

**THE IMPACT OF THE TARGETED HARMONIZED  
WAGE CODE ON UNEMPLOYMENT INSURANCE**

**Lalith de Silva, Dominic Rotondi, and Mikel Lasa**

**Planmatics, Inc.**

**November 2001**

## **EXECUTIVE SUMMARY**

Social programs that provide benefits and protection to workers are generally funded by taxes levied on employer payrolls. Key among the laws governing these taxes are the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and the individual State Unemployment Insurance Laws (SUI). The diversity and complexity of the state and federal laws governing taxes and withholding have been identified as creating a burden for the business community.

In response to these concerns the federal government established a multi-agency task group called the Simplified Tax and Wage Reporting System (STAWRS) to review the tax and wage reporting process and to develop strategies for a simplified reporting system to replace the multitude of laws currently in effect.

One of the principal initiatives of the STAWRS Group is the Harmonized Wage Code (HWC) project. The HWC project group reviewed some 100 laws relating to the reporting of wages by employers, both federal and state, to identify the similarities and differences among them and, once identified, ascertained whether a measure of harmonization or uniformity would be feasible. During this process it became apparent that the differing objectives among income tax withholding laws and employment tax laws added materially to the project's complexities. To facilitate their work, the project divided into two segments – one for income tax withholding and one for employment tax laws (i.e., FICA, FUTA, and SUI).

The group further recognized that complete harmony was not necessary to achieve a high degree of success for a majority of the nation's employers. The group then focused on employers with 20 or fewer employees, since they comprise 85% of employers in the United States, and deal with fewer of the differing components of wages.

This approach became known as the Targeted Harmonized Wage Code (THWC). It addresses 14 elements or components of payroll that are most common to small employers. The intent of the THWC is to produce a set of recommendations which, if adopted, more closely harmonizes or aligns the wage components identified among the federal and state employment tax laws. States could achieve harmony with minimal modifications to existing laws; preferably in some cases by administrative action rather than statutory changes; and accomplish a large measure of harmony within a relatively short period. The group believed that the proposed changes would have minimal negative economic impact on state revenues.

While endorsing the concepts of simplification and efficiency, the U. S. Department of Labor made note of the fact that to the extent that in those states where redefinitions could serve to reduce wages subject to SUI, there will be a commensurate reduction in SUI revenues financing the unemployment insurance system. Further, such redefinitions may reduce the unemployment insurance benefits payable to qualified workers or eliminate some of them from eligibility. Therefore, DOL and the IRS authorized this study to obtain feedback on what small employers perceive to be burdensome in tax and wage reporting systems and obtain suggestions from employers, and to determine the probable impact of the THWC on SUI revenues and benefits.

For the task of eliciting opinions on what is perceived to be burdensome in the wage code and obtain suggestions for changes and simplification, qualitative input was obtained from interviews with UI administrators and focus groups of small employers and payroll processors.

A number of Unemployment Insurance administrators were of the mistaken opinion that the THWC recommendations appear to be addressed to benefit large multi-state employers and accounting and payroll providers, and have little or no value to the majority of small employers who conduct business in only one state. Legislative staff in the nine states visited were unanimous in opinion that if a state is asked to change the way a component is currently reported for UI tax purposes and if the removal of the component would result in any significant reduction in benefits of individuals by income class or occupational category, it is unlikely that state legislatures would be amenable to the proposal.

Approximately fifty small employers were surveyed in focus groups. The majority stated that any plan for simplification should not have a negative impact on workers, especially in reducing worker benefits even though such a plan might produce an economic or administrative benefit to them.

Employer groups interviewed seemed generally unaware of many of the current differences in the reporting of some of the wage components for federal and state unemployment purposes. Employers are probably not reporting correctly. However, as is stated in the report, they were not too concerned with the *burden* of tracking the different components of wages for federal and state requirements.

Small employers expressed dissatisfaction with the differences in reporting times and payment schedules. They would like greater uniformity in this area, including some consolidation of the periodic payment processes. Almost everyone was in favor of reporting simplification, but looked upon harmonization of wage definitions as being of little value in reducing the employer reporting burden when compared to other wage and tax issues of greater concern to them: such as treatment variances in sales tax reporting requirements, complications in tip reporting rules, severity of penalties for late payment of taxes, difficulty in communicating with the government offices, and distinguishing between employees and independent contractors.

To estimate the impact of the THWC on SUI revenue and benefits, two types of wage record and benefit data were needed from a sample of states. A major payroll service with a nationwide presence agreed to assist in the study and provided one quarter of employee wage record information, disaggregated by the THWC components, for a sample of states for calendar year 1999. SUI revenue and benefit data on the universe of employers for each of the sampled states for 1999 was also needed. Five states provided this needed data: California, Georgia, Minnesota, Montana and Pennsylvania. Collectively, these states had a fair representation of the wage component differentials in their UI laws. The data from the payroll service and SUI agencies were combined and a series of calculations and simulations were performed.

The impact on SUI revenues is the difference between UI taxes collected under current laws and the taxes collected if the THWC items were harmonized. The application of the ratios of the components in the sample payroll files to the state wage files was tailored to the state being studied to recognize the annual taxable wage base limit involved.

The impact of the THWC on benefits involved a similar set of calculations. The annual dollar value of each THWC component derived from the payroll sample was converted to a weekly benefit amount (WBA) in keeping with the state's principal method of computation. Since the components represented reductions in gross wages, the conversion represented a potential reduction in an individual's WBA. For each individual in the UI claimant file, an adjustment to the WBA was made based on the estimated parameters determined by the payroll sampling. The total estimated benefits paid is the sum of all the adjusted WBAs in the UI claimant file. The total estimated benefits paid was compared to the actual benefits paid for the time period covered by the data to determine the expected impact of the THWC on claimants.

One of the selection criteria used by the STAWRS Group in advancing the THWC initiative was to select wage components for harmonization that were most common to the small employer. The study's computations show that the selected components met this criterion, particularly when assessing the impact of the relevant components on SUI revenues. The impact on state revenue was minimal. However it must be noted that the study was conducted using the most current data, therefore the revenue impact was measured for 1999 when average employer contribution rates were among the lowest in the past 10 years. Should these rates increase, the impact would increase as well. The relative impact on revenues increases as taxable wage bases increase because a greater portion of the affected wage components falls within the greater taxable wage base.

Unlike revenues the impact on claimant benefits are not directly linked to the taxable wage base. Rather, they are more closely related to workers' occupations, industries in which they are employed, and their level of earnings. The number of claimants as a percentage of the entire

claimant population was quite small, less than 1% in the sample states. The impact on claimants who would be affected, however is more substantial. The reductions in their weekly benefit rate ranges on average from 7% to 30%.

As expected, the major impact would be from the THWC recommendation of the *meals and lodging* provision<sup>1</sup> that excludes the value of meals and lodging as designed in determining taxable wages and benefits for SUI purposes. At present, 23 states treat meals and lodging as wages in their laws and would be affected by this recommendation<sup>2</sup>. These states include California (included in this study), New Jersey, New York, and Texas. They represent in excess of 26% of the nation's work force. In terms of impact on affected claims, analysis of California's data indicate the average benefit claim over its duration is \$2,433 and the average value of the exclusion of the meals and lodging component on affected claims is \$487, amounting to 20% of the claim of the workers affected. This percentage of reduction, or one close to it, could occur in New Jersey, New York and Texas as well.

It is important to remember that the impacts on benefits were measured at a time when benefit outlays were near, or at, a 10-year long low. Should there be an increase in unemployment rates, the impacts would increase as well. During periods of economic recession, an increase in the unemployment rate does not apply equally among all industries or categories of workers. In past recessions, those industries associated with hospitality services – hotels, restaurants, resort areas – generally sustained an earlier, greater and more prolonged impact than other industries. Since the meals and lodging component exists in hospitality services to a far greater degree than in

---

<sup>1</sup> “This recommendation has caused a great deal of concern in the *non-conforming* states primarily because of the possible impact such payments (payments for meals and lodging) if made excludable might have on the amount of revenue available and the payment of benefits.” STAWRS – The Targeted Harmonized Wage Code, August 2000, p2-8

<sup>2</sup> Prior to 1983, all states and the federal government treated meals and lodging as wages. After 1983, the federal law changed to exclude meals and lodging, and, subsequently, 27 states changed their laws to eliminate these items as wages. As noted, 23 states did not.

other industries, the THWC's impact on the percentage of affected claimants, benefit duration and weekly benefit reductions would be considerably greater.

On the basis of the results of this study, we recommend the draft model state legislation that incorporates the THWC proposal be advanced by the STAWRS Group to the individual states for their consideration. In addition to its stated purpose, it could serve as a point of departure for broader discussion on the entire issue of tax reporting and its need for simplification and greater utility of available electronic technologies.