



**Statement of
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U.S. Department of Labor
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Subcommittee on Human Resources
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Good afternoon, Mr. Chairman and Members of the Subcommittee. Thank you for inviting me to testify today in my capacity as the Inspector General of the U.S. Department of Labor. I am pleased to discuss my Office's assessment of the integrity of the Unemployment Insurance (UI) program. The views I express this afternoon may not be representative of those of the Department.

Administration and Oversight of the UI Program

Mr. Chairman, as you know, the UI program is vital in ensuring the financial security of America's workforce. This multi-billion dollar entitlement program, administered through a unique Federal-State partnership, provides temporary financial assistance to workers who lose their jobs through no fault of their own. Benefits are paid out so long as workers meet certain eligibility requirements. Funding for these benefits comes from employer taxes deposited into the Unemployment Trust Fund. States are primarily responsible for the collection of these taxes and the payment of benefits through State Workforce Agencies (SWAs), while the Department is charged with ensuring that states comply with applicable laws and regulations, and with providing oversight, policy guidance, and technical assistance to the states.

In addition to the Department, the OIG has certain oversight responsibilities regarding the UI program. Preserving the integrity of the UI program has been a long-standing concern of the OIG. Our investigative casework and audits show that the UI program remains vulnerable to fraud, waste and abuse, which result in millions in losses to the UI trust fund. We conduct periodic audits of the program that look at internal controls and program integrity, among others. We also engage in casework that identifies complex interstate UI fraud schemes, as well as single claimant fraud cases committed by federal employees or ex-military personnel. Based on this body of work, we believe that more can be done by the Department to strengthen the integrity of the UI program. We have highlighted UI program integrity as one of the top management issues facing the Department. Congress also recognized the

importance of improving the integrity of the UI program in a 2001 report on government mismanagement, as well as OMB in a report released last month on erroneous payments.

Fraud Against the UI Program

As with any multi-billion dollar benefit payment program, the UI program is vulnerable to fraud and abuse. We have focused our UI investigative activities on three types of schemes: 1) fictitious or fraudulent employer schemes; 2) internal embezzlement schemes; and 3) identity theft or imposter schemes. I will elaborate on each of these areas.

Fictitious / Fraudulent Employer Schemes

Mr. Chairman, a fictitious employer scheme involves creating a company that exists only on paper with no actual employees, business operations, cash outlays for taxes or any other normal business expenses. The intent is to have in place a company that is used to file fraudulent claims. In many of these cases, the individuals will operate in multiple states and include their family and friends, or individuals who have been recruited to assume false identities in order to collect UI benefits. Conversely, a fraudulent employer scheme usually involves a legitimate business with employees and valid business expenses. However, the employer actively engages in fraudulent activity such as laying off workers, only to return them to work under a cash system, or allowing non-employees to file claims against the company in exchange for part of the claimants' benefits. Unfortunately, mail, telephone, and Internet claims filing, which are designed to make the program run more effectively, can have the unintended effect of facilitating these types of schemes because they eliminate the need to fill out UI forms in person. In one case that is illustrative of how these schemes can result in significant losses to the UI program, an individual used 13 fictitious companies and 36 fictitious claimants using names and Social Security numbers of deceased persons to collect over \$135,000 from California, approximately \$65,000 from Massachusetts, \$16,000 from Nevada, and over \$15,000 from Texas. The individual submitted fraudulent interstate UI claims based on false reported wages, and then collected the benefit checks from various locations based on claims filed by mail.

Internal Embezzlement Schemes

Fraud and embezzlement of UI funds by state personnel who administer the program is another problem in the UI system. These schemes vary in complexity. A simple fraud scheme may be the acceptance of a payoff by a state UI employee in exchange for the approval of an unauthorized UI claim. These schemes, however, can mushroom into operations involving multiple individuals when state UI employees work with outside employers who certify false employment information. We believe that advanced technology, which has consolidated certain tasks into a single job that once had been handled by several people, has had the unintended effect of facilitating this type of fraud

since it has eliminated certain controls by reducing the levels of peer review and supervisory oversight in UI offices. An illustration of this type of internal embezzlement involves a New Jersey state employee who sent false wage and employment information to local unemployment offices to verify the employment of as many as 30 co-conspirators. The scheme consisted of registering four fictitious companies with New Jersey for the purpose of “employing” his co-conspirators. The individual and his co-conspirators filed false UI applications claiming that they had been laid off from these companies and thus entitled to benefits. The state employee then verified their employment with UI offices and used a false name to disguise his involvement. In return, he received half of the co-conspirators’ UI benefit checks.

Identity Theft or Imposter Schemes

Fraud against this program has also been carried out through identity theft. Under this type of scheme, individual identities are stolen and then used to apply for UI benefits. Identity theft victims are usually unaware that someone is using their identity. Unfortunately, fraud detection in these cases is complicated because any preliminary fraud screening that may be done would disclose that the employer and employee actually exist. An example of how such a scheme can operate involves our investigation of a California man who orchestrated an identity theft scheme designed to obtain UI benefits by filing over 30 fraudulent claims totaling more than \$130,000. The stolen identities were obtained from customer transaction receipts printed by a Los Angeles public employees’ credit union. This credit union, like others, uses Social Security numbers as customer account numbers. Victims of the scheme included 18 Los Angeles City and two Los Angeles County employees. The individual used the UI system to create fictitious employers and had the benefit checks sent to his home. Assisted by his girlfriend, he would then deposit the fraudulent UI checks into bank accounts that he controlled.

Internal Control Weaknesses and Other Vulnerabilities in the UI Program

Mr. Chairman, in addition to fraud schemes, there are a number of internal control weaknesses and other vulnerabilities that impact the integrity of the UI system. Over the years, OIG work has also identified weaknesses or vulnerabilities relative to: 1) overpayment detection, recovery and reduction; 2) misuse of administrative grant funds by states; 3) misclassification of workers and its impact on employers’ payment of UI taxes; and 4) vulnerabilities created by telephone and Internet claims systems now in place by most states. In our opinion, these weaknesses can be compounded by the program’s requirements that timely benefit payments be provided to unemployed workers.

Overpayment Detection, Recovery and Reduction

With respect to overpayments, Mr. Chairman, the OIG is concerned about the efficiency and effectiveness of the Department’s activities to detect, recover, and reduce UI benefit overpayments. The Department funds two systems that

measure UI benefit overpayments. The Benefit Accuracy Measurement (BAM) system uses statistical sampling techniques to project the total UI benefit overpayments made. The Benefit Payment Control (BPC) system at each state identifies and investigates benefit overpayments, establishes receivables, and collects overpayments.

Benefit Accuracy Measurement System

As part of our audit of the DOL FY 2001 financial statements, we noted that the BAM system projected overpayments of \$2.3 billion for FY 2001. For the same period, actual overpayments identified by BPC totaled \$669 million, or just one-third of the amount estimated by BAM activities. We also noted that overpayment rates projected by BAM have remained relatively flat at approximately 8.5 percent over the past 12 years. This raises a concern that the BAM system is not being utilized to reduce the amount of overpayments.

To examine these seemingly divergent results more closely, the OIG is performing an audit of the Department's oversight role regarding UI benefit overpayments. Our ultimate objective is to assess BAM results and identify how the system can best be utilized to reduce the amount of overpayments.

Benefit Payment Control System

As part of their BPC activities, states routinely conduct crossmatches to compare weekly UI benefit payment records with quarterly wage records reported by employers in order to detect possible overpayments. When claimants are identified with both UI benefits and wages for the same period, a potential UI overpayment case is developed. This has historically been the most effective overpayment detection tool used by the states. However, a 1999 audit we conducted of the crossmatch systems in seven states – Illinois, Texas, California, New Jersey, Maryland, Kentucky and Florida – showed inherent weaknesses in this fraud detection method. Foremost among these weaknesses was the failure of employers to respond to the states' requests for detailed wage information. This information is critical because it provides specific information as to how much the claimant earned on a weekly basis, which states can then use to determine if an overpayment has occurred. As a consequence, we estimated \$17 million in overpayments were not being detected in four of the seven states we audited. Many employers failed to respond because they either misunderstood the purpose of the request or were confused over who should respond.

To improve the UI benefit-wage crossmatch overpayment system, we recommended that:

- ETA provide policy guidance and direction to the SWAs to ensure that employers are reminded of their responsibility to respond to wage requests, and that adequate follow-up routinely occurs for those who fail to respond, particularly those with the highest potential for overpayments.
- ETA assume a leadership role in assuring that SWAs obtain timely access to the data of the National Directory of New Hires, established under the welfare reform legislation, and to fully incorporate that data into UI Benefit Payment Control operations.

ETA has agreed to take corrective action, and we will work with them to ensure that they implement our recommendations.

The Use of UI Administrative Grant Funds by States

Mr. Chairman, another area of concern involves the use of UI administrative grant funds. These funds are issued to the states for the costs of processing unemployment claims, collecting UI taxes, and all necessary related activities. State funding is based on the cost of proper and efficient administration and such other factors as the Secretary deems appropriate. In just three audits, we identified questioned costs of nearly \$20 million related to improper uses of UI administrative grant funds. Included in the amount of questioned costs we identified were unallowable charges for direct and indirect costs, overcharges for state automatic data processing and information technology central service costs, and un-allocable maintenance and operating expenses relating to building space occupied by non-SWA personnel. Amid SWA complaints that administrative funding is inadequate, the inefficiency identified by our audits points to the need for more careful use of current funding to allow more to be done to enhance quality control and other essential functions.

Misclassification of Workers and Lost Contributions to State UI Trust Funds

Our work has also disclosed that not all employers voluntarily pay their fair share of UI taxes. Some employers intentionally misclassify their employees as independent contractors in order to hide the wages they pay out in order to avoid paying benefits or taxes. Employee leasing companies are another method used to avoid paying taxes. These companies lease workers back to client firms, serving as the employer of record for purposes of UI tax payments and experience-rating calculations. Losses to UI trust funds occur when companies purchase an inactive or defunct company that has few or no employees and very low tax rates. Upon purchasing this “shell” company, the employee leasing company obtains that company’s lower UI rate and transfers employees from other affiliated entities to the lower UI tax-rated shell company, thereby avoiding higher taxes. This undermines the state’s experience rating system, which is

designed to assess UI tax rates based on an individual employer's history of UI tax assessments paid, versus benefits charged.

To combat these activities, SWAs rely on field audits to determine whether employers are reporting all UI-covered wages and paying their fair share of UI taxes. In March 1999, we reviewed the field audit practices of 12 states. We determined that if states adopted some of the best practices used by the top performing states, the identification of non-compliant employers could be improved. Among the best practices we found were: 1) selecting a significant percentage of employers based on Standard Industrial Classification codes that identify employers with the highest probability for non-compliance; and 2) implementing a blocked claims audit program that encourages the conversion of field audit investigations into audits. In response to the latter recommendation, ETA revised its reporting instructions to permit states to take credit for blocked claims audits. As a result of our audit, almost \$16 million in additional taxes have been recovered as a result of ETA's implementation of our recommended actions.

Telephone and Internet Claims Systems

Over the last several years, almost all states have moved from traditional in-person claims services to telephone or Internet claims services, or both to improve the delivery of services. Shifting to remote claims filing via the telephone or Internet has reduced administrative costs for states, and users have cited the convenience, ease, and privacy it provides. However, we are concerned that as remote claims filing increases, the ability of states to monitor the integrity of the claims-filing process will be eliminated. Reducing or eliminating personal contacts during the initial claims filing process removes a first-line defense against fraud schemes. In addition, electronic claims filing effectively enlarges the potential universe of identity theft victims, and makes it easier to initiate multiple state schemes from a single location. We are concerned that this type of activity will only increase absent up-front identity or eligibility verification, or the implementation of proper controls and safeguards.

Current and Future OIG Work in the UI Program

Mr. Chairman, the OIG will continue to engage in proactive investigative casework, audits, and evaluations designed to improve the integrity of the UI program. The following is a brief description of our planned work in this area.

In FY 2003, we plan to conduct a comprehensive, nationwide initiative to help safeguard the integrity of the UI program. Our initiative will focus on identifying systemic weaknesses that make the program vulnerable to fraud and overpayments; identifying and disseminating information on best practices used by the states to detect fraud; and determining if UI administrative funding is used to its maximum effect. Specifically, we will continue to expand our investigative efforts to detect and investigate interstate, fraudulent employer schemes used to defraud the program. We will also continue to audit the Department's oversight

role regarding UI benefit overpayments, and will follow up on our earlier audits that highlighted excessive charges by the Treasury Department to the UI trust fund to pay for the IRS' costs of administering the fund. Finally, we will begin looking into issues related to the solvency of state UI trust funds and how states have been using the \$8 billion in Reed Act distributions they received in March.

Recommendations for Strengthening the UI Program

Based on our audits and investigative casework, the OIG has made several recommendations to the Department and the Congress for strengthening and enhancing the integrity of the UI program. Among our recommendations is the need to:

- Grant the OIG and the Department unimpeded access to UI, Social Security, and New Hire data for fraud detection and program evaluation purposes

The OIG and the Department needs efficient access to data that is maintained by other agencies such as state UI and Social Security wage records; and wage data contained in databases such as the National Directory of New Hires. Such data would be used for two primary purposes: 1) to aid in our fraud detection and investigative efforts; and 2) to better help us and the Department assess program performance and return-on-investment. If we had routine and expeditious access to the centralized Social Security wage database, we could more efficiently and consistently verify eligibility of program applicants and whether their Social Security numbers are valid. This would aid in identifying potential overpayments and preventing millions of dollars in future losses.

- Enhance fraud detection and investigative training for state personnel

In order to better detect fraud and abuse, state personnel who are responsible for benefit payment control, tax, and internal security need to be provided high-quality, consistent training. Any training should focus on fraud prevention and detection, information sharing regarding common fraud schemes, and dissemination of best practices used by the states. This transfer of knowledge will assist the states in their efforts to improve their enforcement and oversight capabilities.

- Improve the UI benefit-wage crossmatch overpayment system

Although ETA has distributed to the states our 1999 audit report on the UI benefit-wage crossmatch overpayment system, ETA should implement a corrective action plan to address our findings and recommendations in order to detect the millions in overpayments that are being missed.

Conclusion

In conclusion Mr. Chairman, the UI program provides financial assistance to workers who lose their jobs through no fault of their own. It is vital, therefore, that the UI program function effectively and efficiently, and that UI benefits only go to those who are eligible to receive these benefits. My Office will continue to provide oversight and conduct investigations to this end. This concludes my full statement. I would be pleased to answer any questions you or any other Subcommittee Members may have.