing as the reforms this paper suggests, the Bush proposal would return most of the FUTA money to the states and stimulate them to find better ways to boost employment. For the unemployed, this would be a giant step forward.

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