EXPERIENCE RATING

ALMON R. ARNOLD

Follow this and additional works at: https://digitalcommons.law.yale.edu/ylj

Recommended Citation
ALMON R. ARNOLD, EXPERIENCE RATING, 55 YALE L.J. (1945).
Available at: https://digitalcommons.law.yale.edu/ylj/vol55/iss1/18
EXPERIENCE RATING

ALMON R. ARNOLD†

The funds from which benefits are paid under the state unemployment compensation systems are obtained almost uniformly from payroll taxes levied on employers. In most states the tax is a differential tax. Rates are varied with relation in some degree to the past employment experience of each employer, in accordance with widely differing methods. The variation of employers' tax rates by these methods is known today as experience rating.¹

The differential employer tax was introduced in the first State unemployment compensation law adopted in this country, the Wisconsin Unemployment Compensation and Reserves Act of 1932. The system which the act created was fashioned after existing workmen's compensation plans and provided for contributions by employers alone to individual reserve accounts administered by the state. Each employer's rate was varied on the basis of the size of his reserve. The methods of financing thus provided represented a departure from the arrangements of existing foreign systems which generally obtained their funds, which were pooled, from contributions paid by employers and employees or by employers, employees, and the government, and made no provision for differentiation in the payments of employers.² The pattern of financing which the Wisconsin law established strongly influenced the development of the other state systems. When statewide pooled fund plans were formulated, whether including provisions for employer contributions alone or for both employer and employee contributions, room was found in them for differentiating the employers' payments. This met "the Wisconsin idea halfway."³ By the time the Social Security Act was passed, the variable employer tax had a firm position in the thinking concerning the contribution structure appropriate to a system of unemployment compensation.⁴

† Principal Attorney, Federal Security Agency.

Opinions expressed herein are the author's and are not intended to reflect the official views of the Federal Security Agency or of the Social Security Board.

1. Terminology has not been consistent. As applied to pooled fund systems, differentiation of employers' rates was at one time generally called "merit rating."


3. Rubinow, The Movement Toward Unemployment Insurance in Ohio (1933) 7 SOCIAL SERVICE REV. 175, 201.

4. For a review of the early development of the financial methods employed by the state systems, see Malisoff, The Emergence of Unemployment Compensation: II (1939) 54 POL. SCI. Q. 391.
The Social Security Act did not require the states to finance their systems through a tax on employers alone nor did it require them to vary the rates at which payments from employers were collected. These problems were turned back to the states, but under conditions that strongly favored the adoption of both measures. First, the payroll tax which the Act imposed on employers, with its offsetting credits for taxes paid under a state unemployment compensation law, provided a method of financing that furnished the tax base necessary to experience rating. Second, the additional credit provisions of the Act supplied the means whereby reductions in rates which the states permitted could be made effective through a corresponding reduction in the employer's federal tax.

In the years following the passage of the Social Security Act, the use of the employer payroll tax, with experience rating, as the sole method of financing spread rapidly as the state unemployment compensation systems were created and put into operation. There are only four states today which require worker contributions. Experience rating forms an integral part of all but six of the systems.

**OBJECTIVES OF EXPERIENCE RATING**

The avowed objectives of experience rating in unemployment compensation may be stated quite simply: first, the prevention of unemployment by inducing employers to stabilize their operations, and, second, the allocation of the social costs of unemployment to the individual business concerns responsible for those costs. Both objectives have their sources in social and economic views of the functions of an unemployment compensation system and the methods appropriate to its financing. The first was early identified with what was considered the primary objective of an unemployment compensation system itself. Unemployment compensation "must include both an attempt to reduce the hazard [of unemployment] to its smallest possible proportions, and provision for compensating the unemployment that remains." The differential employer tax under this conception of unemployment compensation was viewed less as a revenue measure, adequate to finance any extensive system of benefits for the unemployed, than as a tax to discourage unemployment and thereby to eliminate the need for benefits. The objective of cost allocation is often coupled with the first objective as a sort of by-product of a measure designed primarily to pro-

---

5. Alabama, California, New Jersey, and Rhode Island.

6. The states requiring a uniform payroll tax are Alaska, Mississippi, Montana, Rhode Island, Utah, Washington.

mote the stabilization of employment. But it is also accounted for independently, partly on grounds of social fiscal policy which is viewed as requiring the allocation of the costs of unemployment to "the business units which are at least proximately responsible for it" so that such costs may be reflected in the prices charged consumers, and partly on grounds of fairness in the distribution of costs among employers. 8

Unemployment Prevention.

Experience rating viewed as a preventive measure rests on the assumption that employers have a substantial degree of control over unemployment and that differential rates will serve as an effective incentive to employers to stabilize their operations. 9 Those who favor rate differentiation as an incentive device in unemployment compensation point to workmen's compensation plans where differential rating schemes have had a significant effect in reducing industrial accidents and occupational diseases. On the other side are those who see unemployment as essentially a different problem from that involved in work injuries. The major causes of unemployment, they believe, are beyond the control of the individual employer; unlike the causes of work accidents, which have their source within the plant, unemployment is due largely to national and international forces over which employers have little or no control. 10 It is further suggested that even where individual firms have the ability to decrease the irregularity of their employment, the gains that they achieve may be at the expense of the stability of other employers. For example, the action of an employer in diversifying

8. Raushenbush, The Wisconsin Idea: Unemployment Reserves (1933) 170 ANNALS 65; Brandeis, The Employer Reserve Type of Unemployment Compensation Law (1936) 3 LAW & CONTEMP. PROB. 54. Fundamentally rate variation in unemployment compensation reflects "the normal desire or effort to achieve some sort of fair proportion between the degree of hazard and the rate of contribution upon industry as the hazard-carrying factor." Rubinow, State Pool Plans and Merit Rating (1936) 3 LAW & CONTEMP. PROB. 65, 79. See also Witte, Experience Rating and Other Forms of Incentive Taxation to Promote Employment in NATIONAL TAX ASS'N, PROCEEDINGS OF THIRTY-FOURTH NAT. CONF. ON TAXATION (1941) 479.

9. "At any rate the Wisconsin unemployment reserves plan assumes that much of our chronic irregularity of jobs should prove gradually preventable, and that compensation laws should encourage rather than penalize efforts in that direction." Raushenbush, The Wisconsin Idea: Unemployment Reserves (1933) 170 ANNALS 65, 70. Some apprehension has been voiced whether employment stabilization is in itself a desirable social goal, since it might mean under a low volume of employment that one group of workers would be steadily employed while another would be unemployed. See Richard A. Lester, Economics of Labor (1941) 448; Report of the New York Unemployment Insurance Advisory Council (1940) pt. 1, pp. 4-5.

his products to fill in slack seasons may cause some other employer to lay off workers because part of his market has disappeared.

Aside from the relation of individual employers to unemployment and its causes, a real question remains whether possible reductions in unemployment tax rates can ever be effective as a stimulus to employment regularization. Those who are opposed to experience rating believe that any savings that might be offered employers through reductions in their unemployment taxes would add little or nothing to the financial incentives employers already have to regularize their operations. "Nor is it necessary," stated the majority of the New York Advisory Council in 1940, "once more to point out that the losses which an employer sustains because of the irregular operation of his plant exceed by a wide margin the fullest contribution that could be asked of him for unemployment insurance. Thus, every employer has these many years already had a financial incentive to stabilize, greater than any savings that can be promised him under any system of experience rating." 11 Those who favor experience rating, on the other hand, see the reductions in tax rates that may be granted under experience rating as an "immediate and obvious" addition to the rewards that might be gained through more regular operations. They also urge that possible savings through the tax reductions can be expected to have psychological effects "that would enhance the force of all other incentives." 12

Wherever the line of truth may lie between these conflicting viewpoints, there has been a noticeable shift in emphasis from unemployment prevention to cost allocation as the most important objective of experience rating. After a survey of unemployment compensation operations in eleven States, the Ives Committee reported in 1943, "Stabilization of employment [as an objective of experience rating] is barely being talked about in the present period." 13 This was accounted for on the basis of war conditions. But the change in emphasis began before the war and reflects not only changes in views concerning the major functions of an unemployment compensation system, but also a growing recognition that the reduction in rates which are permitted under the state systems depend less on an employer's achievements in preventing unemployment than on such factors as the general

11. REPORT OF THE NEW YORK UNEMPLOYMENT INSURANCE ADVISORY COUNCIL, (1940) pt. 1, p. 1. See also 2 INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, REPORT OF THE COMMITTEE ON EMPLOYER EXPERIENCE RATING (1940). The majority of the committee concluded after extensive study of the problem that the control of the individual employer over unemployment is "too limited to justify the use of variable tax rates as an incentive to stabilization.


13. REPORT OF THE NEW YORK STATE JOINT LEGISLATIVE COMMITTEE ON INDUSTRIAL AND LABOR CONDITIONS (1943) 120.
level of employment, the industry he happens to be in, and the place his business is located.14

Cost Allocation.

Allocation of the costs of unemployment to individual employers as contemplated by the second major objective of experience rating has never meant more than allocation of the cost of the benefits paid out as unemployment compensation. These costs may be limited, depending upon the extent to which the system compensates unemployed workers; and in any event will never represent the total social costs of unemployment. Beyond the point that unemployment is compensated under the systems, the cost of unemployment will continue to be borne by workers and society as a whole.

The objective of cost allocation is in part an expression of the view that unemployment compensation benefits should be reflected in the prices of goods produced. "The perennial major problem of organized society is so to devise its legal and economic rules that the price system will adequately reflect social costs and conserve social standards. The social and human costs of irregular employment should properly be charged against and compensated by each employing unit. Only in this way can consumers be assured that a low price is not a misleading and parasitic price, and that the competitive (or other) system is really functioning in the public interest." 15 But this view of the function of rate differentiation rests on concepts of shifting and incidence of taxes which are by no means uniformly accepted by students of the subject. 16 Critics of experience rating point to the complexities of the various processes of shifting and incidence as well as to the speculative character of the factors which go to influence prices. 17

The objections to cost allocation as a desirable objective do not stop here. Serious questions are raised whether it is wise social fiscal policy to put the burden of the unemployment taxes on industries characterized by unemployment not within their control. "We must conclude," stated a majority of the Committee on Experience Rating of the Interstate Conference of Employment Security Agencies in 1940, "that there exists in our present economic pattern wide variation in the stability or regularity of employment due to forces beyond the control of the indi-

---

vidual employer or even of groups of employers. The highest degree of instability exists in the construction industry, in mining, and in the capital goods or durable goods industries. These are what might be termed the cornerstones of the business and employment structure. It follows that a penalty imposed on the basic industries—principally because of uncontrollable factors—will have adverse effects on the whole national economy. Such a tax is clearly against national policy."

Those who are opposed to experience rating do not see in it even the element of fairness that cost allocation is supposed to achieve. They view the differential tax as a highly discriminatory tax. “The concept of merit rating with individual tax rates rebels against the accepted principle of taxation used in this country that all taxpayers in the same class share equally the cost of government.”

**Tax Reduction and Volume of Revenue.**

The dual objectives of experience rating, reflected with varying emphasis and effect in the systems that the states have adopted, have not furnished the sole principles of growth. Two other elements have entered into the development of the state experience rating systems, often with predominating force. The first of these is tax reduction. “... it is the cost as expressed in the premium rate,” stated I. M. Rubinow in 1936, “and not the possible stabilizing influence of premium rate that really matters, and ... it is because of the prevailing American system of placing the entire cost upon the employer, that this whole question has become the crucial one.” The second element is the control over the volume of revenue needed for the payment of benefits; it involves essentially the gearing of revenue provisions to anticipated expenditures, a problem which is discussed elsewhere in this issue.

The use of experience rating as a device for over-all tax reduction or as a device to control volume of revenue has been viewed by some state administrators and legislators with misgivings. It is the only device,
however, that is available to the states for these purposes, for flat rate reductions to all employers in a state would not meet the conditions for additional credit allowance against the federal unemployment tax.

The Federal Standards: Reserve Accounts, Guaranteed Employment Accounts, and Pooled Funds

The conditions governing the allowance of additional credit included in the Social Security Act, and transferred with amendments in 1939 to Section 1602 of the Internal Revenue Code, do not establish a single, ready-made system of experience rating for the states to follow. The minimum standards are cast in terms of the type of fund, provided by a state system, to which contributions at reduced rates may be permitted. Standards are included covering reductions in rates of contributions to pooled funds, partially pooled funds, guaranteed employment accounts, and individual employer reserve accounts. These are not exclusive alternatives; various combinations of the several types of funds are possible.

Section 1602(a) of the Internal Revenue Code reads:

"STATE STANDARDS.—A taxpayer shall be allowed an additional credit under section 1601(b) with respect to any reduced rate of contributions permitted by a State law, only if the Board finds that under such law—

"(1) No reduced rate of contributions to a pooled fund or to a partially pooled account is permitted to a person (or group of persons) having individuals in his (or their) employ except on the basis of his (or their) experience with respect to unemployment or other factors bearing a direct relation to unemployment risk during not less than the three consecutive years immediately preceding the computation date;

"(2) No reduced rate of contributions to a guaranteed

---

23. The term "pooled fund" is defined in Section 1602(c)(2) of the Internal Revenue Code as "an unemployment fund or any part thereof (other than a reserve account or a guaranteed employment account) into which the total contributions of persons contributing thereto are payable, in which all contributions are mingled and undivided, and from which compensation is payable to all individuals eligible for compensation from such fund."

24. The term "partially pooled account" is defined in Section 1602(c)(3) of the Internal Revenue Code as "a part of an unemployment fund in which part of the fund all contributions thereto are mingled and undivided, and from which part of the fund compensation is payable only to individuals to whom compensation would be payable from a reserve account or from a guaranteed employment account but for the exhaustion or termination of such reserve account or of such guaranteed employment account. Payments from a reserve account or guaranteed employment account into a partially pooled account shall not be construed to be inconsistent with the provisions of paragraph (1) or (4) of this subsection."
employment account 25 is permitted to a person (or a group of persons) having individuals in his (or their) employ unless (A) the guaranty of remuneration was fulfilled in the year preceding the computation date; and (B) the balance of such account amounts to not less than 21/2 per centum of that part of the pay roll or pay rolls for the three years preceding the computation date by which contributions to such account were measured; and (C) such contributions were payable to such account with respect to three years preceding the computation date;

"(3) No reduced rate of contributions to a reserve account 26 is permitted to a person (or group of persons) having individuals in his (or their) employ unless (A) compensation has been payable from such account throughout the year preceding the computation date, and (B) the balance of such account amounts to not less than five times the largest amount of compensation paid from such account within any one of the three years preceding such date, and (C) the balance of such account amounts to not less than 2Y2 per centum of that part of the pay roll or pay rolls for the three years preceding such date by which contributions to such account were measured, and (D) such contributions were payable to such account with respect to the three years preceding the computation date."

25. The term "guaranteed employment account" is defined in Section 1602(c)(4) of the Internal Revenue Code as "a separate account, in an unemployment fund, maintained with respect to a person (or group of persons) having individuals in his (or their) employ who, in accordance with the provisions of the State law or of a plan thereunder approved by the State agency,

"(A) guarantees in advance at least thirty hours of work, for which remuneration will be paid at not less than stated rates, for each of forty weeks (or if more, one weekly hour may be deducted for each added week guaranteed) in a year, to all the individuals who are in his (or their) employ in, and who continue to be available for suitable work in, one or more distinct establishments, except that any such individual’s guaranty may commence after a probationary period (included within the eleven or less consecutive weeks immediately following the first week in which the individual renders services), and

"(B) gives security or assurance, satisfactory to the State agency, for the fulfillment of such guaranties, from which account, unless such account is exhausted or terminated, is paid all and only compensation, payable on the basis of services performed for such person (or for one or more of the persons comprising the group), to any such individual whose guaranteed remuneration has not been paid (either pursuant to the guaranty or from the security or assurance provided for the fulfillment of the guaranty), or whose guaranty is not renewed and who is otherwise eligible for compensation under the State law."

26. The term "reserve account" is defined in Section 1602(c)(1) of the Internal Revenue Code as "a separate account in an unemployment fund, maintained with respect to a person (or group of persons) having individuals in his (or their) employ, from which account, unless such account is exhausted, is paid all and only compensation payable on the basis of services performed for such person (or for one or more of the persons comprising the group)."
What shaped the standards in the form of the type of fund to which contributions under the state systems were paid was the absence of agreement at the time the Social Security Act was passed concerning the proper functions of unemployment compensation and the basic mechanics to be employed by an unemployment compensation system. Proposals that had been formulated in the states included the use of five different types of unemployment funds—totally pooled, partially pooled, industrial funds, individual employer reserve accounts, and guaranteed employment accounts. The major conflict centered around the choice between an unemployment compensation system based on employer reserve accounts and a system in which all funds were pooled, alternatives which expressed the underlying opposition between the views of those who saw unemployment compensation primarily as a device to prevent unemployment and those who saw it chiefly as an insurance device for the payment of benefits to unemployed workers. The principal differences between the two types of organization have been described by Miss Brandeis as follows:

"The essential elements of the employer reserve system are three. First, employers alone contribute to the fund—there are no contributions from employees or the State. Second, the contributions of each employer, though mingled with those of others for safe-keeping and investment purposes, are kept distinct like an account in a bank, and can be used only to pay benefits to his own laid-off employees. Third, the rate of contribution of each employer varies directly and automatically with the size of his reserve account. . . .

"In contrast to the employer reserve system, a pooled insurance set-up: (1) may include contributions from employees and the state, as well as from employers; (2) mingles all contributions in one fund, from which benefits are paid to all laid-off employees regardless of their previous employer; (3) may, or may not, provide for varied employer contribution rates under some kind of 'merit rating.'" 28

The features distinguishing the two types of organization as thus described were almost obliterated as the systems developed. Most of the states which provide for pooled funds require contributions only from employers. The methods used in varying employers' rates are in many instances not substantially different from the methods used in reserve-account states. Of the states that still provide for individual employer reserve accounts, none makes the worker's benefits depend alone upon the funds in the account of his former employer; all have established balancing or partially pooled funds from which benefits may also be paid. These funds generally are made up in part of em-

ployer contributions, amounts syphoned from each individual employer's reserve account, interest on the state's moneys in the Federal Unemployment Trust Fund, and interest and penalties collected on delinquent contributions.

By the end of this year the employer reserve system (modified by the use of balancing or partially pooled funds) will continue to be employed in only four states. Wisconsin, where the system originated, and Indiana will both go to pooled fund systems on January 1, 1946. There are two basic reasons why the employer reserve account system, which had the advantage in time over pooled fund plans, has not prevailed. From the standpoint of the worker, the incentive idea underlying the reserve account system requires too high a price in making both the worker's job and his benefits depend upon "the fortunes of a single employer." From the standpoint of employers, it probably is not the type of fund so much as the element of rate variation in the contributory provisions that really matters, and rate variation can be accomplished as well under a pooled fund type of organization as under a reserve account organization without some of the conditions made applicable to employer reserves by the federal standards.

The minimum standards for reserve accounts set forth in Section 1602(a)(3) of the Internal Revenue Code are couched in narrow mathematical terms. The standards require, for example, that a conforming state law permit no reduced rate of contributions to a reserve account unless "the balance of such account amounts to not less than five times the largest amount of compensation paid from such account within any one of the three years preceding" the date as of which rates are determined, and unless "the balance of such account amounts to not less than \(2\frac{1}{2}\) per centum of that part of the (employer's) payroll or payrolls for the three years preceding such date by which contributions to such account were measured." From the viewpoint of possible rate reductions, the first of these conditions has been thought to be particularly onerous, since a heavy drain on an employer's account in benefit payments in any one of the three years preceding the computation date might deprive the employer of a reduced rate even though the actual balance in his account remained relatively large. By establishing the state's experience rating system under a pooled-fund organization, however, it is possible to avoid both conditions.

The widespread interest of labor organizations and other groups in guaranteed employment plans does not show up in the experience rating systems which the states have adopted. Only a few of the early laws included provisions for such plans, and these have been eliminated from

29. Richard A. Lester, Economics of Labor (1941) 446. Feldman and Smith in stating the case for experience rating (loc. cit. supra note 2) dismissed the employer reserve system of experience rating as "an obviously weak straw man."
all laws but that of Idaho, and in this state the provisions have had no practical effect. Lack of support for an experience rating system based on guaranteed employment accounts has been ascribed to administrative difficulties which such plans entail and provisions of the federal minimum standards which make them unattractive to employers. Under the provisions of the Internal Revenue Code applicable to guaranteed employment accounts, a guaranteeing employer would be required by the state law to guarantee employment in advance to all his employees, would have to provide security satisfactory to the state for the fulfillment of his guarantee, and in addition would have to pay contributions to his account until the balance therein aggregated 24 percent of his payrolls for three years—and in the end could be allowed additional credit for a lower rate permitted by the state law only if his "guarantee of remuneration was fulfilled in the year preceding the computation date." On the side of protection for the worker, guaranteed employment plans as envisaged by the minimum standards of the federal act have also not been regarded as fully satisfactory; as in the case of the reserve account system, unless such a plan were accompanied by provisions for balancing or partially pooled funds, the worker's job and his benefits would depend entirely upon a single employer.

Just as features of the employer reserve account system of experience rating may be accomplished under a pooled fund organization, so it is possible that a system of experience rating based on guaranteed employment plans might be included within the framework of a pooled fund organization and within the requirements of the Internal Revenue Code applicable to reduced rates of contribution to pooled funds. This has never been attempted. Whether current interest in such plans will lead to a study of the prospects in this direction is conjectural.

If the minimum federal standards applicable to additional credit allowance for reduced rates of contributions to employer reserve accounts and guaranteed employment accounts limit somewhat the range of discretion of the states in formulating such plans, the pooled fund standards of the Internal Revenue Code, in contrast, are broad and

31. "... up to the present time [Nov. 9, 1943] no employer has met the requirements and applied for exemption under the guaranteed employment plan contained in the Unemployment Compensation Law." CCH Unemployment Ins. Serv.—Idaho ¶ 1800 [Explanatory of the Law: Merit Rating—Stabilization of Employment—Reducing Payroll Taxes].
32. For a discussion of guaranteed employment plans in relation to the requirements of the Federal standards see Hibbard, Guaranteed Employment Plans (1936) 3 Law & Contemp. Prob. 89; see also Rubinow, State Pool Plans and Merit Rating (1936) 3 Law & Contemp. Prob. 65.
34. Section 1602(a)(1) (1939).
EXPERIENCE RATING

leave the states a wide choice as to the particular methods to be employed in their systems of experience rating. The conditions essential to additional credit allowance for reductions permitted under a State law are three: (1) any reduced rate of contribution permitted to an employer is to be based on his "experience"; (2) this experience is to be "with respect to unemployment or other factors bearing a direct relation to unemployment risk"; (3) the experience on the basis of which a reduced rate is permitted to an employer must cover a period of not less than three years. Various methods and devices for the variation of employers' rates have been formulated within the framework of these requirements.

RATING METHODS

The formulas which state experience rating systems employ in determining rates of contribution consist in general of three main elements. The first is a measure or indicator of the employer's experience. The second is an index of each employer's experience, representing a reduction of the experience of different employers to comparable terms. The third is the assignment of rates of contribution to each employer. In terms of Section 1602(a)(1) of the Internal Revenue Code, the first represents the factor or factors "bearing a direct relation to unemployment risk", the last two the process whereby a reduced rate permitted an employer is determined "on the basis of his... experience."

The Formulas Used.

A brief description of the formulas that are in use will serve to indicate their general structure.

1. Reserve Ratio. This is the formula of the employer reserve account system of experience rating. That it was carried over and applied to pooled fund laws should not be surprising. The reserve ratio is by far the most common of the systems used by the states. Its essential features are quite simple. All benefits charged to the employer's account are subtracted from the amounts he has paid to the fund. The resulting figure is the employer's theoretical reserve and represents the amount he has provided, or failed to provide, to meet the cost of the benefits to his workers. The amount of the employer's reserve is next divided by his payroll during a past period in order to reduce the reserves of different employers, large and small, to a comparable basis.

35. Under the standards a state may also permit reduced rates of contribution to a group of employers, based on group experience. While a number of states have included in their systems provisions for group rating, there has been no extensive use of these provisions by employers.

36. Such an index is not developed under the system used in New York.

37. No attempt is made in this description to enumerate the details, which may vary widely from state to state.
The quotient thus obtained is the employer's reserve ratio and is the index on which rates are assigned in accordance with a fixed schedule.

2. **Benefit Ratio.** Under this system benefits alone, rather than the excess of an employer's contributions over benefits, constitute the measure of experience. All benefits charged to an employer over a past period are divided by his payroll during the same period. The quotient thus obtained is known as the employer's benefit ratio. For purposes of assigning rates, under most benefit ratio systems, all employers are grouped according to their benefit ratios. The groups are made up to correspond with rate categories of a schedule that is provided, and each employer is assigned the rate applicable to his group.

3. **Benefit Wage Ratio.**[^38] Instead of the employer reserve balance or benefits as the measure of experience, this system uses wages paid a compensated worker on which his benefits are based. When a worker is paid unemployment benefits each of his former employers is charged with the amount of wages he paid the worker during the worker's base period.[^39] The wages so charged are known as "benefit wages" or "beneficiary wages." A ratio between all such wages charged against an employer during a three-year period and his total payroll during the same years is established which is known as the "employer's experience factor." Rates are not assigned directly in accordance with this index. Each employer's experience factor is first correlated with a state experience factor representing a ratio of all benefits paid in the state during the same three-year period to the benefit wages charged to all employers during that period. Under a schedule of rates which is provided, each employer's rate approximates the product of his experience factor multiplied by the state experience factor.

4. **Compensable Separation Ratio.** The measure of experience under this plan is the weekly benefit amount of a worker who is paid unemployment compensation. The ratio of the total of such weekly benefit amounts charged to an employer over a three-year period to his payroll during the same years forms his experience rating index. All employers are grouped according to their indexes, and rates are assigned in accordance with a statutory schedule. Only Connecticut uses this plan.[^40]

5. **Annual and Quarterly Payroll Decreases and Age.** This is the plan which has been established in New York.[^41] It departs from other plans, first, in making no use of benefit payments in the measure of employer

[^38]: This system is sometimes called the "Texas Plan" or the "Cliffe Plan."

[^39]: A worker's "base period" under state unemployment compensation laws is generally a four calendar-quarter period preceding (by at least one calendar quarter) the worker's benefit year. The wages earned by a worker in his base period determine his weekly benefit amount and, unless the state law provides for uniform duration, the maximum amount of benefits he may be paid during his benefit year.


[^41]: N.Y. Laws 1945, c. 646.
experience and, second, in providing for the distribution of dollar credits to employers for application on future contributions. The measure of experience is a composite based on annual and quarterly payroll decreases over a period of three years and the number of years the employer has been subject to contributions under the state law. The different elements are described as "annual factor," "quarterly factor," and "age factor." The "employer's experience factor," made up of his annual factor, quarterly factor, and age factor, determines in which of six classes he will be placed for purposes of computing any credit which is to be assigned to him. The total credit for allotment to all employers each year is an amount (called "surplus") by which the state's unemployment fund exceeds four times the amount of contributions payable by all employers during the preceding calendar year, not to exceed in any event 60 percent of the contributions payable during that year. The credit assigned to each employer may be applied by him against contributions payable during a twelve-month period beginning on July 1 following the date as of which the credit is determined.

**Measures of Experience.**

In all these plans the basic ingredient is the factor or factors used to measure the employer's experience. Under the standards of Section 1602(a)(1) of the Internal Revenue Code, it is not necessary that the state plan, as a condition to additional credit allowance for employers permitted reductions in rates, employ a factor or factors that will measure precisely each employer's experience with unemployment, or, for that matter, that will measure such experience at all. What is required is that the factors used bear "a direct relation to unemployment risk," which is quite different. The measures of experience which are provided in all the state plans have been recognized by the Social Security Board as "factors bearing a direct relation to unemployment risk" within the meaning of the Internal Revenue Code.

To serve one or the other of the primary objectives of experience rating, the measure that is used under a state's system ought necessarily to reflect each employer's performance in terms of the cost of unemployment which he places upon the fund, or of his performance in stabilizing his employment. In this respect it has been pointed out that employment stability may mean different things.\(^{42}\) It may mean the

\(^{42}\) Richard A. Lester and Charles V. Kidd, *The Case Against Experience Rating* (1939) 8. "A tentative definition of stabilization would be 'the maintenance of a labor force of approximately the same size for approximately the same number of hours per week over a particular period.' This would rule out all extreme work spreading, but would allow some flexibility of hours in order to avoid minor fluctuations in employment. Downturning of employment between two or more firms would have to be excluded, however, and this illustrates the impossibility of a rigid definition." Myers, Employment Stabilization and the Wisconsin Act (1939) 29 Am. Econ. Rev. 711.
maintenance by the employer of the same individuals in his employ. If so, the measure of experience to be used would require a periodic accounting of any changes in the employer's personnel. If, on the other hand, employment stability means the maintenance by the employer of a particular volume of employment, then the logical measures of stability would be the number of manhours of employment given by the employer from period to period, the number of persons employed by him from period to period, or, perhaps, fluctuations in his total payroll. All these measures, however, would disregard benefit costs to the fund that might result from labor turnover. The measures which the state systems have in fact incorporated in their formulas represent a compromise between the dual objectives of experience rating, and are intended to attain a reflection of both stability and cost.

The compensation of unemployed workers appears as an element in the measure of employers' experience in all the state systems except New York. In the benefit ratio system benefit payments alone are used as the measure of experience. Benefit payments are primarily indicators of cost and will not necessarily measure the degree of stability achieved by an employer. They reflect the unemployment of the individual worker only to the extent that unemployment is compensated under the state unemployment compensation law, and will not reflect potential risk as between different employers due to lay-offs or separations. For example, one worker may find a job the same day his former employer lays him off and will thus draw no benefits, while another worker may remain unemployed and draw benefits during the full period allowed under the state law. With benefits as the measure of experience, therefore, the rate determined for an employer may depend a good deal more on the adequacy of the system in paying benefits and on factors of chance than on the employer's actual performance in stabilizing his operations.

Benefit payments are also used in the reserve ratio formula, coupled, however, with contributions which the employer has paid to the fund. The composite measure includes both benefits paid to the employer's workers and the provision made by the employer to finance the risk of benefits which may become payable because of his status as a covered employer. The same chance factors are reflected in the measure, then, that are present where benefit payments are used alone as the measure of experience, as in the benefit ratio formula. In addition, the use of contributions as a part of the measure of experience will have a varying effect on an employer's rate from year to year, resulting from the operation of the formula itself. A low rate which an employer may receive in one year will produce a lesser amount of contributions in relation to the same volume of payroll and will affect the balance in the employer's account on which his rate will be based in the following year.
The systems which employ the benefit wage factor or the compensable separation factor as the measure of experience represent an attempt to escape some of the chance factors in the rating process which are the inevitable result of the use of benefit payments. Underlying both the benefit wage and compensable separation factors is the view that the actual duration of a worker’s benefits may depend less upon his separation from a particular employer than on the worker’s initiative in seeking employment, the ability of the employment service to place him, and the state of the labor market. As found in the only system which uses compensable separations, the measure consists of the weekly benefit amount of a worker who is separated and draws benefits. Benefit wages, on the other hand, represent compensable separations weighted by the worker’s base period wages. Neither measure reflects the length of time a worker may draw benefits and, therefore, will not furnish an indication of the benefit costs placed upon the fund by individual employers. As measures of employment stability, both depend upon the payment of compensation to workers who have been separated from their jobs, and are therefore affected by the benefit eligibility and disqualification provisions of the state law, as well as by chance factors which may determine whether or not a separated worker draws benefits. The benefit wage factor as a measure of an employer’s performance in stabilizing his operations is further impaired by the provisions which the systems make for correlating it with a state-wide factor, the effect of which is to adjust the measure of each individual employer’s experience by the average duration of compensable unemployment for the entire state.43

Fluctuations in payroll as a measure of experience are not an indicator of the benefit load an employer may place upon the fund. They will serve to measure some sort of stability, but they will not indicate labor turnover, nor will they necessarily reflect maintenance of a particular volume of total employment, since an employer’s payrolls from period to period may be influenced as much by changes in wage rates, payments of bonuses, the difference in the number of paydays falling within different periods, and other extraneous factors, as by the amount of employment he furnishes. The use of payroll fluctuations as a measure of employment stability is further limited under the system estab-

43. "... beneficiary wages [as a measure of employer experience] do not measure anything which furnishes a particularly valid reason for changing an employer's contribution rate. They do not measure the amount of unemployment in his establishment or the instability of his employment, or the amount of benefits paid to his unemployed workers.” WALTER MATHCHEK AND RAYMOND C. ATKINSON, PROBLEMS AND PROCEDURES OF UNEMPLOYMENT COMPENSATION IN THE STATES (Public Administration Service No. 65, 1939) 66. The Committee on Employer Experience Rating of the Interstate Conference of Employment Security Agencies found the use of the measure "difficult to justify on any ground other than simplicity of administration." 1 INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, REPORT OF THE COMMITTEE ON EXPERIENCE RATING (1940) 37.
lished in New York, which gives to an employer's annual decreases in payrolls double the weight that it gives to his quarterly decreases, and adjusts both by the years the employer has paid contributions. "The most hopeful point of attack in preventing unemployment," Paul A. Raushenbush stated in 1933, "is obviously to lessen fluctuations within the relatively normal year. Such fluctuations result not only from physically seasonal causes, but partly from created customer habits and partly from sheer haphazard causes. The possibilities of stabilization in this field are rather generally conceded." 44 By the weight it gives to an employer's annual payroll decreases and his age, the New York plan seems to eliminate from the measure of experience incentives toward stabilization where these might most likely be effective.

Relating the Measure to the Individual Employer.

A part of the problem of selecting an appropriate factor with which to measure employers' experience is the problem of relating the factor that is selected to individual employers. Unlike work injuries which happen during the course of employment for a particular employer, a worker's unemployment occurs generally after severance of the employment relation. Before he became unemployed a worker may have had one or more employers. Where benefits are used as the measure of experience or as an element of the measure, to which of the worker's former employers are they to be attributed? Or in the language of experience rating, to which employer shall the benefits be charged?

The problem fundamentally is that of assessing responsibility for unemployment, which is a major part of the business of experience rating, whether considered from the standpoint of stabilization or cost allocation. No common view has been worked out, however, as to the methods by which such responsibility is properly to be determined. Two general principles have been proposed, and both have their supporters. The first is that the unemployment of a worker is attributable to the employer or employers whose action in separating him, or in retaining him at reduced hours and wages, is nearest in time to the unemployment. 45 The second is the principle that the compensable unemployment of an individual is attributable to the employer or employers whose wage payments to him form the basis and the measure of his benefit rights. 46 Some state systems have followed the first principle in establishing a method of charging, and some have followed the second. Others have attempted to reach a middle ground, and have adopted methods which reflect in some instances a combination of the

45. This principle is favored in HERMAN FELDMAN AND DONALD M. SMITH, THE CASE FOR EXPERIENCE RATING (1939).
46. This is the principle favored in 1 INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, REPORT OF THE COMMITTEE ON EMPLOYER EXPERIENCE RATING (1940).
two general principles, and in other instances an effort to accommodate theoretical difficulties to the practical necessities of administration. An enumeration of the most common charging methods will serve to indicate the extent of the uncertainty and lack of conviction in this field. Methods which are in use include charging to: (1) the last employer only; (2) the last and preceding employers in inverse chronological order of employment, (3) the last base period employer only, (4) the last base period employer and preceding base period employers in inverse chronological order of employment, (5) all base period employers in proportion to wages paid by each, (6) the base period employer from whom the largest amount of the worker's wage credits were earned, (7) any employer who employed the worker during at least four different calendar weeks in the 56-day period before the unemployment for which the worker was paid benefits.

Systems which allocate charges to the employer who last employed a worker rely on the principle that an individual's unemployment is attributable to the employer whose action in separating the individual is nearest in time to the individual's unemployment. Unemployment follows employment with a particular employer, but this does not mean necessarily that an individual's last employer caused his unemployment. A worker may have lost his regular job and become unemployed at the time his last employer hired him. By giving him work for a short period, it might reasonably be concluded that the last employer instead of causing the worker's unemployment actually reduced it. States which follow the second principle that the compensable unemployment of an employee is attributable to the employer whose wage payments to him form the basis of his benefit rights, or follow a combination of the two principles, avoid some of the anomalies inherent in charging only the last employer but in doing so may produce results which are also questionable. For example, under some of these charging methods, a worker's last employer may escape all responsibility for the worker's unemployment while charges are made to an employer whom the worker left over two years before his unemployment occurred.

At the time a worker becomes unemployed, he will in many instances have had only one employer since the beginning of his base period. Where this is true the results obtained under the various methods of charging employed by the state systems will be the same. However, in those instances where the worker has had more than one employer, the various methods may be expected to give different results.

The Payroll Factor and Contribution Rates.

The measure of an employer's experience as it appears in his record under the state formulas is in terms of dollar amounts. Two further steps are involved under most formulas in the translation of such expe-
rience into an actual adjusted contribution rate. The first is the development of an index in order to establish a comparison between the experience of different employers. For this purpose all the formulas (except New York, where payroll decreases for each employer are expressed in percentage terms) use the employer's dollar payroll over a past period as a measure of exposure to unemployment risk. The final step is the translation of the indexes thus established into contribution rates.

The payroll that is used as the measure of exposure in the reserve ratio formula is generally the employer's average payroll over a three or five preceding year period. In the benefit ratio, the benefit wage, and compensable separation formulas, the payroll is generally the employer's total payroll during the three-year experience period. Changes in payroll may affect the rate that is determined for the employer, and if the changes are sharp they may cause violent fluctuations in rate. It is notable that increases and decreases in payroll do not have the same effects under the different formulas. Under the reserve ratio formula, high reserve ratios produce low tax rates, while low reserve ratios produce high rates. Without any change in the measure of an employer's experience, therefore, an increase in an employer's payroll may give him a higher rate, while a decrease in his payroll may give him a lower rate. Under the other formulas the effect of changes in payrolls is reversed. An increase in an employer's payroll may have the effect of reducing his tax rate, while a decrease in his payroll may have the effect of raising his tax rate. Under all plans, of course, the more drastic the change in payrolls, the more immediate will be the effect on the employer's rate. 47

At the end of the rating process is the assignment of a specific tax rate to each employer (or the assignment of the credit which is provided for under the New York system). As the description of the various formulas has indicated, the methods that are employed by the state systems in assigning rates differ widely. Under the reserve ratio formula, for example, the relationship between an employer's rate and his experience index is direct; each employer is assigned the rate appearing in a fixed schedule that is applicable to his experience index. Under most benefit ratio systems, on the other hand, an employer's rate will depend upon the employer group in which his experience index puts him, and will be influenced by the experience of other employers. 48 A

47. For further discussion see Experience-Rating Operations in 1943, Social Security Bulletin, Sept. 1944, pp. 11-19; Clague, The Economics of Unemployment Compensation, page 53 supra.

48. The grouping of employers is according to their indexes and the number of classes that there are contribution rates to be assigned, each class being made up of an equal amount of the total state payroll in the previous year. For example, if the rate schedule consists of five rates and the total state payroll were $500,000, the employers with the lowest benefit
particular employer may continue year after year to have the same ratio of benefits to payroll but nevertheless receive a different tax rate in each year because of changes in the experience ratios of other employers. Under the benefit wage systems, each employer's index is adjusted by state-wide experience in the payment of benefits during the previous year, and rate schedules are constructed to yield a return to the fund merely sufficient to replenish the amount of benefits paid during the previous year. Whatever method of assigning rates is employed, the tendency has been to reduce the over-all range of the rate differentials by lowering the maximum rate to 2.7 percent. Of the 45 states which now provide for experience rating, the highest rate in 28 of them is 2.7 percent.

**SOME EFFECTS OF EXPERIENCE RATING IN PRACTICE**

There is little evidence up to this time of achievement of employment stabilization through experience rating. The expanding volume of war employment since most experience rating systems became effective has permitted no real test. A study of the Wisconsin system made by Charles A. Myers during 1937 and 1938 indicated that a number of employers had made efforts to stabilize their operations with some degree of success under the stimulus of possible tax savings. But the study also disclosed that the differential tax tended to stabilize underemployment and to increase "somewhat the volume of unemployment.”

None of the state systems is designed to reward an expanding volume of employment. The systems tend rather to retard the hiring of workers because any increase in an employer's force will subject him to a higher tax rate if he should fail to give all his workers continuous employment and the workers who are laid off draw benefits. It is apparent, on the other hand, that existing experience rating systems are not devised to separate stability achieved through positive efforts on the part of the individual employer from stable employment which may be characteristic of the industry or business in which the employer is engaged, or which may be due to general economic conditions. An employer in the utilities industry may receive the lowest rate without doing a thing to stabilize, while an employer in the durable goods industry may receive the highest rate despite all his efforts to reduce unemployment in his operations.

Of more serious significance from the standpoint of unemployment compensation is the fact that under all but one of the systems an employer's tax rate depends not upon how much unemployment he may

---

have but upon the volume of *compensable* unemployment among his former workers. From efforts to reduce unemployment, the step is but a short one to efforts to avoid the payment of benefits through practices which do not stabilize employment and through provisions designed to disqualify workers from receiving benefits. Practices intended to avoid benefits without stabilization, which have been employed under the stimulus of experience rating include work spreading, the hiring of ineligible workers such as students, the laying off of employees with the lowest accumulation of wage credits, and the hiring or laying off of employees at such times as will prevent the payment of partial unemployment benefits. Of the effect of experience rating on the benefit provisions in the state laws, the Ives Committee had this to say:

"In all the States which the group surveyed it appeared that the entire benefit program was modified and restricted because of experience rating. Whenever it was pointed out that the administration of a benefit system was awkward or unnatural, the answer always was 'This is because of experience rating.' The unrealistic disqualification program, which on the surface appears to be for the purpose of elimination of anomalies, in effect disqualifies large classes of covered workers because of the desire to minimize benefits in order to create low contribution rates. Among the individuals within these classes, there are thousands who under normal circumstances should be paid."

As an alternative to measures distorting the disqualification provisions of state laws, the Social Security Board suggested to the states at the end of 1944 that provisions might be adopted eliminating all charges to employers' experience rating records for benefits paid to unemployed workers under certain circumstances. Charges might be omitted, for example, where benefits were paid a worker who at some previous time had voluntarily left a job with good personal cause

---

50. "More important and more serious is the fact that under all experience rating provisions now in unemployment compensation laws ... it is possible to reduce compensable unemployment without reducing unemployment through taking advantage of the qualifications and exclusions of these laws so as to throw most of the unemployment into the groups among the employees who have no benefit rights." Witte, *Whither Unemployment Compensation* in *Proceedings of the Institute on Employment Security* (Univ. of Minn. 1940) 55.


although perhaps without "good cause attributable to the employer." 54 There was nothing essentially new in the Board's suggestion; many states had already adopted provisions for non-charging in situations of this kind, as well as in other situations.

Pressures for tax reduction through experience rating which lead to benefit avoidance without stabilization and to harsh disqualification provisions also are reflected in the character of experience rating plans themselves. The non-charging device, for example, may serve to neutralize in part the influence of the differential tax on the disqualification provisions of a state unemployment compensation law. For experience rating, however, non-charging means a spreading of costs among all employers instead of the allocation of costs to specific employers, and may in addition result in the elimination of all incentive to stabilization where it might most likely be effective. The list of situations to which non-charging is applied is a long one. It includes the omission of charges that may be relatively small, as well as the omission of charges which may be of major significance in terms of the rate which the employer receives. For example, under some state laws which contain special provisions applicable to seasonal unemployment (themselves prompted largely by experience rating) all charges to a seasonal employer may be eliminated for unemployment of his seasonal workers occurring outside the normal season.55

Examples of the force of tax reduction which tend seriously to impair experience rating as a stabilization or cost allocation device may be multiplied. A number of these have already been mentioned in the discussion of the rating methods which the states have adopted. One not previously discussed which stands out is the use by some systems of voluntary contributions in the rate adjustment process. Through this device an employer, by making a small additional payment, may escape liability for contributions that would otherwise be assessed against him.55 Another example is the action taken in many states of lowering the maximum rate of contributions to 2.7 percent. Apart from aspects of financing and solvency, which are discussed elsewhere in this issue,57 it is generally recognized that if experience rating is to furnish any real incentive to stabilization, the maximum tax savings possible to an employer must be at least large enough to offset the inconveniences and costs of such stabilization. In stating the case for experience rating, Feldman and Smith expressed the view in 1939 that, "present

56. See REPORT OF THE NEW YORK STATE JOINT LEGISLATIVE COMMITTEE ON INDUSTRIAL AND LABOR CONDITIONS (1943) 124.
57. See Clague, The Economics of Unemployment Compensation, page 53 supra.
rate differentiations are too small to serve as a stimulus to regularization to certain employers whose costs of stabilization would be high. . . . If the maximum were 5 or 6 percent and the possible rate of saving about 4 percent, an ample incentive to employment stabilization should be provided."

Yet, as of this time, only seventeen states provide for tax rates above 2.7 percent (aside from so-called "war-risk contributions"; and the highest rate provided under any state system of experience rating is 4 percent.

The varying conditions under which reduced rates are allowed in the different state systems has had the result, which the uniform federal payroll tax was intended to avoid, of giving competing employers in different states contributions at varying rates even where their unemployment experience may not be substantially different. This has led to competition between the states in rate reduction whose effects, as indicated in the preceding discussion, show up not only in the character of the experience rating plans that are adopted but also in the provisions which each state makes for the compensation of its unemployed workers.

Several proposals have been offered which seek to correct deficiencies in the present experience rating systems (or to eliminate such systems) through amendment of the additional credit provisions in the Internal Revenue Code. One of these would remove the additional credit provisions entirely and thus destroy the foundation on which the state experience-rating systems rest. Another proposal would write into the additional credit provisions of the Internal Revenue Code minimum standards which would, on the one hand, limit the amount of rate reductions that might be permitted through experience rating; and, on the other hand, establish specifications relating to the scale of benefits provided under the state unemployment compensation laws. Feldman and Smith, writing in 1939, viewed national standards of this character as essential to the proper functioning of experience rating. Such standards were also advocated in 1940 by the majority of the Committee on Employer Experience Rating of the Interstate Conference of Employment Security Agencies.

59. For a discussion of provisions that a number of states have made for the collection of additional contributions from certain employers whose payrolls have expanded during the war see Friedman, War-Risk Contribution Provisions in State Unemployment Compensation Laws, Social Security Bulletin, May 1944, pp. 2–8.
Whether or not any action is taken in this direction, it is generally recognized that the existing systems are deficient in many respects and have serious consequences from the viewpoint of unemployment compensation. "Experience rating as thus far developed," stated Edwin E. Witte in 1941, "is defective in that it does not accurately measure differences in costs and in making it possible through various devices, most of them anti-social, to reduce compensation costs without decreasing unemployment. If experience rating is to continue, it needs to be improved." 63

63. Witte, Experience Rating and Other Forms of Incentive Taxation to Promote Employment in National Tax Ass'n, Proceedings of Thirty-Fourth Nat. Conf. on Taxation (1941) 483.