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THOMAS PROPOSAL TO SUSPEND THE TAXATION OF UNEMPLOYMENT BENEFITS WOULD PROVIDE NO IMMEDIATE STIMULUS AND FAVOR HIGHER-INCOME UNEMPLOYED WORKERS OVER LOWER-INCOME WORKERS

Suspension Also Would Reduce State Revenues and Widen State Budget Deficits

by Wendell Primus, Robert Greenstein, and Nicholas Johnson

On December 5, House Ways and Means Committee Chairman Thomas proposed a modified unemployment insurance package. The package would provide 13 additional weeks of benefits in all states for workers who lost their jobs after March 15, 2001 and exhaust their regular unemployment benefits. The Thomas proposal also would suspend the taxation of unemployment benefits for calendar year 2002. Finally, the proposal retains a House-passed provision to accelerate the scheduled transfer of $9 billion from the Federal Unemployment Insurance Trust Funds to state unemployment trust funds. As a recent survey of states conducted by the National Association of State Workforce Agencies shows, little of the transferred funds would be used to strengthen unemployment benefits.[1]

While this is a significant improvement over the meager unemployment insurance provisions in the stimulus bill the House of Representatives passed earlier this fall, it falls well short of what is needed in two key respects. First, the Thomas proposal does not include important provisions included in the Senate Finance Committee stimulus legislation that would enable a substantial number of deserving — and primarily low-income — workers to receive unemployment benefits when they are laid off. Second, the Thomas proposal replaces the Senate Finance Committee provision for a temporary 15 percent increase in unemployment benefits with the provision to suspend the treatment of unemployment benefits as taxable income through December 31, 2002. As this brief analysis explains, this change is extremely ill-advised: it would largely eliminate the stimulative effect of the measure, would shift significant relief from low-income households with an unemployed worker to higher-income households with an unemployed worker, and would cause states to lose substantial state revenue, thereby aggravating state budget problems. The proposed replacement of a modest across-the-board increase in unemployment benefits with a benefits-related tax cut represents the elevation of anti-tax ideology over sound policy.

- Suspending the taxation of unemployment benefits in calendar year 2002 would provide virtually no immediate fiscal stimulus. *Workers generally would not*

[1] See Wendell Primus, "Survey Shows Most States Would Not Use Unemployment Insurance Funds They Would Receive Under House Stimulus Bill To Expand or Extend Unemployment Benefits," Center on Budget and Policy Priorities, December 3, 2001.

benefit from this change until March or April 2003, when they filed their 2002 income tax returns. This is borne out by the Joint Tax Committee estimate of the proposal, which shows that 90 percent of the revenue loss from the provision would occur in fiscal year 2003.

Since the Thomas proposal does not put money in these workers' hands until 2003, it sacrifices the stimulative effect the Finance Committee's increase in weekly unemployment checks would have. For the same reason, the Thomas proposal fails to provide relief to these workers when they need it most — during the time they are unemployed. (Note: the Thomas proposal does not appear to exempt unemployment insurance benefits received in 2001 from taxation. Doing so would be difficult or impossible at this late date: the IRS has completed the tax forms and instructions for tax year 2001, and it is too late to make a change such as this for the current tax year.)

- The Senate Finance Committee proposal to increase unemployment benefits by the greater of 15 percent or $25 a week would provide $6.35 billion in additional benefits. The Thomas proposal to suspend taxation of benefits costs $4 billion, or about one-third less. But for low- and moderate-income workers, the difference is much greater than this. The Thomas proposal is of no value to the majority of unemployed workers who earn too little in 2002 to owe income taxes;[2] based on IRS data, about 30 percent of unemployment insurance benefits are paid to workers who pay no income tax. Under the Senate Finance Committee provision, by contrast, the unemployment check these workers receive each week would rise by the larger of 15 percent or $25. Lower-middle-income workers in the 10 percent tax bracket also would benefit less from the Thomas proposal than the Finance Committee's 15 percent benefit increase.

- The workers who would benefit the most by far from the Thomas approach are high-income households that include a worker who collected unemployment benefits during the year. (A significant number of higher-income households could include both a high-income earner and a spouse who collected unemployment benefits for part of 2002.) A household in the 38.6 percent bracket in 2002 that received unemployment benefits would effectively receive *a 63 percent boost in its benefits* under the Thomas proposal. If such a filer

[2] The provision would assist some low-income filers who owe little or no income tax and who receive unemployment benefits during 2002 by increasing their earned income credit. Filers who receive the EITC and are in the income range over which the EITC phases out would receive a larger EITC benefit as a result of unemployment benefits not being counted as part of adjusted gross income in 2002. In some cases, the increase in the EITC benefit would exceed the increase in unemployment benefits an unemployed worker would receive under the Finance Committee provision; in other cases, the increased EITC benefit would be less than the increase a worker would receive under the Finance provision. Even in cases where the increased EITC benefit would exceed the increased unemployment benefit under the Finance provision, the increased EITC benefit would not be provided until early 2003, rather than as part of the unemployment checks a worker would receive while unemployed in 2002.

Effect of Proposal on Filers in Different Tax Brackets	
Tax Bracket	**Increase in Net Unemployment Benefit Under Thomas Proposal**
38.6%	63%
35%	54%
30%	43%
27%	37%
15%	18%
10%	11%
0	0

received $1,000 in unemployment benefits, he or she would pay $386 in taxes on these benefits under current law, for a net benefit of $614. The Thomas proposal would raise this filer's net benefit to $1,000, a 63 percent increase. This is in sharp contrast to the 11 percent boost in net unemployment benefits that many lower-middle-class unemployed workers in the 10 percent tax bracket would receive and the lack of any increase for low-income unemployed workers.[3]

- Suspending taxes on unemployment benefits would cause fiscal harm to states. Many state income tax codes conform to the federal definition of adjusted gross income. Removing unemployment insurance benefits from adjusted gross income for a year would result in a parallel change in these states' tax codes. Of the 43 states with personal income taxes, 35 would face a reduction in revenue, with those 35 states losing a total of more than $500 million in state income tax receipts.

  These revenue losses would be in addition to the approximately $5 billion that states would lose in each of the next three years as a result of a separate provision favored by Rep. Thomas and the Administration that would allow businesses to deduct immediately 30 percent of the cost of purchases for equipment and certain

[3] Consider two workers, one in the 10 percent income tax bracket and the other in the 38.6 percent bracket. Currently, the after-tax value of $1,000 of benefits to the lower-middle-income worker in the 10 percent tax bracket is reduced to $900, while, as noted above, the after-tax value of $1,000 of unemployment benefits to the high-income worker in the 38.6 percent tax bracket is reduced to $614. Suspension of taxation means both workers would receive the full $1,000 of benefits, an increase of 11 percent for the lower-income worker and 63 percent for the higher-income worker. The disparities would be further magnified if state tax implications were accounted for in the calculations.

other items.[4] These reductions in state revenues would come at a time when a growing number of states are falling into fiscal crisis. Fiscal difficulties are projected to last into 2003 in many states.

- Finally, the proposal fails basic standards of equity. Under the proposal, a worker who earns $40,000 in 2002 would be subject to taxation on his or her $40,000 in income, while a worker who earned $35,000 and receives $5,000 in unemployment benefits in place of wages — for a total income of $40,000 — would be taxed on only $35,000. There is no sound reason for the second worker to be subject to lower taxes than the first worker. Such an approach would violate standards of equity.

[4] Iris J. Lav and Kevin Carey, "House Stimulus Package Would Worsen State Fiscal Conditions by Causing States to Lose $5 Billion a Year in Revenue for the Next Three Years," Center on Budget and Policy Priorities, October 18, 2001.