

GAO

Report to the Chairman, Subcommittee
on Human Resources, Committee on
Ways and Means, House of
Representatives

July 2006

UNEMPLOYMENT INSURANCE

States' Tax Financing Systems Allow Costs to Be Shared among Industries





Highlights of [GAO-06-769](#), a report to the Chairman, Subcommittee on Human Resources, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

In 2006, the Unemployment Insurance (UI) program is expected to collect over \$37 billion in taxes from employers to pay \$34 billion in benefits to unemployed workers. Under state UI programs, employers' tax contributions are experience-rated—that is, they reflect the extent to which they laid off workers who then collected benefits. To examine the equity of this system, we met with officials from five states, reviewed prior studies, and examined state data to determine (1) how states ensure that employers pay UI taxes based on their experience with unemployment, and the aspects of state unemployment insurance systems that limit experience rating; (2) the extent to which employers pay unemployment insurance taxes commensurate with unemployment benefits paid to their former employees; and how this varies by industry; and (3) steps states could take to increase the degree of experience rating.

We provided a draft of this report to the Department of Labor (Labor) for its review. Overall, Labor agreed with our findings.

www.gao.gov/cgi-bin/getrpt?GAO-06-769.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Sigurd R. Nilsen at (202) 512-7215 or nilsens@gao.gov.

UNEMPLOYMENT INSURANCE

States' Tax Financing Systems Allow Costs to Be Shared among Industries

What GAO Found

All state Unemployment Insurance-financing systems are experience-rated, but several aspects of these systems limit the connection between an employer's tax contributions and the employer's experience with unemployment. For example, a state's maximum tax rate limits the size of an employer's tax payment, regardless of the costs an employer may have imposed on the system. Similarly, a minimum tax rate ensures that an employer's tax rate will not drop below a specified floor, no matter how much its experience rating improves. Other aspects of state systems allow the cost of some benefits to be charged to all employers rather than to a single employer. These shared costs include, for example, benefits paid to unemployed workers of a firm that has gone out of business. When the cost of benefits is shared in this way, it reduces experience rating and imposes additional costs on all employers.

A series of studies that examine experience rating in state UI systems show that a number of industries used more in benefits than they paid in taxes to finance the system. Certain industries, such as construction and agriculture, forestry, and fisheries, as a whole, consistently received such subsidies, while other industries, such as finance, insurance, and real estate tended to pay subsidies. Newer firms that are not yet experience-rated, regardless of industry, also tend to pay subsidies. Our analysis of more recent data from three states found a similar pattern of subsidies.

States could increase experience rating and reduce subsidies by adjusting aspects of the unemployment insurance tax structure, such as the maximum tax rate. However, each of these adjustments has trade-offs that would have to be considered by a state because the adjustments would raise costs for some employers or reduce costs for others. In addition, such adjustments would have to be evaluated based on the implications for other policy objectives established for a state's unemployment insurance program.

Unemployment Insurance Benefits Charged and Taxes Paid by Selected Industries in Washington State from 1999 to 2004



Source: GAO analysis of data from the Washington State Employment Security Department.

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Abbreviations

ERI	Experience Rating Index
FUTA	Federal Unemployment Tax Act
GAO	Government Accountability Office
NAICS	North American Industry Classification System
SIC	Standard Industrial Classification System
UI	Unemployment Insurance

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United States Government Accountability Office
Washington, DC 20548

July 26, 2006

The Honorable Wally Herger
Chairman
Subcommittee on Human Resources
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Unemployment compensation is a social insurance program designed to partially replace the lost wages of individuals who become involuntarily unemployed and to stabilize the economy in times of economic recession. In partnership with the federal government, individual states administer the Unemployment Insurance (UI) program and fund benefits through payroll taxes levied on employers. In 2006, employers are projected to make state unemployment tax contributions of over \$37 billion, and an estimated \$34 billion will be paid in benefits to unemployed workers.

All state UI systems are experience-rated so that employers' contribution rates are risk-based, and nearly all vary according to how much or how little their workers received unemployment benefits. In principal, this means that an employer who lays off many workers that claim unemployment insurance benefits will pay more in taxes than an employer that lays off fewer workers that claim benefits. However, very limited federal guidance governs how states are to implement the experience-rating provision. Further, because unemployment programs serve as social insurance programs, it is generally recognized that some high-layoff employers may, over time, pay less in taxes than benefits paid to their former workers, while other employers may pay more.

Wanting to know about the equity of state systems of unemployment insurance financing, you asked that we explore how the taxes that pay for the system are distributed among employers. Specifically, we addressed the following questions:

1. How have states ensured that individual employers pay unemployment insurance taxes based on their experience with unemployment, and what aspects of state unemployment insurance systems limit such experience rating?

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2. To what extent do employers pay unemployment insurance taxes commensurate with unemployment benefits paid to their former employees, and how does this vary by industry?
 3. What steps could states take if they wished to ensure that the taxes paid by individual firms more closely matched the benefits paid to the former employees of each firm?

To answer the first and third questions, we reviewed pertinent literature and interviewed Department of Labor (Labor) officials and officials of national organizations representing the perspectives of business, labor, and state unemployment insurance agencies, as well as nationally recognized experts on unemployment insurance. We also conducted in-depth interviews with representatives of unemployment insurance agencies in five states—California, Illinois, Michigan, Texas, and Washington. We selected these states because they are relatively populous and geographically dispersed, and because they take different approaches to ensuring experience rating. We discussed each state’s approach to financing unemployment insurance benefits, and the implications that various aspects of these systems had for experience rating and the existence of cross-subsidies. In addition, we reviewed pertinent documents describing the unemployment insurance-financing systems in each of these five states. To answer the second question, we identified and reviewed 10 studies published between 1972 and 2000 that measured how closely taxes paid by firms and industries matched the benefit costs they imposed. We confirmed with the Department of Labor and national experts on unemployment insurance that these 10 studies constituted the definitive work done to date on this subject. To supplement these studies, we obtained data on tax and benefits payments by industry type from three of the five selected states. We determined that the data were sufficiently reliable for our purposes. See appendix I for more details on scope and methodology.

We conducted our work between September 2005 and June 2006 in accordance with generally accepted government auditing standards.

Results in Brief

All states have established experience-rated unemployment insurance financing systems, but several aspects of these systems limit the connection between an employer’s tax contributions and the employer’s experience with unemployment. In nearly all states, unemployment insurance taxes are based on some measure of benefits paid to a firm’s former workers. However, over time, taxes may not equal benefits for

several reasons. Some aspects of state systems limit firms' tax payments. For example, a state's maximum tax rate limits the size of an employer's tax payment, regardless of the costs an employer may have imposed on the system. Similarly, minimum tax rates ensure that an employer's tax rate will not drop below a specified floor, no matter how much its experience rating improves. Other aspects of state systems cause significant portions of total benefit payments to become "shared"—that is, to become a common cost of all firms. For example, under some conditions, states pay benefits but do not attribute those benefits to a specific employer. One type of such a "noncharge" is a benefit payment made that is finally reversed, but not recovered. Such shared benefit costs reduce experience rating and impose additional costs on all employers. The manner in which states distribute the cost of these benefits, in order to recoup them, also affects the match between taxes paid and benefits charged to each employer.

Studies performed since the 1970s show that considerable cross-subsidization exists among firms and industries in states' unemployment insurance systems. Certain industries, such as construction and agriculture, forestry, and fisheries, as a whole, consistently pay less in unemployment insurance taxes than in benefits received by their former employees, which is likely due to the cyclical or seasonal nature of these industries. In some cases, the differences between taxes paid and benefits received can be substantial. For example, our analysis of 1999-to-2004 data from Illinois shows that firms in the construction industry paid more than \$1 billion less in unemployment insurance taxes than the unemployment benefit costs charged to them. Other industries, in particular finance, insurance, and real estate, tend to have more stable or growing employment and pay overall subsidies. Yet studies using firm-level data have also found that there is a considerable amount of cross-subsidization within industries. For example, although construction is found to be the most consistently subsidized industry, an intra-industry analysis using data from Texas finds that the majority of firms within that industry are paying more in taxes than in benefits received by their former employees. In addition, newer firms that are not yet experience-rated, regardless of industry, tend to pay subsidies.

States could increase experience rating and reduce cross-subsidies by adjusting aspects of the unemployment insurance tax structure, such as the maximum tax rate and the taxable wage base. However, each of these adjustments has trade-offs that would have to be evaluated by a state because these adjustments would raise costs for some employers or reduce costs for others, and have implications for other policy objectives

established for a state's unemployment insurance program. For example, according to officials of the California Employment Development Department, the state's current unemployment insurance-financing system was explicitly developed so that high-unemployment industries important to the state's economy—specifically, construction and agriculture—would not bear the full cost of benefits paid to workers in those industries. Consequently, while raising the maximum tax rate would make these employers pay a more equitable share, it could conflict with other state policy goals.

We provided a draft of this report to the Department of Labor for its review. Overall, Labor agreed with our findings.

Labor also provided technical comments on the draft report, which we have incorporated where appropriate.

Background

The unemployment insurance program was established in 1935 to (1) give workers temporary and partial insurance against income loss during unemployment for which they are not at fault, and (2) to help stabilize the nation's economy in economic downturns by maintaining workers' purchasing power. The program operates as a partnership between the states and the federal government.¹ Under this arrangement, Labor provides broad policy guidance and program direction, while the states design and implement specific program details. Within certain limits, states have broad autonomy in carrying out their basic program operations. They decide the requirements that unemployed workers must meet for eligibility, the amount of benefits, and the length of time they will pay benefits. They also decide on the tax rates employers must pay on their payrolls. Further, states can and do make changes in these and other aspects of their unemployment insurance system. As a result, state eligibility requirements, benefit levels, payroll tax rates, and trust fund balances vary, reflecting variations in program decisions and the economic fortunes of each state.

Federal and state payroll taxes on employers finance the UI program. The federal government uses the proceeds from its payroll tax to (1) pay for all

¹We use the term "states" to refer to the administrative entities of the 53 unemployment insurance programs that cover the 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

program administrative costs and one-half of extended benefit payments and (2) maintain a loan account from which financially troubled states can borrow funds to pay UI benefits.² The gross federal tax rate is 6.2 percent on the first \$7,000 paid annually by employers on each employee. If a state meets federal requirements, and has no delinquent federal loans, however, its employers are eligible for up to a 5.4 percent credit, making the net federal tax rate 0.8 percent. To receive the maximum federal tax credit, states must, among other things, establish a taxable wage base for state UI taxes at least equal to the federal wage base—currently \$7,000.

Most of the funds used to pay UI benefits come from the states, which levy a payroll tax on employers to finance regular UI benefits and one-half of extended benefits. States generally structure their UI taxes to include several tax rate components or schedules. In accordance with federal law, within a tax schedule, an employer's tax rate will vary according to the firm's experience in laying off workers who subsequently receive UI benefits, commonly called their experience rating.³ Those firms with many unemployed workers receiving UI benefits will generally pay a higher UI tax rate than firms with few workers receiving unemployment insurance. These tax rate schedules also vary according to some measure of a state's trust fund balance, with the highest tax schedules generally applying when state fund balances have fallen below a specified level. Each state maintains its own trust fund with the U.S. Treasury that is used for depositing program income and from which UI benefits are paid.

The experience-rating aspect of the unemployment insurance systems is unique in the world—the United States is the only nation that finances its UI system through an experience-rated tax. The objectives of experience rating are (1) the prevention of unemployment by inducing employers to stabilize their operations and thus their employment, so as to reduce their

²The federal tax includes a 0.2 percent surtax to reimburse the general fund for extended or supplemental benefits paid in the 1974-1975 recession. Repayment was completed in 1987, but the surtax has been extended through 2007.

³Under federal law, states are not granted the 5.4 percent credit on the federal tax unless their UI system is experience-rated. Specifically, the law states that a state may not offer reduced tax rates to an employer "except on the basis of his (or their) experience with respect to unemployment or other factors bearing a direct relation to unemployment risk during not less than the three consecutive years immediately preceding the computation date" (26 U.S.C. § 3303(a)(1)). States may also have reduced rates for newly subject employers on a reasonable basis.

tax rates, and (2) the equitable allocation of costs of unemployment benefits.

States' Unemployment Insurance-Financing Systems Limit the Degree of Experience Rating

Although all state and territorial unemployment insurance programs base an employer's tax rates on its experience with unemployment, the design of each state's financing system also limits the degree of experience rating. Nearly all state programs, for example, base tax rates on some measure of benefits paid to a firm's former workers. However, all states have a maximum tax rate that limits the financial liability of an employer, regardless of the amount of benefits paid to a firm's former employees. As a result, some employers will, over time, pay less than the full costs of benefits attributed to them. Also, some benefits are paid but not charged to an individual employer, partly because the employer is not at fault. These and other design features allow an employer's total tax payments to vary from total attributed benefits, over time.

Nearly All States Base Experience-Rated Tax Rates on Benefits Paid to a Firm's Former Workers

All state unemployment insurance programs adjust the tax rates of individual firms on the basis of their experience with unemployment, and 50 of the 53⁴ systems do so based on one of two basic systems—the reserve ratio system or the benefit ratio system.

In these 50 states, when unemployment insurance benefits are paid to a worker, the value of those benefits is “charged” to the worker's former employer or employers.⁵ Under both systems, benefits payments charged to a firm over a defined period of time become a key basis for an employer's experience rating. However, the reserve ratio system and the benefits ratio system also have important differences.

Under the reserve ratio system—used by 33 state and territorial unemployment insurance programs—states set up an account for each experience-rated employer. All taxes paid by an employer are credited to this account, and benefits to a firm's former employees are debited from this account. Ordinarily, this balance—or “reserve”—is carried forward

⁴Two states—Delaware and Oklahoma—use a system known as the benefit-wage-ratio system, and Alaska uses a system known as the payroll variation plan.

⁵States have different practices regarding the charging of benefits—some states charge benefit payments only to the most recent employer; others charge multiple employers, either in reverse chronological order or in proportion to the wages paid during the base period. Further, in some situations, benefits are paid but are not charged to a specific employer.

from year to year.⁶ The balance of this account is positive if cumulative tax payments are larger than cumulative benefits charged, and negative if cumulative tax payments are smaller than cumulative benefits charged. In each year, each employer's experience rating—the reserve ratio—is developed by dividing the firm's reserve balance by a measure of the wages paid by the firm—in most cases, an aggregate or average of 3 years' taxable wages. Table 1 illustrates the calculation of an experience rating using the reserve ratio method.

Table 1: Comparison of Reserve Ratio and Benefit Ratio Approaches

Reserve ratio ^a		Benefit ratio ^b	
Formula		Formula	
<u>Taxes paid minus benefits charged</u> Average of 3 years' wages		<u>Benefits charged over 4 years</u> Total wages over 4 years	
Relationship to tax rates		Relationship to tax rates	
The lower the reserve ratio, the higher the tax rate		The higher the benefit ratio, the higher the tax rate	
Examples			
Reserve ratio range:		Benefit ratio range:	
Maximum tax: Below -0.11	Tax rates 5.4	Maximum tax: Above 0.0575.	Tax rates 5.4
Midpoint: 0.01 to 0.02	4.0	Midpoint: 0.0225 to 0.02375	2.65
Minimum tax: 0.2 or more	0.7	Minimum tax: below 0.000001	0

Source: GAO analysis of California and Washington state UI financing systems.

^aThe reserve ratio example is from one of the tax schedules used in California. In California, different schedules may be used from year to year, depending on the balance of the UI reserve fund. In California, the formula also includes some credits to an employer's account in addition to taxes paid, and some deductions in addition to benefits charged.

^bThe benefit ratio example is from the tax rate schedule used by Washington state. In Washington, a single schedule is used, but rates can be adjusted each year by factors that account for the size of social costs or fund solvency.

The benefit ratio approach, used by 17 of the 53 state and territorial UI systems, does not consider employers' tax contributions, but only benefits charged over a defined period, usually 3 years. As with the reserve ratio system, benefit charges are divided by a measure of the firm's total wages, such as payroll over 3 years. Table 1 illustrates the calculation of an experience rating using the benefit ratio method.

⁶In some states, the contributions and benefits taken into account are limited to those since a certain date. For example, in Rhode Island, they are limited to those since October 1, 1958.

Once a state has established an employer's experience rating as measured by the reserve ratio or the benefit ratio for a tax year, these experience ratings are used to determine an employer's tax rate. In general the basic tax rate is determined through use of a tax rate schedule, and in some states through use of a formula. The basic experience-rated tax rate can also be adjusted in response to other considerations, such as the solvency and financial health of the trust fund or to cover shared costs. As table 1 illustrates, employers with high reserve ratios pay relatively low tax rates, and those with low reserve ratios, especially employers with negative reserve ratios, pay relatively high taxes. Conversely, the higher a benefit ratio, the higher an employer's tax rate.

Each year, an employer's tax payment is calculated by multiplying the tax rate by the employer's taxable wage base. Under federal law, the taxable payroll must be at least the first \$7,000 in wages paid to each employee, but state taxable payrolls vary from this minimum up to \$32,300.

In any given year, both the reserve ratio and the benefit ratio systems allow for considerable differences between tax payments and benefit charges. In theory, unemployment insurance programs rely on a forward-funded approach. Typically, the trust fund is replenished when tax payments exceed benefit payments during times of low unemployment. Conversely, trust funds are depleted during times of high unemployment because benefit payments exceed tax revenue. By design, higher tax payments lag behind increased benefit payments, in part so that employers are not burdened with higher tax rates during times of economic difficulty. Because the reserve ratio is based on the full history of an employer's benefit charges and tax payments, it will change less abruptly because of an increase or decrease in benefit payment than the benefit ratio. However, both are designed to partly recoup charged benefits and ensure some degree of equity among employers over multiple years.

Several Aspects of State UI Systems Limit the Linkage between Tax Rates and Benefits Paid to a Firm's Former Workers

Although the large majority of state UI systems have implemented experience-rated systems that ensure a linkage between taxes paid and benefits charged, several aspects of state UI systems limit this linkage. As a result, state UI systems are only partly experience-rated, and a firm's UI tax payments can be substantially determined by factors other than benefits charged.⁷

Benefit Write-offs and the Time Value of Money

Although benefit ratio and reserve ratio systems establish, for each employer, a basis for a tax rate linked to benefits charged, they both have important limitations in this regard. First, benefit ratio and some reserve ratio systems do not have perfect memories of benefits charged. Typically, benefit ratio systems consider benefit payments over the previous 3 years. For example, benefit payments, charged to a firm in years prior to the 3-year range, even if not fully recaptured in tax payments, are not considered in calculation of taxes for future years. Similarly, while reserve ratio systems generally are supposed to reflect the balance between all benefits charged and all taxes paid since enactment of a state's unemployment insurance law, this does not always occur in practice. Six of the 33 states that use the reserve ratio system have provisions for effectively writing off benefit charges if the firm's reserve balance or reserve ratio sinks below a certain level.⁸ For example, the California unemployment insurance program writes off benefit charges if an employer has a negative balance that would otherwise exceed 21 percent of average taxable payroll during the last 3 calendar years. When these negative balances are forgiven, the benefit charges are effectively erased from the record of an individual firm. In both the case of a reserve ratio or a benefit ratio system, benefits that were once attributable to an individual firm become the common burden of all employers.

A second major factor that limits the degree of experience rating is that these systems do not take into account the time value of money. For example, employers in a state using the reserve ratio approach may—by consistently paying less in taxes than the amount of chargeable benefits paid to former workers—carry a significant and growing negative balance

⁷To some extent, these departures from experience rating are an outgrowth of various changes that have been made to state systems over the years that have typically been established based on negotiations between business and labor interests.

⁸Pennsylvania uses both a reserve ratio and a benefit ratio component in determining employer tax rates. The state also writes off benefit charges for the reserve ratio component.

for many years. Because states maintain records in nominal dollars, such negative balances understate the real cost that such employers have imposed on the state's unemployment insurance trust fund. Conversely, employers that consistently maintain significant positive account balances are not compensated for these balances—the nominal balance understates the real contribution such employers have made to the state's trust fund.⁹ The same effect may occur in states using the benefit ratio system, but because of the 3-year time horizon on the benefits that affect the tax rates, there is less potential for this practice to have a large cumulative effect.

Maximum Tax Rates

While all states vary an employer's tax rate on the basis of experience rating, all states have also established maximum tax rates that limit an employer's tax liability. In accordance with federal guidelines, states must have a maximum tax rate of at least 5.4 percent. However, as table 2 indicates, maximum tax rate policies differ markedly from state to state—ranging from 5.4 percent in 13 states to 15.4 percent in Massachusetts.¹⁰

⁹According to Labor, South Dakota does charge interest to negative balance employers. Further, 16 states credit interest earned on their trust fund balances back to employers in some way.

¹⁰The actual maximum tax rate in a state can change from one year to the next, because of the use of different schedules or changes in factors used to calculate a tax rate by formula.

Table 2: Minimum Tax Rates, Maximum Tax Rates, and Taxable Wage Bases of State Unemployment Insurance Programs

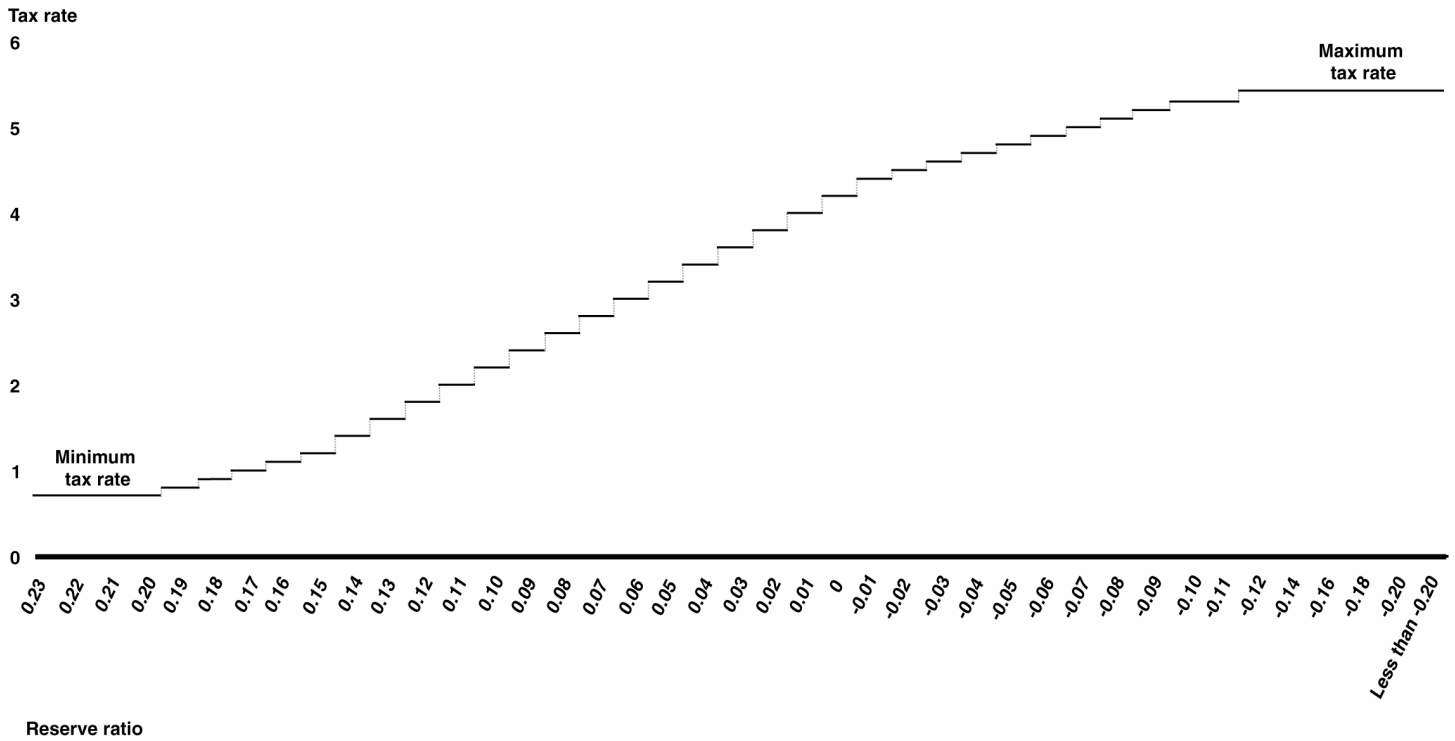
State	Minimum tax	Maximum tax	Taxable wage base	State	Minimum tax	Maximum tax	Taxable wage base
Alabama	0.65	6.8	\$8,000	Nebraska		5.4	\$7,000
Alaska	1.0	5.4	\$27,900	Nevada	0.25	5.4	\$22,900
Arizona	2.85	5.4	\$7,000	New Hampshire	2.8	6.5	\$8,000
Arkansas	0.9	10.8	\$10,000	New Jersey	1.2	7.0	\$24,900
California	1.3	5.4	\$7,000	New Mexico	2.7	5.4	\$17,200
Colorado	1.0	5.4	\$10,000	New York	0.9	8.9	\$8,500
Connecticut	1.5	6.9	\$15,000	North Carolina	0	5.4	\$16,700
Delaware	0.1	9.5	\$8,500	North Dakota	0.1		\$19,400
District of Columbia	1.9	7.4	\$9,000	Ohio	0.1	6.7	\$9,000
Florida	0.001	6.4	\$7,000	Oklahoma	0.5	5.5	\$13,800
Georgia	0.05	10.8	\$8,500	Oregon	2.2	5.4	\$27,000
Hawaii	2.4	5.4	\$32,300	Pennsylvania	1.0225	10.59	\$8,000
Idaho	2.4	6.8	\$28,000	Puerto Rico	2.5	5.4	\$7,000
Illinois	.2	9.0	\$10,500	Rhode Island	1.9	10.0	\$16,000
Indiana	1.1	5.6	\$7,000	South Carolina	1.24	6.1	\$7,000
Iowa	0	9.0	\$20,400	South Dakota	1.5	10.5	\$7,000
Kansas	0.01	7.4	\$8,000	Tennessee	0.5	10.0	\$7,000
Kentucky	1.0	10.0	\$8,000	Texas	0	6.0	\$9,000
Louisiana	0.3	6.0	\$7,000	Utah	0.1	9.0	\$23,200
Maine	2.4	7.5	\$12,000	Vermont	1.3	8.4	\$8,000
Maryland	2.3	9.5	\$8,500	Virginia	0.3	6.4	\$8,000
Mass.	1.58	15.4	\$14,000	Virgin Islands	0.1	9.5	\$18,600
Michigan	1.0	10.0	\$9,000	Washington	2.47	5.4	\$30,500
Minnesota	0.6	9.5	\$23,000	West Virginia	1.5	8.5	\$8,000
Mississippi	0.1	5.4	\$7,000	Wisconsin	0.27	8.9	\$10,500
Missouri	0	8.7	\$11,000	Wyoming	0	8.5	\$16,400
Montana	1.67	6.37	\$21,000				

Source: Comparison of State Unemployment Laws, 2005, U.S. Department of Labor.

Note: In those cases where cells are empty, no state data were available. The maximum and minimum tax rates in this table are based on the "least favorable" scenario, that is, the highest maximums and minimums. Depending on the condition of the state's trust fund and other factors, in a given year, the actual maximum and minimum tax rates may be lower than these rates. For example, 28 states have higher maximum tax rates on the least favorable schedule than on the most favorable schedule. The differences range from less than a percentage point to more than 7 percentage points.

The maximum tax rate may cause a departure from experience rating in certain circumstances for two reasons. First, as a result of maximum tax rates, firms with very different experience ratings will be assessed the same tax rate. For example, an employer that is just at the threshold of the maximum tax rate will pay the same tax rate as an employer whose experience rating indicates a much greater propensity to lay off workers. Figure 1 illustrates this effect using an example from California. According to one of the tax schedules used in that state, all employers with reserve ratios of -0.11 or less pay at the maximum tax rate of 5.4 percent. Consequently, an employer with a reserve ratio of -0.20 or worse will pay the same tax rate as an employer with a reserve ratio of -0.11.

Figure 1: Tax Rates and Reserve Ratios in California



Source: California Employment Development Department, tax schedule C.

The second departure from experience rating occurs because the maximum tax rate causes some firms to pay considerably less in taxes than benefits charged. Because of the maximum tax rate, it is possible that an employer will continue to pay less in taxes than benefits charged year after year. For example, an Illinois firm with 100 employees at a maximum tax rate of 9.0 percent and a taxable wage base of \$10,500 per employee will pay a total of \$94,500 in taxes in a year. Assuming this employer laid off 15 workers who each earned \$673 per week, each worker would qualify for unemployment insurance benefits of about \$8,400, or a total of about \$126,000.¹¹ In a single year, the employer’s workers would receive about \$31,500 more in benefits than taxes paid by the employer. If this pattern continues for multiple years, the maximum tax rate would prevent the

¹¹In Illinois, a worker generally receives benefits equal to about 48 percent of base period wages. This scenario assumes that each worker collects benefits for the full 26 weeks permitted.

employer's tax contributions from increasing, and the difference between benefits charged and taxes paid may become a permanent subsidy to the employer.

In conjunction with the maximum tax rate, employers' tax contributions are also limited by the level of the taxable wage base set by the state. Because an employer's tax rate is multiplied by its taxable wage base to determine its tax payments, an employer paying at a given tax rate will pay less tax than an employer at the same tax rate with a higher taxable wage base. While federal law requires a \$7,000 minimum taxable wage base, table 2 shows that taxable wage bases vary significantly from state to state, ranging from the \$7,000 minimum in nine states to \$32,300 in Hawaii.

Minimum Tax Rates

Just as states set maximum tax rates, most states also set minimum tax rates greater than zero. Minimum tax rates ensure that an employer's tax rate will not drop below a specified floor, no matter how much its experience rating improves. Consequently, employers with significantly different experience ratings may have the same tax rate. Figure 1 illustrates that employers with a reserve ratio greater than 0.20 would pay at the minimum rate of 0.7 percent. As table 2 shows, minimum tax rates even at the highest rate schedules vary widely among the states—from zero in five states to 2.85 percent in Arizona.

Tax Rate Increments

The method states use to assign an employer a tax rate, and the range of possible tax rates between the minimum and the maximum tax, also affects the degree to which a state UI system is experience-rated. Some states use tax schedules to assign employers whose benefit ratio or reserve ratio falls within a particular range a particular tax rate. Such schedules—if they have relatively few tax rates and broad intervals between the rates—can limit experience rating because employers with different experience ratings will pay at the same tax rate. Also, if the difference between one tax rate and the next is substantial, employers with nearly identical experience ratings may pay significantly different tax rates. As Labor noted in 1983 guidance to states, within the limits of the maximum and minimum rates, the smaller the intervals between the variant rates, the greater the effect of individual employer experience on the employer's tax rate.¹² Further, numerous differential rates make the

¹²Unemployment Insurance Program Letter to States, *General Principles of Experience Rating under Section 3303(a)(1), FUTA (Federal Unemployment Tax Act)*, U.S. Department of Labor, June 23, 1983.

transition from one tax rate to another more equitable because two employers with almost identical experience ratings could have different tax rates if they are on either side of the border between two rates. More tax rates will help ensure that the difference between one rate and the next is smaller.

Some Costs Are Shared among All Employers, a Fact That Contributes to Differences between Benefits Charged and Taxes Paid

State unemployment insurance funds bear some costs that cannot be recovered from the individual employer that might otherwise be considered responsible for such benefit costs. Such costs become the common burden of all employers, and for this reason can be referred to as shared costs. Such shared costs fall into three general categories: (1) benefits that are charged to a specific active employer but are not fully recovered from that firm in tax revenue, (2) benefits paid to former employees of firms that have gone out of business and cannot make additional tax payments, and (3) benefit payments made to workers that are not charged to a specific employer.

Charged Benefits That Are Not Covered by Responsible Employers' Tax Payments.

Some aspects of state unemployment insurance programs prevent the tax payments of some employers from matching charged benefits. For example, if over multiple years, an employer's benefits charges amount to \$50,000 but because of a maximum tax rate, the firm pays only \$43,000 in taxes, the state must raise revenue to cover the costs of this difference. As a result, such costs become the common burden of all firms in the unemployment insurance system.

This aspect of shared costs can be a substantial portion of total benefits paid. Labor publishes one measure of such costs, referred to as ineffective charges.¹³ In 2004, the most recent year for which data are available, such ineffective charges ranged from 2.5 percent of total benefits paid in North Dakota to 38.7 percent in Arizona. In other words, only 2.5 percent of total benefits payments in North Dakota were charged to active employers who did not pay taxes to cover these benefit costs. In Arizona, 38 percent of all benefit payments were charged to active employers, but not matched by commensurate tax revenue.

¹³Labor reports ineffective charges as part of an overall measure of experience rating known as the experience rating index, or ERI. The ERI has important limitations as a measure of experience rating. In particular, the measure of ineffective charges is made only for a single year. It does not take into account that current-year benefits for some employers lead to higher future tax payments.

One of the states we contacted—California—has an alternate measure of such shared costs. Under the state’s reserve ratio method of experience rating, the California Employment Development Department keeps track of annual increases in negative balances for employers that have negative balances. Each year, these increases to the negative balance are totaled and are distributed to all firms in the UI system.

Benefits Charged to Inactive Firms

State unemployment programs also pay benefits to unemployed workers whose former employer has gone out of business. In the event that the state cannot collect commensurate tax revenue from these firms, the costs of such benefit payments—known as inactive charges—must be borne by the UI system, and ultimately by all other active firms. In 2004, inactive charges ranged from 0.2 percent of benefits in Massachusetts to 19.5 percent of benefits in Nevada.

Noncharged Benefits

In some situations, state unemployment insurance programs will pay noncharged benefits, that is, benefits paid to unemployed individuals but not charged to the firms for whom the employees had worked. Because these benefit payments are not associated with an individual employer, they become the common burden of employers in state UI systems. Noncharged benefit payments are allowed partly because of the belief that an employer should not be charged for unemployment for which the employer was not responsible. For example, many states pay unemployment benefits to a worker who voluntarily quits a job and has not found another job after some interval, or under certain conditions, such as compelling personal reasons not attributable to the employer. Policies regarding noncharging of benefit payments vary from state to state.¹⁴ In addition to voluntary resignations, common types of noncharges include benefits paid to employees who were discharged for misconduct and benefit payments made in situations where the benefit award is finally reversed. A few states will not charge unemployment benefits paid to a worker hired to replace a member of the armed services called into active duty and laid off upon the service person’s return.

Noncharged benefits can amount to a significant portion of total benefit payments. In 2004, noncharged benefits in the states ranged from about 3 percent of total benefit payments in Colorado and New York to about

¹⁴States that allow certain general categories may differ in the specific provisions of such noncharges. For example, California and Nevada pay benefits to persons who quit their last job to accompany a military spouse, while some other states do not.

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Affects Experience Rating

32 percent in Maine. In 2004, noncharged benefits exceeded 10 percent of total benefit payments in 34 states and over 20 percent of total benefits in 7 states. Nationally, from 2001 to 2004, noncharges averaged between 10.0 percent and 13.3 percent of all benefits paid.

In order to maintain the solvency of the state unemployment insurance fund, state unemployment insurance agencies must collect tax payments to cover shared costs, and must implement some technique of distributing this tax burden among employers that pay in to the fund. States have considerable flexibility in doing so, and our contacts with 5 states indicated that practices may differ widely. Four of the 5 states that we contacted—California, Michigan, Texas, and Washington—implement tax rate adjustments specifically designed to distribute and recapture shared costs, and each of the 5 implement adjustments in response to changes in the state UI fund.

Tax rate adjustments—whether to recoup shared costs or to ensure fund solvency—can have an effect on the degree of experience rating. For example, Illinois makes two adjustments to employers' experience-rated tax rates—the state experience factor and the fund-building rate.¹⁵ Because the state experience factor is multiplied by the employer's basic tax rate as determined by an employer's benefit ratio, the relationship of the tax rates among all employers does not change. On the other hand, Illinois also adds a fund-building surcharge—in 2005 the fund-building rate was 0.9 percent (or \$94.50 per employee)—to each employer's tax rate. Because this amount is a flat add-on to the adjusted tax rate, it distorts experience rating in that it changes an employer's experience-rated rate relative to those of other employers. For example, an employer with a tax rate of 3 percent would now have a tax rate of 3.9 percent, an effective 30 percent increase. On the other hand, an employer with a 5 percent tax rate would, with the fund-building component added, now have a tax rate of 5.9 percent—an 18 percent increase. A similar effect could occur in Michigan, which adds a flat 1 percent to the tax rate of each employer to recoup the costs of nonchargeable benefits.

¹⁵Illinois' state experience factor is designed to increase or decrease experience-rated tax rates based on recent net gains or losses in the state's UI fund. In 2005, for example, because benefits paid considerably exceeded net revenues for the preceding 3-year period, the 2005 state experience factor was 139 percent. The fund building rate is intended to build up adequate reserves in the trust fund. This rate is set statutorily, and was set at 0.9 percent in 2005, and at 0.8 percent for 2006 and 2007.

State UI Tax Policies Result in Persistent Cross-subsidization among Firms and Industries

Studies conducted over the past 34 years indicate that some industries persistently pay less in unemployment insurance taxes than benefits paid to their former workers, while others persistently pay more. The studies we reviewed found that such cross-subsidies favor seasonal and cyclical industries, such as construction and agriculture, forestry, and fisheries, whereas firms in the finance, insurance, and real estate industry regularly pay subsidies. Our analysis of more recent data from several states finds similar evidence of cross-subsidization, with sometimes substantial differences between taxes paid and benefits received. In addition, research shows that there is a considerable amount of cross-subsidization among firms within the same industry. Studies have also found that new firms that are not yet experience-rated, regardless of industry, tend to pay subsidies.

Cross-subsidization Typically Favors Firms in Seasonal and Cyclical Industries Such as Construction and Agriculture

A series of studies examining data from the 1950s to the late 1990s have found consistent cross-subsidization among industries in state UI systems.¹⁶ The studies we reviewed refer to an excess in benefits received by former workers compared to taxes paid by an employer as a subsidy.¹⁷ Though these studies used varying methodologies, they have all compared total unemployment insurance taxes paid by firms in a broad industry group to total benefits paid to UI recipients from those industries over time.¹⁸ As table 3 indicates, in many cases, studies of different states and time periods show the same industries pay or receive subsidies.

¹⁶In general, the studies we reviewed performed their analysis using two digit Standard Industrial Classification (SIC) codes.

¹⁷The studies we examined calculate subsidies in slightly different ways, and the differing ways affect the size of the subsidy estimates. Typically, studies estimated the size of the subsidy by comparing charged UI benefits to total UI taxes paid by a firm. Other studies compared the total of charged and noncharged benefits to taxes paid in their measures of subsidies.

¹⁸It is important to examine subsidies over multiple years, instead of only for a single year, because the UI system is designed to recoup costs from employers over multiple years. Single-year data may overestimate the extent of cross-subsidization, particularly when the use of UI is related to an unemployment shock and not persistent job turnover or layoffs.

Table 3: Summary of Findings of Cross-subsidization among Industries from Literature Review

Study	Data	Receive subsidies: Industry	Pay subsidies: Industry
O'Leary and others 2000	28 states, 1998	<ul style="list-style-type: none"> • Construction 	<ul style="list-style-type: none"> • Financial service providers • Low-wage manufacturing
Vroman 1999	Washington state, 1989-1999	<ul style="list-style-type: none"> • Construction • Agriculture, forestry, and fisheries • Manufacturing 	<ul style="list-style-type: none"> • Finance, insurance, and real estate
Tannenwald and O'Leary 1997	Massachusetts, 1988-1996	<ul style="list-style-type: none"> • Construction 	<ul style="list-style-type: none"> • Transportation, communications, and public utilities • Trade • Finance, insurance, and real estate • Services
Anderson and Meyer 1993a	6 states, 1978-1984	<ul style="list-style-type: none"> • Construction • Manufacturing • Mining • Agriculture, forestry, and fisheries 	<ul style="list-style-type: none"> • Finance, insurance, and real estate • Retail trade • Services • Transportation • Wholesale trade
Anderson and Meyer 1993b	22 states, approximately 1980-1991	<ul style="list-style-type: none"> • Construction • Manufacturing • Mining • Agriculture, forestry, and fisheries 	<ul style="list-style-type: none"> • Finance, insurance, and real estate • Trade • Services
Laurence 1993	Texas, 1978-1982	<ul style="list-style-type: none"> • Construction • Manufacturing • Services 	<ul style="list-style-type: none"> • Finance, insurance, and real estate • Mining and quarrying
Munts and Asher 1980	21 states, 1968-1975	<ul style="list-style-type: none"> • Construction • Manufacturing • Agriculture, forestry, and fisheries • Mining • Services 	<ul style="list-style-type: none"> • Finance, insurance, and real estate • Trade
Topel 1983	6 states, 1971-1975	<ul style="list-style-type: none"> • Miscellaneous manufacturing • Apparel • Construction 	<ul style="list-style-type: none"> • Primary and fabricated metals • Retail trade
Becker 1972	15 states, 1957-1967	<ul style="list-style-type: none"> • Construction • Mining • Agriculture, forestry, and fisheries 	<ul style="list-style-type: none"> • Finance, insurance, and real estate

Source: GAO analysis of relevant studies.

Notes: Data from states in Anderson and Meyer study (1993b) vary within this time frame. Topel (1983) and O'Leary and others (2000) did not include all major industrial categories in their studies.

According to the studies, certain industries, such as construction and agriculture, consistently received subsidies, which can be substantial. Across different states and time periods studied, the construction industry most consistently paid less in taxes than benefits paid to its former employees. For example, one study examined industry groups over a 12-year period, from 1980 to 1991, for 22 states and found that the construction industry received the largest subsidy.¹⁹ To compare the relative size of subsidies, the study calculated a summary benefit-tax ratio for each industry averaged across states by dividing benefits received by total UI taxes paid.²⁰ The ratio of 1.68 averaged across 22 states indicates a large subsidy to the construction industry—as a whole, employers in this industry paid about \$1 for every \$1.68 in benefits received by their former workers. A more recent study of Washington state’s UI program also examined cross-subsidization among industries over an 11-year period and found the construction industry received the largest subsidy, as indicated by the benefit-tax ratios reported in table 4.²¹ The total taxes paid by construction firms covered 77 percent of charged benefits over this time period.

¹⁹Patricia M. Anderson and Bruce D. Meyer, “The Unemployment Insurance Payroll Tax and Inter-industry and Interfirm Subsidies,” in *Tax Policy and the Economy*, Ed., James M. Poterba, Cambridge, Massachusetts: MIT Press, 1993, pp. 111-144.

²⁰A benefit-tax ratio equal to 1 means that an employer is paying exactly the amount of taxes as benefits received by their former workers. Similarly, an employer or industry with a benefit-tax ratio greater than 1 is receiving a subsidy, while an employer or industry with a ratio less than 1 is paying a subsidy.

²¹Wayne Vroman, *Unemployment Insurance Tax Equity in Washington*, Report No. 3, Washington, DC: The Urban Institute, January 1999.

Table 4: Cross-subsidization among Industries in Washington State, 1989 to 1999

Dollars in millions

Industry	Benefits charged	Taxes paid	Benefit-tax ratio
Agriculture, forestry, and fisheries	318.6	282.7	1.13
Mining	19.5	18.4	1.06
Construction	916.4	701.7	1.31
Manufacturing	982.4	1334.9	0.74
Transportation, communication, and utilities	251.4	381.2	0.66
Wholesale trade	315.8	481.1	0.66
Retail trade	398.5	735.0	0.54
Finance, insurance, and real estate	199.0	338.2	0.59
Services	677.8	1027.0	0.66

Source: Wayne Vroman, *Unemployment Insurance Tax Equity in Washington*, Report No. 3, Washington, D.C.: The Urban Institute, January 1999.

Note: The benefit-tax ratio is equal to charged benefits divided by total taxes paid.

Although cross-subsidization is found to most consistently favor firms in the construction industry, other industries also tend to benefit. The majority of these studies found that firms in agriculture, forestry, and fisheries receive subsidies. As shown in table 4, for instance, the study of Washington state found that this industry received the second largest subsidy from 1989 to 1999. Charged benefits exceeded total taxes paid by about 13 percent.²² In addition, several of the studies report that firms in manufacturing and mining industries also tend to receive subsidies. For example, the mining and manufacturing industries on average received 37 percent and 9 percent more in benefits than in taxes paid, respectively, according to the study of 22 states.

Conversely, other industries, in particular finance, insurance, and real estate consistently pay more in taxes than their former employees receive in UI benefits, according to studies reviewed. Data from all of the studies that examine cross-industry subsidies and include the finance, insurance, and real estate sector indicate that firms in this industry pay a subsidy, which is often substantial. The study which used data from 22 states to calculate a combined average benefit-tax ratio for each industry concluded

²²Although agriculture, forestry, and fisheries received a relatively large subsidy proportional to taxes paid, it tends to be one of the smallest sectors of the economy. Thus, the industry's overall contribution to cross-subsidization may not be as great as other, larger sectors that also receive subsidies.

that the finance, insurance, and real estate industry received about half the taxes it paid in benefits to its former workers, which was the largest subsidy paid by any industry. While firms in the finance, insurance, and real estate industry most consistently pay a subsidy to the UI program, overall, many other industries also tend to pay subsidies, although not in every state and time period studied. These industries include wholesale trade, services, retail trade, transportation, communications, and public utilities.

While some industries tend to receive or pay subsidies over time and in different states, other industries do not show a consistent pattern. An industry may receive a subsidy in one state and pay a subsidy in another state because of differences in the structure of states' UI programs or the regional economy. For example, evidence for the service industry may be inconsistent across states.²³ One study using data for 21 states from 1968 to 1975 found that the service industry tends to receive a net subsidy, while a more recent study using data for 22 states from 1980 to 1991 found that the service industry paid almost 32 percent more in taxes than in benefits received by its former workers.²⁴ There is also mixed evidence for the mining industry. Although several studies have found that mining receives an overall subsidy, a study of the Texas UI program found that this industry had the highest percentage of firms that are subsidizers.²⁵

More recent tax data obtained from three of the five states we contacted largely parallels the findings of earlier studies.²⁶ (See table 5.) In two of the three states, as in the previous studies, construction, as well as agriculture, forestry, and fisheries received subsidies. For example, in Washington, the taxes paid by construction firms covered approximately 70 percent of

²³These findings for the service industry may also vary, in part, because of the diversity of subindustries in this category.

²⁴See: Raymond C. Munts and Ephraim Asher, "Cross-Subsidies among Industries from 1969 to 1978," in *Unemployment Compensation: Studies and Research*, Volume 2, Washington D.C.: U.S. National Commission on Unemployment Compensation, July 1980, pp. 277-297, and Anderson and Meyer, "The Unemployment Insurance Payroll Tax and Inter-industry and Interfirm Subsidies," p. 122.

²⁵Louise Laurence, "How Large Are the Subsidies Provided by the System of Financing Unemployment Insurance?" *The Quarterly Review of Economics and Finance*, Vol. 33, Fall 1993, p. 242.

²⁶Data provided by Illinois and Texas contained taxes assessed to employers. Officials from both states indicated that in excess of 99 percent of taxes assessed are collected from employers.

charged benefits paid to their former employees. In Illinois, the subsidy to the construction industry was substantial—from 2001 to 2004, firms in the construction industry, as a whole, paid more than \$1 billion less in unemployment insurance taxes than the unemployment benefit costs charged to them.²⁷ In Texas, the construction industry had the highest ratio of benefits to taxes, indicating that benefits charged were high relative to taxes paid compared with other industries for the 2-year period. However, the construction industry actually paid a subsidy in Texas from 2004 to 2005.²⁸ During this time all industries in Texas paid more in taxes than in benefits charged to their former employees. Officials from Texas indicated this was to repay a trust fund deficit, which the state covered with a bond issuance in 2003.

²⁷It should be noted that over this period, taxes paid by all experience-rated employers in Illinois were about \$2.2 billion less than benefits charged. Hence, the construction industry accounted for about half of this difference. Data we obtained from Illinois, Texas, and Washington are reported in base year 2005 dollars.

²⁸Employers in Texas were assessed higher taxes relative to benefits charged during this time period in order to pay off deficits generated in previous years. Employers were charged an obligation assessment to cover a bond issuance in 2003.

Table 5: Industries Ranked by Benefit-Tax Ratio for Selected States

Benefit-tax ratio	Illinois (2001-2004)		Texas (2004-2005)		Washington (1999-2004)	
	Industry	Benefit-tax ratio	Industry	Benefit-tax ratio	Industry	Benefit-tax ratio
Highest:	Construction	2.48	Construction	0.92	Construction	1.42
	Mining	1.67	Educational services	0.89	Manufacturing	1.08
	Agriculture, forestry, fishing, and hunting	1.62	Utilities	0.75	Agriculture, forestry, fishing, and hunting	1.06
	Professional, scientific, and technical services	1.54	Agriculture, forestry, fishing, and hunting	0.74	Information	1.05
	Administrative and support, and waste management and remediation services	1.51	Administrative and support, and waste management and remediation services	0.74	Professional, scientific, and technical services	1.02
Lowest:	Management of companies and enterprises	0.74	Mining	0.44	Utilities	0.49
	Health care and social assistance	0.84	Accommodation and food services	0.44	Health care and social assistance	0.51
	Accommodation and food services	0.84	Wholesale trade	0.54	Accommodation and food services	0.59
	Educational services	0.91	Information	0.57	Retail trade	0.62
	Utilities	0.96	Arts, entertainment, and recreation	0.58	Finance and insurance	0.63
Average:		1.27		0.66		0.85

Source: GAO analysis.

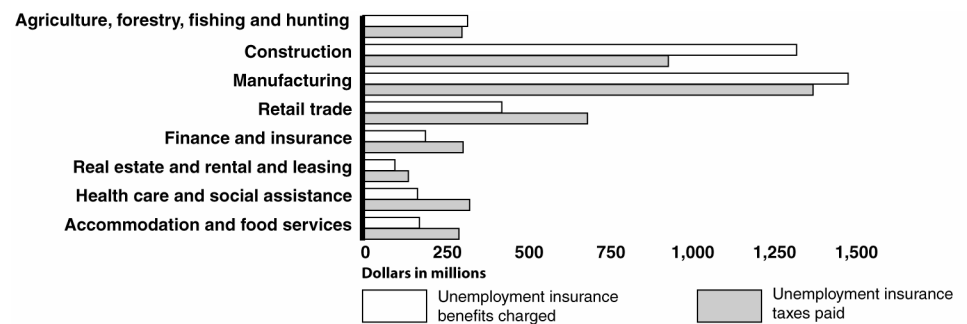
Note: The average benefit-tax ratio for each state is based on all major North American Industry Classification System codes, but does not include public administration or unclassified employers.

Our more recent tax data also show a similar pattern with regard to those industries that paid subsidies.²⁹ In two of the three states from which we had data (Texas and Washington), as in the studies reviewed, the finance, insurance, and real estate industry paid more in taxes than in benefits paid

²⁹Data GAO obtained are reported according to the North American Industry Classification System (NAICS). Dollar figures are reported in base year 2005 dollars. In 2003, the Bureau of Labor Statistics converted from the U.S. Standard Industrial Classification (SIC) system to NAICS codes.

to its former workers. Other industries that paid subsidies in Illinois and Washington include utilities, health care and social assistance, management of companies and enterprises, and accommodation and food services. (See fig 2. for Washington) Although the mining industry is often found to receive a subsidy, in Texas this industry paid a subsidy of more than \$56 million from 2004 to 2005.

Figure 2: Unemployment Insurance Benefits Charged and Taxes Paid by Selected Industries in Washington State from 1999 to 2004



Source: GAO analysis of data from the Washington State Employment Security Department.

The persistence of subsidies to firms in industries such as construction and agriculture, forestry, and fisheries may be caused by the industries' susceptibility to seasonal or economic cycles that result in layoffs and push firms to the maximum tax rate. As one study of UI programs in New England notes, "firms enjoying the largest subsidies tend to face highly cyclical or seasonal demand for their products."³⁰ If this susceptibility causes firms in industries such as construction or agriculture to chronically be at the maximum tax rate, the subsidies they receive may not be recovered by the state. There is at least one anomaly with regard to this explanation: The retail trade industry is also seasonal in nature but, according to some studies, pays subsidies. According to one study, a possible explanation may be that many unemployed workers in this industry were not eligible for UI benefits.³¹ If unemployed workers in the retail trade industry were only employed for a short time, they may be unable to receive benefits and their former employer would not be

³⁰Robert Tannenwald and Christopher O'Leary, "Unemployment Insurance Policy in New England: Background and Issues," *New England Economic Review*, Federal Reserve Bank of Boston, May 1997, pp. 3-22.

³¹Tannenwald and O'Leary, "Unemployment Insurance Policy in New England: Background and Issues," p. 16.

charged. Aside from the retail trade industry, firms in industries like finance, insurance, and real estate may consistently pay more in taxes than benefits paid, because they tend to have more stable or growing employment and pay the minimum tax rate.

Studies Reveal That Subsidy Patterns for Broad Industries Do Not Apply to All Firms in an Industry, and New Firms Tend to Pay Subsidies

Using more detailed data, some studies have found cross-subsidization within industries. While, at the broad level, some industries receive or pay subsidies, not all subcategories or firms within these industries fit the pattern of the overall industry. For example, one study found that within the manufacturing industry, apparel manufacturing receives a subsidy that is three to four times as great as the benefit-tax ratio of other manufacturing subgroups.³² Another study, using data from Texas, found that, even though the construction industry as a whole receives the second largest subsidy, the majority of firms within the construction industry paid more in taxes than benefits received by their former employees.³³ In that study, approximately 52 percent of construction firms paid a net subsidy.

Research has also shown that the likelihood an individual firm will receive a subsidy can vary by the age of the firm. In particular, young firms that are not yet experience-rated are found to pay more in taxes than benefits received by their former workers.³⁴ Typically, firms with less than 3 years of employment history are assigned a standard tax rate or the average industry rate. One study, using data from Texas, reports that the majority of such new firms pay a subsidy, although a few of these firms receive large subsidies.³⁵ Among firms less than 5 years old, approximately 67 percent pay a subsidy, which is the highest rate of all age groups. Overall, the author found that young firms and old firms tend to subsidize firms in the 11- to 20-year age group. In addition, our analysis of recent data from Illinois also indicates that firms that are not yet experience-rated pay a relatively large subsidy. In Illinois, new employers paid

³²Joseph M. Becker, S.J., *Experience Rating in Unemployment Insurance: An Experiment in Competitive Socialism*, Baltimore, Maryland: The Johns Hopkins University Press, 1972.

³³Laurence, "How Large Are the Subsidies Provided by the System of Financing Unemployment Insurance?" pp. 241-242.

³⁴Using a practice known as SUTA dumping, some employers have created a new company to improve their experience rating and attain a lower tax rate. See [GAO-03-819T](#). Despite this practice, new employers, as a whole, pay subsidies in some states.

³⁵Louise Laurence, "How Do Firm Characteristics Affect the Subsidies Provided by the Unemployment Insurance System?" *Applied Economics*, Vol. 9, September 1991.

21 percent more in taxes than benefits received by their former workers from 2001 to 2004, to the amount of more than \$84 million.

Measures to Improve Experience Rating and Reduce Subsidies Must Be Balanced against Other Goals

States could take various actions to improve experience rating and reduce subsidies, but state officials and experts indicated that such changes should be considered in light of other program goals and considerations. For example, higher maximum tax rates would better balance tax payments and benefit charges for employers whose former employees impose high costs on a state's program. However, according to state officials and experts, states may also wish to limit the financial liability of firms under the unemployment insurance system and that for some firms and industries, higher tax rates might be difficult to bear.

Increasing Tax Payments of Subsidized Firms Could Reduce Subsidies but Increase Financial Strain on Some Businesses and Have Other Undesirable Effects

State unemployment insurance programs could improve experience rating and reduce cross-subsidies by increasing the unemployment insurance taxes paid by firms that receive subsidies. Among the several ways states could improve experience rating, some of the key adjustments would be to raise the maximum tax rate, increase the taxable wage base, or adopt some combination of these two modifications.³⁷ A 2003 analysis of the Massachusetts unemployment insurance program indicates that making an adjustment can have a substantial effect on closing the gap between benefits charged to and taxes paid by firms that get a subsidy.³⁸ Using a simulation analysis, the study found that using a new tax rate schedule with higher maximum rates reduces ineffective charges from \$978.4

³⁷Labor also cited another innovative option it referred to as a flexible maximum tax rate. The option would allow a UI program to add a tax increment beyond the maximum tax rate for employers whose tax payments are substantially smaller than benefit charges. The goal would be to make each marginal layoff have some added impact on an employer's rate, but not be enough to be a complete reimbursement. According to Labor, this innovative concept would provide increased cost allocation and an active incentive to decrease benefit costs that does not exist with a fixed maximum tax rate.

³⁸Wayne Vroman, *Unemployment Insurance Financing Options in Massachusetts*, The Urban Institute, Washington D.C., December 2003.

million to \$801.3 million, an 18 percent decrease.³⁹ Further, an increase in the taxable wage base from \$10,800 to \$18,000 was found to reduce ineffective charges—that is, benefit charges to active firms that are not matched in tax revenue from those firms—from \$978.4 million to \$773.6 million, a 21 percent decrease.

U.S. Department of Labor and state officials, as well as unemployment insurance experts, have noted that measures to improve experience rating or reduce cross-subsidies involve trade-offs that states would need to consider. Several unemployment insurance officials and experts have stated that full experience rating is not desirable, in part because some firms could not afford to pay the full costs of benefits their former employees incur. Commenting on the possibility of higher maximum tax rates, an official with the Texas Workforce Commission told us that firms that now pay at the highest tax rates include seasonal employers and employers whose business activities are being taken over by overseas firms and other declining companies. He noted that some of these companies are already under financial stress, and some may well have adjusted their business models based on the assumption of the maximum tax rate. An increase in the rate could seriously hurt such firms.

States may also face political resistance to such increases. An Illinois official said that increases to the maximum tax rate would be portrayed by affected businesses that are already paying at the maximum tax rate as creating a bad business climate; some might say that such a change would drive them out of business or force them to relocate out of the state. Similarly, in a 1996 report to the President and Congress, the Advisory Council on Unemployment Compensation noted that some employers—especially small ones—that need to lay off workers may find that their tax rates increase so dramatically as a result of those layoffs that that additional layoffs become necessary. The report further noted that no research has been conducted on the potential negative effects of experience rating.

Reducing subsidies by raising the maximum tax rates or the taxable wage base may also conflict with particular policy objectives of a state. For example, officials of the California Employment Development Department

³⁹The tax schedule also included a number of changes in addition to a higher maximum tax rate. Consequently, some portion of this change may be due to factors other than the increased maximum tax rate.

told us that the California unemployment insurance system was intentionally developed to subsidize two industries important to the California economy—agriculture and construction. The officials explained that the California agricultural sector includes not just farms, but canneries and other associated industries that have large seasonal fluctuations in demand for labor. When the state’s UI system last underwent major revision in 1985, there was an emerging need to provide alternative sources of income so that workers would be available from season to season. Unemployment benefits paid during the off-season became an essential part of an agricultural worker’s annual income. The officials stated that a pattern of a working season, followed by a period of subsisting on unemployment benefits, followed by another working season, has become the norm for many of these workers.

Improving experience rating by increasing the taxable wage base might involve offsetting effects on experience rating. As noted by the Advisory Council on Unemployment Compensation, a change in the taxable wage base most directly affects the degree of experience rating by changing the distribution of employers’ tax rates.⁴⁰ Raising the taxable wage base increases the degree of experience rating for employers at the maximum tax rate before the increase, and below it afterward. However, if the tax rate schedule was not adjusted at the same time, raising the taxable wage base could also reduce experience rating, as it would increase tax payments by employers who already pay subsidies into the unemployment insurance system. If the tax rate schedule was modified, some employers might move to the minimum tax rate, a change that would also limit experience rating.

Reducing Noncharged Benefits Would Restrict UI Eligibility or Impose Additional Costs on Employers

Noncharged benefits—benefits payments that are not charged to a specific employer—detract from experience rating because they are shared—that is, they are borne to some degree by all employers, thus adding to the costs of employers who had no responsibility for the unemployment. Noncharges could be reduced either by reducing benefit payments in such cases or by charging such benefits to the recipient’s previous employer or employers. However, each approach has its drawbacks.

⁴⁰ Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, and Coverage*, Washington D.C.: February, 1995.

Eliminating noncharged benefits would restrict the breadth of coverage of state unemployment insurance programs. For example, nearly all states will, in some situations, pay benefits to unemployed workers who voluntarily quit their last job. Elimination of such benefit payments would leave such workers uncovered by the unemployment insurance system. Elimination of benefit payments in some noncharge situations would also restrict a state's ability to promote broader policy objectives through the unemployment insurance system. For example, an official of the Illinois Department of Employment Security told us that during a 2003 debate over statutory changes to the state's unemployment insurance system, organized labor advocated for a noncharge in the event that a person became unemployed because of domestic violence. A person might, for example, be unable to go to his or her former place of work because the abuser might stalk that person there. In considering how to reduce noncharges, states are faced with the choice of paying these noncharges or denying benefits to individuals in such a situation.

On the other hand, charging many noncharges to employers could be seen as contrary to the experience-rating principle, because, in theory, the employer was not responsible for the unemployment. Further, state officials told us that such an action would likely be strongly resisted by employers. For example, in describing the domestic violence noncharge mentioned above, an Illinois official said that employers concurred with the change, but on the condition that individual employers should not be charged because responsibility for the unemployment would not be theirs.

Other Actions to Improve Experience Rating

States could take various other measures to improve experience rating and reduce cross-subsidies. For example, they could improve experience rating by lowering or eliminating minimum tax rates. This would improve experience rating for firms that impose little to no cost on the trust fund. However, a very low minimum tax rate—especially a zero tax rate—could also have drawbacks. For example, officials of the Michigan Unemployment Insurance Agency noted that the tax rate in their state could be too low, given that shared costs need to be recovered, and that the current minimum rate may not be sufficient to ensure that firms at the minimum rate pay their share. Others have noted that a zero tax rate would not be consistent with the notion of social insurance, which requires that an entity receiving coverage pay some premium, even if the entity imposes no costs on the system.

States could also make other adjustments to improve experience rating, such as taking into account the time value of money or, in the case of the

reserve ratio state, eliminating the practice of writing off negative balances. Such actions would better ensure that a firm's experience rating reflects the full costs it has imposed on the UI system. However, such actions might have little effect on the actual tax payments of firms that are at the maximum tax rate and receive subsidies year after year. Further, California officials told us that the practice of writing off negative balances prevented negative balance employers from falling into too deep a deficit position. Without such write-offs, the employer would have no incentive to improve its experience rating by reducing its number of layoffs.

Concluding Observations

Cross-subsidies in state unemployment insurance systems are a long-standing part of the system, and the subsidies occur because unemployment insurance taxation systems are not fully experience-rated—a fully experience-rated system would ensure that, over time, the costs that an employer imposed on the unemployment insurance programs were equal to the taxes it paid. As with other insurance systems, such as automobile insurance, many of the potential beneficiaries may never receive benefits, understanding that the premiums paid protect them should the need for benefits arise. Several aspects of state unemployment insurance systems cause this shortfall from full experience rating, and states could improve experience rating and reduce these cross-subsidies by adjusting these aspects.

In considering measures to increase the experience rating of state UI systems, it is important to note that stabilizing employment through experience rating is one of several goals of unemployment insurance. The program was also established to provide temporary, partial wage replacement for unemployed workers, and to stabilize the economy through maintenance of consumer purchasing power in time of high unemployment. Further, federal law and regulations provide very limited guidance regarding the degree of experience rating or the acceptable size of a cross-subsidy. Instead, they have left it to the states to design financing systems that are experience-rated to one degree or another.

States could nonetheless increase experience rating and reduce subsidies, but they have chosen to balance these considerations against other policy goals. For example, all states have chosen to limit the financial liability of employers by establishing a maximum tax rate. It is possible that the subsidies arising from these policies provide benefits that extend beyond those directly subsidized. Subsidized industries may be large employers in a given state or represent core parts of a state's economy. Subsidies may have other intended effects. For example, they may encourage employers

to continue contributing to the system, even if they provide only a part of the contribution they should make. Under the current framework, state policy makers decide the appropriate balance between experience rating and the other policy objectives of a state's unemployment insurance program.

Agency Comments and Our Evaluation

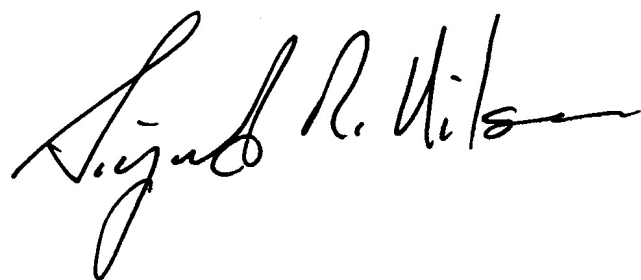
We provided a draft of this report to the Department of Labor for its review. Overall, Labor agreed with our findings, and noted that the report provided a succinct analysis of the issues we sought to address. Labor also cautioned that an emphasis on "full experience rating" may obscure the fact that employers in the United States pay an amount much closer to the benefits assigned to them than do employers in any other country. We concur with this view, and it is in fact consistent with our conclusions. We also modified the report slightly to reflect these issues more explicitly. Labor's formal comments are reproduced in appendix III.

Labor also provided technical comments on the draft report, which we have incorporated where appropriate.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of this letter. At that time, we will send copies to interested congressional committees and members, and the Secretary of Labor. We will also make copies available to others upon request. In addition, our report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

Contact points for our Office of Congressional Relations and Office of Public Affairs may be found on the last page of this report. GAO staff that made major contributions to this report are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink, reading "Sigurd R. Nilsen". The signature is written in a cursive style with a large, looping initial "S".

Sigurd R. Nilsen, Director
Education, Workforce,
and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives were to address the following questions:

1. How have states ensured that individual employers pay unemployment insurance taxes based on their experience with unemployment, and what aspects of state unemployment insurance systems limit such experience rating?
2. To what extent do employers pay unemployment insurance taxes commensurate with unemployment benefits paid to their former employees, and how does this vary by industry?
3. What steps could states take if they wished to ensure that the taxes paid by individual firms more closely matched the benefits paid to the former employees of each firm?

To answer the first and third questions, we reviewed pertinent literature and interviewed Department of Labor officials, and officials of national organizations representing the perspectives of business, labor, and state unemployment insurance agencies, as well as nationally recognized experts on unemployment insurance. We also conducted in-depth interviews with representatives of unemployment insurance agencies in 5 states—California, Illinois, Michigan, Texas, and Washington. We selected these states because they are relatively populous and geographically dispersed, and because they take different approaches to ensuring experience rating. We discussed each state’s approach to financing unemployment insurance benefits, and the implications that various aspects of these systems had for experience rating and the existence of cross-subsidies. We also reviewed pertinent documents describing the unemployment insurance financing systems in each of these 5 states. In addition, we obtained and analyzed the Department of Labor’s experience-rating index, an annual measure of experience rating in the state and territorial unemployment insurance programs.

To answer the second question, we identified and reviewed 10 studies published between 1972 and 2000 that measured how closely taxes paid by firms and industries matched the benefit costs they imposed. These studies used a variety of techniques to measure whether some categories of employers consistently pay more or less in taxes than benefits paid to their former workers. Two GAO economists reviewed these studies and determined that they were sufficiently reliable to use in this report. We confirmed with the U.S. Department of Labor and national experts on unemployment insurance that these 10 studies constituted the definitive work done to date on this subject. To supplement these studies, we asked

the 5 states that we contacted to provide data on tax and benefits payments by industry type according the North American Industry Classification System (NAICS). Three of the 5 selected states—Illinois, Texas, and Washington—provided such data for all or some of the years from 1999 to 2004. We interviewed officials knowledgeable about these data and determined that the data were sufficiently reliable to include in this report. Using these data, we developed updated comparisons of the balance between taxes paid and benefits received for industry groups.¹

¹Illinois and Texas provided data on taxes due rather than taxes paid. However, state officials told us there should be little difference between the two figures.

Appendix II: Example of a State's Unemployment Insurance Tax Schedules

Table 6: California Unemployment Insurance Tax Schedules

Reserve ratio		Contribution rate schedules stated as a percentage							
Exceeds or equals	Less than	AA	A	B	C	D	E	F	*F+
Less	-0.20	5.4	5.4	5.4	5.4	5.4	5.4	5.4	6.2
-0.20	-0.18	5.2	5.3	5.4	5.4	5.4	5.4	5.4	6.2
-0.18	-0.16	5.1	5.2	5.4	5.4	5.4	5.4	5.4	6.2
-0.16	-0.14	5.0	5.1	5.3	5.4	5.4	5.4	5.4	6.2
-0.14	-0.12	4.9	5.0	5.3	5.4	5.4	5.4	5.4	6.2
-0.12	-0.11	4.8	4.9	5.2	5.4	5.4	5.4	5.4	6.2
-0.11	-0.10	4.7	4.8	5.1	5.3	5.4	5.4	5.4	6.2
-0.10	-0.09	4.6	4.7	5.1	5.3	5.4	5.4	5.4	6.2
-0.09	-0.08	4.5	4.6	4.9	5.2	5.4	5.4	5.4	6.2
-0.08	-0.07	4.4	4.5	4.8	5.1	5.3	5.4	5.4	6.2
-0.07	-0.06	4.3	4.4	4.7	5.0	5.3	5.4	5.4	6.2
-0.06	-0.05	4.2	4.3	4.6	4.9	5.2	5.4	5.4	6.2
-0.05	-0.04	4.1	4.2	4.5	4.8	5.1	5.3	5.4	6.2
-0.04	-0.03	4.0	4.1	4.4	4.7	5.0	5.3	5.4	6.2
-0.03	-0.02	3.9	4.0	4.3	4.6	4.9	5.2	5.4	6.2
-0.02	-0.01	3.8	3.9	4.2	4.5	4.8	5.1	5.4	6.2
-0.01	0.00	3.7	3.8	4.1	4.4	4.7	5.0	5.4	6.2
0.00	0.01	3.4	3.6	3.9	4.2	4.5	4.8	5.1	5.9
0.01	0.02	3.2	3.4	3.7	4.0	4.3	4.6	4.9	5.6
0.02	0.03	3.0	3.2	3.5	3.8	4.1	4.4	4.7	5.4
0.03	0.04	2.8	3.0	3.3	3.6	3.9	4.2	4.5	5.2
0.04	0.05	2.6	2.8	3.1	3.4	3.7	4.0	4.3	4.9
0.05	0.06	2.4	2.6	2.9	3.2	3.5	3.8	4.1	4.7
0.06	0.07	2.2	2.4	2.7	3.0	3.3	3.6	3.9	4.5
0.07	0.08	2.0	2.2	2.5	2.8	3.1	3.4	3.7	4.3
0.08	0.09	1.8	2.0	2.3	2.6	2.9	3.2	3.5	4.0
0.09	0.10	1.6	1.8	2.1	2.4	2.7	3.0	3.3	3.8
0.10	0.11	1.4	1.6	1.9	2.2	2.5	2.8	3.1	3.6
0.11	0.12	1.2	1.4	1.7	2.0	2.3	2.6	2.9	3.3
0.12	0.13	1.0	1.2	1.5	1.8	2.1	2.4	2.7	3.1
0.13	0.14	0.8	1.0	1.3	1.6	1.9	2.2	2.5	2.9
0.14	0.15	0.7	0.9	1.1	1.4	1.7	2.0	2.3	2.6
0.15	0.16	0.6	0.8	1.0	1.2	1.5	1.8	2.1	2.4

**Appendix II: Example of a State's
Unemployment Insurance Tax Schedules**

Reserve ratio		Contribution rate schedules stated as a percentage							
Exceeds or equals	Less than	AA	A	B	C	D	E	F	*F+
0.16	0.17	0.5	0.7	0.9	1.1	1.3	1.6	1.9	2.2
0.17	0.18	0.4	0.6	0.8	1.0	1.2	1.4	1.7	2.0
0.18	0.19	0.3	0.5	0.7	0.9	1.1	1.3	1.5	1.7
0.19	0.20	0.2	0.4	0.6	0.8	1.0	1.2	1.4	1.6
0.20	or more	0.1	0.3	0.5	0.7	0.9	1.1	1.3	1.5

Source: California Employment Development Department..

California determines which of the eight tax schedules to use based on the balance in the trust fund as a percentage of gross wages reported by all employers. This calculation establishes the rate schedule used as outlined in table 7.

Table 7: Basis for Rate Schedule Used

In percent		Contribution rate schedules
Greater than	Equal to or less than	
1.8		AA
1.6	1.8	A
1.4	1.6	B
1.2	1.4	C
1.0	1.2	D
0.8(or equal to)	1.0	E
0.6(or equal to)	0.799	F
	(less than) 0.6	F+

Source: California Employment Development Department.

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Employment and Training
Washington, D.C. 20210



JUL - 6 2006

Mr. Sigurd R. Nilsen
Director
Education, Workforce and Income Security Issues
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Nilsen:

The Department of Labor's Employment and Training Administration (ETA) is in receipt of the draft Government Accountability Office (GAO) report entitled, "States' Tax Financing Systems Allow Costs to Be Shared among Industries" (GAO 06-769).

The report provides a much needed look at the experience rating of state unemployment insurance (UI) taxes, which is an often under-appreciated and misunderstood aspect of the UI system. The U.S. is the only country in the world that assigns UI tax rates to participants (employers) based on their experience with unemployment. While all other countries with UI programs charge a single flat rate to all participants, the U.S. applies the common insurance concept of experience rating to its UI premiums (taxes). The implications and impact of this system are important issues for policy makers.

The report provides a succinct analysis in response to certain questions regarding "limits" on experience rating, the extent to which an employer's taxes are "commensurate with" UI benefits paid to former employees and how this varies by industry, and steps states could take to ensure UI taxes "more closely matched the benefits paid to the former employees" of the employer.

While these are important questions for policy makers, we believe it is also important to recognize that the experience rating system is not, as these questions seem to imply, a financing system that is akin to a reimbursement system, where all benefits are meant to be fully repaid by a responsible employer. Instead, the experience rating provisions of Federal law simply allow states to give an employer a reduction in its tax rate by considering its experience with unemployment. Federal law does not, in fact, refer to benefit costs.

As noted in the report, for various reasons related to public policy, all state UI tax structures contain a liability cap for the highest-cost participants. As a result, high-cost employers will not repay the exact amount of benefit charges as they would under a reimbursement system. Moreover, the insured event (unemployment) is not easy to measure, which leads to difficulty in equitably assigning the costs of the unemployment.

For example, when an individual has worked for multiple recent employers, is it equitable to charge the employer who actually laid-off the individual for the full 26 weeks of UI when that employer may have employed the individual for only 13 weeks? Conversely, is it equitable to charge a past employer when the individual may have quit over a year earlier to work for another employer? As a result of the difficulty in determining which employers should be liable for certain benefits in these situations, it is difficult to determine what is an acceptable degree of experience rating.

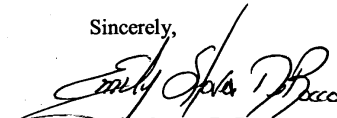
We are concerned that by emphasizing limitations to “full experience rating,” some readers may lose sight of the fact that U.S. employers pay an amount much closer to the benefits assigned to them than do employers in any other country. In fact, the system of experience rating has led to a majority of employers paying much lower taxes than a flat-rated tax system. Seen from this perspective, experience rating, as implemented in the U.S., reduces subsidies rather than causing subsidies.

Finding an optimum level of benefit charging is a difficult issue that receives little attention. This report is valuable in clarifying a number of the relevant issues and in identifying some of the imposed limitations to a system of increased benefit charging.

To improve understanding of state tax systems and their impacts, we will soon begin publishing a new state tax structure report. This annual report will contain a number of newly published variables that will allow users to better evaluate state tax structures and make more valid comparisons on the impact of experience rating across states than previously published data.

Thank you for the opportunity to comment on this interesting report. If you have any questions, please don't hesitate to call me at 693-2700.

Sincerely,



Emily Stover DeRocco

Appendix IV: GAO Contacts and Acknowledgments

GAO Contact

Sigurd R. Nilsen, Director, (202) 512-7215, nilsens@gao.gov.

Staff Acknowledgments

Patrick di Battista, Assistant Director, and Michael Hartnett, managed this assignment. Others who made key contributions throughout the assignment include Sharon Hermes and Dan Meyer. Dan Schwimer, Pauline Seretakis, Scott Spicer, and Shana Wallace provided key support.

Related GAO Products

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