Fixing the Payroll Tax … *and Improving Unemployment Insurance Reserves*

by

Gary Burtless

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Strengthening Unemployment Insurance – Promising Solutions to Systemic Problems:

"Fixing the Payroll Tax and Improving State Unemployment Insurance Reserves"

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I want to talk about an unusual feature of the U.S. financing system for unemployment benefits … a uniquely ***bad*** feature: The extreme regressivity of the unemployment insurance (UI) payroll tax. Most of you know that employers must pay a statutory UI tax for each of their employees. They pay this tax on each worker's wages below an annual ceiling called the "*taxable wage base*". Many of you probably know, too, that the federal minimum wage is currently $7.25 / hour. A simple calculation shows that a minimum-wage worker who works full time – 2,000 hours a year – earns $14,500 a year.

What you may not know is the relationship between the taxable wage base in unemployment insurance and the annual earnings of a minimum-wage worker. The earnings subject to taxes for unemployment insurance are usually *below* the annual earnings of a minimum-wage worker! How many states have a "taxable wage base" lower than minimum-wage earnings? If we count the District of Columbia as a state, the correct answer is: **33**. In other words, in two-thirds of the states, employers pay exactly the same UI tax for a minimum-wage worker as they do for their Chief Executive Officer.

[SEE SECOND SLIDE] This chart shows states' "taxable wage bases" in relation to the annual earnings of a minimum-wage worker. In three states, employers pay the maximum UI tax for minimum-wage workers who are on half-

time schedules. Employers in those states pay the *maximum* UI tax for a minimum-wage worker who is employed just 20 hours a week. In another **19** states, employers pay the maximum UI tax for minimum-wage workers who work between 20 and 30 hours a week, all of whom would be classified as part-time workers.

Interestingly, in some these states if the part-time minimum-wage workers have the misfortune to get laid off, they will not even qualify for UI benefits. (At least they would not qualify if they honestly told a UI in-take worker they're looking for a part-time job.) These unlucky souls would not qualify for UI benefits, even though their previous employer paid the maximum UI tax on their wages. Note also that if a minimum-wage worker holds two part-time jobs with two different employers, each employer pays the maximum UI tax in his or her behalf. Thus, a minimum-wage worker holding down two part-time jobs may pay twice the UI tax paid on a CEO's wages.

Let's think about what this means for workers in a couple of states. [SEE THIRD SLIDE] Start with California, where the UI wage base is just $7,000. According to DOL, the minimum statutory UI tax in California is 1.5%; the maximum is 6.2%. This chart shows the tax employers pay on workers with three wage levels – ½ the minimum wage; exactly the minimum wage; and 4 times the minimum wage. The red bars show the UI tax liability of an employer facing the minimum statutory UI tax rate; the blue bars show the tax of a company facing the maximum rate. As it happens, the Californian minimum wage last year was $0.75 / hour higher than the federal minimum. But that makes no difference. Using either the federal minimum wage or the California minimum wage, employers paid exactly the same UI payroll tax for someone who earned *one-half* the minimum wage, *exactly* the minimum wage, or *four times* the minimum wage. For an

employer facing the lowest statutory rate, that tax was $105 / year; for a company facing the maximum rate, the annual tax was $434, regardless of the worker's wage.

California is one of the states with the lowest wage base. What about a state nearer the middle, like Massachusetts? [SEE FOURTH SLIDE] The Massachusetts wage base is $14,000. The state has a minimum statutory tax rate of 1.26% and a maximum UI tax rate of 12.27%. In Massachusetts, an employer pays a higher UI tax for full-time minimum-wage workers than for half-time minimum-wage workers. Notice, however, that the tax is not twice as high, even though under my assumption the higher-paid worker earns twice as much. That's because in Massachusetts and many other states, employers are liable to pay the maximum UI tax for minimum-wage workers who work just 35 hours a week. The employer pays the same UI tax for a 35-hour-a-week minimum-wage worker as it pays for workers earning the median wage … or earning 10 times the median wage, for that matter.

The state with the highest UI wage base is Washington state. Its wage base last year was $37,300. [SEE FIFTH SLIDE] That's a little more than twice the annual earnings of a minimum-wage worker in Washington who is employed on a full-time schedule. (Washington's minimum wage is $8.67 / hour.) As you can see on the right side of this chart, employers pay higher UI taxes for workers earning four times the minimum wage compared with workers who only earn the minimum wage. Still, the UI tax rate is effectively higher as a percentage of earnings for workers earning the minimum wage compared with workers earning four times the minimum wage.

Some of you may think a tax that is the same for a minimum-wage worker as it is for a highly paid CEO is a regressive tax. I agree. More than a decade ago

Patricia Anderson and Bruce Meyer wrote a paper estimating the regressivity of the UI tax.[1] Let's assume for a minute that the full burden of the UI payroll tax is effectively paid by workers, even though technically the check is signed and mailed by their employers. The idea that workers "bear the burden" of the UI tax conforms with the way most economists see the payroll tax. They think workers essentially pay the tax, because their employers would pay them higher gross wages if the UI tax did not exist.

Turning to Anderson and Meyer's findings: In 1994, workers in the bottom one-tenth of the American wage distribution paid about 2.8% of their wages to the UI system in UI taxes. Workers in the top one-tenth of the wage distribution paid about 0.4% of their wages in UI taxes. The tax-rate ratio is therefore 7-to-1: As a percent of wages, the bottom one-tenth of wage earners pays 7 times the UI tax paid by the top one-tenth of wage earners.

The data in Anderson and Meyer's study are now 17 years old. In many states the taxable wage base hasn't increased very much in those 17 years. However, wages in the top one-tenth of the earnings distribution have increased much, much faster than wages in the middle and at the bottom of the distribution. Given these facts, it's a reasonable guess that the UI tax has become even more regressive since the year analyzed by these economists.

Compared with the UI tax, both the Social Security payroll tax and the sales tax look like models of progressive taxation. The Social Security payroll tax is capped when wages reach about $107,000 a year. As I recall some old CBO analysis, the Social Security tax is actually a progressive tax up to family incomes

[1] Anderson, Patricia M. and Bruce D. Meyer. 2006. "Unemployment Insurance Tax Burdens and Benefits: Funding Family Leave and Reforming the Payroll Tax," *National Tax Journal*, pp. 77-95.

of about $150,000 a year. That is, the Social Security tax represents a rising share of family income for families with incomes between $0 / year and $150,000 / year. (The reason for this is that families with very low and modest family incomes often receive unearned income, like Social Security benefits and food stamps, which are not subject to the Social Security payroll tax. The payroll tax is only owed on families' labor income, and labor income tends to represent a rising percentage of family income as we move up the income ladder from, say, $2,000 to $150,000 a year in income.) In contrast, the UI payroll tax is lower for the middle income one-fifth than it is for the bottom one-fifth, and it is much lower for the top one-fifth than it is for the middle one-fifth.

To be sure, the UI tax does not look so bad if you consider it in relation to the distribution of UI benefits that it finances. In comparison to the income distribution of UI tax payers, the income distribution of UI recipients is much more comparable. At least that is what Anderson and Meyer found in their analysis of 1994 data. My suspicion, however, is that the balance of tax payments and UI benefits has gotten less favorable for people with low wages and incomes. The reason is that state UI benefit formulas more or less keep pace with the trend in wages. The average weekly UI benefit is roughly the same percentage of the average weekly wage today as it was 15 years ago, 30 years ago, or 45 years ago.

The UI tax base, however, has not come remotely close to keeping up with average wages, except in a handful of states. As the taxable wage cap has continuously fallen in relation to the average wage, a larger and larger percentage of the tax is being imposed on the wages of the workers with the lowest annual earnings.

The main factor that is generating increased regressivity in the UI tax is the very low cap on taxable wages. The low cap has two other pernicious effects:

- First, it causes UI payroll tax revenues to climb more slowly than wages. This doesn't make any sense when weekly UI benefits are climbing roughly in line with wage growth. In the long run, the effect is to starve the UI system of revenues unless state legislatures increase the tax rate on earnings below the cap. But at least initially, the effect of the low cap is to push state UI systems toward very low trust fund balances, which I think is bad for insurance protection in recessions.

- Second, by maintaining low taxable caps, state UI systems tend to boost the tax rate applied to the low earnings amounts that are subject to the tax. The UI tax becomes the equivalent of a "poll tax" on new employment. Any jobs created in a year, except jobs paid the very lowest wage rates, will cause employers to pay the maximum UI tax for that job. Simple economic theory suggests the incentive created by a high tax rate imposed on a small taxable wage base is to discourage job creation while encouraging employers to add to the work hours of their current employees. In states with a low tax base, the UI tax becomes a tax penalty on job creation, at least in the short- and intermediate-runs.

In sum, the UI tax is regressive and growing more regressive each passing decade. The regressivity seems unfair, whatever adverse incentives are created by the tax. Second, the regressivity is caused by the very low and very slowly rising tax cap. This feature of the tax causes two other problems for the system. It slows the growth of UI tax revenue in comparison to wages given the fact that nominal wages have been rising 2½% to 4% a year for the past few decades. This in turn hurts UI trust fund balances, which reduces the insurance protection offered by UI in recessions. And finally, it pushes state legislatures to impose higher taxes on a narrow tax base in order to finance benefits. This has undesirable incentive effects, because it discourages job creation in comparison with a tax that imposes lower tax rates on a larger tax base.

My suggestion is simple. The federal government should raise its own UI taxable wage base to one-half the wage base of Social Security – bringing it to $53,000 – and it should raise the wage base every year at the same rate as it

increases the Social Security wage. Moreover, it should require states to have a wage base that is no lower than the federal UI wage base. Of course, the tax *rate* on wages included in the higher tax base can and should be lowered. If a state has an ample UI trust fund and there is no reason for additional revenues, the current tax rate can be lowered quite significantly. However, if a state needs additional revenue to replenish its UI trust fund or pay down its debt to the federal Treasury, then it is better to obtain the additional revenues with increases in the taxable wage base than with an increase in the current tax rate.

- *Gary Burtless*
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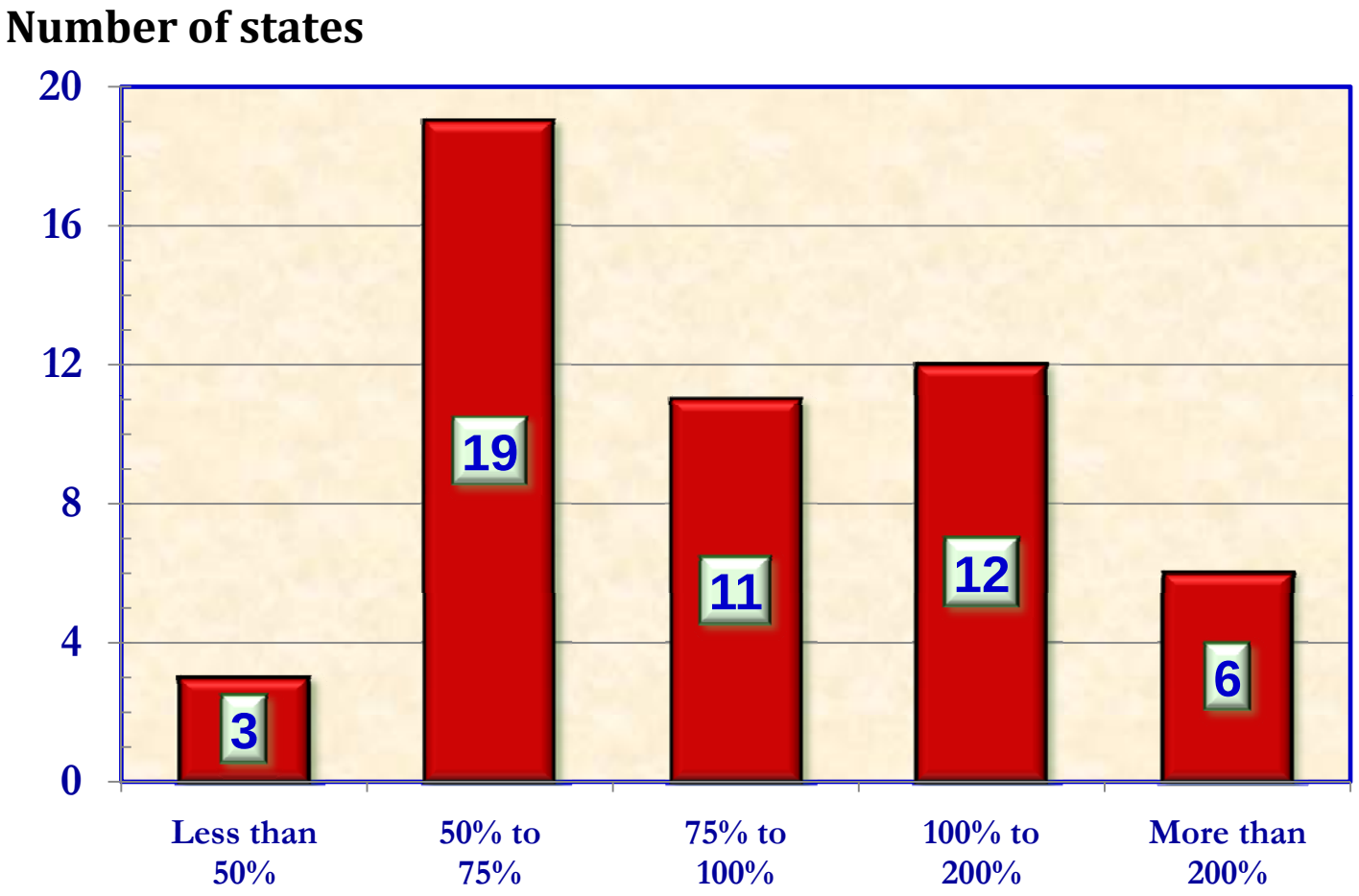
SLIDE 1: The UI payroll tax is imposed on a taxable "wage base" that is too small

- UI tax is too regressive
- Low wage base means –
  - **Poorest wage earners face the maximum tax**
  - **Wages subject to UI taxes increase more slowly than earnings that are insured by program**
  - **Anemic growth in taxed earnings slows growth of UI revenues … hurting state trust funds**
  - **UI payroll tax is now a "poll tax" on jobs**
- UI wage base should be increased to one-half the Social Security wage base (i.e., $53,000)

Slide 2: The taxable wage base in 50 states + D.C.



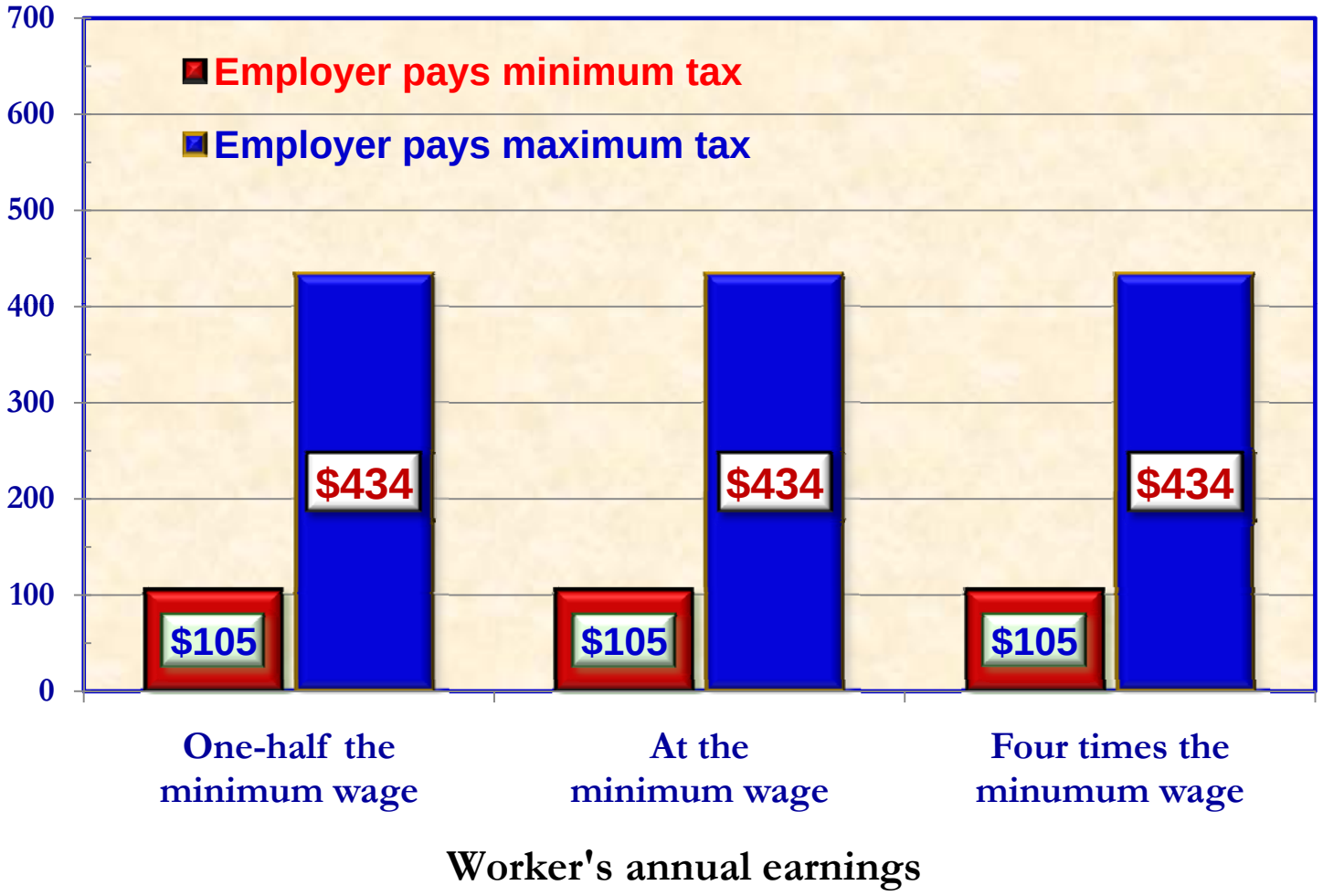
Taxable wage base as a percent of annual earnings of full-time minimum-wage worker

Source: American Payroll Association (2011).

Slide 3: Annual UI tax liability: Workers at selected wage levels

UI tax liability: California

(Taxable wage base = $7,000)

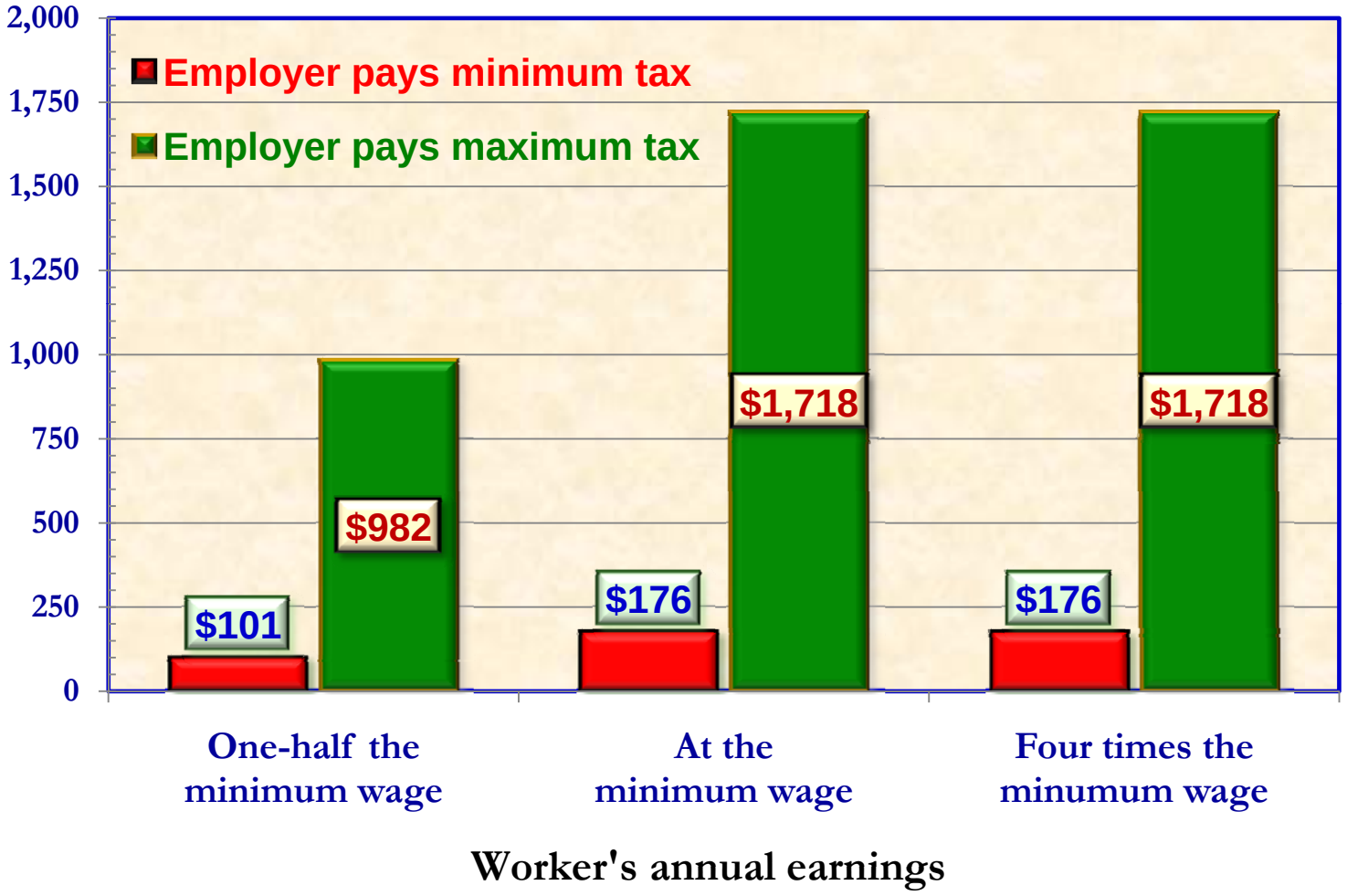


Source: U.S. DOL/ETA and American Payroll Association (2011).

Slide 4: Annual UI tax liability: Workers at selected wage levels

UI tax liability: Massachusetts

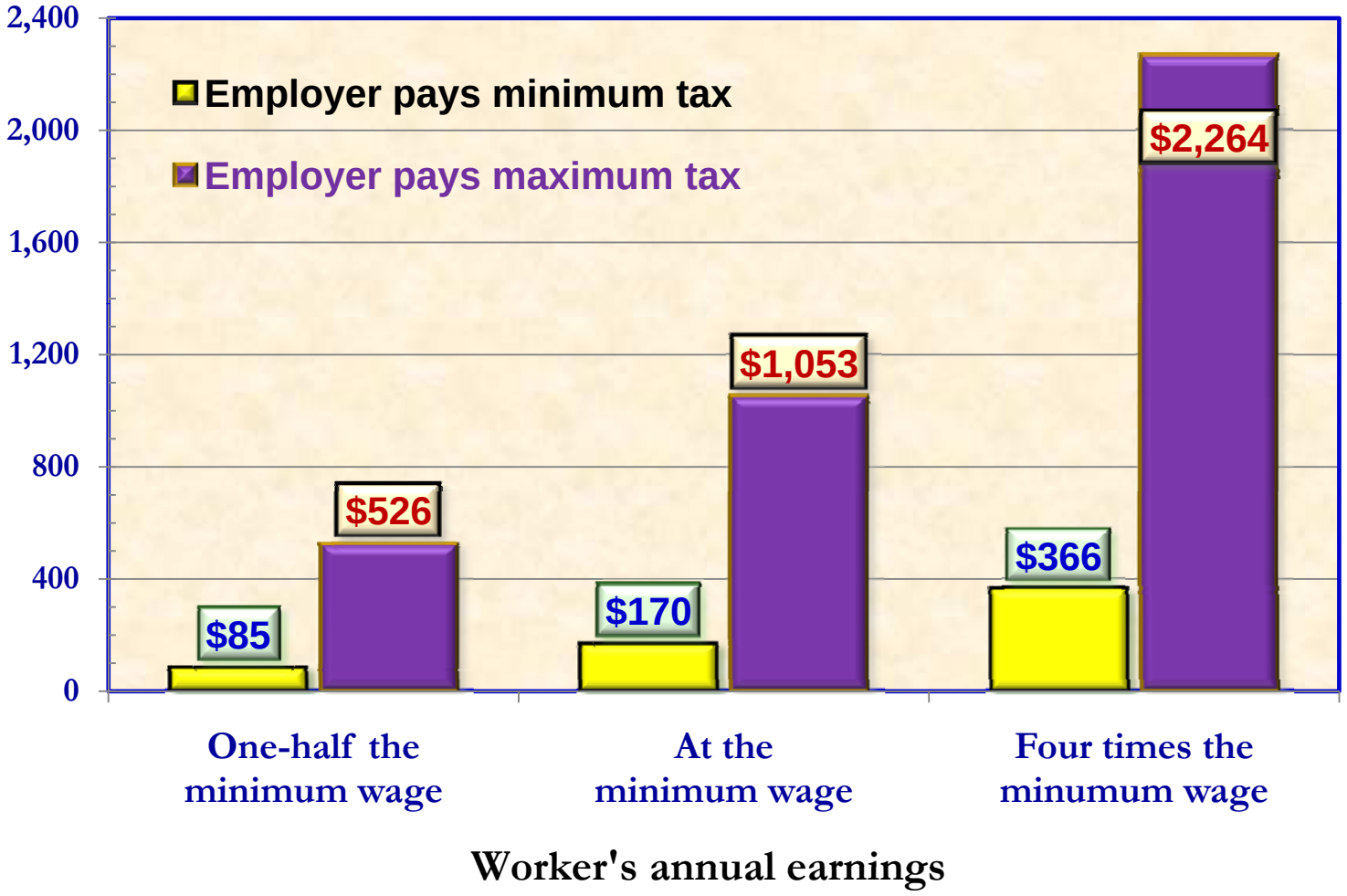
(Taxable wage base = $14,000)



Source: U.S. DOL/ETA and American Payroll Association (2011).

Slide 5: Annual UI tax liability: Workers at selected wage levels

UI tax liability: Washington State
(Taxable wage base = $37,300)



Source: U.S. DOL/ETA and American Payroll Association (2011).