

Comments on the D.C. Family Leave Tax Proposal

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Chairman Mendelson and members of the Committee:

My name is Joseph Henchman, and I'm vice president at the Tax Foundation, which is a non-profit organization based here in the city. I wear two hats at the Tax Foundation, one as a policy expert who testifies on state tax issues all over the country, and one as our COO in charge of hiring and internal budgeting, so those things bring me here today. I participate in a roundtable of other operations and HR people from D.C.-based think tanks and organizations across the political spectrum, where we discuss common issues. I should also say that I am a Ward 5 resident and that 50 percent of Tax Foundation staff are D.C. residents. We can be anywhere but we like being here.

By all accounts, the Council is determined to take the time to do this right, and I thank you for that. I'm hopeful my perspective helps you get there.

Summary of Universal Paid Leave Proposal

- Establishes a universal paid leave program for (1) all D.C. residents, (2) individuals who work more than 50% in D.C.; (3) individuals employed by D.C. employers who do not spend 50% or more of their working time in another state; and (4) self-employed residents of D.C. who do not opt out of the program. There is no exception for small employers, non-profit employers, or employers who already have paid leave programs. Individuals (except self-employed) are also prohibited from opting out of the system.
- Eligible individuals would be entitled to take up to 16 weeks of paid leave for self-care, to care for a family member, or to care for a new child. Recipients technically face a waiting period, with the first 5 days of leave not eligible for benefits, but if the leave period exceeds 5 days, those first 5 days are paid retroactively. Unlike systems in other jurisdictions, pay is matched 100 percent with no co-payment required. Eligible beneficiaries will receive up to \$1,000 per week, plus 50% of average wages above that amount up to \$3,000 per week. Partial weeks are prorated, and leave may be taken intermittently.

- The proposal would impose a 1 percent tax on the payroll of each covered employee, collected and paid by the employer. Federal employees, self-employed individuals, and D.C. residents working for an out-of-state employer would pay the tax directly. Once the fund reaches a solvent level, the tax then becomes a sliding scale tax, with rates of 0 percent of individual salaries up to \$9,999; 0.5 percent on salaries between \$10,000 and \$19,999; 0.6 percent on salaries between \$20,000 and \$49,999; 0.8 percent on salaries between \$50,000 and \$149,999; and 1 percent on salaries of \$150,000 and over.
- Covered employers must give notice of the paid leave benefit at hiring, annually thereafter, and “at the time the covered employer is aware that the leave is needed,” or be fined \$100 for each employee. Employers must also post a written notice in the workplace or be fined \$100 for each day that the notice is not posted.
- An administrative process is established to process claims, adjudicate eligibility, and hear appeals. Employees may also file civil actions. Employers found guilty of committing a violation must pay compensation denied to the employee, interest, and reasonable attorney’s fees and costs, *plus* the greater of (1) liquidated damages equal to the lost compensation or (2) triple damages plus any uncovered medical expenses. Employees who are paid benefits through fraud or error may be asked to repay the amounts received at the Mayor’s discretion.
- The bill also expands the D.C. Family & Medical Leave Act, which guarantees unpaid leave up to 16 weeks per year for medical leave and 16 weeks every two years for family leave for employees who have worked for the employer for at least 12 months or for at least 1,000 hours in the past year. The bill changes this eligibility threshold to 6 months or 500 hours in the past year.

Comment One: Program costs will likely outstrip the revenue stream.

An individual earning the D.C. average income of \$45,877 would thus pay a tax of \$459 per year until the fund became solvent, and then a tax of \$205 per year thereafter. The individual would be entitled to a paid leave benefit of \$882 per week, or \$14,116 if he or she takes the full 16 weeks. While the benefit level greatly exceeds the tax contribution of each person, it is not anticipated that all taxpayers will take advantage of the full benefit each year.

But it’s worth noting that a D.C. average income earner will have collected more benefits than taxes paid after taking 2.6 days of paid family or medical leave per year. If average use is much more than that, a 1 percent tax rate will be insufficient. Given the lack of effective waiting period, the full 100% payment of lost wages, the lack of penalties for fraudulent or erroneous payments, and the structural incentive for employers to encourage use of the program, usage under this program is likely to

exceed the utilization of unpaid leave, and even the utilization of paid leave in other jurisdictions with similar programs.

Comment Two: Better program design options exist for paid leave.

I have written extensively on unemployment insurance programs, which are similar to this proposal in that both (1) impose payroll taxes on employees' wages that are (2) assessed at the employer level, to (3) fund a benefit of a certain amount (4) for a certain number of weeks (5) based on eligibility set and awarded by a government entity.¹

Consequently, it's worth noting that this proposal does not include a number of features of unemployment insurance administration that have been adopted over the years in nearly every state to make the program workable and solvent:

- *Experience Rating.* Unemployment insurance balances (1) the goal of sharing the costs of unemployment among all employers with (2) not equalizing burdens among all employers, which would result in good employers effectively subsidizing all the costs of "bad apple" employers (those who frequently lay off employees). This is done most significantly by requiring employers who have a recent history of excessive layoffs to pay higher unemployment insurance tax rates, the "experience rating." This proposal imposes identical taxes on all employers regardless of how good or bad their paid leave policies are.

The unintended consequence would be that employers who currently have good paid leave policies would effectively subsidize employers who do not, facing increased costs with no additional benefits. Employees who currently are able to ask their boss for time off might then only be able to get the benefit by going through the government administrative process (estimated at 10 days' time in the proposal).

- *Co-Payments or Deductibles.* Insurance programs often require a payment of some amount that must be paid by the beneficiary before the insurance pays out. For example, an insurance policy with a \$1,000 deductible would require the beneficiary pay costs up to that amount in any claim. Co-payments and deductibles make people think twice about filing a minor claim, lowering overall costs and reducing unnecessary claim processing. They also ensure that beneficiaries do not rely entirely on the insurance program, taking actions to minimize or avoid out-of-pocket costs (moral hazard). For unemployment insurance, all states cap benefits at significantly below previous full salary; in most cases, the benefit is about 60 percent of previous full salary, with the average benefit around \$300 per week. Here, with no benefit cap or waiting

¹ For the full paper on unemployment insurance program design options, visit <http://goo.gl/nF5MWX>.

period, there will be strong incentives to use the program unnecessarily or excessively beyond its designed purpose.

- *Verification Requirements.* The vast majority of states require unemployment insurance beneficiaries to conduct “work search” of a certain number of job contacts per week (usually 2-3). Verification cuts down on fraud and encourages recipients to avoid excessive use of benefits beyond the amount necessary. The paid leave proposal has no on-going verification requirements, with might include doctors’ notes or confirmation of new births or sick relatives. These verifications may be unnecessary where there is strong employer-employee trust but this would be lost in a government-administered program. Additionally, the strong penalties on employers who in any way prevent an individual collecting benefits would make it unlikely that employers would alert officials about any excessive or non-essential use of the program.
- *Strong Anti-Fraud Measures.* All states have sizeable enforcement arms to root out unemployment insurance fraud, penalties on beneficiaries found guilty of fraud, and even tip lines to report fraudulent use. This proposal has excessively strong measures to punish employer violations but no measures to punish individuals who defraud the program beyond discretionary repayment of the benefits received. Even with these measures, anecdotal evidence suggests that excessive use of unemployment insurance benefits, beyond that required to transition between employment, is commonplace.

Additionally, the federal-state structure of unemployment insurance limits states’ abilities to engage in a number of innovations that could improve program design. Some of these ideas could be incorporated for a paid leave structure:

- *Active case management to minimize benefit time.* Arizona assigned one-on-one counselors to facilitate benefit payments and helping the beneficiary solve issues while on benefits. The face-to-face sessions, rather than Internet- and phone-based contacts, improved the experience for beneficiaries and led to an estimated \$14.94 savings in benefit costs for each \$1 additional in administration costs.
- *Insurance options.* Workers’ compensation programs pay an employee’s lost income and medical expenses in any job-related accident. While many states have public funds for workers’ compensation, employers in nearly all states can opt to purchase private insurance, self-insure, or group self-insure. This is in contrast to a single-provider model that would be inflexible for the wide variety of employment environments. An option would be to require all employers to demonstrate ability to provide family and medical leave benefits to eligible workers, either through self-funding, purchasing private insurance, setting up savings accounts for workers, or participating in a state fund.

- *Worker Savings Accounts.* Rather than collecting taxes and immediately paying the collected funds out in benefits, an option would be to require individuals to contribute to his or her account, with the mandatory saving stopping when a specified accumulated balance has been reached. Such a program would reduce the adverse incentive effects of unnecessary or excessive claims without any decrease in coverage. A 1998 paper by Daniel Altman and Martin Feldstein proposed various savings account alternatives for unemployment insurance, including a high-savings base (4 percent of earnings up to a cap of three times the average wage), low-savings base (4 percent of earnings up to a cap of the average wage), target account (accumulate until it reaches 50 percent of annual income), experienced-based target account (accumulate until it reaches 30 percent of annual wage plus all benefits received over the past two years), and experience rating component (combining any option above with a requirement that employers fund the first few weeks of benefits, to discourage creation of excessive employment). Accounts can be conservatively invested, and can operate in place of or alongside a state-run system.

Comment Three: Competitive Impact of 1%, 2%, and 3% Payroll Taxes

The D.C. government deserves great credit for a number of initiatives in the past several years that have improved quality of life, income, and competitiveness. We can't rest on our laurels, because there's always more to be done, but the record of each and every member of the Council shows a commitment to an economy that both works and works for everyone.

Balancing the costs of new programs and requirements with the economic productivity and growth needed to bear their cost is no easy science. One description I've always liked is that you can strain at the leash but you can't jerk it free and run off. I've testified in dozens of states in the last two years and in a lot of places they aren't able to discuss how to make the economy work for everyone because the economy in that state isn't working in the first place.

That's not the case here, and I don't play Chicken Little easily. The only real time I've done that is when I warned Kansas Governor Brownback not to cut taxes the way he did in 2012 or else a budget calamity would ensue. He didn't listen and I think I've been vindicated there. Mostly tax policy is about how you'll be a little better off or a little worse off with some change.

One tool we use to evaluate this is our *State Business Tax Climate Index*, which ranks the states on over 100 variables of tax policy. It's award-winning, widely-cited, and heavily used by experts and policymakers to evaluate policy. Not long ago, D.C. was ranked 45th of out of the 51 states, but has risen in recent years to 42nd as the first elements of the landmark D.C. tax reform package began taking effect, leapfrogging Ohio and Connecticut. As what you've already passed continues to take effect, we'll soon be able

to say D.C. is more tax competitive than Maryland, Georgia, and South Carolina, which will be huge.

We used our *Index* to model a payroll tax of 1% associated with this proposal, as well as 2% and 3% taxes that might be necessary to fully fund the paid leave program as outlined. We find that a 1% tax takes back about two-thirds of the tax competitiveness gains from the tax reform package (moving D.C. down to 44th), and a 2% tax takes back all of the gains (moving D.C. back to 45th). A tax higher than 3% would move D.C. below where it was before the tax reform package began taking effect (46th).

Tax Rate	Rank
Current	42 nd of 51
+ 1%	44 th of 51
+ 2%	45 th of 51
+ 3%	45 th of 51
+ 4%	46 th of 51

Conclusion

As you consider this proposal alongside many others, the cumulative and tradeoff impacts on D.C.'s growing economic successes must be kept in mind. If we can provide any additional materials or answer any questions, please let us know.

Thank you.

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