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UNEMPLOYMENT INSURANCE

Opportunities to Strengthen the Tax Collection Process

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The Honorable John Glenn
Chairman, Committee on
Governmental Affairs
United States Senate

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

The Honorable Tom Lantos
Chairman, Subcommittee on
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Committee on Government Operations
House of Representatives

This report discusses ways of strengthening tax collection processes for the nation's Unemployment Insurance system. Our review found that (1) the levels of program delinquency and debt write-off have been increasing in recent years and (2) federal guidance and support for dealing with tax delinquency and nonfiling could help reverse this trend. The report reflects comments from the Department of Labor, the Internal Revenue Service, and five selected states.

Copies of this report are being sent to other interested Senate and House committees and subcommittees; the Director, Office of Management and Budget; the Secretary of Labor; the Commissioner of Internal Revenue; and other interested parties.

This report was prepared under the direction of J. William Gadsby, Director of Intergovernmental and Management Issues. Other major contributors are listed in appendix III.

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Executive Summary

Purpose

The Unemployment Insurance (UI) system provides unemployed workers temporary income financed by employer taxes. The program is administered jointly by the Department of Labor and state government agencies. Because state UI tax collections have suffered recently from significant increases in delinquencies and bad debt write-offs, GAO evaluated the oversight and guidance Labor provides the states for establishing effective tax collection systems.

Background

UI program administration and benefit payments during fiscal year 1987 were financed by $6.1 billion in federal UI taxes and $19.1 billion in state UI taxes collected from employers. These funds are maintained in the Unemployment Trust Fund by the U.S. Treasury and are allocated to the states by Labor for benefit payments and administration costs.

Labor is responsible for ensuring the proper and efficient administration of state-operated UI programs. To do this, Labor maintains a Quality Appraisal Program to annually assess state UI performance against limited quantitative goals for benefit payment and tax collection. In addition, Labor (1) recently implemented a Quality Control Program to test samples of state benefit payments throughout the year for compliance with UI laws, policies, and procedures and (2) has been planning to develop a similar program for UI tax collection.

Results in Brief

Nationally, delinquent UI tax payments from private employers passed $1.3 billion in September 1987, a 60-percent increase from 3 years earlier, when delinquencies were $830 million. This excludes $296 million that states wrote off as uncollectible during this period and potentially significant losses from employers that paid wages in cash to avoid UI and other tax liabilities. In states where collection systems are not adequate, lax procedures can reduce the protection afforded unemployed workers and place a burden on employers already paying UI.

To improve state collection functions, GAO is recommending procedures to reasonably assure that (1) employers required to pay UI taxes are identified, (2) collection from employers is timely, (3) collection accurately represents employers' obligations, and (4) program administrative funds for the state collection function are used effectively. In addition, Labor's oversight and guidance needs to be improved to better ensure that states' UI tax collection systems are functioning effectively and that states are improving collection processes.

GAO's Analysis

Strengthening Oversight of State Tax Collection

Labor's Quality Appraisal Program goals for state tax collection are general and could provide more meaningful measures of state performance. In addition, delays in planned development of the tax collection Quality Control Program have left Labor without a system of continuous oversight of state conformance with established laws, policies, and procedures. This program is now projected for implementation in 1992. GAO believes Labor needs to improve its Quality Appraisal Program and implement its planned Quality Control Program to ensure that state systems for collecting UI taxes are functioning effectively.

Since 1986, Labor has reduced (1) control over how states use UI administration moneys to accomplish program functions, such as making benefit payments or collecting taxes, and (2) federal reporting and administrative requirements. Further, Labor has supported legislation that would consolidate responsibility at the state level for collection and management of all UI employer taxes (moneys for both program administration and benefit payments). GAO believes Labor should be reviewing these actions to determine their impact on state UI program administration. (See ch. 2.)

Developing Guidance for State Tax Collection

Some states are establishing active collection systems that maximize use of administrative and judicial procedures for reducing losses from employer delinquency and nonreporting. Others are implementing passive collection systems that have the effect of signaling employers that tax avoidance will be tolerated. When losses occur, they can result in curtailing the entitlements of unemployed workers or impose a greater burden on those employers who are already paying their share of taxes into the UI system.

To improve this situation, Labor should develop guidelines for use by states in establishing judicial and administrative procedures to minimize UI tax delinquency and the number of nonreporters. (See ch. 3.)

Promoting Use of Improved Collection Techniques

During the last 10 years, Labor has sponsored pilot projects in several states to develop new UI tax collection techniques. Other states have developed successful collection techniques on their own initiative. However, these new techniques are not being implemented by most states. To

improve this situation, Labor needs to (1) routinely promote and disseminate information on successful collection techniques and (2) provide financial incentives and better technical support for states to implement new collection techniques.

The states GAO visited were generally receptive to improving collection performance through exchange of new collection techniques and methods employed in other states. However, because administrative costs are federally funded, the cost savings states achieve accrue to the Unemployment Trust Fund and not the states involved. Some states indicated that UI administrative funding reductions accompanying improvements can discourage states' participation in efforts to improve collection. Previous GAO recommendations to address this problem have not been implemented by Labor. (See ch. 4.)

Single Audit Implementation and Internal Control Reporting

In the absence of a Quality Control Program for tax collection and an effective Quality Appraisal Program, Labor has placed increased reliance on the results of audits performed under the Single Audit Act. Labor uses these results to determine whether state UI programs are managed effectively and material internal control weaknesses are corrected.

Effective single audits are important, over the long term, for independent testing of state management systems. They were not, however, intended to be a substitute for Labor's oversight through Quality Appraisal and Quality Control programs. Since some single audits are being performed biennially or less frequently, they may not provide timely information on operations of the state UI programs. However, effective Quality Appraisal and Quality Control programs, coupled with results of the single audits, could provide Labor with an adequate basis for assessing and reporting on the status of internal controls. (See ch. 5.)

Recommendations

GAO is making a number of recommendations to Labor for improving oversight and guidance to (1) determine whether states are maintaining effective UI tax collection systems and (2) implement system improvements (see pp. 22, 38, 50, and 57).

Agency Comments

Labor agreed with many of GAO's findings and indicated that it will, or had already begun to, act on many of GAO's recommendations. Labor stated that in those instances where it did not agree with GAO discussion

or recommendations, the disagreement related to differences in perceptions about the degree and nature of federal oversight (see pp. 22, 39, 50, and 57).

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Abbreviations

FMFIA	Federal Managers' Financial Integrity Act
FUTA	Federal Unemployment Tax Act
GAO	General Accounting Office
IG	Inspector General (Labor)
IRS	Internal Revenue Service
OMB	Office of Management and Budget
UI	Unemployment Insurance

Introduction

The Department of Labor's Unemployment Insurance (UI) system is a federal-state partnership for providing temporary income to unemployed workers. Labor is responsible for ensuring the proper and efficient administration of state-operated UI programs. Program benefits and administration are financed by state and federal UI taxes paid by employers. In fiscal year 1987, employers paid $19.1 billion in state UI taxes and $6.1 billion in federal UI taxes.

This report focuses on the adequacy of oversight and guidance Labor provides the states for establishing effective UI tax collection programs.

Background on Federal UI System and State Programs

Labor provides states with annual grants for the purpose of administering UI under state laws the Secretary has approved. To be eligible for grants, state programs must meet specific legislative requirements (42 U.S.C. 503). Two requirements are that states (1) use methods of program administration that ensure payment of unemployment compensation when due and (2) submit reports as required by the Secretary. Labor regulations require states to maintain management systems to adequately control grant funds.

State and federal UI payroll taxes collected from employers are maintained in the U. S. Treasury Department's Unemployment Trust Fund. The Trust Fund consists of 53 state (here state includes the District of Columbia, Puerto Rico, and the Virgin Islands) accounts and separate federal accounts for specific purposes. Funds flow into these accounts from state and federal payroll taxes, loans from other accounts, and loans and transfers from the federal general fund. Funds flow out of the accounts for benefit payments, administrative costs, and the provision of loans to other accounts (transfers permitted between accounts when statutory limits are reached).

General tax revenues are advanced to the states on a reimbursable basis, through the Unemployment Trust Fund, to make up deficits in their Trust Fund accounts, which are a result of the payment of benefits during high levels of unemployment that exceeded the amounts collected. During the 1970s, as a result of high unemployment, states paid more in unemployment benefits than they collected in taxes. Rather than increasing employer taxes or reducing benefits to a level that could be paid from state funds, 26 state trust funds became insolvent and borrowed heavily from the national Trust Fund. The Trust Fund deficit created by this borrowing was underwritten with federal loans that peaked at $14 billion in March 1984. As of July 1988, all but two states had

repaid their debt to the Trust Fund and about $1.2 billion remained outstanding.

Management of the UI system is the responsibility of both the federal and state governments. At the federal level, Labor establishes UI system policies, provides states with guidance, and monitors the efficiency and effectiveness of state program operations. At the state level, specific procedures and practices are established for the operation of each state's individual UI programs.

Under the Federal Managers' Financial Integrity Act of 1982 (FMFIA), federal program managers are responsible for the quality of federal level program controls. Federal agencies must report annually to the President and the Congress on (1) whether there is reasonable assurance that their internal controls, among other things, safeguard resources against waste, loss, and misuse and (2) what actions are planned, if no reasonable assurance can be given, to correct known control weaknesses. At the state level, the Single Audit Act of 1984 requires each state receiving substantial federal funds to have an independent annual audit of its operations. Federal regulations and guidelines implementing the Single Audit Act (1) make Labor responsible for monitoring audits of the state UI programs to assure their completeness and timeliness and (2) require independent auditors to determine whether there is reasonable assurance that the states' UI programs are managed in compliance with applicable laws and regulations.

Labor relies primarily on evaluations by independent accountants, under the Single Audit Act, to provide reasonable assurance that state UI programs are properly and effectively administered. Labor has also established two separate UI oversight programs: a Quality Appraisal Program to annually assess state UI performance against limited quantitative goals for benefit payments and tax collection;[1] and a Quality Control Program, recently implemented for benefit payments, to test samples of state transactions, selected throughout the year, for compliance with established UI laws, policies, and procedures. For several years, Labor has also been planning to develop a Quality Control Program for tax collections, now targeted for implementation in 1992. In addition, Labor relies on evaluations by its Inspector General (IG) and

[1] As part of Labor's approval of states' administrative budgets, states are required to report planned actions to meet goals not attained in the preceding year. Labor regional offices may review states' programs during the year

GAO for further insight into the operation of state UI programs (see ch. 2).

State costs of administering the collection of UI taxes from employers are paid with federal UI taxes provided under Labor grants. For state collection programs to be properly managed, procedures must be in place to ensure that (1) employers required to pay UI taxes are identified, (2) collection from employers is timely, (3) collections accurately represent employers' obligations, and (4) program administrative funds for the state collection function are used effectively. In addition, procedures are needed to ensure that (1) tax money received from employers are properly managed, following receipt, and (2) taxes are structured so that sufficient revenues will be collected to pay projected benefits and maintain state program solvency. In general, for-profit business employers pay state UI taxes on the first $7,000 or more of salaried employees' wages. Individual employer's tax rates are increased (or decreased) in most states based on (1) the level of unemployment they experience and (2) the financial condition of the state's UI Trust Fund.

Objectives, Scope, and Methodology

Because significant increases in levels of delinquency and debt write-offs have occurred in state UI tax collection programs, we initiated an evaluation of the oversight and guidance Labor provides the states for these programs. Our objectives were to determine whether Labor's guidance to the states and oversight processes were adequate to ensure that states were (1) identifying all employers required to pay UI taxes, (2) accurately identifying the amount of taxes due and collecting them in a timely manner, and (3) effectively using administrative funds. We also wanted to determine (1) how Labor was using UI program audits under the Single Audit Act and (2) whether Labor's annual FMFIA report to the President and the Congress was identifying UI system material weaknesses and planned corrective actions.

At Labor, we evaluated the progress being made toward implementing an effective program to guide and monitor state UI tax collection efforts. To accomplish this, we assessed Labor's efforts to improve the quality of selected state tax collection programs. We also examined Labor's (1) annual Quality Appraisal Program and state plan approval process, (2) efforts to implement a continuous Quality Control Program, and (3) support for broader use of improved tax collection methods.

We also assessed UI tax collection programs in the states of California, Ohio, New Jersey, and Pennsylvania. We originally planned to perform

similar work in Illinois but did not because the state performed its own audit of UI tax procedures. We used the findings from the Illinois audit and a similar audit (started after our review) by the state of Pennsylvania, where appropriate, to supplement our work. We analyzed the results of these audits to ascertain whether they met Labor's requirements under the Single Audit Act for completeness, timeliness, and state UI program evaluation.

We selected the states in our review to provide variation in employment levels, location, demography, and extent of collection delinquency. We excluded smaller states from our review because the potential for impact on the national level of UI tax delinquency was low. We evaluated the states' collection procedures to ascertain whether there was a need for improved Labor oversight of the states' UI programs. This entailed (1) defining states' principal tax collection procedures, (2) analyzing the risks of material loss, (3) documenting and evaluating related collection activities, (4) testing a sample of collection actions against delinquent employers, and (5) determining needed corrective actions.

To test states' procedures for dealing with delinquency, we judgmently selected samples of 24 to 35 employer collection actions (for a total of 121) from each state's inventory of 1987 delinquent accounts. We selected accumulated debts, excluding nonsubstantive accounts (less than $1,000), from accounts that were (1) either delinquent over 1 year or (2) deleted from the states' inventories by write-off or debt cancellation during 1987. We evaluated the states' administrative and legal actions to secure payment in these cases. Although the results of the sample are not projectible, information from the cases illustrates how control techniques employed by the states function in actual practice.

Certain states that we selected for review had implemented improved collection methods and enacted laws that increased their ability to collect delinquent taxes. Accordingly, we compared and analyzed these state collection methods and laws to determine their potential for resolving collection problems of other states. We also evaluated the system for coordinating Internal Revenue Service (IRS) and state UI employer tax collection data to determine if there are better methods for states to use in (1) identifying and tracking delinquent employers and (2) eliminating practices used by employers to avoid paying their state UI taxes.

Our review was made in accordance with generally accepted government auditing standards. The review was done at Labor's UI headquarters in Washington, D.C., and Labor's regional offices in Philadelphia,

Chicago, New York, and San Francisco. Work was also done at IRS headquarters in Washington, D.C. We evaluated state UI tax collection programs at state headquarters offices in Harrisburg, Pa.; Columbus, Ohio; Sacramento, Calif.; and Trenton, N.J. During our review, we obtained data and interviewed UI program operating officials in these states and at Labor's headquarters and regional offices.

Strengthening Oversight of State Tax Collection

Labor does not know whether (1) the states are identifying employers who are required to pay UI taxes and (2) states' UI tax collections are timely and accurately represent employers' obligations. Labor's Quality Appraisal Program for assessing state UI performance annually against quantitative goals for state UI tax collection is general and should provide more meaningful measures of accomplishment. In addition, Labor needs a means of testing a sample of state UI tax collection transactions throughout the year to ascertain whether states are complying with applicable laws, policies, and procedures. Labor does plan to implement a Quality Control Program for this purpose in 1992.[1]

In addition, since 1986, Labor has reduced (1) control over how states use UI administration moneys to accomplish program functions, such as making benefit payments or collecting taxes, and (2) federal reporting and administrative requirements. Further, Labor proposed legislation that would place responsibility with the states for collection and management of all UI employer taxes (moneys for both program administration and benefit payments). The effects of these actions need to be evaluated by Labor.

Establishing Meaningful State UI Performance Goals

Labor's Quality Appraisal Program measures state UI performance against 26 benefit payment and tax collection goals established about 12 years ago.[2] Labor uses these goals, called Desired Levels of Achievement, to measure performance and obtain commitments as needed from states to improve performance under their grant agreements. Some state officials advised us, however, that the collection goals could be improved to better measure performance. Officials in one state also advised us that they do not attempt to meet Labor's goal for auditing a specified number of employers each year because this would require them to audit more smaller companies, for which there is less likelihood of increasing tax collections (see p. 14).

Labor's goals are focused primarily on benefit payment performance. The following four goals, however, apply to tax collection functions:[3]

[1] Labor implemented a Quality Control Program for benefit payments in 1987.

[2] Labor's goals for benefit payments were not included within the scope of GAO's review.

[3] Other Labor goals cover cash management, a function relating primarily to the administration of UI tax after it has been collected.

- Status determination promptness: a minimum of 80 percent of taxable employers are identified within 180 days of an employer's liability date.
- Report delinquency: a minimum of 95 percent of employers file contribution reports by the end of each quarter in the year.
- Field audit coverage: a minimum of 4 percent of states' for-profit business employers obligated to pay UI taxes before the end of the preceding year are audited annually.
- Collection timeliness: a minimum of 75 percent of delinquent accounts pay some moneys within 150 days from the end of each quarter in the year.

States that fail to achieve one or more of these goals were required to submit corrective action plans to Labor describing how the goals will be met the following year. While the states submitted the plans, Labor generally did not hold the states in our review accountable for improving their performance from one year to the next.

We sought the opinions of UI program officials from each of the four states in our review concerning (1) whether Labor's goals were useful for measuring the relative effectiveness of states' UI tax collection efforts and (2) the priority states placed on achieving these goals. Generally, these officials believed the goals—based on accomplishment of numbers of employer actions in a state—were not a meaningful measure of performance. The opinions of Labor regional officials on the goals were, in many cases, consistent with states' program officials' views.

The goals state officials most often identified as needing revision were those related to field audit coverage and collection promptness. State officials in three of four states indicated that the 4-percent audit coverage goal should be changed. Major concerns were that this goal did not take into account the difficulty of the audits, size of employers being audited, or potential for dollar returns. For example, Pennsylvania officials told us that they attempt to meet the 4-percent audit goal. Pennsylvania selects predominately smaller employers for audit instead of those with the most potential for large dollar returns. We believe a more effective course of action would be for states to provide focus on taxable wages and ways to maximize tax collections, as well as on the number of employers audited.

California does not attempt to achieve Labor's 4-percent audit coverage goal and, typically, has audited only 2 percent of its employers. California, however, focuses on maximizing returns on collection and directs audits where there appears to be recovery potential. State officials said

that they could achieve the 4-percent goal if they revised their target mix of employers, but indicated this revision could reduce the amount of tax collection. In its corrective action plan for Labor, California said that it is reviewing its audit selection criteria to determine ways to achieve Labor's performance goal without reducing the amount of tax collection. However, the state does not believe that it will meet the performance goal in the near future.

In April 1987, Labor modified its audit performance goal to require that at least 1 percent of the states' total audit coverage include large employers (100 or more employees). However, large employers typically maintain employment records on computerized data bases, and several states in our review did not believe that they had the personnel or technical capability to fulfill this requirement. Specialized knowledge and training for state auditors is needed for them to effectively evaluate these records. Labor's technical support for auditing large employers is discussed in chapter 4.

State UI officials advised us that collection of some moneys within 150 days from the end of a quarter from 75 percent of delinquent employers is not a meaningful goal. Although states were generally achieving this performance objective, officials believed that to make it meaningful, the monetary goal should be stated in terms of a specific amount or be eliminated. During a period when total dollar delinquencies increased dramatically, Labor regional officials found that tax collectors in one state (not part of our review) were focusing collection efforts on small dollar value accounts where recovery was easy to achieve Labor's goal. Revision of this goal, accompanied by effective oversight through state plan review, could motivate states to adopt methods of collection that strengthen performance (see ch. 3.).

Although Labor monitors states' performance in collecting UI revenues, it has chosen to take a passive oversight role. In fact, officials in one Labor region indicated that they were not overly concerned with whether states achieve the performance goals. The officials' preference was to maintain a consultant role with the states in their region, being careful not to take any actions that would be viewed by states as interference.

In July 1987, Labor initiated action to strengthen its oversight of state corrective action plans by adding requirements for (1) reviews of state plans, (2) progress tracking, and (3) identification of needed actions. These efforts represent progress in improving Labor's Quality Appraisal

Program. However, the impact of these efforts will probably be limited until Labor's goals are upgraded to better measure state accomplishment.

In October 1988, Labor contracted with a consultant to review its UI performance measurement systems (Quality Appraisal, Quality Control) over the next 2 years. Labor plans to (1) review its legal responsibilities for the UI program; (2) identify alternatives for evaluating state performance, focusing on key outcomes; (3) identify gaps in current assessment processes; and (4) establish new methods of measuring performance (including performance minimums).

Expediting Development of Tax Collection Quality Controls

In 1984, Labor began developing a comprehensive Quality Control Program for benefit payments and tax collections, which would provide an ongoing evaluation of sampled state UI transactions to assess conformance with established laws, policies, and procedures. However, Labor advised us that resource limitations and the complexity of tasks resulted in Labor's implementing the program in phases. Initial efforts were primarily directed toward developing the Quality Control Program for benefit payments, which was implemented in October 1987. During this time, limited planning efforts were also devoted to the tax collection phase. In the spring of 1988, a task force was established with plans for developing and implementing a tax collection Quality Control Program by 1992.

In August 1985, Labor's Acting Deputy Assistant Secretary for Employment and Training issued a public notice and separate letters to governors, requesting their views on the design dimensions and consequences of Labor's proposed Quality Control Program, which had been under development during the preceding 18 months. The Quality Control Program goals were to maintain and improve the accuracy and timeliness of state UI tax collection and benefit payment activities by installing a system to detect problem transactions and to support corrective actions.

State benefit payment activities had for some years been subject to a quality control process known as "random audit," but tax collections had not previously been subject to any quality control. In requesting public views on a quality control design plan in 1985, Labor's Acting Deputy Assistant Secretary for Employment and Training stated that

"Revenue [Tax] collections are an area of known problems but one as yet unexplored through a random audit-like approach. Tax operations are complex and would

require benefit-like decisions about the scope of actions covered and methodology to be used. Omitting revenues would lower cost but leave the revenue half of UI processes without an error measurement mechanism and place an unfair burden on law-abiding employers. Covering revenue operations would greatly increase the complexity of the system, while tapping potential revenue gains from correcting under collections and collection delays on $20 billion of tax liabilities annually."

In March 1986, Labor began planning a pilot project for its Quality Control Program for state UI tax collections. Labor contracted with a consultant to provide technical support for the project, and 13 states volunteered to become pilot sites for testing. However, these plans were deferred and, during the 2 years that followed, Labor gave priority to developing the benefit payment phase. In September 1987, the Secretary of Labor announced the implementation of the benefits Quality Control Program and indicated that Labor still intended to implement a Quality Control Program for tax collection.

In December 1988, Labor requested public views, including state comments, on what this Quality Control Program should include. Labor indicated that its initial efforts were completely open-ended and that there were no preconceptions about methodology at this point. Labor asked respondents to indicate preference for a program focused on (1) a minimal set of measures that would capture the quality of key revenue function outputs or (2) a fuller set of output-related measures, including data on processes leading to each outcome.

Design and pilot testing of the new program are projected to occur through 1991, with implementation in 1992. Labor officials advised us that a 4-year system development period is necessary to provide ample time for advice, consultation, and consent of all interested parties.

Reviewing the Impact of Devolving Federal Responsibilities to the States

In 1986, Labor began devolving its UI oversight responsibilities to the states. Although Labor has informed states of its plans for devolvement, there have been no provisions for evaluating the impact of these changes. Labor's goal is to devolve substantially all administration and financing of the UI program to the states while retaining its responsibility for ensuring that state programs meet overall UI program objectives. Labor plans to carry out its oversight responsibilities through its Quality Appraisal Program and its planned Quality Control Program.[4] Labor expects devolvement will

[4]The Quality Appraisal Program is being evaluated for change (see p. 22).

- simplify administration of the UI system,
- increase state responsibility and discretionary authority over the financing and administration of each state's UI program,
- increase state administrative flexibility in responding to changing state economic circumstances,
- reduce federal responsibilities and authority in the determination of state program administration methods and costs, and
- maintain basic UI system objectives for (1) providing short-term partial wage replacement for workers who lose their jobs and (2) collecting employer taxes to finance the system.

In May 1986, Labor announced changes in procedures that reduce its control over states' UI administrative spending during the grant year. These changes

- eliminated Labor's line-item monitoring of state UI spending for program administration,
- eliminated Labor's quarterly recovery of unobligated grant funds in favor of recovery on an annual basis only,
- reduced state fiscal reporting to Labor, and
- reduced Labor's oversight of states' use of administrative contingency funds.

Although these short-term administrative changes substantially decreased the degree of federal oversight of state UI programs, the impact of these changes on states' administration is not being evaluated by Labor. We noted that the flexibility afforded states by eliminating Labor's mid-year budget controls resulted in states' incurring fund losses and eliminating required employer audit coverage (see pp. 30, 31, and 53).

State UI administration is currently funded by federal UI taxes, which are distributed to the states by Labor. Benefits are funded by state taxes collected from employers. Legislative changes were deemed necessary by Labor to fully devolve administrative and financial control of the UI program to the states. In February 1987, the necessary changes were introduced in the Congress under the President's proposed Trade, Employment, and Productivity Act of 1987 (S.539). Title I-F of the bill would have given states full responsibility for financing and administering their UI programs by providing them new authority to levy and collect the tax for their UI administrative costs; the bill would have added to their existing authority to collect taxes for benefit payments. The bill would have done this by amending the Federal Unemployment Tax Act

(FUTA) so that IRS would no longer be responsible for the collection function. Although these funds are currently collected by IRS, they are allocated to states by Labor. Labor expected its proposed long-term legislative changes would (1) simplify administration of UI by consolidating employer taxing authority at the state level and (2) give states the flexibility to apply resources and provide services as they see fit.

Labor distributes revenues for state administration in the form of grants, which are based on state-forecasted workload and the unit costs of processing that workload. For a few states, administrative grants far exceed the federal UI taxes paid by their employers; for a few other states, taxes and grants are roughly equivalent. For the remaining states, sufficient taxes are collected to cover administrative costs and generate excess revenues, which are applied through the UI Trust Fund to make up other states' funding insufficiencies. Thus, S. 539 could affect some states' ability to adequately fund their UI administration. Because states would have authority to collect taxes for both benefits and administration, some might elect to make up administrative funding deficiencies through increasing employer taxes and using taxes needed for benefit payments for this purpose. The level of benefits could be eroded in states unable to increase taxes.

National pooling of tax revenues for administering the UI system and distributing them based on workload has enabled Labor to adjust funding in response to workload shifts among the states. State collection of these taxes would end national pooling and leave, as the only source of administrative funding, the states' collections from their own employers. Some states believe that (1) a form of pooled risk will still be necessary to assure the continuation of a national system of employment security and (2) this might be accomplished by establishing an administrative loan fund for states that are unable to collect sufficient taxes to administer their programs.

The collection and distribution of UI taxes for administration is another issue that will be difficult to resolve. Employers currently pay FUTA taxes quarterly; these taxes are, in turn, deposited in the Unemployment Trust Fund of the U. S. Treasury. FUTA taxes are used, in addition to paying for state UI administrative costs, to pay for federal UI program administration, the federal share of the extended benefits program (covering longer periods of unemployment for employees exhausting regular UI benefits), and federal loans to states for benefit payments. These federal functions would be continued under the proposed legislative

changes, but would be supported from taxes states collect that they designate for these purposes.

Labor officials told us that whether states' administrative resources are increased or reduced under the legislation was not the key issue. They believe that to improve the administration of the UI program, legislation is needed to provide states combined tax authority and the flexibility, within broad federal guidelines, to determine the amount of resources they wish to collect and expend for administration. However, title I-F of S. 539 (see p. 18) was not enacted during 1988. Labor officials advised us, however, that the impetus for devolvement would continue into 1989, but they were uncertain whether S. 539 or a variation of this bill might be reintroduced. Although Labor promoted S. 539 to devolve UI funding, it had not evaluated the proposed UI program funding methods to be implemented when tax authority is consolidated at the state level.

The need for such evaluation was recognized by the National Governors' Association in policies adopted at its meetings in December 1987 and August 1988. Rather than recommend passage of the legislation, the association proposed a 3-year federal demonstration project that would allow three to five states to fund their operational costs through the same taxing mechanism that funds benefit costs. The association suggested that (1) the project be carefully designed so as to include states that contribute both more and less in federal taxes under the current law than the administrative costs they incurred and (2) a comprehensive evaluation of the project be undertaken to assess the effectiveness of the financing strategy in improving the program.

In its August 1988 meeting, the National Governors' Association recommended changes in the way operating costs of the current employment security system (comprising UI as well as other programs) are financed. The association determined that resources currently appropriated have been inadequate to fund essential services although sufficient employer taxes had been collected for these services. To rectify these shortages, the association proposed, among other things, that (1) the states be guaranteed a minimum of 80 percent of the employer taxes they collect, based on workload for program administration, and (2) a minimum of 90 percent of taxes collected nationally be appropriated annually for the operation of state programs.

Labor officials advised us that they expect these proposals to be introduced in the Congress in early 1989. If enacted, these proposals could

substantially increase outlays from the UI Trust Fund for state administration.

Conclusions

Improved monitoring of states' UI tax collection activities could facilitate Labor's ability to (1) provide leadership and policy guidance to the states for the development, improvement, and operation of their UI programs and (2) determine whether the states are in conformity with federal requirements. Labor oversees state UI programs with only limited involvement in states' operation and administration of the UI tax collection functions. Labor has been acting to further devolve its oversight role through administrative changes and the promotion of legislation to devolve all UI program financing to the states. We believe Labor has the opportunity to strengthen the federal tax collection process by establishing (1) a more meaningful Quality Appraisal Program for measuring states' collection performance and (2) a Quality Control Program for tax collection.

Labor has not yet established design criteria for developing its Quality Control Program for tax collection. Labor has long recognized that there are problems in collecting UI taxes; it needs to give priority to developing a program that would help (1) identify state management problems with national implications that require Labor's intervention and (2) resolve specific problems with state UI programs in a timely manner. Labor should consider the legal and administrative control principals discussed in chapter 3 of this report in developing its tax collection Quality Control Program.

Labor should also evaluate the financial implications of devolving taxing authority to the state level. Legislation like title I-F of S. 539 would necessitate that each state generate sufficient taxes for its UI program to be self-sustaining in terms of paying state benefits, program administration, and meeting other federal requirements. Labor needs to evaluate whether new financing strategies to be considered in the upcoming legislative session of the Congress will provide a means to effectively

- maintain benefit levels during periods of peak unemployment;
- supplement funding deficiencies for administrative costs in the states where the employer tax base will not generate sufficient taxes to adequately administer UI program operations; and
- fund the cost of federal UI system administration, extended benefits, and federal loans to other states through the same taxing mechanism used for funding benefit costs.

This could be accomplished through a prospective evaluation of the impact of proposed legislation using past benefit and administrative costs states have experienced.

Recommendations to the Secretary of Labor

We recommend that the Secretary of Labor direct the Assistant Secretary for Employment and Training to

- replace Labor's Quality Appraisal Program goals for state UI tax collections with more meaningful performance expectations that focus on ways to maximize collections rather than numbers of actions accomplished;
- expedite the development and implementation of the planned UI tax collection Quality Control Program, utilizing principals of effective state controls identified in this report; and
- review legislative proposals for consolidating UI tax collections at the state level to determine their effect on states' ability to maintain benefit levels and fund UI administrative costs.

Agency Comments and Our Evaluation

In commenting on a draft of this report, Labor stated that it would address our recommendations to replace Labor's Quality Appraisal Program goals for state UI tax collection with more meaningful performance expectations through its Performance Measurement Review and Quality Control Projects. Labor also indicated, in response to recommendations in our draft, that its Quality Control Task Force would use much of the information contained in our report for development of the tax collection Quality Control Program, but that it would not be able to expedite the program's completion before the projected 1992 target date. It stated further that in areas where it differed with us, the differences generally relate to perceptions about the degree and nature of federal oversight. Labor stated that the focus of federal oversight has shifted from concern with process to an emphasis on program outcomes.

Labor indicated that although public consultation on tax collection issues occurred in 1985, it would not be accurate to characterize the tax collection improvement efforts as beginning that early. Labor stated that the Quality Control Program for benefits and revenue was being implemented in stages due to the complexity of the management task and the realities of resource limitations. We added information to our report recognizing these views and Labor's postponement of the development of the tax collection Quality Control Program to permit completion of the benefits Quality Control Program.

We believe that current Labor initiatives for development of the tax collection Quality Control Program are an important first step toward implementing an effective program. Initiating program planning efforts without preconceptions about program structure should encourage open cooperation and support from the states and other affected parties, thus reducing front-end design time for the program. In addition, implementing the benefits Quality Control Program will free Labor's resources and enable the tax collection Quality Control Program to progress unimpeded by other program efforts. Because Labor is not beginning development of tax collection controls based on established programs, as was the case with the benefits program, we believe the findings of this report and other external views received could help Labor shorten its projected 4-year planning and development effort.

In obtaining public comments on its development plans, Labor has asked whether the tax collection Quality Control Program should, for federal oversight purposes, be oriented to the quality of (1) key program outputs alone or (2) key outputs, as well as the processes that generate those outputs. While the former approach would most likely require fewer Labor resource commitments, we believe it would not be a prudent course of action. Labor is responsible for fostering the effective operation of state UI programs. The inability to assess the processes that yield effective or ineffective program outputs would mean losing a significant opportunity to facilitate management improvement at the state level.

In response to our recommendation that Labor review future legislative proposals consolidating UI tax collections at the state level, Labor essentially reiterated the position its officials took during our review (see p. 20). Labor reaffirmed its belief that program administration would improve by consolidating both tax collection authorities and granting authority to determine the level of resources to be collected and spent.

Although Labor's belief might be correct, we noted (see p. 18) that it had not evaluated the potential impact of devolving both tax collection authority and resource decision-making authority to the states. We continue to believe, as did the National Governors' Association, that such an evaluation would be useful.

Developing Guidelines for State Tax Collection

Labor should provide guidelines for use by the states in establishing administrative and judicial procedures and other techniques to minimize the rate of UI tax delinquency and the number of nonreporters. State UI tax collection systems are developing with substantial variations in quality and effectiveness. Some states have established active collection systems that maximize use of such procedures and techniques for reducing losses from delinquency and nonreporting. Others have implemented passive systems that have the effect of signaling employers that tax avoidance will be tolerated. When losses occur, they are borne by employers who are already paying their share of UI taxes. In addition, when employers do not report wage payments or UI tax obligations, significant losses in benefit entitlements and state and federal income taxes can result.

Nationally, delinquent UI tax payments on record from private employers passed $1.3 billion in September 1987, a 60-percent increase from 3 years earlier, when delinquencies were $830 million.[1] This excludes $296 million in uncollectible employer accounts, written off by states during this period, and potentially significant losses from underground economy employers that deal in cash to avoid UI and other tax liabilities.

Some state procedures and techniques for collecting UI taxes are inadequate to control delinquency and identify employers that have not reported UI tax obligations. In addition, Labor's efforts to facilitate states' matching of IRS and state data — to identify employers with delinquent UI tax obligations — have met with limited success.

Variation in Effectiveness of State Administrative and Judicial Procedures for Controlling Delinquency

The effectiveness of state collection from delinquent employers is largely dependent on the quality of control procedures used and the timeliness of action taken using these procedures. States that adopt weak delinquency control procedures are, in effect, increasing ultimate program losses by permitting employers to accumulate more in delinquent taxes while the likelihood of their making payments is diminishing.

The approaches states in our review used to manage their UI programs, including the extent of effort expended to deal with delinquent employers and the aggressiveness of collection techniques used, were reflected in how well the states fared in recovering taxes. This is illustrated by

[1]The level of state UI tax collections has remained relatively stable during this period ($19 to 20 billion).

(1) the statistics on UI tax collection activities for the four states included in our review (see tables 3.1 and 3.2); (2) the differences, active versus passive, in the states' approaches to collecting delinquent UI taxes (see table 3.3); and (3) examples of the significant procedures and techniques used by the states in collecting delinquent UI taxes (see table 3.4).

Table 3.1: UI Tax Collection: Delinquency and Exposure Rates in California, New Jersey, Ohio, and Pennsylvania
(as of Jan. 1, 1987)

Dollars in millions

	Collection		Delinquency		Exposure rates	
	Employers	During 1987	Inventory	Written off from 1984-86	Delinquent percent of all collection	Delinquent dollars per all employers
California	661,000	$1,906.4	$85.2	$13.0	4.5	$129
New Jersey	181,000	986.5	89.5	7.4	9.1	494
Ohio	192,000	964.0	71.2	2.6	7.4	371
Pennsylvania	213,000	1,396.0	101.8	19.6	7.3	478

Note: Data in this table were obtained from (1) quarterly state reports for the Labor Department that summarize UI collection activities and (2) state records of aging delinquent accounts. The amounts written off, pending assessment, and unreported are excluded from the analysis of delinquency and exposure rates. Data were not available to exclude from collections amounts received from about 1 percent of nontaxed employers that reimburse the UI program for employees they discharge.

Table 3.2: Age of Delinquent UI Tax Accounts for California, New Jersey, Ohio, and Pennsylvania (as of Jan. 1, 1987)

Dollars in millions

	California		New Jersey		Ohio		Pennsylvania	
Age of account	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Under 1 year	$22.1	26	$18.0	20	$9.8	14	$27.1	27
1-2 years	39.1	46	15.5	17	11.0	15	25.7	25
Over 2 years	24.0	28	56.0	63	50.4	71	49.0	48
Total	**$85.2**	**100**	**$89.5**	**100**	**$71.2**	**100**	**$101.8**	**100**

Note: Data on this table were obtained from (1) quarterly state reports for the Labor Department that summarize UI collection activities and (2) state records of aging delinquent accounts. Amounts written off, pending assessment, and unreported are excluded from this analysis.

Table 3.3: Comparison of Active and Passive Approaches to UI Tax Collection

Type of action	Active approach	Passive approach
Follow up on initial delinquency notice	Automated telephone delivery of a pre-recorded payment request with live interrupt for payment arrangements	Manual system relying on availability of field collection agents to make personal contacts
Liens filed	Tax liens filed for all delinquent employers after first overdue notice	Tax liens filed selectively; continued delinquency permitted
Offsetting other income	Attaching wages, payments for liquor licenses, services rendered to the state, lottery winnings and tax refunds (see p. 71)	No offsets provided
Aging receivables and analyzing employer financial conditions to reduce debt accumulation	Employer financial condition and aged amount of delinquency used to focus collection efforts before debt accumulates	Limited information compiled to focus collection efforts
Recovery from company officers	Corporate officers' personal assets subject to attachment and seizure for nonpayment of UI taxes	Corporate officers' personal assets exempt from attachment and seizure
Seizure of company assets	State law permits UI program officials, without court action, to seize company assets for nonpayments of UI taxes	State law requires UI officials to file and await a court judgment and writ before seizure of assets; process used infrequently

Table 3.4: Comparison of Selected State Administrative and Judicial Procedures as Well as Techniques for Collecting Delinquent UI Taxes and Related Costs

	Procedures/techniques affecting for-profit employers				Procedures/techniques affecting government and non-profit employers			
Procedure or technique[a]	**California**	**New Jersey**	**Ohio**	**Pennsylvania**	**California**	**New Jersey**	**Ohio**	**Pennsylvania**
Administrative levy	*				O			
Tax lien	*	*	*	O	O	O		O
Warrant	*				O			
Writ of execution		*	*	O				O
Offset	*				O			O
Individual (memo) assessment	*	O			O	O		O
Employer (arbitrary) assessment	*	O		O	O	O		
Civil action	*	O	O	O	O	O	O	O
Criminal action	*	O	O	O	O	O	O	O
Liquor license hold	O		*	O	•	•	•	•
Out-of-state judgments recognized	*				O			
Administrative subpoena of tax records	*			O	O			O
Earnings withholding orders	*	O		O				
Budget withholding	•	•	•	•				O
Bonding						O	O	*
Security deposit								*
Employer status change	•	•	•	•	O	O		*
Corporate officers held individually liable for employer UI tax	O				•	•	•	•

Legend
* = Frequently used collection procedure or technique
O = Infrequently used collection procedure or technique
• = In general, collection procedure or technique not applicable

Note: For-profit businesses pay unemployment insurance taxes quarterly, on the basis of established rates. Governmental and nonprofit organizations have the option of paying only the amount necessary to fund the benefits of the employees they discharge.

[a]See Glossary.

Source: State officials identified the above procedures and techniques as well as extent of use.

Typically, states with passive control systems (1) depend on the integrity of employers to be responsive in paying UI taxes and (2) periodically demand payment from delinquent employers, as shown in table 3.3. Occasionally, states filed liens (unsecured by specific assets) with the courts, but usually allowed employers to continue operating indefinitely without paying UI taxes. For many delinquent employers, insolvency or bankruptcy eventually occurred and the level of assets available for

payment of UI taxes to the states was substantially diminished or assets were no longer available.

States' UI laws and the extent of their use were also determining factors in whether states adopted an active or passive approach to delinquency control. For example, as shown in table 3.4, California law makes corporate officers individually liable for UI employer tax debts. California law also allows the state to administratively seize corporate or individuals' personal assets through an administrative levy process (see Glossary) to satisfy UI debts without pursuing a time-consuming writ action in the courts. Other states in our review did not have these options available under their state UI laws.

Annually, states propose thousands of amendments to both UI legislation and other state statutes with an impact on their UI programs. States are required to submit copies of these proposed amendments to the Secretary of Labor. Labor is obligated to determine whether legislation ultimately enacted conforms to the Federal Unemployment Tax Act (FUTA), Social Security Act, and other Labor requirements. Labor does not have criteria defining which areas of proposed state laws it will review and comment on, such as benefit payment administration, UI program solvency, and tax collection. During the last 3 years, Labor has not commented on any proposed changes in state tax laws with an impact on UI tax delinquency.

The following description of collection procedures and techniques in Ohio, Pennsylvania, New Jersey, and California illustrates the different types of approaches.

Ohio

Ohio has no formal written procedures for its UI Collection Department operations, and establishes procedures on an ad hoc basis. It has been streamlining certain collection processes and eliminating other processes that have, in the past, motivated employers to be timely in making payments. In November 1986, Ohio implemented an automated telephone business system, which enhances the state's ability to be timely in communicating collection requests and to discuss payment arrangements.[2] The state also began filing general creditor liens against all delinquent employers about 1 month after the first delinquency notice was issued, and has been focusing audit emphasis on problem industry employers

[2]Labor has encouraged states to implement these systems through support from UI automation funds (see ch. 4).

that have a poor track record of UI tax payment. However, the cases we reviewed disclosed a lack of action to obtain recovery by seizure or attachment of assets when payment was not forthcoming. In some cases, an individual employer's debts accumulated for years, and Ohio was ultimately unable to collect any of the delinquent taxes despite having a general creditor lien.

In its streamlining efforts, Ohio has been gradually reducing controls over employer tax collection. It has discontinued the use of the following compliance techniques that in the past had been effective in prompting employers to pay delinquent taxes:

- requiring delinquent employers not under audit to file a written personal financial history statement with a proposal for payment of overdue taxes;
- obtaining asset specific liens, which permitted Ohio UI officials to red tag equipment (for example, machinery and vehicles identified by state lien tags) at the employer's place of business; and
- holding corporate officers personally liable for delinquent UI taxes.

State UI officials advised us that they would like to have the latter authority made a part of UI statutes.

Pennsylvania

Pennsylvania has written procedures for collection functions, many of which are done manually (without automation). The state may file liens against delinquent employers when a payment discrepancy occurs or business difficulties are observed. The state has focused audit and collection efforts on the 200 employers with the largest dollar delinquency. However, its collection actions have not been effective in reducing UI tax delinquencies even though it has conducted audits and notified employers (see pp. 53 and 54).

A 1987 report by Pennsylvania's auditor general found that the state's delinquent UI tax debt increased from $15 million to $102 million during the 8-year period ending in 1986. This excludes an additional $18 million that the state wrote off as uncollectible during 1986. The auditor general indicated that increased delinquencies were due to funding actions by the state. Administrative resources originally allocated by Labor for staff needed to perform collection functions had been used by Pennsylvania for other purposes.

The following example illustrates what can occur when a state maintains a passive collection system: In 1985, an employer incorporated his fourth business in a series of businesses he has operated in the state during the last 13 years. This employer, who established himself as president of each of the companies, had incurred over $80,000 in UI tax debt from three previously failed businesses and the current active business. The failed businesses ended with (1) little or no UI tax contributions having been made, (2) insufficient assets to pay any UI debts, and (3) discharged employees that were paid UI benefits. Successor companies started by the employer were in closely related but not identical businesses, and some residual assets of failed businesses were acquired by the employer for the new companies. Pennsylvania officials believe that the employer, as founder and president of these companies, has substantial resources in the state. However, Pennsylvania has no law holding corporate officers individually liable for employer UI tax contributions; state efforts to transfer the debt, through successor-in-interest laws, to the new businesses have been unsuccessful.

Pennsylvania requires newly established nonprofit businesses, a kind of reimbursable employer (see p. 44), to post a bond or make a cash deposit in the event they later fail to reimburse the state for UI benefits paid for employees they discharge. This alternative does not extend to for-profit businesses organized by individuals that have shown a poor track record of UI tax payments. Pennsylvania state law also does not hold company officers and others individually liable for the employer UI tax debts (attributable to employer contributions) of their companies. Either of these practices might help minimize future losses from delinquents in Pennsylvania's UI program.

New Jersey

New Jersey's collection procedures provide for aging delinquent accounts and selectively evaluating the financial condition of delinquent employers. Once the account becomes delinquent, the length of time in delinquency determines the intensity of collection efforts. When an employer fails to submit a first-quarter contribution report or to make full payment, a series of letters, billings (where tax debt is known), or both are sent by the state to the employer, requesting that a contribution report and payment be made. After the account is delinquent for one full quarter, telephone contacts are begun; when the second quarter passes, the state has the option to subpoena the books and records of the employer for financial evaluation. When delinquency extends to three quarters, New Jersey procedures provide for a field audit of the

employer, and the state can arbitrarily assess the amount of delinquency and bill the employer. During the third quarter, a general creditor lien may be filed at the state's discretion.

Staffing resources have not been available in New Jersey for timely implementation of these processes. As a result, there has been a backlog in filing liens and carrying out other functions, such as making employer (arbitrary) assessments (see Glossary). This, in turn, limits the state's ability to collect delinquent UI taxes when companies terminate. Of the 24 cases we reviewed in New Jersey, seven were in bankruptcy with less than 20 percent of their $533,000 delinquent UI tax debts secured by liens. The following example illustrates difficulties New Jersey is encountering when liens have not been filed to obtain payment before companies terminate: In July 1986, after an audit by the state of New Jersey, an employer submitted missing UI contribution reports to the state for three quarters in 1984 and 1985. At the time, the state was unable to be timely in implementing existing procedures for filing a lien. In November 1986, the employer declared bankruptcy, leaving New Jersey with limited recovery prospects for about $277,000 in UI taxes.

New Jersey officials advised us that the state has received less funding from Labor for UI administration in recent years than previously because its workload to process benefits has dropped with improved economic conditions. State officials said that under Labor's requirements, performance of benefit payment functions takes priority (based on Labor's goals) over collection of UI taxes; hence, there have been many funding cuts and staff reductions in the collection activity. Under current funding procedures, Labor provides an annual budget allocation to all states, but does not monitor or influence states' spending priorities among the various UI program functions during the year (see p. 18).

California

California's judicial and administrative procedures for dealing with delinquent UI accounts have been formalized in writing. The state maximizes voluntary compliance by presenting an aggressive collection image, supported by a tax law that gives the state substantial latitude and flexibility for dealing with delinquent employers.

California develops employer trend data to focus its collection efforts through a new automated tax accounting system. This system uses employer delinquency problems (payment history over time and other factors) as a basis for focusing the state's collection attention in areas of the greatest potential loss. Audits are performed primarily in response

to audit leads and do not originate from this system. Audits are also focused on maximizing dollar return, but all employers (large and small) can be selected for examination. The state also maintains an extensive network of information from other tax and business operating data bases in the state to identify employers that are understating or otherwise avoiding their UI tax obligations (see p. 34).

California has automated its collection process to provide frequent follow-up bills to employers who do not pay and has implemented an automated telephone system similar to the system recently implemented in Ohio. When employers do not respond to the state's requests for payment, state law provides UI officials the authority to

- encumber and seize both real and personal property of the business or the companies' officers or both at the UI administrator's discretion without a court order and
- offset delinquent taxes against other state money owed to individuals and firms, such as tax refunds, lottery winnings, and other earnings.

These measures are used by the state, and examples of tax recoveries are publicized. Although not readily susceptible to measurement, California officials advised us they believe that the image of an active collection program has a significant deterrent effect on employer delinquency. Among the states in our review, California showed the lowest dollar level of delinquency in relation to total collection (see tables 3.1 and 3.2).

Limitations in States' Procedures for Identifying Employers Not Reporting UI Tax Obligations

UI taxes can be significantly reduced if states have not established effective procedures to ensure that employers obligated to pay UI taxes are identified. The level of effort and quality of procedures established for nonreporters were generally consistent with the states' overall approach for collecting from delinquent employers that report their obligations in the UI program but do not pay. Some states have developed a policy of limited action in identifying and collecting from nonreporters. Labor has not issued any guidance to states for establishing procedures to deal with these employers.

Most states in our review recognized that there is the potential for substantial lost taxes from employers that fail to report UI tax obligations. Yet the states' policies differed on whether they should present an aggressive image to nonreporters or a passive one, which might have the

effect of allowing their nonpayments to go undetected and ultimately be paid by other employers supporting UI.

Three of the four states in our review had a passive approach for identifying nonreporters, relying primarily on (1) the integrity of employers to file correct returns and (2) follow-up on those UI claims for which the state has no earnings reported for the claimant. This latter technique, referred to as obstructed claims, is a normal by-product of the benefit payment system; it frequently identifies employers who have not filed or improperly filed UI tax returns. The technique is used for tax recovery, with varying degrees of effectiveness in all states, when the employer is still in business.

New Jersey, for example, had a passive approach for dealing with nonreporters. In the absence of employee claims for benefits, New Jersey state officials informed us that they expend limited effort to identify unregistered employers, particularly unregistered out-of-state employers or other types of employers that are difficult to identify. Although unsupported by study, New Jersey officials expressed the opinion that such efforts could be labor intensive and probably not cost effective. New Jersey officials advised us that they have identified some nonreporters through requirements for matching IRS and state data. New Jersey has experienced a related problem with about 94,000 registered employers who are delinquent. About 23,000 (a portion of which are included among the 94,000) have not filed quarterly UI tax returns, forcing New Jersey, under its procedures, to prepare an arbitrary assessment for taxes owed. Limitations in New Jersey's efforts to collect UI taxes from these employers and the arbitrary assessment process are discussed later (p. 44).

In contrast, California has studied the problem of nonreporters and adopted active policies and procedures for identifying and making collections from them. In 1985, the Commission on California State Government Organization and Economy completed a study concerning ways California could more effectively deter underground economy activities through improved detection and enforcement. On the basis of the study, a California task force estimated $30 billion a year of otherwise legal business transactions could be attributed to the cash payment segment of the state's underground economy, representing a loss of over $400 million in state income tax revenues. Given these amounts, lost UI taxes could total as much as $58 million annually and employees could lose significant benefits to which they are entitled.

California uses several sources of information — including sales tax records, business licenses, and nonemployee compensation reports — to identify employers that are not reporting. In addition to analyzing this information, the state has established a special unit to investigate unregistered businesses that operate within the underground economy on a cash basis. During fiscal years 1986 and 1987, California's investigative unit brought criminal charges in 38 underground economy cases involving $16.3 million in unreported wages and $2.5 million in unpaid employer taxes including UI.

When such investigations uncover incidents in which obligated employers illegally avoided paying their taxes, the state prosecutes the individuals involved and publicizes the information, as illustrated in the following case: Corporate officers of a California plaster contractor were arraigned in 1986 for failing to report UI and other tax obligations associated with cash salary payments made to more than 100 employees. On payday, the state served a search warrant to the contractor; the search revealed that the employer was putting cash in pay envelopes and had been doing so for the past 3 years. The state (1) determined that the employer had made unreported cash payments totaling in excess of $1.4 million during this period and (2) charged three corporate officers with felony violations of the California UI Code. The officers charged pled guilty to two counts of felony tax evasion, and the California Employment Development Department assessed them $201,000 for back taxes due. California state officials advised us that the news of one arrest in the case was televised. In addition, the press covered the subsequent arraignment and pleading of the company officers. Following the media coverage, the state notified individual contractors in the same trade of the availability of training seminars being offered by the state on employer UI and other tax obligations.

According to state officials, the seminars and assistance they offer businesses that may be potential nonreporters and the publicity of cases prosecuted have been an effective deterrent in the underground economy.

Problems in States' Identifying Employers' Tax Liabilities From IRS Records

The states in our review and IRS have, for many years, experienced difficulties in matching federal and state UI tax data reported by employers. IRS and the states maintain a nationwide system for computerized certification of state FUTA tax credits; the system verifies employers' eligibility for reduction of FUTA tax for having made timely and accurate payment of state UI taxes and provides assurance that employers are complying with applicable federal and state regulations for tax payment.[3] States benefit from using the system to match with employers' state returns in order to identify underreported state UI taxes. Federal and state employer identification numbering systems vary markedly; to date, reporting both numbers in employer returns and computerizing such data have not been possible. IRS advised us they would like to encourage states to use the federal number.

For the most part, the states we reviewed made limited use of IRS data to identify employers' obligations for state UI taxes when mismatches with federal data occur. Although states not using the process believed that it could be useful, they indicated that following up on mismatches of the IRS and state data was not possible without extensive manual research.[4] Impediments often cited by state officials were that (1) the federal employer identification numbers on the IRS tapes had to be manually traced and converted to match their state-assigned employer numbers and (2) there were inaccuracies in the IRS data. Similarly, IRS officials advised us that they have experienced accuracy problems and delays with the tapes that states provide to IRS.

Ohio officials said they stopped utilizing IRS data to identify employers that may be obligated to pay state UI taxes because the data provided by IRS are not usable by the state without extensive manual research. The officials told us that using any employer detection process, such as the IRS-FUTA match, requires a sizable commitment of human and equipment resources in such areas as typing, filing, and follow-up. This does not take into consideration the additional commitments—telephone contact and field representative contact—that are frequently required in the process of filtering out the useful information on the tapes.

[3]Employers that pay their state UI tax in full at the end of the tax year are required to pay a federal UI tax of 0.8 percent on the first $7,000 of an employee's wages. Employers that have not paid their state UI tax are required to pay a federal UI tax of 6.2 percent. This penalty of 5.4 percent acts as an incentive for employers to pay the state UI tax. In some cases, employers may report that they have paid when they have not.

[4]IRS provides states with quarterly computer data tapes updating the status of employers obligated for FUTA tax. These data tapes identify new or changed federal employer numbers and employers that have changed names.

The last match Ohio carried out covered 199,154 employer records for tax year 1985. During this effort, 171,410 records were certified correct, and 27,744 records had discrepancies. The discrepancies included situations in which the employer could not be found in state records, the amounts of taxes the employer reported as paid did not agree with a list of state records, or other errors had occurred. In addition, Ohio provided IRS with 18,609 potential federal nonreporters that were listed on state records as having paid taxes but not identified on automated IRS records. There was no summary of information in Ohio showing how these cases were resolved.

About 3,000 employers annually request a certification from the state, showing their UI taxes had been paid, in order to clear exceptions taken by IRS on their federal tax returns, according to Ohio officials. Ohio does not maintain statistics showing how many of these employers, in order to avoid the increased federal UI tax, paid their unpaid state taxes at the time of certification.

In March 1986, the California Employment Development Department and the IRS Fresno and Ogden Service Centers began testing ways to reduce the number of zero certifications that must be manually reviewed by all state employment security agencies under the IRS-FUTA certification process. A zero certification results when an employer's FUTA tax form is processed by IRS, claiming credits for payment of taxes to a state, but the state has no record of such payments being made (the state is unable to match the employer's federal employer identification number on computerized IRS employer identification tapes with the federal number of record on the state's employer master file). Under the process, these steps are followed:

- Employer federal tax returns are manually pulled at the IRS service center to determine if a state employer number is present.
- If present, this number is written by hand on the proposed notice and sent to the state for manual recertification. (Labor has found the manual process is labor intensive for the state and undependable because it does not always get the state number properly matched with the federal employer identification number).
- The state then attempts to manually recertify this number on the basis of the information manually provided by IRS.

These zero certifications are voluminous nationally, and result in significant public relations problems if employers are incorrectly denied FUTA credits due to discrepancies in federal or state data matching.

During the California test, the state's zero certification tapes were returned to the federal IRS service centers for the additional automated and manual processing. IRS researched its records (FUTA as well as other tax information) to locate state employer identification numbers as reported by employers on their tax returns. IRS then entered this information on the automated zero certification tape provided by California and returned it to the state for recertification (computer match against the state employer numbers on agency records). The test results completed in May 1987 showed that 65 percent of the California zero certifications arise due to data discrepancies that can be resolved when the missing state employer numbers are obtained from IRS; this reduces the need for employer contacts and further scrutiny.

In July 1987, the Labor UI program director provided copies of the California test report to IRS; she indicated that the success achieved during the test had prompted California to recommend that the new methodology developed be adopted by IRS and incorporated into the annual certification process that all states are required to perform. According to the director, if IRS and Labor evaluations showed that the system will reduce costs and improve operational efficiencies, Labor would recommend that the states be given the option to implement it and would strongly encourage that they participate. The director asked IRS to (1) review the test results and (2) share with Labor its evaluation of the usefulness of the approach and its reaction to the California recommendation. The director advised IRS that if it agreed that implementation would be desirable, Labor and IRS staffs could get together on the next steps to be taken.

The acting director of the IRS Returns Processing and Accounting Division advised Labor, in August 1987, that the results of the test would reduce costs and improve the FUTA certification process. He stated that IRS would evaluate the resources for implementing the program nationwide and provide Labor with recommendations by mid-October 1987. However, IRS did not provide Labor with its recommendations; in July 1988, IRS advised us it had been studying alternatives that would upgrade computer capability at its service centers.

IRS officials advised us that they began preparing a request for proposals to upgrade hardware at IRS service centers in fiscal year 1987; the earliest they would consider implementing the California methodology nationwide was in 1992. In addition, they believed, with computer program modifications, a fully automated recertification procedure would be feasible for resolving FUTA discrepancies.

Conclusions

Labor has the opportunity to improve the UI tax collection process by developing guidelines for use by the states in establishing court and administrative procedures to minimize UI delinquency and identify nonreporters. Labor's memoranda and instructions provide some useful guidelines for state UI program administration, audits, and other functions. However, these documents focus, in large measure, on states' reporting requirements to Labor, rather than providing a framework for states to use in establishing procedures for tax collection. Furthermore, the funding controls and guidance Labor provides under these documents are being reduced in conjunction with Labor's devolvement initiatives (discussed in ch. 2). Consequently, important areas of tax collection management for minimizing delinquency and dealing with nonreporters are being neglected by some states.

Review of proposed state UI laws is an integral part of Labor's responsibilities under the Social Security Act. However, Labor's efforts in reviewing state law changes have been limited in recent years. As a result, significant differences have developed in the effectiveness of states' laws governing UI tax collection. Some limit actions states can take to recover UI taxes; others maximize available legal remedies for recovery. We believe Labor should implement procedures for systematically reviewing state UI legislative proposals. These procedures should (1) focus reviewers' attention on significant areas of UI law, (2) provide states with an indication of which areas Labor is interested in, and (3) encourage states to strengthen their controls over collections.

IRS and Labor officials have been working to resolve federal and state operating problems in the FUTA certification process. Informal relationships, maintained between Labor and IRS for this purpose, have been beneficial for the exchange of information and data to facilitate this process. Future technical developments at IRS should enable implementation of an effective FUTA certification process by 1992.

Recommendations to the Secretary of Labor

We recommend that the Secretary of Labor direct the Assistant Secretary for Employment and Training to develop

- guidance for states to use in establishing judicial and administrative procedures for state tax collections directed to minimizing delinquency and detecting nonreporters and
- criteria and procedures to govern Labor's review of state UI law amendments and use the process to promote effective collection practices.

Agency Comments and Our Evaluation

In responding to a draft of this report, Labor advised us that the development of tax collection procedures is a responsibility it reserves for states. However, it recognized there was value to sharing information among the states on effective tax collection practices and said it would consider doing this. We believe this is a step in the right direction. Labor's national perspective should place it in an ideal position to provide such information. Labor's current oversight focus on program outcomes will be greatly facilitated if it can help states that do not meet desired program outcomes to identify processes that will lead to program improvement. However, if information sharing does not facilitate improvement in state tax collection processes, we believe Labor should reconsider our specific recommendation.

In response to our recommendation to develop criteria and procedures concerning Labor's review of state UI law amendments, Labor did not indicate whether any action would be taken. Labor indicated that (1) current policy is to address only state law changes not conforming to federal law requirements, although past reviews had included administrative issues, and (2) review of administrative issues would slow the process.

Our recommendation was intended to provide states with a basis for identifying and sending to Labor only those legislative proposals that are relevant for Labor's evaluation. Under current procedures, Labor receives thousands of draft bills annually, but ordinarily comments on fewer than 200 bills each year. Defining areas of concern and obtaining states' submissions on these areas could only reduce (1) states' paperwork burden in submitting draft bills and (2) Labor's resources expended in reviewing bills that require no comment. Labor could then use its resources to assist states in adopting measures that would improve tax collection and other UI program outputs that will be measured under the new Quality Appraisal and Quality Control programs being developed.

Promoting Use of Improved Collection Techniques

Labor could be more effective in promoting use of improved tax collection techniques among the states. During the last 10 years, Labor has sponsored pilot projects in selected states to develop new collection techniques. Other states have developed successful collection techniques on their own initiative. However, the new techniques have not been widely implemented because (1) Labor does not routinely promote and disseminate information on successful collection techniques and (2) financial incentives and technical support for states to implement new collection techniques have been limited.

A difficult problem faced by states is identification and collection of unreported taxes from out-of-state employers. Of the states we reviewed, only California made a significant effort to collect UI taxes from obligated employers from other states. In general, the success of collection efforts against out-of-state employers is dependent on cooperation among the states. However, we found that cooperation varied; support for another state's collection was generally not a priority activity.

The states we visited were generally receptive to improving collection performance through exchange of information on new collection techniques and methods employed in other states. Some indicated that federal UI administrative funding reductions (which may result from administrative improvements) discourage state participation in efforts to improve tax collection.

Extending Implementation of Labor-Sponsored Improvements

Labor's approach to improving UI tax collection among the states is consistent with its policy of allowing states substantial latitude in the design and management of their UI programs. In recent years, Labor has supported a few pilot projects that have improved participating states' tax collection programs, but nationwide implementation of changes from these projects has been slow. Program improvements initiated by the states with Labor's support include (1) California's development and dissemination to other states of computer software for auditing large employers' tax operations and (2) Missouri's employer audit selection system. Although some states have taken advantage of these improvements, many have yet to obtain or use information on them.

California's System for Auditing Large Employers

In 1977, Labor sponsored a project in California to improve UI audit coverage and collection from large employers (100 or more employees) with computerized wage-base data. Labor identified and purchased a software system from the Department of Health and Human Services and

initiated a pilot project in California to test whether that system could be effectively used in the UI program. The pilot test was successfully completed. When implemented, the system gives states the capability to audit large employers with computerized wage-based data and multi-million dollar annual payrolls. California has made the system available to all states at minimal cost.

Although this project has met with acceptance by some states, its potential has not been fully realized. Representatives of 39 states attended briefing (training) sessions funded by Labor in the use of the California system. Initially, 20 states implemented the system or a version of it they developed themselves, but 6 of these subsequently discontinued use of the system.

With the exception of California, the three other states in our review were not using California's software. Discussions with UI officials from the three states revealed they had doubts concerning their technical capability to audit large employers. These concerns focused on the states' (1) ability to develop the computer data base for applying the new criteria for audit selection and (2) lack of experience in conducting audits of large employers with computerized wage data.

Responding to the lack of states' audit coverage of large employers (cited in a 1984 IG report) and the delayed use of the California system, Labor acted to increase audit coverage of large employers.[1] In April 1987, Labor issued instructions requiring that 1 percent of the audits states perform under the Quality Appraisal Program be of large employers. Adoption of California's software system by additional states may enable the states to more readily comply with this requirement. Computerization and programming support from Labor may be necessary, however, to help ensure that state audit coverage, in the future, includes large employers.

Missouri's System for Employer Audit Selection

In 1978, Missouri implemented a computerized field audit selection system after extensive development efforts with Labor and a consulting firm. The system was designed to provide (1) stratified random audit selection of employers based on potential noncompliance, (2) data for Labor's required reports, and (3) program portability to other states. The audit selection system used in Missouri is based on development of

[1] Large employers' wage based data are computerized; specialized knowledge of computer programs and equipment is required to perform such audits.

a history of past audit experience (about 5 years) with employers in the state. Parameters used in employer selection for audit include significant changes in wage rates, rate of UI benefits paid, employer size (taxable wages or number of employees), experience with industry types, and business location. Although the system provides that the majority of employers audited are to be selected using these parameters, it also provides for additional employers to be selected randomly.

Missouri became the pilot state for the audit selection system with the expectation that the technology developed would be exportable and could be transferred to other states following completion of testing in 1978. A study completed years later, in August 1987, by the Interstate Conference of Employment Security Agencies, found that 23 states had adopted their own form of audit selection system or the Missouri system.

None of the four states in our review used the Missouri system. Some of these states were unfamiliar with it, while others indicated that development of the computer data base would demand significant UI resources. Some states had adopted a less structured process, emphasizing problem industries and other known conditions in the state.

Labor could facilitate wider use of audit selection systems by states that are not fully apprised of the benefits such systems offer by (1) informing all states of effective approaches being used, including the Missouri system, and (2) providing technical assistance and administrative funding to implement systems in states with limited audit selection processes.

Promoting Improved Collection Techniques Developed by Individual States for Use Elsewhere

States in our review have developed some unique and beneficial UI tax collection techniques that are not being promoted elsewhere. Although existing intergovernmental forums have proven useful for information exchange,[2] they have not provided the impetus that Labor could provide with a formal program for the development and replication of effective UI processes nationally. Better use could be made of resources and knowledge at Labor's disposal through systematic screening and promotion of innovative state collection methods for possible replication nationwide.

[2]There is an informal network for exchange of new UI systems ideas through the Interstate Conference of Employment Security Agencies. States can also publicize ways their governmentwide programs have improved through the Council on State Governments.

We analyzed beneficial collection processes used by the states in our review and discussed the processes we considered unique with responsible state operating officials. The following are examples of actions states have taken to improve their UI collections that have potential for replication outside the state from which they originated:

- California has consolidated UI tax collection functions with all other wage-based state employer taxes, achieving economies of scale (savings from cost sharing) in audit and tax-processing operations.
- California and New Jersey have adopted a process for arbitrarily assessing employers that fail to file timely reports of UI taxes owed.
- Three states required nonprofit governmental entities (reimbursable employers) to post a bond or place a security deposit with the state in case these entities fail to pay UI benefits for employees they discharge.

Consolidating Wage-Based Tax Operations

In 1983, with Labor's approval, California finished consolidating, under one state agency, the responsibility for reporting and collecting four wage-based taxes — unemployment insurance, disability insurance, personal income, and employment training. California officials advised us that several efficiencies and cost savings are achieved in (1) the state's collection and auditing functions and (2) employers' reporting, which is substantially reduced and simplified. Overall administrative costs are reduced by reporting all four taxes on one return, allocating state processing, auditing, and collection costs among the four tax programs. In effect, each state program benefits from the economies resulting from consolidation of collection activities.

California uses a cost model, in fulfilling requirements of the Office of Management and Budget (OMB) Circular A-87, to determine how total administration costs are to be allocated among the four tax programs. Under a shared-cost method, direct costs are first determined for each tax program separately; indirect costs are allocated according to the ratio that direct costs bear to each other. The UI share, determined by using this cost-allocation method, is reviewed and approved by Labor.

New Jersey was the only other state in our review that combined its collection and auditing efforts for more than one tax. Their consolidation is limited to taxes for UI and Disability Insurance programs. State officials advised us that this consolidation has resulted in cost savings.

For three states in our review that currently administer wage-based employer taxes through separate programs, operating officials advised

us that reorganization, collection cycle changes, and legislation could be required to consolidate wage-based tax collections. The officials were concerned about making changes because they had not evaluated the merits of California's methods for consolidating wage-based tax collection functions in their states. Although Labor approved the methods adopted by California, we found no evidence of efforts by Labor to promote their use elsewhere.

Employer (Arbitrary) Tax Assessment for Nonfilers in California and New Jersey

An effective collection technique used by California and New Jersey is the employer (arbitrary) tax assessment process. In this process, employers who are not timely in reporting UI taxes they owe are assessed the tax on the basis of a state estimate. Employer assessments are calculated from available employer records; normally, they include amounts for interest and penalty charges. The arbitrary assessment does not only initiate a collection action. It also provides the states with the foundation necessary to file a lien or obtain a court judgment against a delinquent employer.

In California, state officials advised us that this process has worked effectively for many years. However, New Jersey officials told us they lacked the staff and technical support to implement the arbitrary assessment process in that state. This has resulted in a backlog of unprepared arbitrary assessments against 23,000 employers. New Jersey officials told us they had unsuccessfully attempted to obtain Labor UI automation funds in 1984 to convert arbitrary assessments from a manual to an automated process.

During our review, state officials advised us that they (1) could manually assess only about 300 to 400 employers over the next few months and (2) would concentrate on cases nearing the statute of limitations. Without timely legal action on the remaining cases, UI taxes could go uncollected if employers relocated or went out of business.

Bonding of Nonprofit Employers and Local Governments

State and local governments, as well as nonprofit entities (all of which are reimbursable employers), are not ordinarily taxed for UI; these employers reimburse state UI programs only for the cost of benefits paid to employees they discharge. For most states in our review, these employers experienced a higher rate of delinquency and default as compared with rates experienced by for-profit businesses that pay UI taxes (contributory employers). Although reimbursable employers constitute

a small portion of total employers in each state, their defaults are ordinarily absorbed by the general state Trust Fund.

Three states in our review—Pennsylvania, New Jersey, and Ohio—had adopted laws requiring that nonprofit businesses post a surety bond or a security deposit to be forfeited in the event of UI benefit reimbursement default. To illustrate, Pennsylvania requires bonding (see Glossary) of nonprofit organizations operating on a reimbursable basis; that is, the organization must either execute and file an approved surety bond with the state or deposit with the state money or securities of equal present monetary value. The amount of bond or deposit is set at 1 percent of the nonprofit organization's taxable wages for the most recent four calendar quarters or an amount set by the state, if wages were not paid during that period.

Because the bonding process can offset the impact of default, it should be used consistently for nonprofit employers. It would also be useful for (1) other reimbursable employers at state and local government offices and (2) certain contributory employers, such as those with a high rate of delinquency and potential default, as well as those with a history of nonpayment of UI debts because of sequential bankruptcies (see p. 30).

Establishing a National Program for Out-Of-State Employer Collection

The identification and collection of unreported taxes from out-of-state employers is a difficult problem faced by state UI collection programs.[3] Under current procedures, when these employers fail to report or deliberately understate their UI obligations, there is little assurance that they will pay taxes owed. The success of collection efforts against out-of-state employers is dependent on support between the states for each other's interests. In most states, identification and collection from out-of-state employers is a second priority to other state program efforts. When employee benefit claims are obstructed (see p. 33) by lack of documented earnings reports from employers, states in our review placed priority on settling the benefit claims. However, collecting back UI taxes from employers that had not reported earnings was more protracted because audit resources and legal support from another state were usually required.

No separate grant funds are earmarked by Labor for out-of-state employer collection efforts, and states in our review adopted widely

[3]Employers headquartered outside a taxing state must pay UI taxes for their employees residing in the taxing state.

varying policies for dealing with them. In some cases, state UI financial and staff resources were not specifically designated for dealing with out-of-state employers; states considered action against nonreporters only if benefit claims that were obstructed by a lack of documented earnings reports surfaced. In other cases, the states had staffed tax units for dealing with out-of-state employers. One state (California) performed all out-of-state audits with its own staff regardless of distance and used a variety of different sources to identify nonfilers (see p. 48).

We noted that one state not in our review (Alaska) advised Labor, in its fiscal year 1986 performance plan for meeting Labor's Quality Assurance Program requirements, that

> "Alaska is deeply concerned about the lack of cooperation among the states in helping each other collect both delinquent employer taxes and benefit overpays. We have been trying to publicize this issue in our region and through the appropriate ICESA [Interstate Conference of Employment Security Agencies] committees but it is apparent that there is little incentive or inclination on the part of the individual states to assist each other. In fact, state law frequently prohibits assistance unless their state has a financial interest in the case.
>
> "With increased detection methodologies and tracking systems we are now going to be able to better discover delinquent claimants or employers, but without a commensurate commitment to collection, this will only result in a deterioration in our performance statistics. Alaska feels it is time for a national push in this area. The establishment of reciprocal agreements among the states is needed."

Labor officials advised us that three states have jointly funded a single staff, located in the state of Washington, to audit large employers, but other states have been unable to agree on mutually acceptable approaches. The following describes the approaches to dealing with out-of-state employers taken by states in our review.

New Jersey Limits Efforts on Out-Of-State Employers

To identify out-of-state employers, New Jersey relies only on reports of obstructed benefits claims and does not use any other information sources. In addition, the state does not maintain a special unit or staff designated to identify, investigate, and collect from those that are not registered to pay New Jersey UI taxes. As a matter of procedure, New Jersey does not audit out-of-state employers unless they are within 25 miles of the state's borders. Beyond that distance, New Jersey may request audit assistance from other states.

New Jersey state officials advised us that they know of no coordinated effort at the national level to determine if out-of-state employers are paying UI taxes to all the states in which they operate. The officials believe that Labor should issue standards for interstate audits to encourage states to cooperate with one another and share audit information on multistate employers that have a record of tax avoidance. The officials indicated that such audits could be performed centrally at the employer's home office; they could cover an individual employer's activities in all of the states in which it operates.

Ohio Experienced Difficulty in Obtaining Other States' Support

Ohio has no special procedures for identifying out-of-state employers that have not voluntarily registered with the state; it relies on obstructed benefit claims (see p. 33) as its only source for these identifications. Ohio has requested and received some cooperation from other states in auditing the records of a few out-of-state employers. Other states have requested and received similar assistance from Ohio. However, these states have already identified the out-of-state employer as obligated for UI, and only requested that Ohio determine the magnitude of the tax obligation.

Ohio officials viewed out-of-state support for their assistance requests as ranging from poor to excellent. States requested Ohio's assistance for claims that both did and did not involve obstructed claims. Ohio officials advised us they assign a higher priority to those situations where an obstructed claim was holding up the payment of employment benefits.

Pennsylvania Limited Efforts to Collections From Currently Identified Delinquent Out-Of-State Employers

In March 1987, Pennsylvania was attempting to collect from 1,200 identified delinquent out-of-state employers owing $6.2 million in UI taxes. These employers were identified primarily through the obstructed claims process. Pennsylvania has a small out-of-state unit, which had concentrated on resolving these delinquencies rather than identifying unregistered out-of-state employers.

At the time of our review, the unit was conducting no out-of-state audits and, with its workload, was not requesting that other states perform any new audits of out-of-state employers. County field offices were handling audit requests from other states. Many of the employer transactions the field offices were working with dated back several years; locating obligated employers was not possible in some cases. By December 1988, Pennsylvania's unit had initiated some out-of-state audits and was requesting audit assistance from other states.

California Audits Employers in Other States

California performs its own audits of out-of-state employers through a separate interstate field office. The administrator of California's Interstate Office advised us that there are about 23,000 out-of-state employers registered in California, with 3.4 million employees and annual revenues of $3 billion. These employers tend to be large, multinational businesses; the number and extent of out-of-state audits California performs in any one year varies, depending on the availability of travel funds.

California estimated that its interstate operations recovered an estimated $143 in taxes for each $1 spent. Recoveries of each of California's four wage-based taxes were made (see p. 43) including UI. Costs of interstate operations included all tax-related functions of the interstate field office (audit, investigation, collection, registration, and support activities). At the time of our review, the interstate field office had about 2,000 active cases against out-of-state employers, involving an estimated unpaid $28 million for four wage-based taxes. At current tax levels in California, the UI portion of this amount could represent about $4 million.

California has an aggressive program using several sources of information for identifying in-state employers obligated for UI (see p. 34). These same sources are utilized for identifying out-of-state employers that have not registered to pay UI taxes. California extends help to other states by providing collection support, audit and registration support, tax collection and compliance information, and information on California tax law. To help other states identify out-of-state employers, California provides information in response to about 300 requests a month from their wage files.

Earlier GAO Report Cited Actions Needed by Labor to Facilitate and Encourage UI Program Improvement

In an earlier study,[4] we recommended that Labor develop an approach for identifying and disseminating information on the best UI program management practices among the states. We found states were not making improvements because their administrative budgets were reduced when improved management practices were implemented. We recommended that Labor evaluate alternative financial incentives suitable for promoting state adoption of beneficial practices. Labor agreed there was merit to GAO's recommendations, but did not take action on them. Studies planned by Labor to address GAO recommendations were refocused to

[4] A Comprehensive Approach Needed for Further Productivity Improvement in the Unemployment Insurance Program (GAO/HRD-85-8, Oct. 25, 1984).

evaluate the impact of reduced unemployment and related budget reductions on states' performance.

Comments of National Governors' Association on Labor's Role in Promoting UI Program Improvements

In its December 1987 and August 1988 meetings, the National Governors' Association adopted policy positions for 1988 and 1989 concerning the role Labor should play in the promotion of state improvement in the UI program. Among other things, the association indicated that the federal role should

- assist states by performing activities that cannot be efficiently performed by individual states, such as test development and evaluation;
- support a research capacity and provide a national forum for assessing the effectiveness of specific projects undertaken (and assume a clearinghouse function — collecting and disseminating the findings of projects designed to resolve state-identified problems and other findings of national import); and
- take responsibility for the coordination of programs that operate between the separate states, such as interstate job banks and interstate claims programs, to ensure efficient use of limited funds.

Conclusions

Labor should take a stronger leadership role in assisting states to expand the use of improved collection techniques. Some states, on their own initiative, have implemented innovative collection techniques that could be developed and promoted for use elsewhere with effective Labor support. Labor has also sponsored a few demonstration projects in selected states that could, with effective promotion and technical support from Labor, be used in other states.

States generally have no financial incentives to improve UI administrative efficiency because such efficiency may result in funding reductions. More improvements would most likely be undertaken if financial incentives suitable for promoting adoption of beneficial practices were adopted. However, before this can occur, Labor should study and identify the alternative financial incentives that are most effective for motivating improvements, as we previously recommended (see p. 48).

Labor should establish and fund a separate activity within the UI program for motivating states to identify out-of-state employers obligated for UI taxes. Under current procedures, there is little assurance that the out-of-state employers not registering in states where their employees are located will pay UI taxes. States are motivated to use their budgeted

administrative resources for their own program purposes before providing assistance to other states. This situation could be dealt with by (1) establishing a clearinghouse function within Labor to identify, on the basis of states' requests, delinquent out-of-state employers and (2) earmarking UI funds for out-of-state audit work in locations where these employers were headquartered or where wage data were maintained. Under this type of arrangement, coordination and support from the requestor states benefiting from these audits could be a normal product of that state's collection activity.

Recommendations to the Secretary of Labor

We recommend that the Secretary of Labor direct the Assistant Secretary of Employment and Training to

- designate an organization in Labor to be responsible for overseeing the identification, development, and dissemination of effective UI control techniques and
- establish and fund a national program for identification of out-of-state employers that are obligated to pay UI tax.

Agency Comments and Our Evaluation

In responding to our recommendation that responsibility for the oversight of UI control technique be placed in one organization, Labor advised us that it (1) agreed that sharing of effective UI control techniques between the states is desirable and (2) would examine how it might improve existing processes with available resources. Toward this end, it said that current information sharing has been effective through (1) meetings and conferences with states, sponsored by Labor and the Interstate Conference of Employment Security Agencies, and (2) bulletins and similar notices. We continue to believe that responsibility should be placed in one organization in Labor.

Labor did not agree with our recommendation that it establish and fund a program for identification of out-of-state employers that are obligated to pay UI tax. It advised us that this is primarily a state responsibility and that multistate liability, involving nonfilers and nonpayers, is being identified through the FUTA certification process.

We believe that when the level of FUTA certification matching errors can be reduced, this process will become a more meaningful way of identifying multistate nonfilers and nonpayers. Even so, the accomplishment of needed improvements in the FUTA certification process will still not provide a system that can identify underground employers or resolve the

lack of audit evaluation and identification efforts by some states. We believe Labor, as the federal UI partner that provides states with administrative resources, is in the most advantageous position to deal with this matter.

Single Audit Implementation and FMFIA Reporting

In the absence of a Quality Control Program for tax collection and an effective Quality Appraisal Program, Labor has placed increased reliance on the results of audits performed under the Single Audit Act. Labor uses these results to determine whether state UI programs are managed effectively and whether material weaknesses in state programs are corrected. Single audits are not intended to replace management oversight and evaluation of state program management controls. Since some single audits are being performed biennially or less frequently, they may not provide information on operations of the state UI programs needed by Labor to carry out its oversight responsibilities on a continuous basis.

Effective single audits are important over the long term for independent testing of the adequacy of state management systems. However, they are not a substitute for Labor's Quality Appraisal and Quality Control programs (discussed in ch. 2). These programs, when effectively implemented, should provide Labor with the means of carrying out its day-to-day oversight responsibilities. In addition, effective Quality Appraisal and Quality Control programs, coupled with results of the single audits, should provide Labor with an appropriate basis for assessing and reporting on the state of internal controls in its annual FMFIA report to the Congress and the President. Past Labor FMFIA reports have not identified internal control weaknesses relating to Labor's oversight and guidance for UI tax collections.

Under the Single Audit Act, states that receive $100,000 or more in federal funds annually are required to have an independent audit made for that year or biennially if the state contribution or state law authorizes audits less frequently than every year. The Senate report (S.R.-98-234) recommending passage of the Single Audit Act stated that

> "The single audit approach would not substitute for other reviews, such as economy and efficiency audits, program results reviews, investigative audits, program monitoring, and other special audits directed toward a specific overall Federal Program ...."

In April 1985, OMB issued Circular A-128, implementing Single Audit Act requirements for state and local governments that receive significant federal aid and defining federal department responsibilities for implementing and monitoring those requirements. In August 1985, Labor incorporated the OMB circular intact into its own regulations, briefly identifying the entities to which the circular applied and sources of audit standards to be used. In February 1987, Labor's Office of IG issued

a Single Audit Manual, setting out in detail Labor's approach to implementing the circular.

Single Audit Act Coverage of State UI Tax Collections

The status of single audits varied widely among the five states we visited.[1] As of December 1988, one state was completing its first single audit covering its UI program and, of the four states that had completed single audits, two did not have substantial focus on internal controls for UI tax collections.

California's single audit provided coverage of UI tax collection controls. The audit included testing controls by sampling employers to determine whether they had filed applicable contribution returns accurately and properly charged nonreporters and delinquent employers for taxes they owed.

New Jersey carried out a single audit in 1986 that included the UI program within its scope. That audit and the report on internal controls was focused primarily on the state's Trust Fund management and not New Jersey procedures relating to employer delinquency, nonreporters, and other aspects of UI tax program management. New Jersey officials advised us that subsequent audits are covering these issues.

Pennsylvania's single audit, completed in October 1987, focused primarily on financial accounting controls for all state programs. A separate operational compliance audit, completed in February 1988, did address UI tax collection controls. Among other things, the audit identified these findings:

- During the preceding 8 years, employer UI tax delinquencies increased from $15 million to $102 million; $18 million of this amount was considered uncollectible.
- Over $11 million (15 percent) of funds budgeted by Labor for administering state tax operations during 1980-86 was used for other purposes, contributing to ineffective state oversight of UI collection functions.
- Pennsylvania's records did not disclose specifically how $4.9 million of the $11 million had been spent.
- Reduced collection efforts significantly increased employer delinquency levels in the state and may have had an impact on the state's need for federal borrowing to cover state UI deficits.

[1] As discussed in chapter 1, we visited five states, reviewed UI tax collection functions in four (California, New Jersey, Ohio and Pennsylvania), and obtained the results of audits in a fifth (Illinois).

- Labor's evaluations have been significantly overstating the quality of Pennsylvania state audits of employers' UI tax records—documents supporting findings of the state's audit were not available.

Pennsylvania is planning corrective actions to resolve long-standing weaknesses in staffing and the quality of tax collection program controls.

Ohio had not issued any reports on single audits or operational audits involving UI collection functions, but an independent accounting firm was completing review work on Ohio's first single audit during December 1988. The planned audit is about 1 year behind the schedule required by the Single Audit Act.

We did not perform specific program evaluation work in the state of Illinois. However, we obtained the two most recent biennial compliance audits of the UI tax system by the Illinois auditor general. These audits were done by an independent accounting firm and released by Illinois in February 1986 and June 1988 (the latter audit was intended to meet requirements of the Single Audit Act).

The state's compliance audit, issued in 1986, provided coverage of the adequacy of many UI collection program internal controls, disclosed 60 material weaknesses, and reported the following conditions:

- About 62,000 delinquent employers (25 percent of all employers) owed taxes totaling $97 million, excluding interest and penalties, at the end of fiscal year 1985.
- The size of the delinquency backlog had limited active state collection efforts to employers with balances approaching 4 years overdue (the statute of limitations in Illinois).
- Employers cited by IRS as not paying UI taxes were not being fully investigated.
- The state unit responsible for collection from bankrupt employers spent nearly all of its time on benefit payment assignments, thus limiting work on bankruptcies.

Since completion of its 1986 compliance audit, Illinois has reported that steps were taken to improve controls. During fiscal years 1986 and 1987, about $59.8 million in uncollectible debt was written off,[2] and the

[2]Illinois officials advised us that this write-off was the first initiated by the state and included all bad debts accumulated since the beginning of its UI program.

level of UI delinquency being carried was reduced to $92 million as of September 1987.

In 1988, Illinois completed its first single audit of its UI program. Findings of this audit, with 15 material weaknesses disclosed, reflect improvement since the 1986 compliance audit.

Reporting of Weaknesses in Labor's Oversight of State UI Collections Under FMFIA

Labor has not used FMFIA evaluations to identify and report weaknesses in its oversight and guidance for ensuring the quality of state UI tax collection program controls. Almost all material weaknesses cited in Labor's FMFIA reports each year have been derived from GAO disclosures or IG or congressional evaluations. Thus far, none of the material weaknesses identified in Labor's annual FMFIA reports have related to problems with UI collection functions.

Each year, Labor qualifies its responsibility for state controls in FMFIA reports to the President and the Congress, indicating that almost 90 percent of the Department's funds (primarily for UI) pass through entities not under Labor's operational control. We do not believe this qualification relieves Labor of the responsibility to ensure that (1) federal oversight and guidance are adequate and utilized to maintain effective controls for state UI collection programs and (2) FMFIA evaluations address the ability of the federal systems to detect and resolve state control problems.

Labor believes that state UI operations and internal controls are not subject to FMFIA evaluation and need not be included in its annual FMFIA reports. It is true that states need not provide assurances and report to the Congress and the President about the adequacy of their UI operations and program control systems; nevertheless, we believe Labor is responsible for such reporting at the federal level where weaknesses in Labor guidance and oversight are resulting in weaknesses at the state level.

In November 1985,[3] we reported that Labor's year-end FMFIA report for the previous year (1984) was incomplete because its assessment of the UI program did not appropriately consider Labor's responsibility for the adequacy of controls in state UI programs. Labor's assessment results showed the vulnerability of the UI program to waste, loss, or misuse of

[3]Second-year Implementation of the Federal Managers' Financial Integrity Act in the Department of Labor (GAO/HRD 86-29, Nov 18, 1985).

funds was predominantly low. We concluded that had Labor assessed its oversight of state systems, the UI program's limitations would have been more accurately depicted.

Labor's FMFIA evaluations in 1986 and 1987 still did not adequately address vulnerability of the UI program controls. Labor's FMFIA report for 1987 indicated that there were no changes over previous years in the level of vulnerability for 15 employment and training programs, including the UI program. Among the five programs Labor reassessed risk for in 1987, the UI program was found to be low. Conditions of UI controls at the state level and their implication for Labor management oversight and guidance were not among the issues addressed in Labor's risk assessments or year-end FMFIA report.

Through 1985, Labor's FMFIA reports stated that Labor was redesigning its UI Quality Control Program. As discussed earlier (ch.2), Labor has acted to implement an improved benefit Quality Control Program during this period, while deferring development of the separate Quality Control Program for tax collections. This program is now scheduled for completion in 1992.

Labor's 1986 FMFIA report indicated that implementation of the UI Quality Control Program was complete after most states had voluntarily adopted Labor's proposed Quality Control Program for benefits. During 1987, Labor continued implementation of this program but devoted little effort to a Quality Control Program for tax collection. Labor's 1987 and 1988 FMFIA year-end reports made no mention of any future efforts to implement this program. FMFIA risk assessments and internal control evaluations in 1987 have not been focused on the UI Quality Control Program or other Labor oversight and guidance needs involving UI tax collections.

Conclusions

Audits performed under the Single Audit Act are not intended to provide continuous monitoring and evaluation of state UI program controls but to periodically test them. Single audit reports are not due until 1 year after the end of the audit period, and states in our review were performing the audits biennially. Thus, Labor's oversight programs (Quality Appraisal and Quality Control), as well as guidance for states when fully implemented, would better serve as the principal means for Labor to carry out its ongoing oversight of state UI management.

Improving Labor's oversight and guidance, using recommendations in this report in conjunction with single audit reports, should (1) help ensure that state UI programs and controls are functioning effectively and (2) provide Labor with an appropriate basis to report to the Congress and the President under FMFIA. When state controls are found to be ineffective, limitations in Labor's oversight and guidance that contribute to the condition of these controls should be reported as a material weakness under FMFIA. The relationship between weaknesses in state controls over collections from delinquent employers (ch. 3) and the absence of Labor's guidance and a Quality Control Program for collections oversight (ch. 2) illustrate an area that Labor should include in its FMFIA report.

Recommendations to the Secretary of Labor

We recommend that the Secretary of Labor direct the Assistant Secretary for Employment and Training to (1) utilize Labor's oversight systems, when improved, as the principal means for determining whether state UI programs are being managed effectively and (2) augment these systems with state single audit results. We also recommend that the Secretary include in Labor's year-end FMFIA reports to the President and the Congress a discussion of material internal control weaknesses in Labor's Quality Appraisal and Quality Control programs.

Agency Comments and Our Evaluation

Labor agreed with our recommendation to use its own oversight systems, when improved, as the principal means of determining whether state UI programs are being managed effectively, augmenting these systems with single audit results. Labor recognized there were limitations in existing Labor systems; Labor had, it said, instituted system reviews and will provide a further assessment mechanism with its Quality Control Program for tax collection. Labor did not believe that the absence of such a program or the improvements in the Quality Appraisal Program should be reported under FMFIA as material weaknesses.

Until 1987, when the benefits portion of the Quality Control Program was nearing completion, Labor, in its annual FMFIA reports, identified the absence of a Quality Control Program and progress in development efforts. We believe that this weakness should have remained open in subsequent Labor FMFIA reports, pending implementation of the Quality Control Program for tax collection. We also believe it would be desirable to report and track Quality Appraisal Program modifications, including strengthening goals and other program modifications. Such reporting enables better tracking of development efforts, ensuring timely and

effective implementation and providing the President and the Congress with information on the strengths and weaknesses of major federal programs.

Comments From the Department of Labor

U.S. DEPARTMENT OF LABOR

DEPUTY SECRETARY OF LABOR
WASHINGTON, D.C.
20210

FEB 28 1989

Mr. Lawrence H. Thompson
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Thompson:

This is in response to the GAO Draft Report - Opportunities to Strengthen the Unemployment Insurance Tax Collection Process.

According to the report, GAO objectives were to determine whether the Department's guidance and oversight processes were adequate to ensure that States were identifying all employers required to pay Unemployment Insurance (UI) taxes, accurately identifying the amount of taxes due and collecting them in a timely manner, and effectively using administrative funds.

The report's nine specific recommendations for the Department fall into four action areas: (1) strengthen oversight of tax collection, (2) develop guidelines for State tax collection, (3) promote use of improved collection techniques, and (4) modify use of the Single Audit Act and Federal Managers Financial Integrity Act reporting requirements.

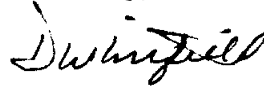
The Department appreciates these kinds of management reviews, which assist us in identifying, as well as confirming program strengths and weaknesses. We agree with many of the report's findings, some of which present new opportunities to improve UI program operations and some of which highlight problem areas that we have already begun to address.

Our comments on each specific recommendation are enclosed. By way of general comment, I would note that in those areas where there is disagreement with your discussion or recommendations, it is generally related to perceptions about the degree and nature of Federal oversight. Some points made in the report do not fully take into consideration recent Federal policy initiatives to provide States with increased financial and operational flexibility in the management of UI programs. As part of these initiatives, States were given increased discretion to manage ongoing operations. The focus of Federal oversight has shifted from concern with process to an emphasis on program outcomes.

- 2 -

As the report notes, the Department has underway several projects to strengthen and enhance these oversight processes, including the UI Performance Measurement Review and the Revenue Quality Control program. We find much in the report of merit and will utilize many of its findings in our efforts.

Sincerely,



DENNIS E. WHITFIELD

Enclosure

ENCLOSURE

A. STRENGTHEN OVERSIGHT OF TAX COLLECTION

Recommendation 1. Replace Labor's Quality Appraisal Program goals for State Unemployment Insurance (UI) tax collections with more meaningful performance expectations that focus on ways to maximize collections rather than numbers of actions accomplished.

DOL Response: Performance measures for tax collections are being reviewed through the combined efforts of the Performance Measurement Review project and the Revenue Quality Control project which are currently underway. These projects will result in revised measures for Federal assessment of key aspects of State UI tax operations, including the effectiveness of collection efforts.

Recommendation 2. Expedite the development and implementation of the planned UI tax collection quality control program utilizing principles of effective State controls identified in this report.

DOL Response: The report inaccurately characterizes the timing of the Department's efforts to improve State revenue operations, stating that efforts "begun in 1984 are not scheduled for implementation until 1992." In reality, the Quality Control (QC) program, designed to cover both benefits and revenue, is being implemented in stages due to the complexity of the management task and the realities of resource limitations. Although public consultation on revenue design issues did occur in 1985, the UI has focussed primarily on benefits QC, which became fully operational as a mandatory program in October 1987. The present Revenue QC effort was begun in the spring of 1988, and operates on a specific workplan that has been shared with States, the Office of Management and Budget, and the representatives of Washington-based groups having an interest in the UI program.

The Revenue QC timetable has been carefully developed to provide the opportunity for full consultation with all interested parties, and provides time to consider the design complexities of the program, to develop prototype programs, and then to test those programs before implementation in 1992. This approach builds on the lessons learned from benefits QC implementation, and is also based on realistic expectations of resource availability.

Much of the information in the report will be very useful for the Revenue QC Task Force.

Recommendation 3. Review legislative proposals for consolidating UI tax collections at the State level to determine their effect on States' ability to maintain benefit levels and fund UI administrative costs.

DOL Response: The legislative proposals put forth in the 100th Congress for reform of the administrative financing system, including the consolidation of tax collection, were based on certain assumptions. Among these was the assumption that providing flexibility to States to determine the levels of administrative resources they wish to expend, and which they are willing to collect, would improve the administration of the UI program. By combining the authority to determine the level of resources which may be expended and the responsibility for revenue collection and expenditure in the same entity, the incentive for proper and efficient program management is enhanced. It would be difficult to set up evaluations or demonstrations of policy positions which involve the exercise of increased choice.

B. DEVELOP GUIDELINES FOR STATE TAX COLLECTION

Recommendation 1. Develop guidelines for States to use in establishing court and administrative procedures for State tax collections directed to minimizing delinquency and detecting nonreporters.

DOL Response: This is an area usually reserved to States to be accomplished under State law and regulations. The Department's oversight focuses on program outcomes, such as the actual collection of delinquent amounts, rather than the process used by the States. We believe program improvement occurs through State flexibility and innovation rather than procedures recommended or mandated by the Federal partner. At the same time, we recognize that effective innovations should be shared among the States. This is currently being accomplished through forms such as the annual UI Directors' meeting, regional conferences of State tax staff and through the activities of the Interstate Conference of Employment Security Agencies (ICESA). In light of the GAO recommendations, we will give thought to increased focus on technical and legal information sharing in the tax area.

Recommendation 2. Develop criteria and procedures to govern Labor's review of State UI law amendments and use the process to promote effective collection practices.

Recommendation 1 was not made in our final report because IRS has initiated action to resolve limitations in the FUTA certification program—the subject that gave rise to our draft recommendation (see app. II).

- 3 -

DOL Response: The UI Service currently reviews State laws to determine if they conform with Federal law requirements. Proposed State legislation is also reviewed in this context, since it is easier to resolve potential conformity issues before a bill becomes law. The ETA did at one time review State legislation for other than conformity issues, (i.e., policy and organizational questions), but found that States frequently encountered problems differentiating between DOL policy or administrative advice, and actual Federal legal requirements. In any case, reviewing proposed legislation for administrative considerations would slow the review process. Written comments are generally limited to State requests for comments on bills likely to pass and more complex proposals. These usually must be reviewed on an expedited basis.

C. PROMOTE USE OF IMPROVED COLLECTION TECHNIQUES

Recommendation 1. The Secretary of Labor negotiate with IRS, an interagency agreement defining mutual administrative responsibilities for the effective operation of the Federal Unemployment Tax Act (FUTA) certification process.

DOL Response: The certification program is constantly reviewed to keep pace with automation, law changes and innovative approaches to using the process to improve both State and Federal compliance with tax laws, particularly those that promote improved collection techniques. An additional interagency agreement will not alter any of the obstacles IRS identified as preventing nationwide use of the California zero certification methodology.

Recommendation 2. Designate an organization in Labor to be responsible for overseeing the identification, development, and dissemination of effective UI control techniques.

DOL Response: We agree with the concept that sharing effective UI control techniques among the States is desirable. We do this to a large degree through the meetings and conferences of State UI officials sponsored by ETA and ICESA as well as in written form through Information Bulletins and other issuance systems. In addition, States receive reports and summaries describing projects, techniques and innovations developed with separate UI research and training funds. While we believe our current approach to dissemination of information is effective, we will examine how we might improve it within current resources.

- 4 -

Recommendation 3. Establish and fund a national program for identification of out-of-State employers that are obligated to pay UI tax.

DOL Response: Locating and determining liability of employers is a State responsibility with different requirements in each State. This makes a single Federal locator system impractical. Multi-State liability is being identified through the 940 certification process of identifying those employers who claim credit for taxes paid to a State on their FUTA return but may have been a nonfiler or nonpayer in the State claimed. As noted elsewhere in the report, both Labor and IRS encourage cooperative approaches to expand and improve the 940 certification process.

D. MODIFY USE OF THE SINGLE AUDIT ACT AND FEDERAL MANAGERS FINANCIAL INTEGRITY ACT (FMFIA) REPORTING REQUIREMENTS

Recommendation 1. Utilize Labor's oversight systems, when improved, as the principal means for determining whether State UI programs are being managed effectively and augment these systems with State single audit results.

DOL Response: The Department supports this approach to fulfilling its tax oversight responsibilities. We utilize the Quality Appraisal System as the primary means of assessing program performance and management. Monitoring reviews and audit results augment our findings and also serve as mechanisms to review corrective action being undertaken by the States. We recognize the limitations of some of the measures and have instituted their review. Revenue Quality Control will provide a further assessment mechanism.

Recommendation 2. Include in Labor's year-end FMFIA reports to the President and the Congress, a discussion of material internal control weaknesses in Labor's Quality Appraisal and Quality Control programs.

DOL Response: We do not believe that material "weaknesses" exist in Labor/ETA oversight controls. We view our efforts in these areas as an attempt to improve on methods that have proven satisfactory but must be modified to keep pace with changing times and technologies.

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

MAR 2 0 1989

Mr. Lawrence H. Thompson
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Thompson:

Thank you for the opportunity to review your recent draft report entitled "Unemployment Insurance: Opportunities to Strengthen the Tax Collection Process".

We have enclosed comments to clarify information contained in Chapter 3 "Develop Guidelines for State Tax Collection."

We hope you find these comments useful.

With best wishes.

Sincerely,

Acting Commissioner

Enclosure

IRS COMMENTS ON GAO DRAFT REPORT ENTITLED
"UNEMPLOYMENT INSURANCE: OPPORTUNITIES
TO STRENGTHEN THE TAX COLLECTION PROCESS"

Chapter 3, Develop Guidelines for State Tax Collection

Problems in States' Identifying Employers'
Tax Liabilities from IRS Records

Now on p. 35, but revised.

GAO states (Pages 46 - 47):

"IRS and the states maintain a nationwide system for computerized certification of state FUTA tax credits that was created primarily for verifying employers' eligibility for credit reduction of FUTA tax for having made timely and accurate payment of state UI taxes." GAO Footnote 3 further states: "Employers that paid their state UI tax in full at the end of the tax year are required to pay a federal UI tax of 0.8 percent. Employers that have not paid their state UI tax are required to pay a federal UI tax of 6.2 percent. This penalty of 5.4 percent acts as an incentive for employers to pay the state UI tax. In some cases, employers may report that they have paid when they have not."

IRS Response:

The primary purpose of IRS' certification process is to provide a check and balance system to assure that employers comply with federal and state regulations. The computerized FUTA certification program is the method IRS uses to verify that the credit claimed on the Form 940, was actually paid into the states' unemployment funds. Footnote 3 provides an explanation of how the tax is computed. However, the reduction of the tax should not be confused with a reduction of the credit. Credit reduction occurs when a state is unable to repay a loan from the Federal Unemployment Fund. Employers doing business in those states are required to pay an additional amount of tax on their Form 940. This is done by a reduction of the allowable credit given for timely payments to the states.

-2-

Now on p. 35.

GAO states (Page 47):

"Federal and state employer identification numbering of systems vary markedly; to date, reporting both numbers in employer returns and computerizing such data have not been effective."

IRS Response:

The IRS uses a federal Employer Identification Number (EIN) to identify accounts of employers filing Forms 940. The State Account Numbers (SANs) are not used in our tax processing or compliance programs because we have no way of validating these numbers. Incorporating the state number into routine IRS tax account databases would also be expensive. We would like to encourage states to use, or cross reference, the federal EIN in their FUTA certification programs.

Now on p. 37.

GAO states (Page 50):

"However, IRS did not provide Labor [DOL] with its recommendation; in July 1988, IRS advised us it had been studying alternatives that would upgrade computer capability at half of its 10 service centers."

IRS Response:

Computer capability at all 10 service centers is scheduled to be upgraded during 1989 which should facilitate resolution of FUTA discrepancy cases.

Now on p. 37.

GAO states (Page 51):

"IRS officials advised us that they began preparing a request for proposals to upgrade hardware at these service centers in fiscal year 1987, and that they planned to consider implementing the California methodology nationwide by 1992."

IRS Response:

The report should reflect that the earliest possible implementation date is 1992 when new computer capability is scheduled to be in place in all 10 service centers. During late 1987 and early 1988, IRS reviewed the initial results of the California methodology, and found it to be less cost beneficial than originally computed. Extensive coordination with the Department of Labor and other states is required to further evaluate the California methodology. Early efforts to use the California tape data found it unusable. Matching the data from the state tape to IRS records was a very labor intensive process for both IRS and the state. We do believe, however, that with modifications to the computer programs, a tape-to-tape recertification procedure may be feasible and could be helpful in working the discrepancy cases in the FUTA Certification Program.

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Glossary

Administrative Procedures and Techniques

Administrative Levy
An action by a UI program director (without court involvement) establishing a right to seize or attach liquid assets of an employer delinquent in UI taxes. Administrative levy has the same effect as a tax lien (see below) issued by a court.

Administrative Subpoena
An action brought by the state's attorney general, obligating an employer to turn over UI tax records to the state; the action is usually written and served by tax collectors or supervisors as contrasted with a court-processed subpoena requiring a judge's approval.

Bonding
Private nonprofit entities making UI payments on a reimbursable basis are required to post a bond equal to a specified percentage of their annual taxable wages.

Budget Withholding
A state withholds payment of budgeted funds from municipalities and other state public entities pending payment of delinquent UI moneys.

Employer (Arbitrary) Assessment
An administrative process whereby the state (1) establishes by estimate the UI tax liability of employers' failing to report UI tax obligations and (2) bills the employer for that amount.

Employer Status Change
Allows the state UI program director to terminate an employer's reimbursable status and convert it to a contributory basis when the employer reimbursement record is poor; after conversion, the employer may request a status change to reimbursable only if delinquencies are paid.

Individual (Memo) Assessment
An administrative procedure establishing personal liability of an individual other than the original tax debtor (the employing business). Liability can be established for any officer, major stockholder, or other

person having charge of the affairs of the corporation or business who fails to pay or withhold UI taxes.

Liquor License Hold

Places a hold on the sale of a liquor license transferred from an existing to a new business; the hold establishes a priority claim for UI debt on any moneys received resulting from the sale of the license.

Offset

Withholding payments from amounts owed to employers by other state agencies — tax refunds, license fees, lottery winnings, or payments for services rendered.

Security Deposits

Private nonprofit entities making UI payments on a reimbursable basis may elect, in lieu of bonding, to provide a security deposit equal to a percentage of their annual taxable wages.

Warrant

An administrative order enabling local law officials, through seizure and sale of an employer's assets, to enforce an existing levy or lien to collect delinquent UI taxes. The order has the same effect as a writ of execution (see below) processed in the courts.

Judicial Procedures

Civil Action

A lawsuit under civil statutes to recover unpaid taxes, as well as court, investigation, collection, and prosecution costs, when other legal remedies are insufficient.

Criminal Action

State prosecution, under criminal statutes, of an employer when the employer willfully fails or refuses to (1) file reports of UI taxes owed or (2) pay UI taxes or (3) both.

Earnings Withholding Order (Salary Garnishment)

A court order for an employer to withhold a portion of an individual's wages for use in paying delinquent taxes when the individual is a delinquent employer earning wages.

Individual Liability

State law provides that corporate officers may be held individually liable for a corporation's nonpayment of UI taxes.

Out-of-State Judgments Accepted

State commercial codes include specific provisions permitting enforcement of judgments (court decisions ordering an employer to pay debts) that are rendered in one state when properly recorded in the transfer state.

Tax Lien

A legal right conferred by the court to sell property in order to satisfy a UI debt. The lien protects state UI program interests in the event of (1) bankruptcy or disposal proceedings and (2) the sale of property, both real and personal.

Writ of Execution

A court order to local law enforcement officials to seize and sell assets, based on existing liens, of a UI debtor.

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