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Experience Rating: Its Objectives, Problems and Economic Implications

Edwin R. Teple

Charles G. Nowacek

EXPERIENCE RATING: ITS OBJECTIVES, PROBLEMS AND ECONOMIC IMPLICATIONS*

EDWIN R. TEPLE† AND CHARLES G. NOWACEK‡

Within a decade, the system of rate differentiation which has become one of the distinctive characteristics of the unemployment insurance program in the United States spread from the North Woods to the shores of the Gulf of Mexico. The idea so vigorously advocated by Professors John R. Commons and Harold M. Groves, and their Wisconsin colleagues, having been first put into effect under the Wisconsin Law in 1938, was finally incorporated in the Mississippi Law in 1948.[1] Though unknown to the older European systems, experience rating thus took a firm grip upon the program in this country.[2]

In the process of becoming universally accepted by the states, however, the original scheme underwent a rather complete metamorphosis. The Wisconsin plan, incorporated in the first Wisconsin law, was based on the reserve account principle, in which the possibility of reduced contribution rates based upon favorable experience was inherent. Most other states were unwilling to run the risk attending individual employer reserves and adopted the so-called pooled fund type law, sometimes referred to as the Ohio plan. With a pooled fund, a flat contribution rate without individual variations was the simplest, and perhaps the natural pattern, but the advocates of this type of law

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† Cleveland Attorney and Lecturer in Labor Law and Social Legislation, Western Reserve University; formerly with the legal staff of the Department of Health, Education and Welfare and its predecessor agencies.

‡ Regional Employment Security Representative, United States Department of Labor, Cleveland, Ohio; Lecturer on Economic and Accounting Subjects at Western Reserve University and Fenn College; C.P.A.

1. There was not much occasion to worry about reduced contribution rates during the early years of the unemployment insurance program in this country, since benefits were not payable immediately under the terms of the state laws, and under the provisions of Title IX of the Social Security Act (subsequently incorporated into the Internal Revenue Code) no reduced rate could be granted under pooled fund laws until there had been at least three years of experience with respect to unemployment. When the critical period arrived, however, most states were quick to take advantage of the additional credit provisions of the federal law. It was two years before the next state followed Wisconsin, but in 1940 the experience rating provisions of three states went into effect. The others followed suit in succeeding years as follows: 1941—thirteen; 1942—seventeen; 1943—six; 1944—two; 1945—three; 1947—five; 1948—one.

2. When the House of Representatives first passed the original Act, Title IX provided that all employers pay the same total tax rate; the Act was amended in the Senate to permit additional credit under an approved experience rating plan. The conference committee accepted the Senate provision which later was enacted into law. Senator LaFollette of Wisconsin was active in the efforts to obtain this highly significant revision.

soon matched the pocketbook appeal of reserve accounts by working out feasible arrangements to allow reduced rates within the structure of a statewide pooled fund. As one early authority on the subject pointed out: "If there are any sound arguments in favor of the Wisconsin plan, they all can be met through a system of merit rating."[3] And that is the pattern which actually developed, even Wisconsin abandoning its reserve account provisions in 1948, encouraged, perhaps, by the more favorable terms in the federal law applicable to pooled funds.

Both the extent and the importance of the system may be gathered from the fact that the rate reductions actually in effect in 1953 resulted in total contributions being about $1.4 billion less than would have been collected under a standard 2.7 percent rate; and from the beginning of the program through the same year, contributions were more than $10 billion less than they otherwise would have been.[4] Obviously, this is destined to be a potent factor in any discussion of the subject, particularly if abandonment or modification is under consideration.

Experience Rating in Theory

One of the most striking features of experience rating in the United States after nearly fifteen years of actual operation is its high survival rate. Despite vigorous opposition both on theoretical and practical grounds over the last decade and a half, experience rating on an individual employer basis has flourished and grown to maturity. Whatever their convictions, students and administrators alike must recognize and cope with its reality, not only from the standpoint of day-to-day administrative problems and the growth and development of the system, but also from the viewpoint of understanding its underlying objectives.

This is not to imply that there is no longer room for conflicting opinions and theories as to the desirability of individual employer experience rating in unemployment insurance. That these conflicts continue to rage is indication enough that, although fifty-one jurisdictions now have adopted experience rating, the issue in both its theoretical and political form has not been settled.

Objectives of Experience Rating

The system of differentiating individual employer rates on the basis

3. Rubinow, *State Pool Plans and Merit Rating*, 3 LAW & CONTEMP. PROB. 64, 79 (1936). The term "merit rating" has since fallen almost entirely into disuse, and the term "experience rating" now carries virtually the same connotation, at least for all practical purposes. The same author proved to be an extremely accurate prophet when he said that "some provision for merit rating is destined to become . . . part of the rate-making system of unemployment insurance in the United States, particularly so long as the present Federal Social Security Act remains in force." 3 *Id.* at 81.

4. 1953 SUPPLEMENT TO HANDBOOK OF UNEMPLOYMENT INSURANCE FINANCIAL DATA 2 (U.S. Dep't Labor 1954).

of their experience with unemployment has traditionally been justified on three grounds. First, it is said that the employer, responding to the incentive of the avoidance of a higher tax or the reward of a lower tax, and being able within limits to control the volume and duration of his employment, will manage his business in such a manner as to minimize unemployment of his workmen. Second, it is argued that the identification of the immediate cost of unemployment with the individual employer or industry produces a desirable social and economic effect.[5] Third, the employer, it is claimed, will become an interested party participating in the system, both as to its content and its operation, only if he has some direct financial interest therein.

Prevention and Stabilization

The objective of unemployment prevention, or the stabilization of employment, is undeniably a desirable one; it has a very high sales appeal to employers and to state legislators.

The soundness of this objective, however, rests on the extent to which the individual employer, responding to the tax incentive, can alter his demand for workers, week by week, in order to regularize his employment. The economic forces that work to change the levels of employment for the economy as a whole, for a particular industry, or for a particular employer, are, to a very large extent, forces over which an individual employer has little or no control. Why the demand for his product or the product of his industry changes, rests essentially on a matter of consumer choice; a new machine process or innovation which will reduce labor costs and total costs, compels the manager, because of competition, to adopt the new idea and reduce labor needs; national or international shifts in economic or security policies may directly affect labor demands. Experience rating is obviously not designed to check this type of employment fluctuation. The system may, however, be expected at least to influence that irregularity of employment over which the management of the concern does have some control.

How long the worker, after being laid off, continues to be unemployed is generally related to the condition of the labor market, *i.e.*, the number of job openings in other establishments, and the competition from other workmen for jobs. Once separated, an individual employer can exercise very little control over the length of the workers' unemployment, although there are some notable exceptions revolving around the temporary interruption of employment of a worker who continues for all practical purposes to be attached to his last employer. Production interruptions, inventory needs, model and design changes that result in temporary layoffs of hourly paid

5. For a discussion of the objectives of experience rating—unemployment prevention and cost allocation—see Arnold, *Experience Rating*, 55 YALE L.J. 218, 219-23 (1945).

workers with seniority, for example, do affect the length of unemployment and are within some control of the employer.

The strength of the unemployment insurance tax incentive to provide stable employment has frequently been challenged on the basis that employers have other and more powerful incentives to stabilize employment wherever possible, such as higher profits. With the range in tax rates becoming more and more narrow in recent years, and with the increased popularity of non-charging provisions, there are additional reasons for accepting this viewpoint.

Allocation of Costs

The second justification for experience rating is to achieve an allocation of the cost of unemployment as between various industries and various employers, which would have the effect of assessing such costs against the economic product or service of the employer.

Under this view, experience rating is a system of cost accounting according to which the dollar value of the wage loss actually compensated will be "charged" to the various industries and employers through the system of contribution rate differentials. Accordingly, the burden of unemployment taxes will be distributed in relation to the incidence of unemployment among particular industries and employers. Questions have been raised regarding the economic desirability of this effect produced by experience rating. It is contended, for example, that since unemployment is a general social problem, the costs thereof should be shared on a joint basis rather than having some industries penalized and other inherently stable industries rewarded.

The economic undesirability of assessing the higher rates against the durable and consumer-durable goods industries is frequently stressed since stability of conditions in these industries, including the stability of unemployment costs, may play a vital role in the stability and growth of general economic conditions.[6]

6. The economic effects of the payroll tax on the individual employer when the tax is suddenly and sharply increased, are often such as to make it difficult to pass costs forward to the consumer or backward to the worker. According to the present structure of experience rating systems, the force responsible for any sharp increases in contribution rates will at about the same time, also produce a decreasing price level, or at best a stable price level. That force is unemployment. Both results will be fairly closely matched from the point of view of time. To pass a contribution rate increase forward to the customer under these conditions would be difficult. To pass it backwards to the worker might appear easier except for wage contracts and worker pressure. The ultimate effect on any industry or firm within industry will depend upon its competitive position, upon its stage of development, expanding, stable, or declining, and upon the elasticity of demand for its product. It is claimed, also, that a flat tax rate does not treat industries uniformly since there is considerable variation between firms and industries in the relationship of payrolls to total costs. However, the risk of unemployment is associated directly with the number of workers on the payroll, and the employer under a flat rate would not be confronted with an increase in the tax rate at a time when he

Employer Participation

The third justification for experience rating is that it provides an incentive for the employer to participate as an interested party in the unemployment insurance system.[7] Since the employer bears the entire cost of both the administration of the program and the payment of benefits thereunder,[8] experience rating is the best means of provoking and sustaining this interest. Flat rate contributions will not achieve this end, it is claimed.

Participation by the employer as an interested party under experience rating takes various forms. In the first place, and vital to the proper administration of an unemployment insurance law, the employer must participate by furnishing information regarding not only wages and employment, but also the conditions surrounding the workers' separation from employment and the reasons for the unemployment. The employer, it is said, does this best when he has some direct financial interest in the result.

Participation also takes the form of interest and activity in state law changes as to the amount and duration of benefits, the disqualifications and eligibility conditions, experience rating changes, and other changes in the provisions of the state laws. Because of this interest in the content of the state laws, employers are frequently held responsible for the severe disqualification and eligibility conditions found in many state laws, and for the tardiness of the states in general in providing adequate unemployment benefit payments to workers for a sufficient number of weeks. In addition, employers, either directly or through fee-agencies, in the interest of minimizing benefit charges, "police" the system of benefit payments and the appeals process. There is rather violent disagreement as to the need for, or desirability of, these types of employer activities;[9] that they are induced by experience rating there seems to be no doubt.

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was compelled by the market to reduce his work force. A flat rate of contributions over a period of time would have a uniform effect so far as the individual employer is concerned, with a consequent lower dollar payroll tax when employment was reduced.

7. See Schmidt, *Experience Rating and Unemployment Compensation,* 55 YALE L.J. 242 (1945).

8. Only Alabama and New Jersey provide for a worker's contribution to unemployment insurance. In New Jersey the rate paid by the employee is 0.25 percent of the first $3000 in wages or salaries; in Alabama the employee's rate is varied from 0.1 to 1.0 percent as the rate assigned to his employer varies from 0.5 to 2.7 percent. Formerly, the following additional states provided a worker contribution: California, Indiana, Kentucky, Louisiana, Massachusetts, New Hampshire, and Rhode Island. A worker contribution, of course, is inconsistent with the principle of individual employer responsibility for unemployment.

The only governmental contribution to the program was made in 1936-1938 in the District of Columbia.

9. See Rainwater, *The Fallacy of Experience Rating,* 2 LABOR L.J. 95, 96-97, 101-03 (1951); cf. Rector, *The Frailty of the "Fallacy" of Experience Rating,* 2 LABOR L.J. 338, 346-49 (1951).

Much of the recent criticism of experience rating stems from the participation in the program by the employer as an interested party, chiefly on the grounds that this participation has seriously interrupted changes and improvements in the system which it is assumed would have been made if experience rating were not in the picture. Other reasons, however, may have been responsible for at least some of these interruptions.

Even without experience rating there would undoubtedly remain a substantial interest in unemployment insurance and its administration among many employers and employer groups.

Joint or Individual Responsibility

A state unemployment insurance official recently based his opposition to experience rating on the theory of collective responsibility: "Unemployment is a phenomenon and an ever-present reality as much attached to the economic order as the arms and legs are attached to the human body. Being so, responsibility for it is collective rather than individual, and, therefore, all the components—every employer and every worker in every industry alike—are severally and jointly responsible for it."[10] He denies that the employer is at fault[11] or is individually responsible for unemployment; *i.e.*, unemployment, inherent in a free economic society, cannot be said to be caused by an individual or group of individuals; blame or reward, then, should not be attached to the employer in the form of unemployment insurance differential tax rates. In his view neither logic nor equity can justify experience rating since he challenges the premise underlying the system—individual employer responsibility. He states further that because experience rating in state systems embodies this false concept of employer responsibility, certain misconceptions about unemployment insurance have developed. Among these are the notion that a claim for benefits is a claim against an employer rather than a state fund, that the payment of benefits takes the form of a penalty assessment against the employer for causing the unemployment, and

10. See Rainwater, *The Fallacy of Experience Rating*, 2 LABOR L.J. 95, 96 (1951). On the nature of unemployment, it was recently stated that: "All the experience in this country to date emphasizes the fact that, by and large, the risk of unemployment is more closely associated with general economic conditions than with conditions in a particular industry or establishment. . . . The particular grouping of industries within State boundaries and the extent of mobility across State boundaries will result in different State average benefit costs, but the underlying factors are Nation-wide. The labor market within which the risk of unemployment occurs is also in very large measure a national market. . . . If interdependence is the basic feature of our type of economy, the risk of unemployment should be regarded as a social risk arising out of the nature of the economy and not a risk attaching specifically to individual employing units." MERRIAM, SOCIAL SECURITY FINANCING, 74-76 (FEDERAL SECURITY AGENCY, BUREAU REPORT No. 17 1952).

11. For a discussion of employer fault in unemployment compensation, see Simrell, *Employer Fault v. General Welfare as the Basis of Unemployment Compensation*, 55 YALE L.J. 181, 204 (1945).

that any disagreement about the claim is between the employer and worker with the state agency a mere onlooker.[12]

In challenging the concept of joint responsibility, Mr. Stanley Rector states that there is no proof of the major assumption made by opponents of experience rating that unemployment is inherent in our economic system and that employers can do nothing to minimize it. He categorically denies that the responsibility for unemployment is joint and indivisible.[13]

Evidence available to show that employers will minimize their risk if financial incentives are held out includes the early experience in Wisconsin with Workmen's Compensation self-insurers, the results of a 1940 Wisconsin Steadier Job Conference, and the 1947-48 experience of General Motors with job stabilization.[14] This evidence is offered to contradict the assertion that employers "can do nothing" to minimize unemployment.[15] No more recent information or experience is available to demonstrate the success of stabilization efforts in the field of unemployment insurance experience rating.

Under this concept, employers can individually exercise some control over the causes of unemployment in their establishment. The difference between workmen's compensation and unemployment insurance from this point of view is one of "degree only."[16] Because of the smaller degree of control possible in unemployment insurance compared to workmen's compensation, it is pointed out, the employer is accountable directly for only a fraction of his costs of unemployment. The rate limits in unemployment insurance experience rating are relatively narrow; beyond the highest tax rate the cost of unemployment is in fact equally borne by all employers.[17]

Proposals are expected to be made by the United Automobile Workers (CIO) to the auto manufacturers covering guaranteed annual wage plans. In discussing the objectives of these plans, it was recently stated ". . . the UAW proposal is not supplementary unem-

12. Rainwater, *Fallacy of Experience Rating*, 2 LABOR L.J. 95, 97 (1951). See also *id.* at 101-03 for indictments of experience rating in actual operation.

13. Rector, *The Frailty of the "Fallacy" of Experience Rating*, 2 LABOR L.J. 338, 340 (1951).

14. *Id.* at 341-44.

15. There is no agreement among economists as to the amount of unemployment that may prevail as a minimum in any functioning free private competitive economy. Under a full-employment economy, assuming a non-war condition, unemployment has reached recorded lows of less than 2.0 percent of the civilian labor force. (August and October 1953, 1.9 percent and 1.8 percent, respectively.) A normal expected rate might approach 5.0 percent. There is agreement, on the other hand, among economists that a certain minimum amount of unemployment is inevitable, resulting from the free functioning of the system.

16. Rector, *supra* note 13, at 342.

17. *Id.* at 342-43. A comparison can be made between the *maximum rate* in workmen's compensation (with premium rates as high as 20 to 30 percent of payroll) and unemployment insurance (4.0 percent of payroll the highest, with most states at 2.7 percent).

ployment compensation because its objective is primarily to stabilize employment and only secondarily to compensate workers for loss of income."[18] It is further stated that costs of the plans can be held substantially below maximum liability levels by employers "stabilizing employment to the great extent that it lies within their direct power to do so in individual plants."[19]

Here is agreement with the concept of individual employer responsibility insofar as guaranteed annual wage plans are concerned. Many of these plans are proposed to be integrated with public unemployment insurance. Experience rating on an individual employer basis is consistent with this concept of guaranteed annual wages.

Criticisms of Experience Rating

Actual operation of experience rating under a wide variety of industrial and local conditions has removed many of the earlier criticisms and doubts about the system.

Its general practicability was first questioned.[20] The administrative complexities of measuring the individual employer's risk of unemployment, relating the result to other employers' experience, and the final translation into contribution rates, were frequently emphasized. The anomalies resulting from the various methods of charging benefits raised doubt that a satisfactory and administratively workable scheme could be developed that would assess responsibility for unemployment to the employer on a logical and equitable basis. In practice, however, these difficulties, as well as other problems of detail in content and operation, were overcome or evaporated when their true dimensions were recognized.

The cost of experience rating operations in the states has also come under attack from time to time. However, the costs do not appear to be unreasonably high,[21] amounting to 2.6 percent of the total administrative expenses for employment security purposes in 1952.

One of the most telling early criticisms of experience rating in its original form of individual employer reserves, was the possible re-

18. WEINBERG, ANALYSIS OF SOME ARGUMENTS AGAINST THE GUARANTEED ANNUAL WAGE, SUPPLEMENT TO PROCEEDINGS OF SIXTH ANNUAL MEETING OF INDUSTRIAL RELATIONS RESEARCH ASSOCIATION, DECEMBER 28-30, 1953.

19. *Ibid.* To demonstrate the possibility of management action under financial incentives, the case of Workmen's Compensation and plant noise was used. Management remained unconcerned about plant noise until a possibility arose that workers might be able to collect on claims for deafness. When that became a possibility, management took remedial action.

20. See LESTER AND KIDD, THE CASE AGAINST EXPERIENCE RATING IN UNEMPLOYMENT COMPENSATION 45-46 (INDUSTRIAL RELATIONS COUNSELORS, INC., MONOGRAPH 2, 1939).

21. In the fiscal year 1952, total costs for direct experience rating operations in all states amounted to $4,829,325 or the equivalent of 1,425 man years; this compares with $2,165,148 expended during 1948 (878 man years). STUDY OF ADMINISTRATIVE COSTS OF CHANGES IN STATE EMPLOYMENT SECURITY LAWS, FISCAL YEARS 1948-1952, A REPORT TO THE APPROPRIATIONS COMMITTEE, HOUSE OF REPRESENTATIVES, 28a (U.S. Dep't of Labor 1953).

duction or interruption of benefits upon exhaustion of the employer's reserve. This obvious and serious fault was quickly corrected so that unemployed workers, so far as benefits were concerned, were treated uniformly under the various state systems regardless of their former attachment to a given employer. The only remaining individual employer reserve fund system,[22] with its pooled account, has, in reality, all the essential characteristics of a straight pooled fund.

The solvency and adequacy of the unemployment trust funds of the states under experience rating conditions were often questioned. There appears to be a natural antithesis between reduced contribution rates, which has been the situation under experience rating by and large, and the need for reserve accumulations for purposes of assuring the solvency of trust funds. The first need of the system was considered to be a fund adequate in size, and with adequate revenue-producing capacity, to sustain the anticipated withdrawals. Much of the discussion in the literature of experience rating rests on this concern for fund solvency.

While there are still some anomalies in the financial structure of unemployment insurance in the United States, and also some critical danger signs in a few states, most of the state reserves, by and large, are solvent and adequate, thus belying the early concern for fund solvency. The anomalies and dangers grow largely from conditions within the individual states and cannot be attributed wholly to the principle of experience rating.

On December 31, 1953, about $8.9 billion,[23] or about 8.9 percent of payrolls subject to state laws, was available in all states for benefit purposes. If this fund were commingled and available to all states, it would be sufficient to pay benefits for about six and one-half years, based on the experience of the seven-year period, 1946-52. Since the funds are not commingled but are accumulated separately in each state, what is the condition of individual state funds?

Ordinarily a self-financing state unemployment insurance system should have a reserve balance equivalent to from four to six times the expected average annual benefit cost over an eight to ten year

22. The Kentucky Statute provides in part ". . . benefits shall be charged against the pooled account only if and to the extent that a subject employer's reserve account does not . . . equal the maximum amount of benefits then due and chargeable against such account. . . . To the extent that money in the pooled account is sufficient therefor, the Commissioner shall pay any benefits otherwise due but not payable because of the complete exhaustion . . . of the subject employer's reserve account." KY. REV. STAT., § 341.550 (2) (1948). There is theoretical possibility that the pooled account will be exhausted while substantial funds still are available to pay benefits to the workers of other employers; but the present size and resources of the pooled account, and the likelihood of state action before any such point is reached, make this result very improbable.

23. The total funds available for benefits on December 31, 1953 amounted to $8,912,821,000. 1953 SUPPLEMENT TO HANDBOOK OF UNEMPLOYMENT INSURANCE FINANCIAL DATA 2 (U.S. Dep't of Labor 1954).

period, with reserve accumulating to higher levels during prosperous times and reducing to lower levels during periods of unemployment.[24] Judged by this approximate measure of adequacy, and considered from the point of view of 1953, a year of prosperity, the reserves of all but four or five states appear adequate. In twelve states the reserves seem excessive, being locked into the state unemployment fund with slight prospects of ever being needed or used. These states could pay benefits for fifteen years or more from the accumulated reserve (twenty-five years for Colorado and twenty-seven years for Texas) without collecting any further contributions or receiving any further interest on the fund. Ironically, these states have the least need for a large reserve fund balance since they are the states with the lowest benefit costs.

Significantly, the states with either dangerously low or less satisfactory reserves are the states that, because of their high and fluctuating costs, need a greater reserve than the average state. The benefit costs in each of these states was well above the national average. In Rhode Island the reserve is capable of absorbing only about one and one-half years of benefit payments. In that state, as well as in Massachusetts and Alaska, experience rating has been suspended, and employers paid contribution rates in 1953 at the standard uniform rate of 2.7 percent. The reserves of these three states are the weakest of all the states.

Most of the state funds under experience rating conditions are in satisfactory condition and many have excessive balances in terms of their potential liability. The states with the least satisfactory reserves could have improved the condition of their funds by better planning in advance, by adopting sounder contribution rate tables, providing a yield, if necessary, above 2.7 percent.

The reserve excesses which do exist in many of the states, of course, might well be devoted to increasing the benefit protection afforded by the state laws. That this has not occurred seems rather significant. A higher level of benefit protection would not necessarily change the essential behavior of the experience-rating system in raising revenue, since more liberal benefits would be more or less automatically financed under most of them.[25]

The early designers of experience rating in unemployment insurance were also fully conscious of the primary need for a fund fully capable of meeting in total its benefit obligations. Solvency standards

24. MERRIAM, SOCIAL SECURITY FINANCING 79 (FEDERAL SECURITY AGENCY, BUREAU REPORT No. 17 1952).

25. The rates of firms paying at the maximum, and many paying at the minimum over sustained periods, might not be affected by higher benefit disbursements made to their unemployed workers unless the statutory rate tables were changed. The higher benefit costs for firms paying at the maximum rates would be averaged over all employers below the maximum.

for individual reserve accounts were required as a condition for a reduced rate.[26]

The Federal requirements for pooled-fund laws contain no solvency standards or indicators. The solvency standards required of reserve account states provided a benchmark for writing adequate solvency levels into state pooled-fund laws. In addition, as a condition of approval of a pooled-fund experience rating system, the Secretary of Labor and his predecessor agencies, including the original Social Security Board, have always scrutinized plans submitted by the states from the point of view of the solvency of the state fund.

In order to protect the fund solvency, special financing measures have been built into thirty-two of the forty-two states that have established a maximum rate of 2.7 percent.[27] These measures normally suspend reduced rates so long as the condition of the fund is in danger.

Contributing to the excessive reserves in many states was the overfinancing that was built into the original unemployment insurance system.[28] Wishing to avoid the possibility of deficit financing and to establish clearly the reserve accumulation principle, the original designers of the system required at least one full year of contribution payments before benefits became payable.[29] Most of these reserve accumulations were never needed.[30] In only a few states were these

26. The federal standards for reserve account laws, INT. REV. CODE § 3303 (a) (3) (1954), provide that to be eligible for a reduced rate the balance of any employer's account must equal the greater of either 2½ percent of three years' payroll or five times the highest annual amount of benefits paid during the three preceding years.

27. Seven states allow no reduced rates if the fund falls below a specified dollar amount, *e.g.*, Indiana—$25.0 million; Colorado—$10.0 million; six states permit no reduced rates if the fund level falls below a specified multiple of benefits paid in a specified period, *e.g.*, California—1.5 times the last year's benefits; fourteen states will discontinue reduced contribution rates if the fund level falls below a specified percentage of taxable payrolls in a specified period, *e.g.*, Connecticut—1.25 percent of the last three fiscal years, and Maryland— 5.0 percent of the preceding year; five states use the greater of a specified amount and a multiple of either the benefits paid or the taxable wages. After studying various measures for protecting the solvency of the fund, a committee of the Federal Advisory Council for Employment Security recommended that the critical solvency point at which reduced contribution rates would be suspended should be the level of the trust fund balance stated as a multiple of the state average annual benefit cost. The measure expressed as a formula is:

$$\frac{\text{Current Fund Balance}}{\text{Last Year's Taxable Payroll}} \div \frac{\text{Average Annual Benefits (for specified period)}}{\text{Average Annual Taxable Payroll (for same period)}}$$

The exact criterion in terms of this measure for judging a state fund as being in critical danger, will depend to some extent upon the reserve policy of the state and the characteristics of the probable potential risk of unemployment; what is critical for one state is not necessarily critical for another.

28. Clague, *The Economics of Unemployment Compensation,* 55 YALE L.J. 53, 65 (1945).

29. This requirement created a reserve fund of a minimum of 2.7 percent of payroll; in Illinois and Montana the fund accumulated to 6.75 percent of payroll before any benefits were paid.

30. The original Social Security Act made no provision for loans to states for unemployment insurance purposes. There was no prohibition, of course, against the states arranging their own borrowings outside of the Social Security Act. The temporary loan provisions included as Title XII of the Social Security

accumulations called upon during the first year of benefit payments.

Also, the standard state tax rate of 2.7 percent established in the original Social Security Act to finance the state systems of unemployment benefits has proved, according to experience thus far, to be significantly higher than necessary to finance current benefit costs in most states.

In addition, the low benefit payments maintained in most state laws helped to keep disbursements from rising and contributed to this over-financing, as did the relief afforded many funds by the Servicemen's Readjustment Act of 1944. Some states,[31] anticipating excessive post-war benefit withdrawals, adopted special "war-risk" tax provisions which were assessed primarily against war-expanded industries, and in the case of military contracts on cost-plus terms this extra cost was borne by the United States Government. These special assessments were likewise never needed, as it subsequently developed, to finance post-war benefits, and were utilized either to build the fund to higher levels or to bring about lower rates to employers through the operation of the experience-rating systems.

While most funds today are solvent, it remains for the future to determine whether or not the fund-raising capacity of experience-rating systems can adequately and quickly replenish the reserves drawn down or exhausted by heavy cyclical unemployment.[32] Certainly, to accomplish this over a period of time the maximum rates and the very low minimum rates (including, in nine states, a zero rate) must be increased; this much is dictated by sound experience-rating principles as well as sound solvency considerations.

Act (Advances to State Unemployment Funds) expired on December 31, 1951. Recently Congress passed the Employment Security Administrative Financing Act of 1954 (P.L. 567) providing for a permanent $200 million loan fund which is available to the states on a repayable basis, interest free. No state has yet borrowed to provide funds for unemployment benefit purposes, although two states, at the close of 1954, were eligible for loans under Public Law 567.

31. Wisconsin, Alabama, Florida, Georgia, Illinois, Iowa, Kansas, Maryland, Minnesota, Missouri, Ohio, and Oklahoma. About $200 million was collected under these provisions during the period 1943-1946.

32. With a level seven-year cost (1946-1952) of 1.5 percent or less in forty-one states it may be possible to maintain the continuing adequacy of many state reserves with a 2.7 percent maximum rate which may, if necessary, also become the uniform flat rate. Should benefit scales be increased along the lines of President Eisenhower's recommendation for weekly benefit amounts and duration, undoubtedly the cost structures of the states would be affected and, of course, the capacity of the experience rating systems to rebuild reserves within a 2.7 percent maximum tax rate would be affected. With only nine states providing for a maximum possible rate above 2.7 percent (going up to 4.1 percent), none of these being high-cost states, it seems inevitable that states must increase their maximum contribution rate for those employers with the greatest risk of unemployment. Despite this, the number of states with penalty rates above 2.7 percent declined from seventeen in June, 1945, to nine as of August, 1954, with only five of these establishing a maximum above 3.5 percent.

COMPULSORY FEATURES OF THE FEDERAL LAW

While on the face of it the federal statute allowing additional credit permits a state to exercise a choice of whether or not to set up a system of individual employer experience ratings, as a practical matter this choice does not exist. The states, if they wish to bring contribution yields more in line with benefit costs and to avoid excessive reserve accumulations, must accept some individual employer rating scheme. With actual benefit costs in almost all states averaging substantially less than 2.7 percent over sustained periods of time,[33] this absence of genuine choice in financing state systems when the federal off-set tax is geared to a 2.7 percent standard rate has actually forced some states to adopt experience rating merely to reduce the current revenue to the fund.[34] Under these conditions the federal law is a source of compulsion requiring conforming state action, a result applauded by advocates of individual employer experience rating but condemned by the opponents of experience rating as well as by those who advocate maximizing state initiative and choice in the entire field of federal-state relations.

Proposals to amend the additional credit language of the federal law have from time to time been suggested, recognizing in part the need to restore freedom of action to the states.

The Advisory Council on Social Security reported a recommendation to the Senate Committee on Finance in 1948 that covered the elimination of the individual employer experience rating requirements contained in Section 3303 of the Federal Unemployment Tax Act.[35] The recommendation would have established a new federal unemployment tax rate of 1.5 percent evenly divided between employers and employees, with an 80 percent credit off-set for contributions paid into a state unemployment fund. Thus a minimum employer contribution rate of 0.6 percent would be set for state contribution purposes, with the state otherwise free to finance its costs as it sees fit, including experience rating if it chooses. In discussing its recommendations for new experience rating standards the Council pointed out that it "believes that the States should be left free to set

33. See note 69 *infra*, covering seven-year state costs, 1946-1952.

34. Six states delayed adopting experience rating because of their opposition to the basic principle. One of these, Mississippi, steadfastly refused to accept individual employer experience rating until July 1, 1948, as already noted. The opposition in that state was due apparently to a genuine dislike for the principle of experience rating on an individual employer basis. The state had preferred to distribute an approximate 50 percent tax cut equally to all employers in the state on a flat-rate basis, but was unable to do so because of the federal additional credit restrictions included in Section 3303(a)(1) of the Internal Revenue Code of 1954. See Rainwater, *The Fallacy of Experience Rating: the Rebuttal*, 2 LABOR L.J. 753, 760-61 (1951).

35. UNEMPLOYMENT INSURANCE: A REPORT TO THE SENATE COMMITTEE ON FINANCE FROM THE ADVISORY COUNCIL ON SOCIAL SECURITY, SEN. DOC. NO. 206, 80th Cong. 2d Sess. 30, 34 (1948).

the higher rates uniformly for all employers and employees or to relate the higher employer rates to the employer's individual experience with the risk of unemployment."[36]

That the proposed recommendations would have the practical effect of eliminating experience rating in its present form in the United States is agreed by both its advocates and opponents. Mr. P. L. Rainwater, referring to the recommendations of the Advisory Council relating to experience rating, concluded that the suggested changes in the Federal Standards "would undoubtedly have the practical and highly beneficial effect of each state's abandoning it."[37] Without agreeing to the "highly beneficial effect of its abandonment," Mr. Stanley Rector correctly reflects the opinion of most advocates of experience rating in concurring with Mr. Rainwater that this proposal, or similar proposals advanced for amending the federal additional credit requirements, would have the practical effect of the states' abandoning experience rating.[38] He goes on to predict that the issue of experience rating in unemployment insurance will be resolved on the Congressional front.[39]

Experience Rating Systems

Structure of Plans

While five different systems of experience ratings are in use by the states, each having its own peculiar effect on the actual rates established as between various employers, the structural form of all systems follows a similar pattern.

The first thing to look for is the measure of unemployment risk. It may be benefits paid to eligible workers, wages paid to workers receiving benefits, payroll declines, or combinations of these or other factors.

In Workmen's Compensation, because the employer-employee relationship prevails at the time of the injury, it is comparatively simple to identify the employer in whose plant the worker was injured. The total cost of the injury, regardless of its duration, can be traced and charged to that employer. In Unemployment Insurance, except in the cases of reduced hours of work and short-time temporary layoffs, unemployment, and particularly compensable unemployment, occurs after the termination of the employer-employee relationship and

36. *Id.* at 34. The Council also stated in its report that it "believes that, after establishing certain safeguards, the Federal Government should leave to the States the option of maintaining experience rating plans." If this were possible, it would eliminate a continuing source of friction between the states and the Federal Government.

37. Rainwater, *The Fallacy of Experience Rating*, 2 Labor L.J. 95, 99 (1951).

38. Rector, *The Frailty of the "Fallacy" of Experience Rating*, 2 Labor L.J. 338, 339 (1951).

39. *Id.* at 338.

therefore cannot be clearly associated with a particular employer. How long the worker remains unemployed depends more on the conditions of the labor market than on the actions of any individual employer. In many cases, however, these difficulties disappear because a large proportion of workers are attached traditionally, and in recent years more and more frequently, to a single employer. In addition, the worker's best prospect for re-employment is frequently with his separating employer.

To classify employers according to their relative incidence of unemployment, regardless of size, the payrolls of the various firms are most commonly used as the measure, resulting in a form of index. This index of relative unemployment in terms of the selected measure of unemployment risk is translated into actual contribution rates. A rate schedule is usually used for this purpose.

Special adjustments may be made, either increasing or decreasing the rate, before it is actually assigned to the employer. These adjustments may be for solvency purposes, taking the form of alternative rate schedules, depending upon the solvency conditions of the total fund; they may be used to spread a sharp increase in the employer's rate over several years: or they may be used to assess an additional fraction of a percent to finance a portion of the costs of employers with the greatest risk of unemployment.

All states redetermine each year the new rate applicable to each employer subject to the state law, generally on a calendar year basis. The effective date for the new tax rate in practically all states is January 1. The date for assembling the experience factors and computing the rates is six months earlier in many states. Employers generally are not notified of the new rate until sometime after January 1, but usually before April when the first quarterly contributions are due.

Meaning of Three Years' Experience

The Internal Revenue Code requires a minimum of three years[40] of experience "with respect to unemployment or other factors bearing a direct relation to unemployment risk." In the states that use benefit payments, or a derivative of benefit payments, as the factor bearing a direct relation to unemployment, an employer's three years' experience can include only the period during which benefits paid to his former workers can be charged to his record. As a result, three

40. Under a recent Act of Congress (Pub. L. No. 767, 83d Cong., 2d Sess., Sept. 1, 1954), states may choose to base the rate for an employer with only one year's experience on that single year and to base the rate for an employer with two years' experience on those two years. If forty-five months was the minimum contribution liability period for the three years of unemployment experience, then twenty-one months (forty-five less twenty-four months) and thirty-three months (forty-five less twelve months) would be the minimum contribution period for the one-year and two-year periods respectively.

years of contribution liability is not synonymous with three years of experience with unemployment.

In many states six months elapse between the computation date and the effective date of the contribution rates; this adds six months to the required thirty-six months of experience since there is no opportunity during this period to record any unemployment experience. The administrative agency computes the contribution rates during this six-month period. Too, because of the combined effect of the coverage provisions of the state law and the methods of determining and charging benefits, additional time is required, after the employer becomes liable under the law, in order that the unemployment experience of his workers, in the form of benefit payments, can be reflected in the employer's record.

The length of time an employer must pay contributions at the standard rate depends upon the interplay of several provisions of the state laws: the date provided for the computation of rates, the effective date of the rates so computed, the definition of employer, the definition of "base period" and "benefit year," and the method provided for charging benefit payments to employers. Under state laws which contain the typical pattern of governing provisions,[41] the minimum period during which an employer newly subject to the law must pay contributions at the standard rate of 2.7 percent is four years, and the maximum period is five years.

Experience Rating Formulae

Reserve-Ratio

Of the five systems in use, the reserve-ratio is the most common, having been adopted by thirty-three states; it has also been in use longer than any other. This system establishes an "account" for each individual employer subject to the act; this account is maintained so long as the employer continues to be subject. While these are memorandum accounts used strictly and solely for measuring the risk of unemployment, in practice they frequently and erroneously

41. The typical pattern is one which has an effective date for contribution rates on January 1; a computation date on the preceding June 30; the definition of "employer" as a person having a specified number of workers in each of 20 different weeks in a calendar year; the definition of "base period" as the first four of the last five completed calendar quarters immediately preceding the filing of a claim which begins a "benefit year"; and a provision for charging benefit payments to "base period employers," *i.e.*, employers who paid wages to the worker in the first four of the last five completed calendar quarters. "Benefit year," in its simplest terms, is merely the twelve-month period beginning with the date on which a claim for benefits is first filed.

The necessary period of contribution liability will be shorter if a state provides for a different combination such as charging benefit payments to the most recent rather than to all base-period employers, introducing no time lag between the base period and the benefit year or between the computation date and the effective date for contribution rates, or if the statutory period for becoming an employer subject to the law is shorter.

are assumed to be bona fide fund accounts of the employers, representing their equity in the system. The employer's stake in the account is real, however, since it reflects his individual experience upon which a future tax obligation will be fixed.

The traditional accounting debits (dr.) and credits (cr.) are followed in the day-to-day functioning of the system, with contributions collected being credited to the account and benefits paid being debited (charged). Other miscellaneous debits and credits may be made to the account, such as overpayments, errors in charging, etc.

The concept of the account balance, too, follows accounting principles. The account balance is determined by deducting total cumulative benefit charges (plus other debit actions) from total cumulative contributions collected (plus other credit actions). This balance, stated as a ratio of the employer's payroll, provides the reserve ratio which is used to compare employers one with another.

The interaction of three factors of unemployment insurance experience determines the reserve ratio: the total tax contributions paid by the employer, the total benefits paid to his workers, and the payroll of the employer as the measure of the extent of the exposure.[42] When benefit charges exceed contributions the account is considered overdrawn; in most states, this account deficit must be offset by future contributions before the employer is entitled to a reduced rate.

The computed ratio shows the dollar balance in the reserve account per each $100 of the employer's payroll. A high ratio under this plan indicates a favorable experience with unemployment risk; a low ratio indicates an unfavorable experience.

Benefit-Ratio

Five states[43] employ the benefit-ratio system of experience rating. As in the reserve-ratio states, the amount of benefits paid to unemployed workers is used as the measure of unemployment risk. This system does not involve the concept of an account balance; annual benefits charged to an employer become a statistical factor in the rate computation and then are discarded.

All five states use a three-year period, which is the minimum period under the federal law, for the measurement of the risk. The benefits for the three years are related to the taxable payrolls for the three years for each employer and a benefit ratio is computed. This ratio in effect shows the per-dollar cost of benefits for each employer over

42. The predominant factor is the amount of benefits paid; except for employers at the minimum and maximum rates, contributions received over a period of time will approximate benefits paid. The reserve ratio then measures the employer's most recent experience with unemployment. The final tax rate may be modified because of expansion or contraction in the exposure base (payrolls) but this does not impair the measure as related to benefits paid.

43. Florida, Maryland, Minnesota, Vermont, and Wyoming.

the past three years. Under this plan the ratio varies directly with the degree of risk of unemployment; a high benefit ratio is the equivalent of a high degree of risk.

This plan is designed to replenish within the immediate future the benefits paid from the fund during the past three years. A high volume of unemployment, particularly cyclical in character, would result in immediate high contribution rates, an effect which economically should be avoided. Under this plan, however, the rate impact on an employer of a very high volume of unemployment in his individual establishment is limited to the immediate three-year period since the benefits are not permanently charged to his account as in the reserve-ratio system.

Benefit-Wage Ratio

The benefit-wage ratio plan is followed by six states.[44] When a worker files a claim for benefits and actually receives some benefits, under this plan all the wages paid to that worker by the separating employers are potentially usable in computing benefits and become, therefore, "benefit wages." The benefit wages are those wage payments made by employers during the claimant's base period; the process of charging these against the separating employers occurs only once during the claimant's benefit year. The charging of benefit wages may not take place, in most of these states, unless the claimant receives some benefits.[45]

On the computation date the aggregate of the benefit wages assessed against an employer during the last three years is divided by the employer's total taxable wages to arrive at a proportion of his total wages that have become potentially chargeable with benefit payments under the law. This ratio becomes his index of experience; employers with the lowest index, being employers with the best experience, receive the most favorable rate.

An essential part of the plan also requires the computation of a "state experience factor," which is the relationship between total benefit payments in the state and the total of benefit wages assessed against all employers. The final contribution rate is determined by multiplying each employer's index of experience by the state experience factor, which is facilitated by a table.

This plan, as in the case of benefit-ratio plans, is based on the theory of immediately replenishing the fund. The state experience factor is an expression of the amount of benefits paid in the state per dollar of benefit wages, and this is the fraction, in terms of benefit wages,

44. Alabama, Delaware, Illinois, Oklahoma, Texas and Virginia.

45. In Alabama and Oklahoma this is not until payment is made for the second week of unemployment; in Illinois and Virginia, until the benefits paid equal three times the weekly benefit amount; and in Texas, until the benefits paid equal the weekly benefit amount.

that must be replaced in the fund. This replenishment amount is in effect assigned to employers in the form of rates distributed according to the various employers' indices of experience.

These plans, based on benefit wages, differ sharply from the plans using benefits actually paid and charged to the individual employer. The length of time the unemployed worker receives benefits is not fully taken into account in the application of the measure to the individual employer. Through the influence of the "state experience factor," the employer is sharing the cost of the average state-wide duration of benefits.

Payroll Variation

Payroll variation plans are in effect in five jurisdictions,[46] these states being among the last to adopt individual employer experience rating. These plans are different from all others, inasmuch as they accept as the measure of unemployment risk a factor entirely removed from benefit payments. Under these plans an employer's experience with unemployment is determined by measuring the declines in his total payroll, either quarterly or annually, on the assumption that total payrolls reflect the employer's ability or inability to provide employment. Where annual declines are employed, the effect of seasonal and other types of intermittent unemployment is ignored. A low contribution rate under a payroll decline system is associated with no decrease or a very slight percentage decrease in payrolls.

In several states the plan takes the form of a surplus distributed to employers as credit certificates which may be used against the employer's future tax obligation. The amounts of the certificates are determined on the number of points assigned to the employer on the basis of his experience with annual payroll declines in relation to his taxable payroll.

Compensable Separations

A plan of weighting worker separations from a given employer by the amount of the worker's weekly benefit payment is employed by one state, Connecticut, and is known as the compensable-separations method. A rating index is calculated for each employer by dividing the employer's total payroll for three years by the total of the weighted separations. Employers with the lowest rating index receive the highest contribution rates. Provision is also made for the distribution of a surplus in the fund above a defined level. This surplus distribution takes the form of credit memoranda usable against the next year's contribution, and is made in proportion to the amount of the employer's payroll.

46. Alaska, Mississippi, Rhode Island, Utah and Washington.

Charging of Benefits

When benefits or benefit wages are used as the measure of unemployment risk, alternative methods are employed by the states for charging the benefits or wages to individual employers. The charging process endeavors to identify the employer or employers responsible for the unemployment being compensated and assesses the incurred benefit costs accordingly.[47]

Most states (twenty-two) charge benefits or benefit wages in proportion to base period wages on the basis that the cause of the unemployment cannot be precisely related, in multiple-employer cases, to a particular employer, and that any benefits paid to the worker are derived from all base period wage payments. Fourteen states charge base-period employers in inverse chronological order, with a maximum amount that can be charged to a given employer determined usually as a fraction of the wages paid or employment furnished by that employer. The theory supporting this method is that the most recent employer is more responsible than earlier employers for the individual's unemployment and therefore should be charged first. Where duration is long there is little difference between the inverse chronological order of charging and proportional charging. In eight states the most recent employer, or the most recent employer in the base period, because he is considered primarily responsible, receives the entire charge for the benefits, unless the worker was only casually or intermittently employed by that employer.

Non-Charging Provisions

In those states using benefits as the measure of the risk of unemployment, there has been a growing tendency to omit various types of benefit payments from the employer's experience. These omissions, while affecting employers in different ways, do not impair the measure of unemployment risk based on benefit payments so long as the benefits

47. The matter of charging benefits to a particular employer's account has been considered sufficiently significant in several instances to warrant testing the question in court, even to the point of appealing to the court of last resort. Apart from the principle of the thing, or course, such action might be highly worthwhile financially in any case where the condition of the account is such that the employer is teetering, so to speak, between two contribution rate brackets, his rate for the ensuing year depending upon which bracket he finally falls into.

The charging of benefits is held to be erroneous where the employer has not been notified prior to the final determination of the former employee's right to receive such benefits. Call v. Luten, 219 Ark. 640, 244 S.W.2d 130 (1951) (notice given prior to original disallowance of the claim, but not before a redetermination allowing benefits); Bell-Brook Dairies, Inc. v. Bryant, 35 Cal.2d 404, 218 P.2d 1 (1950). In Horsman Dolls, Inc. v. Unemployment Comp. Comm'n, 7 N.J. 541, 82 A.2d 177 (1951), *cert. denied*, 342 U.S. 890 (1951), however, it was held that notice to the employer that a claim had been filed was sufficient for this purpose; notice of the allowance thereof not being required, particularly where the lay-off in question occurred during the slack season. Note that in either case the payment of benefits is not affected.

which *are* charged assure a reasonable measurement of experience with respect to unemployment.[48]

Historically, payments of unemployment benefits made to workers on the basis of a double affirmation clause,[49] have not been charged to the employer's account where the determination was subsequently reversed.

In California, while duration of benefits reaches twenty-six weeks in many cases, only the first eighteen weeks are chargeable to the accounts of individual employers. Presumably the measure of unemployment risk calculated on the basis of eighteen weeks rather than the twenty-six-week maximum duration, is a reasonable measurement of the employers' experience with unemployment generally. On the same grounds, certain payments made under interstate agreements to combine wage credits for workers not eligible under any state law are not charged to any employer's account.

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48. There have been several instances where state provisions for the omission of benefit charging have been found to conflict with the broad test of Section 3303(a)(1) of the Internal Revenue Code.

In 1940 the Oregon Law contained a provision (§ 126-716) authorizing the state commission to relieve employers from benefit charges "where the unemployment of the individuals to whom benefits are paid is due to an act of God, catastrophe not attributable to the employer, or by operation of law." The original Social Security Board determined that this provision would prevent a true reflection of the employers' experience with unemployment and it was subsequently repealed. ORE. LAWS 1941, c. 448. Interestingly enough, in the interim, a problem of interpretation arose which finally reached the Supreme Court of Oregon. In Woodard Lumber Co. v. Unemployment Comp. Comm'n, 173 Ore. 333, 145 P.2d 477 (1944), it was held that unemployment resulting from the government's acquisition of property by purchase was caused neither by "catastrophe nor attributable to the employer" nor by "operation of law."

An Ohio provision omitting charging where the unemployment was caused solely by the permanent closing down of a mine or quarry because of exhaustion, likewise was met with an unfavorable ruling by federal officials.

An amendment to the Alabama Law (Act 862, Laws of 1953) would have permitted employers' accounts to be relieved from charging in any case where the business ceased or curtailed its operation because the plant had been destroyed or severely damaged by fire, explosion, flood, tornado, windstorm or earthquake occurring after April 1, 1953. In an unfavorable ruling, the Secretary of Labor pointed out that the only rationale for finding such a provision in conformity with Section 3303(a)(1) of the Internal Revenue Code would be that an employer should not be charged unless the unemployment compensated is within his control. To so construe the federal requirement, it was added, would mean that, as a practical matter, very few, if any, charges could be required. As a result of the ruling, the provision never took effect.

Somewhat similar proposals in at least six other states were not enacted when the state authorities were informed of the likelihood of conflict with the federal standard.

The Michigan legislature, on the other hand, amended its law in 1954 to provide that only 60% of the benefits paid during 1946 should be charged to employers' accounts. This provision was enacted in connection with a change from the benefit-ratio to a reserve-ratio system of experience rating. One of the primary purposes of its adoption, of course, was to equalize between all employers a portion of the high postwar benefit charges against employers heavily engaged in war contracts. This approach to the problem, permitting only a partial omission of charging, has not been found inconsistent with the requirement of the Internal Revenue Code.

49. This occurs whenever two successive favorable decisions on the worker's claim are made.

The omission of charges to employers' accounts is also justified on other grounds. It is recognized, for instance, that benefits paid for unemployment resulting from an act of the worker, or from circumstances peculiar to the individual worker, need not be charged. Thus, benefits paid following a period of disqualification for voluntarily quitting work without good cause attributable to the employer, for discharge for misconduct, or for refusing suitable work without good cause, may be omitted.[50] Also, benefit allowances paid for dependents of the unemployed worker need not be charged since the award of such additional benefits is based on conditions peculiar to the individual worker. Thirty-six states authorize no charge for benefits paid following disqualification for a voluntary quit, thirty-five after a discharge for misconduct, and ten after a refusal of suitable work. In eight of the eleven states that now pay dependents' allowances, the employers' accounts are relieved of any charge for these extra payments.

The experience rating effect of the non-charging devices is to narrow further the limits within which the employer is held financially responsible and accountable for the cost of unemployment insurance paid to his former workers. The share of the total trust fund payments that are borne by all employers in the state, irrespective of their individual experience, has increased under these provisions.

Voluntary Contributions

A voluntary contribution made by an employer under a reserve-ratio system of experience rating has the same effect on the employer's experience with unemployment as a required contribution. The employer's contribution is simply received under these circumstances earlier than the law otherwise requires.

Contributions voluntarily made, which change the employer's rate from what it would have been, based on the compulsory provisions of the law, are perhaps an equitable means of overcoming the arbitrary effect of the statistical groupings which are part of the process of fixing the final rate. There may be very little difference between one employer's experience with unemployment and that of another, and yet one of them may fall into the next lower rate bracket. What difference there is may actually be much less than the spread between other employers in the same rate bracket. By making a voluntary payment, where this is permitted by the express terms of the state law, the employer may be able to overcome the arbitrary nature of the statis-

50. An extension of this principle may be found in a West Virginia case holding that benefits paid to workers who refused to go through picket lines were not chargeable against the employer's account, the court considering that this amounted to a voluntary leaving for good cause not attributable to the employer, no "labor dispute" being involved. State v. Ruthbell Coal Co., 133 W. Va. 319, 56 S.E.2d 549 (1949). The decision raises a number of interesting questions.

tical interval written into the law and qualify for a lower rate.[51] This device may be very profitable for employers close to the bottom of a rate bracket.

Establishment and Transfer of Experience-Rating Accounts

In compliance with the express requirement of the federal law, all state laws require three years of chargeability before a contribution rate lower than 2.7 may be acquired by any new employer.[52] Aside from the effect which this provision may have upon businesses being started for the first time, an established business may fall into the same category, *i.e.*, become a new employer as a matter of law, in cases of merger, consolidation, or reorganization. This will occur, for instance, when an individual decides to incorporate his business, or where the members of a partnership change. Such cases frequently raise difficult problems in connection with the retention of a reduced contribution rate which may have been previously acquired by the business. The so-called successorship provisions, which govern the acquisition of a predecessor's "account," are the key to such problems under most state laws.

All states now provide for the transfer of the predecessor's "account," either on a mandatory or optional basis, where the successor, whether new or previously subject to the act, has acquired the entire business. Delaware and Nevada limit such transfers to cases where the business is acquired through a merger, consolidation, or other type of reorganization which involves no change in ownership or control. Nevertheless, questions concerning the acquisition of the reduced rate of a predecessor have frequently been the subject of litigation.[53] Where a rate

51. Twenty reserve-ratio states permit voluntary contributions. In addition, Minnesota permits voluntary contributions to offset benefits in connection with the computation of the benefit ratio.

52. There has been some question about whether the required years of chargeability had to be consecutive. The federal law, as well as some state laws, originally did not specifically require them to be consecutive, although the federal law was so interpreted from the beginning. In one case, however, it was held that the three years did not have to be consecutive in the absence of express language to that effect. Hansen v. Iowa Emp. Sec. Comm'n, 239 Iowa 1139, 34 N.W.2d 203 (1948). The requirement is now specific in both the Iowa act and the Internal Revenue Code. Some states require contribution liability for four years, and it has been held that all four years need not be consecutive where the state law so specifies with respect to the last three years only. Commonwealth v. Sun Ray Drug Co., 360 Pa. 230, 61 A.2d 350 (1948). In a petition for redetermination of an employer's rate, it must appear that his account has been chargeable with *benefits* during the three preceding years, an allegation that contributions had been paid for the required period being insufficient for this purpose. First National Bank v. Florida Ind. Comm'n, 154 Fla. 74, 16 So.2d 636 (1944). *Accord*: Employment Sec. Comm'n v. Lumber Distributors, Inc., 74 Ariz. 388, 250 P.2d 79 (1952).

53. In this connection, failure to appeal an erroneous assessment against a successor within the time fixed by the statute renders the rate final. Acme Engineering Co. v. Jones, 150 Ohio St. 423, 83 N.E.2d 202 (1948). Questions of constitutionality, although frequently raised against other provisions of the unemployment insurance laws, have seldom been directed to the experience rating sections. Experience rating, as embodied in the Illinois law, was found

substantially lower than the standard 2.7 is at stake, a great deal may depend upon the outcome of a case of this type, insofar as the employer is concerned.

There have been a number of cases involving partnerships. Where the management and control remain in the same hands, it is usually considered that the experience of successive partnerships may be combined in determining eligibility for a reduced rate.[54] But the converse is true, under the ordinary successorship provision, where the control falls into different hands.[55]

The problem is essentially the same where other forms of ownership are involved.[56]

There has been some difference of opinion as to the right of transfer where there is no express legislative provision authorizing the transfer of experience. At least one jurisdiction has refused to disregard distinct legal entities under such a circumstance,[57] but in another it was held that the corporate form can be disregarded for this purpose, substance rather than form being considered controlling.[58]

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to be neither arbitrary nor in violation of the equal protection clause, and therefore constitutional. Conlon Bros. Mfg. Co. v. Annunzio, 409 Ill. 277, 99 N.E.2d 119 (1951). The successorship provision of the Missouri law, which placed the successor in the same position as the predecessor and made the former liable for the delinquent contributions of the latter, was also upheld in the face of constitutional attack. Bucklin Coal Mining Co. v. Unemployment Comp. Comm'n, 356 Mo. 313, 201 S.W.2d 463 (1947).

54. Arado v. Keitel, 353 Mo. 223, 182 S.W.2d 176 (1944) (two out of three members of the old partnership also constituted a majority and had control in the new partnership); Bartels v. Director of Div. of Emp. Sec., 326 Mass. 1, 92 N.E.2d 370 (1950) (partnership succeeded to business previously operated under a trust agreement; management and control of the business not materially changed); Lindley v. Murphy, 387 Ill. 506, 56 N.E.2d 832 (1944) (three successive partnerships owned or controlled by substantially the same interests; the employment experience of all three might be combined in determining eligibility for a reduced rate).

55. Billett v. Gordon, 389 Ill. 454, 59 N.E.2d 812 (1945) (partnership and predecessor corporation not permitted to combine their experience where five of the partners who owned 82 percent of the partnership assets had owned only 38 percent of the stock of the corporation); Schlosberg v. District Unemp. Comp. Bd., 167 F.2d 881 (D.C. Cir. 1938) (arrangement under which partnership leased and operated a plant owned by a corporation, involved more than a mere change in form, the management and control thereof having shifted from the corporation to the partnership).

56. A corporation merging with a former subsidiary was held entitled to the latter's "merit" rating as a successor in interest. Texas Co. v. Florida Ind. Comm'n, 155 Fla. 536, 20 So.2d 680 (1945). But there must be substantial continuity in the business enterprise in question. Honeymead Products Co. v. Christgau, 234 Minn. 108, 47 N.W.2d 754 (1951) (the third owner of a business denied the experience record of the first owner, either as the successor directly or through the second owner thereof, the latter having been long out of business). Under the express provisions of twenty-five state laws, there can be no transfer if the enterprise acquired is not continued, and in four of these (District of Columbia, Massachusetts, New York and Wisconsin) the successor must employ substantially the same workers. COMPARISON OF STATE UNEMPLOYMENT INSURANCE LAWS 26 (Bur. of Emp. Sec., U.S. Dep't of Labor 1954).

57. Lund & Co. v. Rolfe, 93 N.H. 280, 41 A.2d 226 (1945) (partnership took over the manufacturing business of a predecessor corporation; "merit" rating of the latter was disallowed to the successor unit).

58. Packard Clothes, Inc. v. Director of Div. of Emp. Sec., 318 Mass. 329, 61 N.E.2d 528 (1945). In this case a corporation succeeded to the business of

Acquisition of the entire business is not always necessary in order to be entitled to the predecessor's contribution rate. Thirty-five state laws authorize partial as well as total transfers.[59] In these states, if only a portion of a business is acquired, that part of the predecessor's record which pertains to the acquired portion may be transferred to the successor.[60] In the absence of such authorization, however, it is generally held that entitlement to a lower rate goes only with a transfer of the whole business.[61]

Considerable difficulty has been encountered in cases where a business has been split up and divided among several successors. In some states it has been held that the successors are still entitled to the reduced rate of the predecessor,[62] but in others a reduced rate has been denied, usually on the basis of a statutory requirement that the business must be continued by the successor as a single employing unit.[63]

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an individual. The corporation, according to the court, although a separate legal entity, was the successor in fact and entitled to the "merit" rating of the predecessor. A 1943 amendment permitting transfers was considered to have disclosed the legislative intent, and the *Rolfe* case was further distinguished on the basis that the same identity of interest did not there exist.

59. COMPARISON OF STATE UNEMPLOYMENT INSURANCE LAWS 25-26 (Bur. of Emp. Sec., U.S. Dep't of Labor 1954).

60. Where the predecessor owned two restaurants, one of which had twenty-two employees and the other four, it was held that a successor to the first and larger establishment was entitled to the predecessor's rate. Indiana Emp. Sec. Div. v. Ponder, 121 Ind. App. 51, 92 N.E.2d 224 (1950). See also, Burlington Truck Lines, Inc. v. Iowa Emp. Sec. Comm'n, 239 Iowa 752, 32 N.W.2d 792 (1948) (railroad subsidiary which operated both a truck division and a bus division transferred former to another subdivision, with no change in the organization thereof; held that the successor subsidiary was entitled to the reduced rate of the predecessor).

61. Emp. Sec. Comm'n of North Carolina v. News Pub. Co., 228 N.C. 332, 45 S.E.2d 391 (1947) (corporation acquiring the assets of only the printing department of a publishing company not permitted to obtain the latter's experience rating "account"); Eiber Realty Co. v. Dunifon, 84 Ohio App. 532, 82 N.E.2d 565, 53 Ohio Abs. 33 (1948). In the latter case, the court referred to the fact that the Ohio Legislature had struck out the phrase "in whole or in part" in the provision governing transfers. The Ohio law has since been further amended to allow transfer of a "clearly segregable and identifiable portion of an employer's enterprise."

62. Royal Jewelers Co. v. Hake, 185 Tenn. 254, 205 S.W.2d 963 (1947) (three corporations formed to take over the business of a partnership). The court mentioned the fact that the three corporations had been combined for tax liability purposes, and ruled that the statute did not clearly require that the successor must be a single unit to succeed to the predecessor's rate.

63. El Queeno Distributing Co. v. Christgau, 221 Minn. 197, 21 N.W.2d 601 (1946) (original partnership reorganized into two corporations and a new partnership, each operating separate businesses in different localities); Ned's Auto Supply v. Michigan Unemp. Comp. Comm'n, 313 Mich. 66, 20 N.W.2d 813 (1945) (partnership split into two corporations, 2/3 of the assets being transferred to one and 1/3 to the other, the five partners becoming equal shareholders in both corporations); Canada Dry Bottling Co. v. Board of Review, 118 Utah 619, 223 P.2d 586 (1950) (two enterprises owned by the same partnership, incorporated); McNear v. Director of Div. of Emp. Sec., 327 Mass. 717, 100 N.E.2d 848 (1951) (two corporations established for accounting purposes to conduct auto sales and service business); Unemployment Comp. Comm'n v. General Engineering Corp., 147 Tex. 503, 217 S.W.2d 659 (1949) (two corporations succeeding partnership); State v. Dallas Liquor Warehouse No. 4, 147 Tex. 495, 217 S.W.2d 654 (1949) (four corporations succeeding to stores previously owned by an individual); Pearson Motor Co. v.

Under state laws requiring that "substantially all" of the predecessor's assets must be acquired by the successor in order to obtain the former's rate, it is usually considered that anything less than 90% of the assets is not enough.[64]

Should the states take advantage of the recent change in the federal three-year requirement by amending their laws to permit new employers to qualify for a reduced rate after one year of experience, the importance of the successorship provisions will be greatly reduced.

Interstate Competition in Rates

One of the cornerstones of the original Social Security Act was the fixing of an initial uniform tax rate for unemployment insurance financing purposes and thus avoiding interstate competition in tax rates. The cost advantage for an employer in a state with no unemployment insurance system over a competing employer in another state with such a system was obvious.

The ultimate actual effect of the experience-rating system in the area of interstate competition in unemployment tax rates, however, was not obvious.[65] The ultimate effect was misjudged primarily because of the mistaken cost estimates of the system. The three percent tax was considered, in the light of unemployment experience of the 1920's and early 1930's, as possibly being too low.[66] It was assumed, further, that experience rating would provide both high penalty rates above the standard rate and low rewarding rates below the standard rates, and that the states would, during a major depression, seek additional sources of revenue over the 3.0 percent such as contributions from general revenues or government loans.

In providing for strictly separate state systems, and at the same time endeavoring to eliminate or reduce interstate competition in rates, it is important to recognize that, with or without experience rating, the

Texas Emp. Comm'n, 247 S.W.2d 429 (Tex. Civ. App. 1952) (two corporations succeeding to business of individual).

64. Auclair Transportation, Inc., v. Riley, 96 N.H. 1, 69 A.2d 861 (1949) (89 percent); Russ Dawson, Inc. v. Michigan Unemp. Comp. Comm'n, 334 Mich. 82, 53 N.W.2d 693 (1952) (76 percent); Winakor v. Annunzio, 409 Ill. 236, 99 N.E.2d 191 (1951) (65 percent).

65. While the original Congressional Committees had no way of determining the effect, one member of the House Ways and Means Committee in the 1935 committee hearings did recognize the interstate rate differential possibilities of the system. Clague, *The Economics of Unemployment Compensation*, 55 YALE L.J. 53, 58 (1945).

66. Of interest are the estimates of unemployment forecast over an eight-year cycle by the British Unemployment Insurance Statutory Committee at about the same time as the passage of the Social Security Act. The eight-year average unemployment rate was estimated to be about 17 percent of the insured population. See PEACOCK, THE ECONOMICS OF NATIONAL INSURANCE 59 (1952). The 3 percent rate was estimated to be adequate to finance only a modest level of benefits (ten weeks maximum duration and two weeks waiting period) and was finally accepted because, primarily, it was felt that the economy could afford no higher rate.

incidence of unemployment varies sharply between the states, thus accounting for a large portion of the differences in unemployment compensation costs as between the states. Other factors contribute to these differences in costs, such as the differences in the benefit and eligibility conditions, differences in interpretation and administration of the law, in worker understanding and claim filing propensities, as well as in the attitudes and participation of employers. The differences between the states in the incidence of both the volume and the duration of unemployment resulting from varying economic characteristics is the primary reason why average costs vary so widely between states. These cost variations would exist under a flat rate tax as well as under a differentiated rate system.

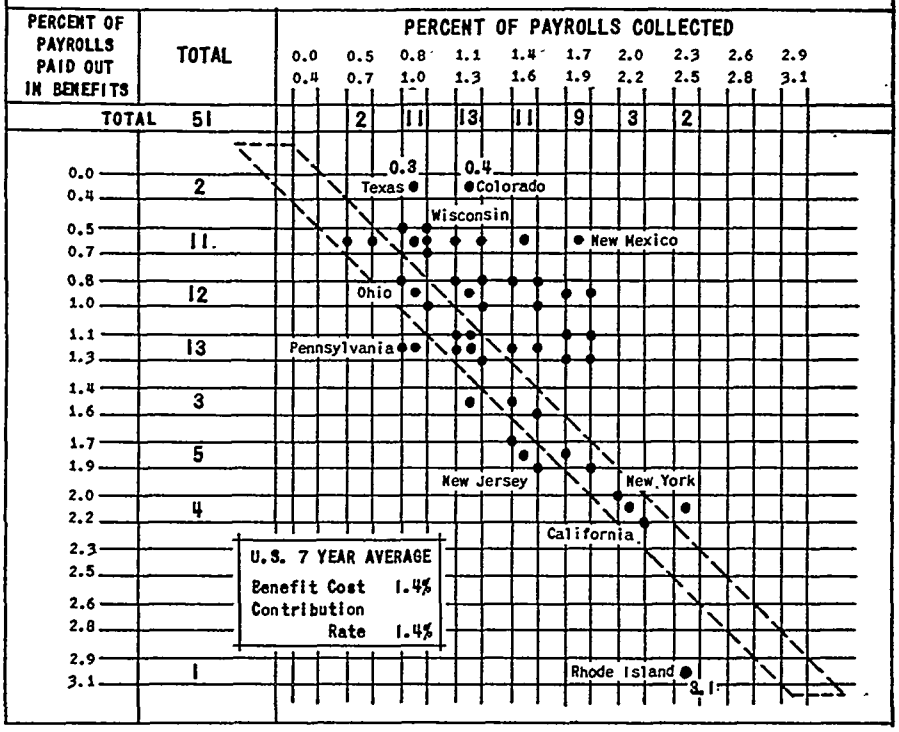
The average benefit costs for the seven-year period 1946 to 1952 inclusive, calculated as a fraction of taxable wages, show a wide difference between states as do the average contribution yields under experience rating calculated on the same taxable wage base. The benefit costs range from 0.3 percent in Texas to 2.2 percent in California and 3.1 percent in Rhode Island. Contributions collected from employers showed a similar pattern both as to range and variability—0.6 percent in the District of Columbia to 2.3 percent in Rhode Island and Alaska.

This seven-year period, 1946 to 1952, while not representative of a business cycle, does reflect modern economic conditions. Years of both moderate and aggravated unemployment are included. The average benefit costs for the United States as a whole varied from 0.9 percent in 1951 to 2.3 percent in 1949, while the average level seven-year cost was 1.4 percent.[67] The heavy benefit disbursements of the postwar year of 1946 and the 1949-50 recession, as well as light benefit-payment experience, were recorded during this period. The seven-year average contributions collected from employers was the same as the average

67. This may represent the long-run level cost of unemployment insurance in the United States, assuming even some improvement in the benefit level of protection offered by the program. Because of exhaustions and insufficient wage credits of new entrants in the labor market, compensation for wage losses resulting from unemployment during a prolonged depression may not be as great as previously calculated. Control of the modern business cycle through compensatory fiscal, monetary and other governmental policies may result in future business fluctuations not much different than the pattern represented by the 1946-52 period, with the same approximate effect on unemployment insurance costs. Assuming a rate of unemployment varying from 5 to 10 percent of the labor force over a ten year period, it has been estimated that a tax rate as low as 1.4 percent would finance benefits at about 50 percent of taxable wages, dependents benefits, a one week waiting period, 26 weeks of uniform duration and standard disqualifications. See WOYTINSKY, PRINCIPLES OF COST ESTIMATES IN UNEMPLOYMENT INSURANCE (Social Security Administration 1948). The cost of prolonged depression unemployment cannot properly be considered an unemployment insurance cost; unemployment insurance is designed to compensate only for wage loss during relatively short periods of unemployment.

benefit cost—1.4 percent.[68] This experience is represented graphically by the following chart:

Average collections for unemployment insurance for each state classified according to the state's average benefit cost, as a percent of taxable wages, for the seven year period 1946-52 inclusive.



The chart shows the variations in the benefit cost as well as the contribution yields among the fifty-one jurisdictions. The vertical scale is based on average benefit cost in terms of percentage of taxable payrolls. Each dot represents a jurisdiction. The horizontal scale reflects the contributions collected during the same seven-year period; and each jurisdiction with a given benefit cost is plotted according to its contribution yield. The seventeen states located within the double-line band

68. While there are sharp differences in state to state situations, the fact that nationwide contributions approximated benefits, could be considered as evidence that the system as a whole under experience rating is soundly financed, automatically adjusting tax liabilities in accordance with benefit obligations. The existence of excessive reserves and collections in states not needing them, and slim reserves and inadequate collections in states needing greater resources, however, casts doubt on the adequacy of experience rating as actually operating, state by state, to properly finance unemployment insurance over a limited period of business fluctuation. Federal loans or grants to state funds, or some method of reinsurance among the state funds may, however, correct this deficiency.

on the chart are those states which, over the period, collected in contributions approximately the same amount that they paid in unemployment benefits. States below the band did not collect sufficient contributions to cover their full benefit payments. Seven states are included in this group. States above the band (twenty-seven) added to their reserves during the period by collecting more in contributions than was paid to unemployed workers.[69]

Interstate unemployment tax differentials for competitive employers in different states have been widened by individual states adopting different measures and devices to minimize the tax on the employer both from the contribution side and the benefit side. Such devices include lower minimum and maximum rates, crediting of trust fund interest to employers' accounts, non-charging of benefits, different systems of experience rating, and stricter disqualification and entitlement conditions for benefits. All of these give the employer an advantage over his competitor in another state that did not adopt such devices or impose stricter benefit requirements. The competitive advantage traceable to these factors is probably small, however, compared to the advantages the employer enjoys by virtue of having his establishment located in a state with a low rate of unemployment.

For employers who have been subject to the law for a number of years, the differences between states is even greater than the average rates would indicate. In eight states, including the lowest cost states of Texas and Colorado, new employers with less than three years of experience with unemployment and not yet entitled to a reduced rate, contributed approximately one-half or more of the 1953 benefit expenditures by paying at a rate of 2.7 percent. In Colorado the proportion paid by new employers for 1953 amounted to 108 percent of the total benefit costs.[70]

The argument of interstate competition was effectively used to defeat state proposals for unemployment insurance before the Social Security Act was passed in 1935.[71] In the light of existing sharp variations in state-to-state tax rates without serious question by competing employers,[72] there may be doubt regarding the genuineness of the

69. In only five states did benefit costs for the seven-year period, 1946-1952, equal or exceed 2.0 percent of payrolls: Alaska, 2.0 percent; California, 2.2 percent; New York, 2.1 percent; Rhode Island, 3.1 percent; and Washington, 2.1 percent; of the remaining jurisdictions, forty-one experienced benefit costs of 1.5 percent or less, with twenty-two of these states below 1.0 percent. In seven states—Colorado, District of Columbia, Iowa, Nebraska, New Mexico, South Dakota, and Texas—the benefit costs for the period averaged 0.5 percent or less.

70. In Nevada new employers paid 70 percent, in Arizona 64 percent, and Texas 47 percent. Under Public Law 767, approved September 1, 1954, new employers may become eligible for reduced rates with less than three years of unemployment experience.

71. Witte, *Development of Unemployment Compensation*, 55 YALE L.J. 21, 28 (1945).

72. New England textile employers, particularily those located in Rhode

arguments originally advanced to defeat state legislation in this field.

Wide differences in average state tax rates can be expected to continue under separate state systems of unemployment insurance without some provision for equalizing the actual benefit costs between the states.

COUNTER-CYCLICAL FINANCING

Increased attention is being focused on building into unemployment insurance reserve financing special devices that will produce counter-cyclical effects. The economic advantages of reserve accumulations during good times were recognized in the early planning of the system.[73] Since then, and as a result of the contribution of Lord Keynes and his economic analysis of national income, more recognition has been given to fiscal and taxation policies of the government and their influence on the economic aggregates of savings, investment, output and employment. Unemployment insurance benefit payments and reserve policies play an important part in the compensatory fiscal actions of the government which are designed to achieve and maintain full employment. The maintenance of consumer spending and demand through the addition to national income of payments to unemployed workers in the earliest phases of a developing business cycle permits the economy to remedy its peculiar illness without the further complications of a decline in the volume of consumer spending. This advantage is partially negated if, at the same time, additional business withdrawals are made in the form of unemployment insurance contributions to finance these benefit payments directly or to rebuild unemployment reserves drawn down by the benefit expenditures. Furthermore, unemployment insurance tax withdrawals would reduce the capacity of business to maintain or expand investments in plant or equipment. Since business investment expenditures cause a high rate of consumer spending oscillations, the economic effect of a reduction in their expenditure is even more pronounced. A part of the problem

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Island and Massachusetts, complained about the advantage accruing to their competitors in the Carolinas and Georgia because of differences in the unemployment tax rates. The 1946-52 average benefit costs for the principal southern textile states were about 1.0 percent compared to 1.9 percent for Massachusetts and 3.1 percent for Rhode Island.

73. The original Committee on Economic Security stated in its report on unemployment compensation that: "These rights are measured by computations of the incidence and duration of unemployment over a secular period, and over the period a balance is maintained between the income and expenditures of the fund. Large reserves must consequently be accumulated in good years if the anticipated drains of poor years are to be met." SOCIAL SECURITY IN AMERICA 9 (Comm. on Economic Security, Social Security Board, Publication No. 20 1947). Since 1938 benefits exceeded contributions only in the post-war year of 1946 when benefits amounted to 1.7 percent of taxable wages, contributions being 1.4 percent of taxable wages; in the 1949-50 recession, when benefits paid during the two-year period represented about 2.0 percent of payrolls while collections amounted to 1.4 percent; and in 1954, when benefit payments reached over $2.0 billion, an all-time high.

of counter-cyclical financing, then, is to arrange the tax system in such a manner that increases in unemployment insurance tax rates are avoided during periods of high or relatively high unemployment. A uniform or level tax rate would appear to achieve this objective.[74]

Another approach to counter-cyclical financing would authorize the accumulation of unemployment reserves in such a fashion that during low-employment periods the fund could absorb not only the higher benefit payments, but also allow some tax reductions to employers. This objective is attainable only if reserves have been liberally accumulated during prosperous or full-employment periods, a condition characterizing many of the individual state funds. The desirable economic effect of such tax reductions are apparent; the political difficulties of introducing tax reductions at the same time that trust fund balances are being drawn down by heavy unemployment benefit payments are also apparent. While the reserve fund may be technically or actuarially "excessive," public reaction may not sanction simultaneous tax saving to employers and high benefit payments. On the other hand with extravagant reserves accumulated, increased benefits and greater contribution rate reductions will be demanded despite high level employment conditions.

The possibility of combining tax remissions with benefit expenditures as built-in automatic stabilizers was suggested by the form of contra-cyclical financing adopted by the British Unemployment Insurance Statutory Committee and later embodied as a part of the British National Insurance Act of 1946. While never actually tested because of the war and transition period, "The scheme . . . suggested that the contributions of both employers and employees should vary in accordance with the unemployment percentage. Thus with a given average unemployment percentage of, say, 8, the contribution would vary inversely with percentages at either side of this average, falling with increased unemployment and rising with a decrease. In this way, not only would the employed workers receive a tax remission, but also employers' prime costs would be reduced and unemployment benefits could remain at the current level."[75]

With a worker as well as an employer contribution, the tax remissions would have a much broader effect, particularly since the remissions would be spread over the low-income groups whose spending propensities would be high.

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74. Some attention is being given to establishing employer contribution rates under experience rating in accordance with conditions designed to yield an approximate level rate of revenue in terms of taxable wages over a planned period of seven to ten years, with individual rates varying around the predetermined rate. One state, Arizona, has adopted a plan which contains the basic feature of a level contribution rate, which has been established as 1.3 percent. This rate might change if the reserve, because of unusual conditions, increases or decreases sharply. See ARIZ. CODE ANN. § 56-1007d (1939).

75. PEACOCK, THE ECONOMICS OF NATIONAL INSURANCE 61 (1952).

Exclusive employer tax reductions, as in the United States, would increase the employers' capacity to expand capital expenditures, usually associated with causing a high rate of consumer and business re-spending, at a critical time in the business cycle.

If it should be possible to devise counter-cyclical tax measures that would be automatically and promptly applied so as to at least avoid tax increases during the downswing and the trough of the cycle, an important compensatory fiscal device would be built into the economic system.

The financing systems under experience rating appear to aggravate rather than to counter the fluctuations produced by cyclical unemployment. In the view of some, contribution rates have been reduced too generously during recent high-level employment periods;[76] this effect as well as increases in rates during low-level employment periods seems to be implicit in the practical functioning of experience rating as it is presently designed.

There is disagreement with the proposition that existing experience-rating systems fail or are incapable of producing counter-cyclical tax effects. Reserve-ratio systems, it is claimed by some, can be made an effective instrument of counter-cyclical financing for the individual employer and simultaneously, then, for the economy as a whole. While no meaningful experience is yet available to test the strength of this contention, it is clear that the reserve-ratio plans do enjoy counter-cyclical advantages over benefit-replacement systems such as the benefit-ratio plan.[77] The influence of the changes in the payroll of an employer subject to a reserve-ratio experience-rating law may produce, within limits, a desirable economic effect for the individual employer. Assuming no significant change in benefit experience, an increase in payrolls will produce a lower reserve ratio and therefore a higher contribution rate. While this may be identified by some as a type of counter-cyclical effect, the real reason for the rate increase is the greater exposure to the risk of unemployment.[78] A decrease in pay-

76. The Advisory Council on Social Security reported in 1948 that under its proposals for a minimum contribution rate (0.6 percent employer and 0.6 percent worker contribution), "experience rating in most states could not operate to reduce the income of the system to a point which would threaten adequate benefit standards. Furthermore, the minimum rate would place a limit on the tendency of most experience rating plans to reduce contribution rates in prosperous times just when general economic principles dictate peak rates, and correspondingly would limit the increase in rates in periods of growing unemployment when it is desirable to have low rates." UNEMPLOYMENT INSURANCE, A REPORT TO THE SENATE COMMITTEE ON FINANCE, FROM THE ADVISORY COUNCIL ON SOCIAL SECURITY, SEN. Doc. No. 206, 86th Cong., 2d Sess. 34 (1948).

77. See a study of Muskegon, Michigan, the case of the declining payrolls. FINANCING METHODS, BENEFIT STRUCTURE, COSTS OF MICHIGAN UNEMPLOYMENT INSURANCE 58-62 (Report of the Michigan Employment Security Commission 1953).

78. Because of the statutory limit of $3000 on taxable wages at a time when actual annual wages in covered employment average above that amount,

rolls resulting from a reduction in the number of workers employed, or a substantial cut in work hours, will by itself reduce the employer's contribution rate and his tax liability; however, under these circumstances, benefits can be expected to increase offsetting the advantage of the lower payroll experience. Higher unemployment tax rates for the individual employer appear likely under these conditions.

When there is general unemployment of a cyclical nature, higher unemployment insurance tax rates appear inevitable under existing experience-rating systems, including reserve-ratio systems, even though the impact of the increase, both as to timing and degree, may be different for different plans.

Should counter-cyclical financing and the fixing of tax rates in unemployment insurance be designed from the viewpoint of the individual employer or from the point of view of the economy as a whole? The first approach, that of the individual employer, presupposes a collective benefit to be derived, automatically, out of meeting the individual employer's need for tax relief, and a chance to accumulate an adequate individual reserve. This would be timed in relationship with the employer's peculiar individual circumstances of economic misfortune or success which may or may not coincide with the generally prevailing cyclical condition. This view is in complete harmony with the stabilization and cost objectives of individual employer experience rating. On the other hand, if the purpose is to achieve a general economic counter-cyclical effect as regards the economy as a whole, which economically appears preferable, then an overriding adjustment must be made in all employer rates, irrespective of individual experience, and these adjustments must be tied to some general economic indicators.[79]

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the changes in the taxable wage base reflect to a great extent increases in the number of workers employed and thus exposed, as individuals, to the risk of unemployment. Payroll expansion or contraction either in the form of wage rate changes or changes in hours of work (when the average work week is relatively high), are frequently not reflected in the exposure base. The $3000 limit does adequately cover wages used by states in computing benefits.

79. Relevant to this question of the behavior of the individual firm within a business cycle pattern, see a description of Wesley C. Mitchell's concept of business cycles in BURNS, THE FRONTIERS OF ECONOMIC KNOWLEDGE 112-14, 194 (National Bureau of Economic Research, Number 57, 1954). Wisconsin has provided for such a system by linking a reduction in contribution rates to changes in total state wages and salaries. A decrease of 5 percent or more over the previous year's total payrolls in the state when the total reserve fund is $25 million or more, requires the Wisconsin Industrial Commission to invoke an adjusted rate schedule. In the rate schedules provision is made for three levels of payroll decreases: 5 percent to 10 percent; 10 percent to 15 percent; and over 15 percent. The counter-cyclical tax remissions vary under each schedule and are different in each schedule for the nine rate categories of the law. The maximum remission under the schedule applicable when wages decrease more than 15 percent is 1.1 percent. Employers under the normal schedule with a zero rate receive no counter-cyclical rate adjustment. See WIS. STAT. § 108. 18(8) (1951).

CONCLUSION

Experience rating over the past fifteen years has profited in its growth and acceptance by forces and developments which were foreign to the system's basic objectives. At the same time, because of these developments, experience rating lost a real chance to test and prove the strength of its basic objectives.

Experience rating was given credit by many employers for reducing their tax burden in the field of unemployment insurance and the system has consequently become very popular. The experience-rating system was, however, only the method used in achieving the reduced rates; the real forces responsible for the sharp reduction in contribution rates to a very large number of employers in practically all states were over-financing, under-benefiting, and the high levels of employment and payrolls during the war and post-war periods.

The ultra-conservatism of the original cost estimates fixing the 3.0 percent Federal Unemployment Tax rate produced an apparent tax savings of around 50 percent which is both a windfall and a handicap to experience rating. A large proportion of the experience rating savings is to a considerable extent illusory because the federal 3.0 percent rate and, in most states, the standard rate of 2.7 percent are too high. The same general result might have been achieved by lowering the standard rate by amendment at both the federal and state levels, with a considerable increase in efficiency and a corresponding decrease in administrative costs.

The extraordinarily high level of employment and payrolls resulting from the war improved the condition of the state funds, the experience of individual employers, and, at the same time, the capacity of the system to grant tax reductions. This improvement resulted from low benefit outlays as well as expanded employment and payrolls for contribution purposes. Reduced contribution rates became more or less automatic without much attention or concern from employers.

On the other hand, experience rating, with its system of preferential treatment of employers with more stable employment, has satisfied and continues to satisfy a vital need in the growth of unemployment insurance in the United States. It was the only available method of adjusting the revenues to the benefit demands, and correcting the unreasonably high original cost estimate and tax rate. Other statutory adjustments in these rates could have been made; but the fact remains that the additional credit provisions of the federal law, together with the experience rating systems of the state laws, provided the only available channel for achieving a technically and economically desirable reduction in the average tax rate in practically all the states.

Experience rating was also a substantial factor in the general acceptance of unemployment insurance by American industry, and in

securing their cooperation in the administration of the law. Experience rating, being a part of the functioning of the system, placed unemployment insurance on familiar ground, somewhat akin to commercial, private insurance with its system of preferred risks, but still with the advantage of state-wide pooling of the risks from the point of view of benefits. The built-in stabilization incentives have popular acceptance by American industry even though their effect, admittedly, is limited.

The same experience rating incentives continue to be criticized on the grounds that rather than reducing *unemployment* they tend only to reduce *benefits*, which is the common measure of the amount of unemployment attributable to the employer.

The systems of experience rating in unemployment insurance must adjust to certain recent developments. With average contribution rates now approximating average current benefit costs, employers are being assigned rates above the average to about the same extent that they are being assigned rates below the average. Should there be any substantial increase in unemployment, most of the rates will be driven upward. If benefit scales are liberalized, a similar effect will be produced; and should earlier reduced rates be granted to new employers, which is now possible under the federal law, the rates of many established employers in some states will very probably be increased. Under these circumstances, experience rating could be blamed for the increases even though the real reasons lie elsewhere.

The guaranteed-annual-wage plans proposed for collective bargaining are being justified on the same theoretical grounds as experience rating in unemployment insurance. The opposition of industry to these plans will clash, to some extent at least, with the theoretical grounds supporting experience rating, just as labor, in attempting to justify guaranteed-annual-wage plans, will clash with their theoretical opposition to experience rating.

Also, the question of individual employer experience rating is likely to receive further attention by Congress as well as state legislatures. The compulsory features of the additional credit requirements of the Internal Revenue Code have created some resentment in the states. The sharp differences between states in the costs of unemployment insurance undoubtedly will provoke continuing interest in ways and means of equalizing to some degree the costs between the states, and of minimizing competition between the states in reducing contribution rates and in devising stricter disqualifying and eligibility conditions. The high cost states, of course, have the greatest interest in these proposals.