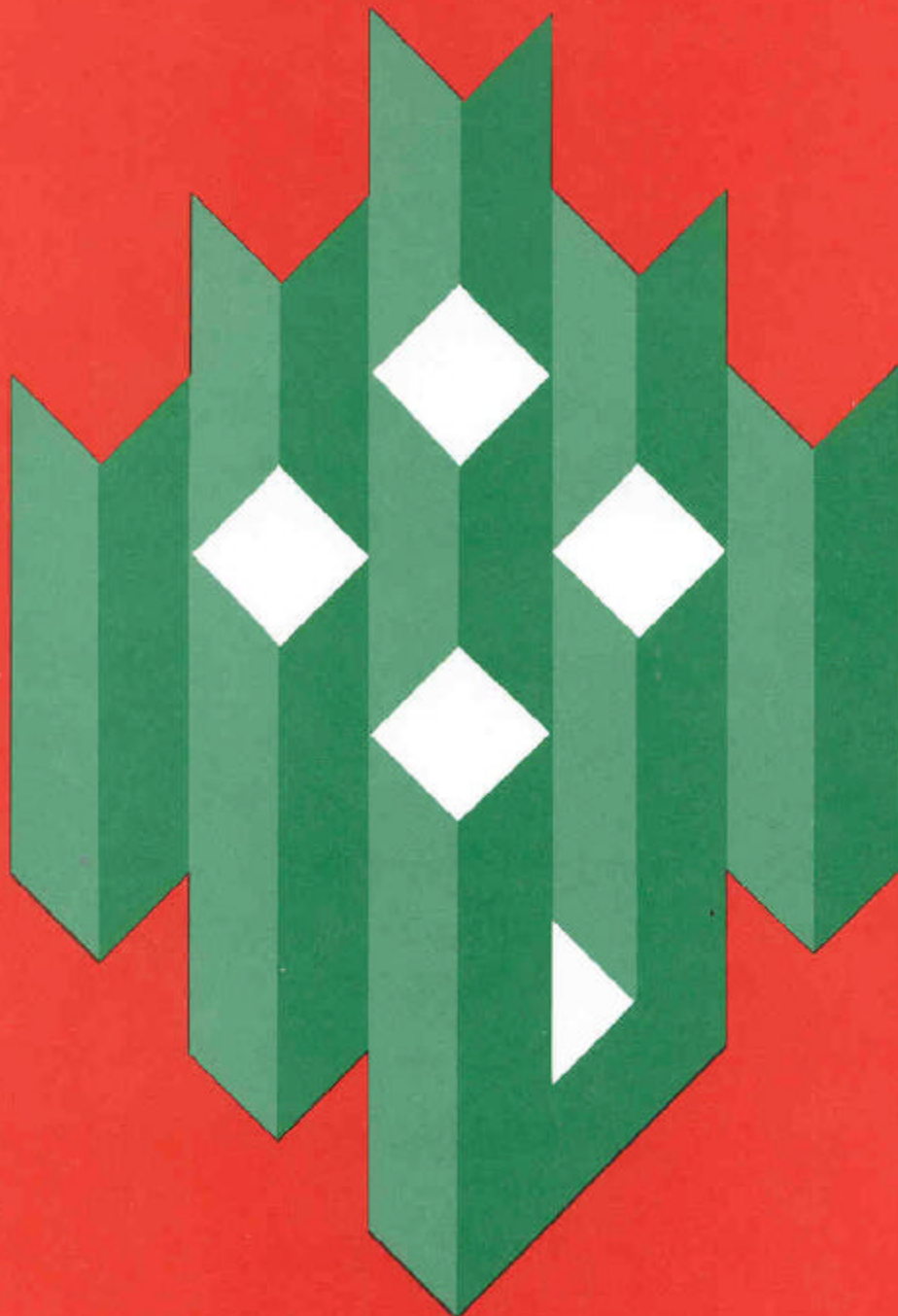


Experience Rating in Unemployment Insurance: Some Current Issues



Unemployment Insurance
Occasional Paper 89-6

U.S. Department of Labor
Employment and Training Administration



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INTRODUCTION

The Unemployment Insurance (UI) System was established with the Social Security Act of 1935 as a Federal-State program designed to be self financing. States have the responsibility to structure their benefit and taxing systems. Employers finance the system with payroll taxes based on their experience with unemployment.

At present all State UI systems except Puerto Rico use experience rating for the regular UI program. States have developed experience rating systems in response to additional tax credit provisions contained in the Federal Unemployment Tax Act. Federal law allows employers who have earned reduced rates under an approved experience rating system in the State additional credit against their Federal tax up to a maximum of 5.4 percent. The primary overall economic goal of experience rating is to stabilize employment by providing employers an incentive to reduce turnover through assigning lower tax rates to employers with reduced employee lay offs.

How effective is experience rating in the UI program? This question was addressed by Stephen A. Wandner and Robert L. Crosslin in a paper entitled "Measuring experience rating" which was published by the National Commission on Unemployment Insurance in July 1980. They developed a quantifiable measure of experience rating termed an Experience Rating Index (ERI). They concluded in their study that an ERI could be determined in all States and that more benefits being experience rated than not which means that the ERI should be greater than 50. At the same time there are programatic reasons why a UI system may not and cannot be totally experience rated, that is, have an ERI of 100 implying a completely reimburseable system. An experience rated UI system, thus, will have an ERI value between 50 and 100, but what that value should be depends on individual judgment, just as whether a system should be experience rated in the first place is a matter of judgment.

The Office of the Inspector General (OIG) conducted an audit to determine the effectiveness of experience rating in financing the UI system. This report entitled "Financing the Unemployment Insurance Program has Shifted from a System Based on Individual Employer's Responsibility Towards a Socialized System" was issued in 1985. The report showed that the degree of experience rating in 9 of the 12 States audited had declined between 1970 and 1983 causing a shift from individual employer's responsibility towards a socialized system. It suggests that the lack of a Federal standard on an acceptable degree of experience rating and inadequate accounting for socialized costs have resulted in this decline. The report recommended that the Secretary of Labor "account for" the degree of experience rating in the States and develop and publish an ERI.

In response to that audit, the Department of Labor (DOL) commissioned Dr. Wayne Vroman, Senior Research Associate, The Brookings Institute, to examine experience rating

in general and the OIG report in particular. In April 1986 Dr. Vroman published his report "Experience Rating in Unemployment Insurance: Some Current Issues". The report pointed out that there are valid reasons why the UI program should not be fully experience rated, but the degree of experience rating can and should be increased. Dr. Vroman concluded that the OIG's report had some serious shortcomings. Most serious, its methodology inflated the extent of the decline in the degree of experience rating that occurred between 1970 and 1983. Despite these shortcomings, however, Vroman concluded that the recommendations should be given serious consideration.

The recommendations presented in Dr. Vroman's report were reviewed by the Employment and Training Administration (ETA) and resulted in Manual Transmittal Letter (MTL) No. 1460 dated January 4, 1988 to all State Employment Security Agencies transmitting revised reporting instructions for the ETA 204, Experience Rating Report. These changes were made to accommodate the development of an ERI. The results of the first ERI were published in Unemployment Insurance Program Letter (UIPL) No. 42-89 dated July 6, 1989.

This Occasional Paper is a compilation of Dr. Vroman's report, the MTL 1460 and UIPL 42-89. These three items are presented together in an attempt to help the reader understand the DOL's development of the ERI.

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PART A

EXPERIENCE RATING IN UNEMPLOYMENT INSURANCE:

SOME CURRENT ISSUES

**Experience Rating in Unemployment
Insurance: Some Current Issues**

by

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*Senior Research Associate, The Urban Institute. The statements made in this paper are the views of the author and do not necessarily reflect the views of The Urban Institute or the U.S. Department of Labor. Helpful comments on a preliminary draft of this report were provided by Virginia Chupp, Joseph Hickey, James Manning, James Rosbrow and Stephen Wandner. Since I have not adhered to all of their suggested changes they bear no responsibility for the analysis or conclusions of this report.

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INTRODUCTION AND SUMMARY

State Unemployment Insurance programs in the United States are financed mainly by employer payroll taxes. The taxes are experience rated, that is, an increase in benefit payments made to former employees during the current year typically causes the employer to be subjected to higher tax payments in future years.

This paper examines experience rating in unemployment insurance. Part I discusses the main objectives of unemployment insurance while Part II defines some important experience rating concepts and describes the different ways that the states experience rate employers. Part III examines four issues associated with experience rating; the size of the interindustry subsidies, the incidence of employer payroll taxes, the effects on employee turnover and current financing problems in unemployment insurance. Part IV examines the degree of experience rating. Included in this discussion are both measurement issues and comments on the optimal degree of experience rating. Finally, a recent analysis of experience rating conducted by the U.S. Department of Labor, Office of Inspector General is reviewed in Part V.

Unemployment insurance can be described as a program that is only partly experience rated. There are valid reasons why it should not be fully experience rated, and these are discussed in Part IV. Nevertheless, I believe the degree of experience rating can and should be increased. Policy actions that would lead to increased experience rating are noted in Parts IV and V. State and federal policy actions already undertaken in the 1980s have greatly increased the range of tax rates which confront employers in several states and will lead to increased experience rating in future years. Additional changes in the structure of unemployment insurance taxes to further enhance the future degree of experience rating are discussed at the end of Part IV.

What will result from statutory changes that increase the degree of experience rating in unemployment insurance? Two consequences can be anticipated. (1) It will change the allocation of unemployment insurance costs across industries. As a matter of interindustry equity, I believe this would be a desirable change, i.e., future tax payments would more closely reflect the pattern of actual benefit cost experiences by industry. (2) It will lead to some lessening of layoffs, employee turnover and unemployment. The size of this effect is probably quite small (smaller than suggested by the studies reviewed in the Appendix), but it would help to make some reduction in unemployment.

I THE OBJECTIVES OF UNEMPLOYMENT INSURANCE

If a worker becomes involuntarily unemployed due to a layoff he or she is typically eligible to collect benefits from State Unemployment Insurance (or UI). This program was created by the Social Security Act of 1935 and is administered primarily by state employment security agencies. Unemployment insurance has been described as having three main objectives. Its primary objective is "to alleviate the hardships that result from the loss of wage income during unemployment." (Haber and Murray (1966) p. 26). The other two objectives are to stabilize the economy through maintenance of consumer purchasing power and to stabilize employment through experience rating of individual employers.

To achieve these objectives UI programs specify coverage, employer payroll tax contributions (plus employee contributions in four states) and benefit payments. Coverage is required for nearly all wage and salary workers in the private sector and in state and local government. Benefits to eligible unemployed workers may be paid for as many as twenty-six weeks and for longer periods when overall unemployment is high. Weekly benefits are determined by the worker's earnings during the pre-unemployment base period, but subject to weekly minima and maxima. States also determine the employer payroll taxes which finance the program. These taxes are partially experience rated so that benefit payment to former employees or related factors influence the employer's tax obligation. Although it is not a federal requirement all UI programs except Puerto Rico's experience rate their UI taxes.

The original authorizing legislation that led to the establishment of UI programs in the states (Title IX of the 1935 Social Security Act) provided for a Federal Unemployment Tax (or FUT) that was to equal 3 percent payroll in

covered employment and to be paid by all covered employers. The legislation also provided for a tax offset, up to 90 percent of the FUT or 2.7 percent of payroll, for state UI taxes paid by employers in states that established acceptable UI programs. If employers paid UI taxes to the state at a rate of less than 2.7 percent, they could still receive full credit for the maximum FUT tax offset provided their reduced state tax rate was based on experience. Thus the net FUT tax rate which employers paid to the federal government was .3 percent. The federal tax whose proceeds are used to defray the administrative costs of UI programs and the Employment Service (and some of the costs of long term benefits in recent years) has always been levied at the same rate on all employers in a given year. Experience rating affects the state taxes which finance benefit payments to unemployed workers. Originally, UI payroll taxes were levied on total payroll, but in 1940 the taxable wage base was set at \$3000 per employee to correspond with the wage base under the CASI (or Social Security) program.

This general arrangement for federal and state UI taxes has continued down to the present. In 1984, the net FUT tax rate was levied at a rate of .8 percent of taxable payrolls (wages up to \$7000 per covered employee), after the tax offset of 2.7 percent for state UI taxes. In 1985 the same net FUT rate continued to be in force, but the maximum offset doubled to 5.4 percent. Effective January 1, 1985 states were required to have a maximum state tax rate under experience rating of at least 5.4 percent in order to satisfy the requirements of federal law to receive the fully allowable credit of 5.4 percent against the FUT. Thus between 1938 and 1986, the net FUT tax rate has increased from .3 to .8 percent of taxable payroll, the gross FUT rate has increased from 3.0 to 6.2 percent and the tax offset (or the minimum

allowable maximum state tax rate under experience rating) has increased from 2.7 to 5.4 percent. The taxable wage base, set at \$3000 in 1940, is \$7000 in 1986.

Experience rating was introduced into UI programs to help in achieving three outcomes; (1) to serve as an incentive to stabilize employment, (2) to produce an appropriate allocation of the costs of UI benefits and (3) to encourage employers to participate more actively in the UI program. Under experience rating employers would be expected to participate more actively by helping to police the program against unjustified benefit payments and by influencing legislation.¹

The arguments for experience rating employer UI taxes were first advanced in the 1930s. Individual employers clearly have some control over the number of job separations. If they are experience rated, i.e., more job separations led to higher UI taxes, they will be more careful to stabilize employment and thereby avoid some costs of job separations. They would also be more likely to contest questionable UI claims if the associated benefit payments led to increased taxes. In practice, UI financing departs substantially from full or perfect experience rating. Some employers, in fact, incur no extra tax costs when they increase the number of layoffs.

The fact that UI programs are not fully experience rated raises several interesting and difficult questions. These questions are addressed in Parts III, IV and V. The next few pages will define some experience rating concepts, give brief descriptions of different experience rating systems and provide a necessary background for the remainder of the paper. Since I was trained as an economist the effects of experience rating on costs, prices and resource allocation will receive considerable attention.

II. EXPERIENCE RATING AND EXPERIENCE RATING SYSTEMS

Although unemployment insurance programs are found in all developed countries, the financing of UI with experience-rated employer payroll taxes is unique to the United States. In other countries UI programs are financed by income taxes or flat rate payroll taxes with contributions made by (some combination of) workers, employers and government. Since the UI payroll taxes levied in the U.S. are usually described as being only partially experience rated, it will be useful to discuss the concept of full or "perfect" experience rating.

There are three possible meanings of the term full experience rating. The first describes a situation where each dollar of benefits paid out in the current year causes the liable employer to reimburse the trust fund a dollar at the end of the year. This is a situation of fully reimbursable benefits and many governmental entities and nonprofit employers currently finance their annual UI benefits in this manner. Reimbursable employers do not maintain UI trust fund balances so that they have complete pay-as-you-go financing.

The second situation of full experience rating involves employers with UI trust fund accounts who experience a one dollar increase in future taxes each time there is a dollar increase in benefits paid to their (present or former) employees. The future tax obligation may be spread over one or more future years. This financing mechanism provides for a smoothing of tax payments through time and causes the program to have a countercyclical effect on the economy while at the same time maintaining full employer liability for benefit payments to their employees.

The third situation is akin to the second except that it also recognizes the present value to employers of tax deferrals. Topel (1984, p. 14) defines

full experience rating as a situation where a one dollar increase in benefit outlays causes a one dollar increase in the present value of future UI taxes. Because the future tax obligation is spread over several years the employer pays more than one dollar in extra taxes for each one dollar increase in benefit outlays. The difference in size between future undiscounted tax payments and present benefit payments grows as the tax deferral takes place over a longer period of time.

The actual situation in UI programs is that a one dollar increase in benefits often causes future (undiscounted) taxes to increase by less than one dollar. State UI programs have partial or imperfect experience rating under both the second and the third of the situations just described. Thus the term imperfect experience rating as it will be used in this paper means that a one dollar increase in benefits causes future (undiscounted) UI taxes to increase by something other than one dollar, i.e., those taxed at the maximum rate will pay less than one dollar while those at lower tax rates may even pay more than one dollar to replenish the fund. Full experience rating, on the other hand, will mean a dollar for dollar link between present benefits and future taxes. Since all regular benefits (and the state share of Federal-State Extended Benefits) have to be financed within the overall UI program, imperfect experience rating implies a degree of cross-subsidization of some employers by other employers.

Although experience rating of employer UI taxes is not a federal requirement that has been imposed on the states, fifty-two of the fifty-three programs (the fifty states, the District of Columbia and the Virgin Islands, but not Puerto Rico) have some type of experience rating. The U.S. Congress has been permissive in allowing the states wide discretion in structuring

their experience rating arrangements. Although employer tax rates are only partially experience rated, the U.S. Congress has never tried to impose uniformity on state experience rating provisions nor has it ever enacted major legislation whose main purpose was to change the degree of experience rating. State legislation has been primarily responsible for determining how experiences with benefit payouts affect employer UI taxes.

There are four distinct systems that UI programs use to experience rate employer taxes. These are termed the reserve ratio, benefit ratio, benefit-to-wage ratio and payroll decline (or payroll variation) systems. For the fifty-two jurisdictions that experience rate employer taxes the four systems are present in 32, 15, 4 and 1 states respectively. Reserve ratio and benefit ratio systems combine to account for more than 90 percent of total employment covered by UI programs.

A summary description of these four systems has been given by Haber and Murray (1966). A long quote from their book (pp. 335-336) provides a concise introduction to each system.

Reserve-Ratio Formulas. These were the earliest and still are the most common formulas for experience rating. For each employer an account is set up, to which his contributions are credited and against which benefits paid to his former employees are charged. The ratio of the resulting balance to the employer's annual payroll is then determined. This is the reserve-ratio. The balance (reserve) is usually carried forward from year to year, and represents the excess or deficit of contributions over benefits since the program began. The payroll factor used to determine the reserve-ratio is the annual average of total payrolls in the last three years.

The employer's reserve must reach a specified minimum ratio to annual payroll before reduced rates are assigned. A schedule of reduced rates is then applied, with the rate lowered as the reserve ratio ascends in size. Most of these states have several rate schedules, the schedule in effect depending on the size of the entire state fund, with a higher schedule going into effect if the total fund is depleted to a specified level and vice versa.

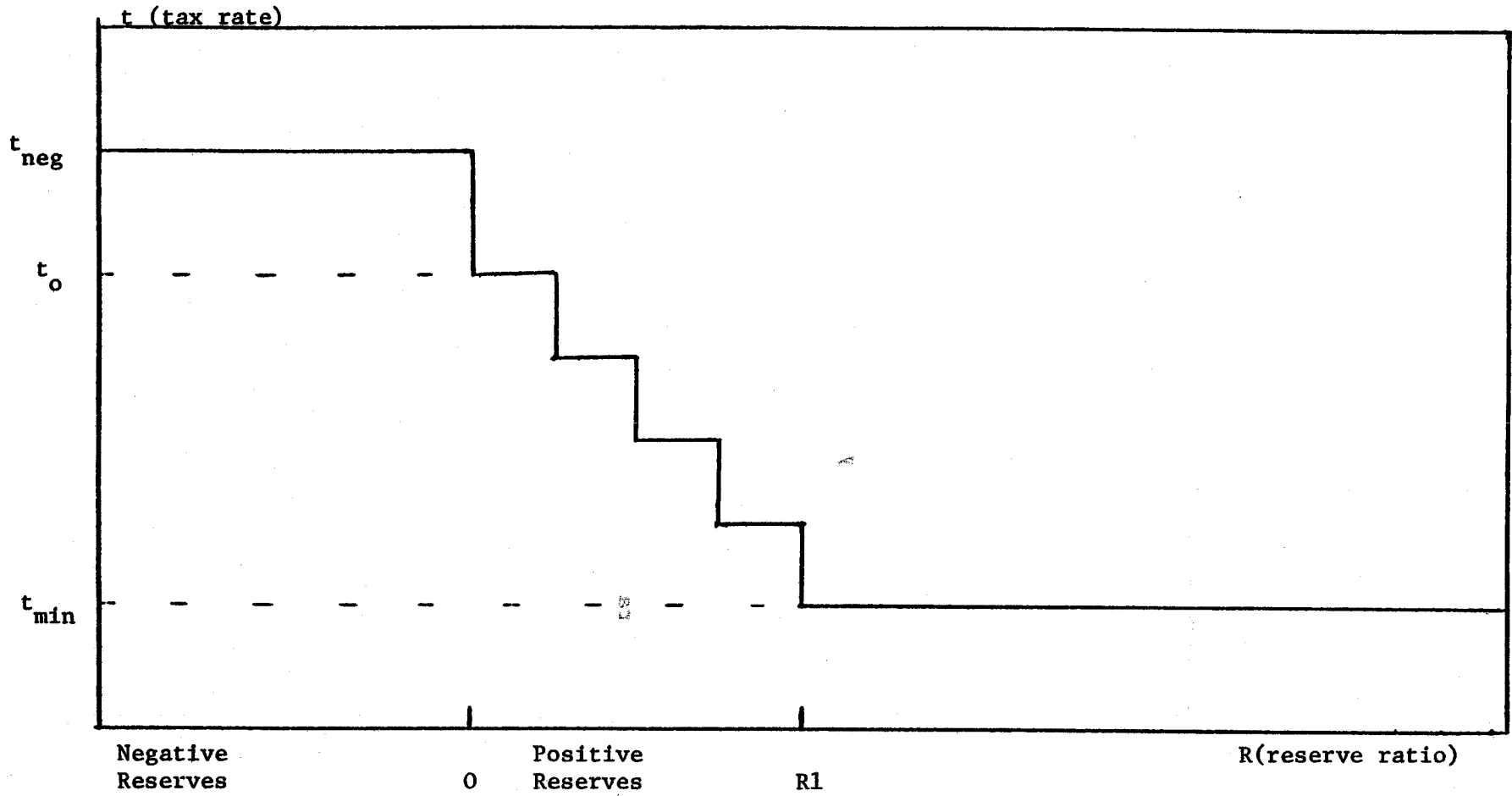
Benefit-Ratio Formulas. Under these formulas, benefits are directly related to payrolls, without taking contributions into account. Contributions are varied according to the ratio of benefits to payrolls, the theory being that if each employer's contribution approximates his benefit ratio, benefits will be adequately financed. Rates are varied according to several schedules in most of these states, depending on the size of the state fund.

Benefit-Wage-Ratio Formulas. These formulas measure the relative experience of different employers by the number of separations of workers who draw benefits. The duration of benefits paid to these is not a factor. The number of such separations from an employer times the total wages that have been paid to the separated workers during their "base-periods" are recorded for each employer as his "benefit wages." The ratio of these "benefit wages" totaled over the last three years to his total payroll during this period is determined once a year for each employer. This is the employer's "experience factor." A "state experience factor" is then determined by calculating the ratio of total benefit payments to total benefit wages in the state in the preceding three years. Each employer's tax rate is then determined by multiplying his experience factor by the state experience factor, according to a table. The rates in this table are designed to replenish the fund annually for all the benefits paid. The length of time an individual worker draws benefits is not taken into account in determining the rate for the individual employer. Through the application of the "state experience factor," each employer shares in the cost of the average state-wide duration of benefits. The cost of each separation varies with the wages paid to the separated worker, but not with the worker's individual duration of benefits.

Payroll Variation Plans. Finally, [Alaska] determine[s] tax rates on the basis of variations in payrolls, without any reference to whether benefits were paid to the employer's former workers. The theory is that payroll declines indicate an employer's "experience with unemployment," which is the measure specified in the federal act. Payroll declines are determined on a quarterly or annual basis. The quarterly basis indicates the amount of seasonal unemployment; the annual basis only general business declines. [In the past] Each state use[d] a different method of determining rates on the basis of the amount of any decline in each employer's payroll over the specified period.

From the preceding it is clear that experience rated tax rates are determined by a variety of methods. It is also clear that reserve ratio systems are by far the most common. Figure 1 is a graphic representation of

Figure 1. Tax Rates in a Reserve Ratio System



- t_{neg} - tax rate for negative balance employers
- t_0 - tax rate for employers with a zero trust fund balance
- t_{min} - the minimum tax rate
- R - the reserve ratio, the trust fund reserve as a fraction of taxable wages

the tax rate structure in a reserve ratio system. The reserve ratio is measured horizontally (the employer's trust fund balance expressed as a proportion of the employer's taxable wages) while employer tax rates are measured vertically.

Figure 1 shows that a minimum tax rate (t_{\min}) is charged when the fund balance exceeds a certain level (R_1). Below this level, a decrease in the fund balance causes the tax rate to increase. The tax function in this range consists of a series of steps which increase until a tax rate of t_0 is reached when the fund balance is zero. The figure also shows that a higher tax rate (t_{neg}) is levied on employers with negative balances.

Figure 1 should be viewed as illustrative and many other variants are possible. For example, t_{neg} and t_0 may be the same tax rate or the tax schedule may have a continuing progression of rates as negative balances become more negative. There may be few or many tax rates in the range between 0 and R_1 . The entire schedule of rates may automatically shift upward or downward when the state's overall trust fund balance changes. Whatever the statutory arrangement is in a particular state, for any given year there is a minimum and a maximum rate and a progression of intermediate rates.

The tax rates t_{\min} and t_{neg} in Figure 1 are important to highlight. When the trust fund is between 0 and R_1 an increase in layoffs (and associated UI claims) will reduce the trust fund balance and lead to higher employer taxes. When the employer is taxed at the rates t_{\min} and t_{neg} , however, extra layoffs do not cause tax rates to change (unless employers taxed at the minimum rate have their balance fall below R_1). When these tax rates apply, the employer is found with a zero marginal (tax) cost of layoffs. Because many employers are taxed at the minimum and maximum rates, UI is commonly

described by economists, actuaries and others as a program with partial or imperfect experience rating.

III. THEORETICAL AND POLICY ISSUES

To provide some perspective on experience rating in State UI programs, it will be useful to examine four topics; (1) interindustry subsidies, (2) the incidence of employee UI taxes, (3) effects on employee turnover, and (4) the current solvency status of the UI programs. The order of these four topics is somewhat arbitrary. Their sequencing can be justified in reference to the following questions. How big are the interindustry subsidies caused by the present UI tax system? What would be the economic effects of changing to a more fully experience rated UI system? How will experience rating be affected by recent legislative changes undertaken in the states to improve the solvency of their programs? Improving program solvency is a paramount UI policy concern in the 1980s. Attempts to achieve solvency that modify tax schedules and the taxable wage base can affect the degree of experience rating.

A. Interindustry Subsidies

Several studies have examined the pattern of interindustry subsidies arising from the procedures used by the states to determine UI taxes. Employers in construction pay substantially less in UI taxes than the benefits paid to unemployed construction workers. The reverse holds for many employers in the retail trade and service industries. Probably the most well known study of this phenomenon was conducted by Becker (1972). His Appendix A presents data on benefit cost rates and tax rates for many states at several levels of industrial detail. These data cover the period from 1957 to 1967. Munts and Asher (1980) examined twenty-one states over the 1969-1978 period and present data at the one digit and two digit level of SIC (Standard Industrial Classification) detail. Most recently the Office of Inspector

General of the U.S. Department of Labor (1985) examined data for the period from 1970 to 1983.

The measure of net subsidy to be used here is the difference between benefit outlays and tax payments expressed as a percentage of taxable payrolls. Becker shows both benefits and taxes as a percent of taxable payrolls while Munts and Asher show just the net difference. We will utilize the Munts-Asher data because they refer to a more recent time period.

Ideal data for illustrating the pattern and size of the interindustry subsidies would be data from UI programs where overall trust fund balances were unchanging. In such data the pluses and minuses for individual industries when summed across all industries would net out to zero. For each industry one could then determine how much was gained or lost vis a vis other industries.

Table 1 presents data at the two digit level of SIC detail that partially illustrate the pattern of interindustry subsidies. These data are based on sixteen of the twenty-one states in the Munts-Asher study. Three small states were omitted because their data did not have two digit detail while two large states (Michigan and New York) were omitted because their trust funds declined sharply over the 1969-78 period. For the remaining sixteen states positive net subsidies (industries where benefit payments exceed taxes) were \$3.0 billion while negative net subsidies totaled \$2.3 billion.² Thus the aggregate trust fund balance for the sixteen states was reasonably constant.

Table 1 displays data for just fifteen of the two digit industries. The industries were selected using three criteria; (i) large positive net subsidies, (ii) large negative net subsidies and (iii) UI taxes were a large

Table 1

Selected Data from Sixteen States on Interindustry Subsidies, 1969-1978^a

Major Industrial Division, SIC Code and Detailed Industry	Number of States (1)	Number with a Positive Subsidy ^b (2)	Proportion with Positive Net Subsidy ^b (3)	Average Net Subsidy (Percent of Taxable Payroll) ^c (4)
<u>Construction</u>				
15. General Construction	11	10	.91	2.19
16. Heavy Construction	11	11	1.00	4.80
17. Special Trade Contractors	10	9	.90	1.18
<u>Manufacturing</u>				
22. Textiles	15	11	.73	.45
23. Apparel	15	14	.93	.78
24. Lumber	16	12	.75	.55
31. Leather	15	12	.80	.61
<u>Transportation</u>				
41. Local Passenger Transit	13	7	.54	.02
48. Communication	13	0	.00	-.72
49. Electricity, Gas and Sanitation	13	0	.00	-.77
<u>Trade</u>				
53. General Merchandise Stores	13	2	.15	-.41
58. Eating and Drinking Places	12	4	.25	-.21
<u>Services</u>				
70. Hotels, Lodging Places	13	8	.62	.04
80. Medical, Health Services	12	0	.00	-.61
81. Legal Services	12	0	.00	-.99

^aSource: Data taken from Munts and Asher (1980), as described in the text of this report. Net subsidies are defined as benefit payments less employer UI taxes and measured as a percent of taxable payroll.

^b States where benefits by industry exceeded UI taxes

^c Simple average for the number of states shown in column (1).

percentage of employer costs when compared to the all industry average. (More will be said about UI taxes as a cost factor in later paragraphs.) Column (1) shows how many of the sixteen states supplied two digit data for the indicated industries while column (2) shows the number of states where that industry had a positive net subsidy. The proportion of states providing a positive net subsidy to the industry appears in column (3), and finally, a simple (unweighted) average of the net subsidies appears in column (4).

Three things are most obvious in Table 1. (1) The largest net subsidies are the positive net subsidies received by construction employers. For employers in heavy construction (SIC 16) the average is nearly 5 percent of taxable payroll. Outside of construction, not one of the other averages (either positive or negative) is as large as one percent of taxable payroll. (2) Positive subsidies are also received by the four manufacturing industries shown in the table. (3) Several industries with low unemployment rates (SIC codes 48, 49, 80 and 81) have negative net subsidies in every state for which there were data. These results are not surprising to those familiar with UI financing. More striking illustrations of positive and negative net subsidies can be found when data are examined for more detailed (three and four digit) industry classifications. Construction is the biggest gainer from the financing system while agriculture, mining and manufacturing also generally receive positive net subsidies. The loser industries are generally found in transportation, trade and services.

It should also be noted that some industries with high unemployment do not receive large net subsidies. Three industries where unemployment is generally high and employer UI taxes are "large" (SIC 41, 58 and 70) were included in the table to illustrate this point. Movement to a more fully

experience rated financing system would undoubtedly affect many employers in these industries (some incurring higher taxes but lower taxes for others) but total tax revenues raised from such industries would not change much.

The system of UI financing as it currently exists can be viewed as having two types of subsidies; within industries and across industries. The distinction between the two types of subsidies is useful because it facilitates a discussion of the type of insurance provided by State UI programs.

Within a given industry employers are substitutes in supplying goods and services to their customers. If, for example, two employers bid for a contract, the losing bidder may have to lay off some workers. His bad luck is compounded if experience rated UI taxes then increase as a result of the layoffs. Reasonable people can disagree about the extent of the successful bidder's responsibility for the unemployment arising from the unsuccessful bidder's layoffs. (This is not the place to introduce a discussion of luck, skill and other factors that may have influenced the contract award). It is much less controversial, however, to suggest that the costs of UI benefits in the industry should be paid by the employers in that industry. Those knowledgeable about unemployment insurance would more generally agree that entire industries should not receive net subsidies than that individual employers within an industry should not receive net subsidies.

The pattern of net subsidies across industries as illustrated in Table 1 represents a very serious problem in the current method of financing UI benefits. It is difficult to advance a convincing argument why an industry like construction should receive a net subsidy year after year for the benefit payments made to unemployed construction workers. One way to eliminate interindustry subsidies would be to fully experience rate each employer in

each industry. Other tax arrangements could also cause the net subsidy to an industry to be zero but allow for cross subsidies within industries, i.e., between employers with low cost and high cost experiences. Any change that eliminated the interindustry subsidies would lead to higher average UI taxes for construction industry employers. Their taxes could be increased by raising the maximum tax rate, increasing the taxable wage base or some combination of the two.³ Employer responses to changes in UI taxes are discussed in the next two sections of this paper.

B. The Incidence of UI Taxes⁴

If the financing of UI benefits evolves towards greater reliance on experience rated taxes, average employer tax rates will rise in several industries. Increases will occur in all construction industries (but especially in heavy construction) and in many manufacturing industries. Employer responses to increased UI payroll taxes can be classified into two broad categories. (1) Employers can try to shift the burden of increased taxes onto other economic agents. The analysis of how taxes affect wages, prices and profits is termed tax incidence, and it will be examined presently. (2) Employers may try to reduce occurrences of unemployment in order to reduce their UI taxes. The effect of UI on worker turnover and unemployment will be examined in the next part of the paper. There is a body of recent research which concludes that the UI system causes unemployment because imperfect experience rating leads to excessive numbers of temporary layoffs and needless turnover of workers. A key (but unproven) assumption of that research is that higher UI taxes cause a reduction in profits. To avoid reduced profits employers are motivated by economic incentives to change their layoff policies. The link between UI taxes and profits will be our present concern.

All but four UI programs are financed completely by employer payroll taxes. The four exceptions are the programs in Alabama, Alaska, New Jersey and Pennsylvania where employees also make contributions. Thus, from a purely accounting standpoint there is no question that UI benefits are financed almost totally by employer payroll taxes.

The final incidence (that is, ultimate burden) of benefit financing, however, need not coincide with the nominal incidence. An employer obliged to make a payroll-related UI tax contributions need not passively accept a reduction in profits. The employer can attempt to shift the real burden of the tax by raising the selling prices of the firms' products or by reducing the prices paid for labor and other inputs into the production process. These two responses, designated as forward and backward shifting, effectively shift the burden of the tax to some other economic agents. When shifting occurs, the other agents in fact bear the real burden of the tax, that is, reduced command over resources or lower real income. In other words, the ultimate burden can differ from the initial nominal incidence of employer UI taxes.

The ultimate burden of employer UI taxes is not clearcut. Instances of all three possible outcomes (no shifting, backward shifting, and forward shifting) undoubtedly occur among individual firms. If no shifting takes place, output prices, wages, and other input prices are unaffected, and the tax causes a reduction in the firm's profits. The ultimate burden rests with the owners of the firms, who suffer a reduced rate of return on their financial investment. In the longer run, they may decide to invest elsewhere, spreading the burden more generally to the owners of capital.

Backward shifting means that the ultimate burden of the employer tax resides with the factor inputs in the firm's production process. Since labor

is usually the main productive input, wage rates of the firm's workers are reduced, or, more accurately, their rate of increase is reduced. If the tax is shifted fully backward onto wages, the input costs to the employer, output prices, and profits are unaffected. The UI program could then be characterized as a risk-sharing insurance arrangement among workers. Backward shifting causes the income of all workers to decline somewhat in order to provide benefits to unemployed coworkers. The extent of the general wage reduction depends on the number of beneficiaries as well as the level and duration of UI benefits.

When employers face a strong union or employees who are unwilling to incur a slower rate of wage growth, it may be difficult or impossible to shift the burden of UI taxes backward onto wage rates. To avoid reduced profits, the employer might decide to try to shift the cost of UI taxes forward as product price increases. In the aggregate, the average price of final goods would rise, and the ultimate burden of the contributions would fall most heavily on units who spend the highest fraction of their income, that is, low-income persons and families. When forward shifting occurs, much of the economic burden as well as the gain from UI benefits falls on low-income units in the economy.

Forward shifting of employer payroll contributions can affect the relative prices of products as well as the overall or average price level. Under forward shifting employers with higher than average UI taxes would find their prices increasing relative to other prices. In a market economy where customers have the information to compare relative prices, such firms could experience a reduction in the demand for their products.

What is known about the relative importance of these three possible responses (no shifting, forward shifting, backward shifting) to UI payroll taxes? To date, there has been no serious empirical research into the incidence of UI payroll taxes. Some empirical studies have combined UI taxes with other employer payroll taxes (largely OASDHI or social security taxes which account for much larger amounts of employer payroll taxes) to test for backward shifting. These studies have reached widely divergent conclusions.⁵ More empirical work is needed on this question.

The main theoretical model of tax incidence, first developed by Harberger (1962), reaches the general conclusion that a tax on labor such as the UI payroll tax is ultimately borne by workers. This can take the form of either backward shifting onto money wages or forward shifting to higher prices, but the direction is not specified. The theoretical model concludes that the least likely outcome is for higher payroll taxes to cause a reduction in profits. This conclusion is sometimes paraphrased as "a tax on a factor is borne by that factor."

In a social insurance program like UI that levies taxes and pays benefits an important determinant of the direction of tax shifting is knowledge that the taxes and benefits are linked. Backward shifting onto wages is more likely when workers are aware of the benefits paid by the program. This would seem to make backward shifting more likely in an industry like construction where workers frequently collect UI benefits. When receipt of benefits is fully preceived, an increase in employer UI taxes can be fully offset by slower growth of money wages and leave employer labor costs unchanged.

Even if higher UI payroll taxes do reduce profits in the short run on a dollar for dollar basis there is more than one long run employer response to

consider. (1) Employers could change their layoff behavior and reduce UI costs arising from the layoffs. (2) Employers could also consider substituting capital for labor in response to higher labor costs caused by higher UI taxes. Either or both of these responses could occur in the long run.

The preceding discussion of UI tax incidence is not at all conclusive. The reason for this is the complicated nature of the subject matter and the paucity of empirical research finding pertinent to this tax incidence question.

Suppose UI taxes were to become more fully experience rated. What would happen? (1) Tax rates by industry would change with Table 1 giving some indication of what industries would be gainers and losers. (2) What would happen to profits in the short run? They probably would decline in industries where taxes were raised, but the declines would be less than dollar for dollar in response to the increased taxes. Employers would try to shift the tax burdens backward (lower wages) or forward (higher prices) in order to avoid an effect on profits. Some tax shifting would undoubtedly occur. Backward shifting would be most likely in industries where workers were frequent recipients of UI benefits. (3) To the extent that higher UI taxes do reduce profits companies could respond in the longer run by substituting capital for labor in production as well as by changing their degree of reliance on temporary layoffs. The link between increased experience rating and reduced reliance on layoffs is not as apparent as it might seem when the incidence of UI payroll taxes is considered.

C. Effects on Employee Turnover

As noted in Part I, one of the major objectives of unemployment insurance is to stabilize employment through experience rating of covered employers.

Benefit payment to former employees are made from the state's unemployment trust fund. The unemployment trust fund consists of individual employer accounts plus a general account (or common fund) that are supported by employer payroll taxes. This institutional arrangement is intended to encourage employee retention through an explicit financial connection between benefit payments and subsequent employer taxes. Thus, increasing the degree of experience rating would be expected to reduce employee turnover.

In the past decade, several economists have examined the linkages among imperfect experience rating, employee turnover, and occurrences of layoff unemployment. The main theoretical work on these relations has been done by Baily (1977), Brechling (1977) and Feldstein (1976). A common finding of their separate theoretical analyses is that incomplete experience rating of unemployment insurance payroll taxes leads to needlessly high labor turnover. Profit-maximizing employers will place greater reliance on temporary layoffs when they are not fully liable for the costs of the associated state unemployment insurance benefits. These models include an experience rating parameter e . As e approaches unity (indicating a greater degree of experience rating) the firm's optimal rate of employee turnover declines.

To date, there have been just a few empirical tests of how experience rating affects employee turnover. Feldstein (1978), Halpin (1980) and Topel (1984) have focused on unemployment arising from employer layoffs while Brechling (1981) directly examined layoff and rehire rates.⁶ Each study concludes that imperfect experience rating is a significant determinant of employee turnover and that an important fraction of total unemployment is caused by imperfect experience rating.

For the three studies that examined effects on unemployment it is useful to first define the major categories of unemployment. The labor force survey of households conducted each month for the U.S. Labor Department by the Bureau of the Census routinely publishes data on four major unemployment categories; job losers, job leavers, labor force reentrants and new entrants into the labor force. Job losers constitute the largest category, 36 percent of the total in the low unemployment year 1969, but 59 percent of the total in the high unemployment year 1982. Job losers, in turn, fall into three categories; those on temporary layoff (expecting recall within 30 days), those on indefinite layoff and "all other" job losers. Typically, researchers have combined workers in the temporary and indefinite layoff categories for purposes of studying what they call temporary layoffs. To avoid confusion, the term layoff unemployment will be used here in reference to all unemployed people on (temporary and indefinite) layoff.

The size of the effects on unemployment found in these studies is worth nothing. Feldstein concluded that the layoff unemployment rate of 1.6 percent observed among men aged 25-54 in March 1971 would have been reduced by roughly half if employers were fully experience rated.⁷ Halpin did not provide an overall summary estimate of the effect on layoff unemployment, but he too concluded it would be reduced substantially if the effectiveness of the maximum employer tax rate was raised (Halpin (1980), p. 421). The largest effect was found by Topel. In data for the five year period 1977-1981 the unemployment rate for all male job losers and job leavers aged 20-64 was 5.16 percent. He estimated this average would be reduced by 1.49 percentage points (or 29 percent of the total) if employers had been fully experience rated. (Topel (1984), p. 51). Finally, Brechling estimated the elasticity of

temporary layoffs with respect to the maximum tax rate levied on negative balance employers was about .55. Thus an increase in the maximum rate (NEG-TAX in his terminology) from 3.4 to 3.74 percent would reduce layoff unemployment by as much as 7 percent from its existing level (Brechling (1981) p. 202). The size of these estimated effects suggests that large reductions in employee turnover and layoff unemployment could be realized if UI programs became more fully experience rated.

The Appendix of this report reviews each of the four papers. It makes comments on the methodology and data used by the four researchers. My conclusion from this review is that each of the authors may have overestimated the potential effects of increased experience rating on employee turnover. There are four bases for this conclusion. (1) The theoretical exposition of the experience rating-employee turnover argument stresses the motivation of individual employers in deciding on their optimal level of layoffs. All of the empirical research, however, has measured the employers' UI taxes with industry data or with statutory tax rates taken from the state's UI tax schedule. Because these averages are used rather than the individual employer tax rates, they do not identify the marginal cost of layoffs that individual employers actually experience. The problems raised by this and other mismeasurement issues are discussed more fully in the Appendix. (2) The heaviest occurrences of layoff unemployment are observed in recessions. Employers, faced with difficult cost cutting decisions, might not be greatly influenced if their UI taxes were more fully experience rated. A discussion of the place of UI taxes in employer costs is given in subsequent paragraphs. (3) The studies of layoff unemployment have assumed that all unemployed persons on layoff receive UI benefits. In fact, reciprocity rates

vary by age, by state and by unemployment duration. This too raises a question of measurement error which is discussed in the Appendix. (4) The specification of the estimating equations can be questioned. Adding other explanatory variables, e.g., a control for the seasonality of industry employment, could change the estimated effects of UI taxes on turnover. Given the seriousness of these problems the results presented in the four papers can be questioned. More research and replication of the earlier studies are needed before we can have confidence in the accuracy of the findings. UI taxes undoubtedly affect turnover, but the size of the effect could be considerably smaller than suggested by these studies.

The place of UI taxes in the overall labor cost structure of employers is illustrated with the data that appear in Table 2. The data are from a former U.S. Labor Department Survey of Employer Expenditures for Employee Compensation (EEC) in which a tabulation by industry identified fifty-two two digit industries.⁸ Most industries included in Table 2 were selected because UI costs were a high percentage of total labor costs. Construction was included because it was obvious from Table 1 that full experience rating would cause UI taxes to rise substantially in the construction industry.

When they are measured relative to total labor costs the UI taxes paid by covered employers are clearly a small component of the total. They averaged only 9 cents per hour across all private industries in 1977 or 1.2 percent of total employee compensation. There were only eight detailed industries where UI taxes were as large as 1.8 percent of total compensation and all eight are identified in Table 2. The percentage breakdown of employer costs into six separate components is intended to identify the large labor cost components. Besides the largest category, pay for time worked, there are three major

Table 2

Employer Costs of Employee Compensation in Selected Industries, 1977^a

SIC Code and Detailed Industry	Hourly Costs		Percentage Breakdown of Employer Costs					
	Total Compen- sation	Employer UI Taxes	Pay for Time Worked	Paid Leave ^b	Retire- ment Programs ^c	Life Ins. and Health Benefits ^d	UI Taxes	All Other Costs
01-89. Private Industries	7.43	.09	76.7	6.1	8.5	6.0	1.2	1.4
07-09. Agricultural Services	5.34	.11	80.7	3.9	6.9	6.3	2.0	.0
15-17. Construction	9.47	.13	80.0	3.6	8.8	6.3	1.4	.8
23. Apparel	4.82	.10	80.3	5.6	7.2	3.9	2.0	.9
31. Leather	5.38	.10	78.4	6.1	7.2	5.6	1.8	.9
41. Local Passenger Transit	7.09	.14	79.7	3.5	8.9	5.6	2.0	.1
53. General Merchandise Stores	4.58	.09	79.6	5.7	7.5	5.0	1.9	.2
58. Eating and Drinking Places	3.77	.09	85.8	2.1	5.9	3.5	2.5	.2
70. Hotels, Lodging Places	4.26	.10	83.0	3.5	5.9	4.9	2.4	.2
78-79. Motion Pictures, Amuse. and Recreation	6.08	.12	82.6	3.7	7.0	4.0	2.0	.6

^aSource: Unpublished tabulations from the former U.S. Labor Department Survey of Expenditures for Employee Compensation

^b Vacations, holidays, civic and personal leave.

^c Social Security (OASDHI) and private pensions.

^d Life insurance, health insurance, sick leave and workers' compensation.

fringe benefit categories; paid leave, employer payments for retirement programs and employer payments for life insurance and health insurance benefits. On average, each of these three fringe benefits is at least five times the size of employer UI taxes.

Generally, the industries where UI taxes are at least 1.8 percent of total labor costs tend to be low wage industries. In the Labor Department survey, thirteen of the fifty-two detailed industries had hourly compensation costs below \$6.00. Six of the thirteen appear in Table 2. Hourly compensation in 1977 was less than the \$7.43 all-industry average for all eight industries in Table 2 where UI taxes are at least 1.8 percent of total labor costs.

Tables 1 and 2 combined provide the information needed to make calculations regarding the costs of movement to a system of full experience rating. Recall from Table 1 that the industries with the largest net subsidies were the three 2 digit construction industries and apparel and leather in manufacturing. The former three are combined in the EEC data of Table 2. A rough calculation suggests that under full experience rating, UI taxes would increase to 2.5 percent of total compensation costs in construction and to 2.5 percent and 2.2 percent of compensation costs in apparel and leather respectively.⁹ Thus, even under full experience rating UI taxes would not increase to as much as 3 percent of total labor costs in any industry identified in Table 2.

The labor cost detail given in Table 2 provides useful background for considering how employer layoff behavior would be affected under a system of full experience rating. When production declines and an employer contemplates making layoffs there could be an impact arising from an increased degree of

experience rating. Regardless of the employer's experience rating situation, a decision to lay off some workers would lead to labor cost savings in pay for time worked and all of the other fringe benefit cost categories (besides UI taxes) identified in Table 2.¹⁰ Compared to the labor cost savings to be realized on pay for time worked and the other fringe benefits, it would seem that the increased costs of UI taxes caused by full experience rating usually would not be sufficient to prevent the layoffs from taking place. After a review of the various labor cost categories one could be highly skeptical regarding claims that full experience rating would have large effects on employer layoff behavior and the amount of layoff unemployment.

To conclude this section, it would seem that movement towards full experience rating would reduce the amount of turnover in the labor force. The size of the effect, even under a UI tax system with full experience rating, however, might be quite small. Empirical research into the question is not fully convincing. Also, a consideration of all the labor costs incurred by employers (as shown in Table 2) provides a basis for skepticism regarding claims of large effects on turnover from full experience rating. Payroll tax incidence questions provide a third basis for skepticism about assertions of large reductions in labor turnover arising from full experience rating.

The preceding does not mean that the status-quo in the current system of UI taxation is desirable or that greater experience rating is not desirable. There does not seem to be a good reason why construction industry employers should be subsidized by employers from other industries. From Table 2 it is clear that construction is a high wage industry. Nearly all of its employers could make the full nominal tax payments associated with the UI benefit costs of their layoffs (particularly if they do not incur the full incidence of the

increased UI taxes). Increased tax payments could be achieved by various combinations of increases in the maximum tax rate and increases in the taxable wage base. After experiencing a large increase in UI taxes caused by full experience rating, however, construction employers might not make large changes in their current practices regarding layoffs.

D. Current Financing Problems of UI Programs

State UI programs in 1986 are emerging from a period where the back-to-back recessions of 1980 and 1981-82 caused a very heavy and sustained demand for benefits. Many states had to borrow from the U.S. Treasury in order to pay UI benefits. Borrowing was especially heavy in 1982 and 1983 when loans totaled \$5.2 billion and \$6.6 billion respectively. Even in the recovery years 1984 and 1985 loans to UI programs totaled \$3.0 billion and \$2.6 billion respectively. Total borrowing for the six year 1980-85 period was \$20.5 billion.¹¹

Because recent borrowing has been so widespread the net reserve position of the UI system as a whole is very weak. Net trust fund reserves (the difference between total reserves and total debt owed to the U.S. Treasury) across the 53 programs (the 50 states plus the District of Columbia, Puerto Rico and the Virgin Islands) stood at -\$5.8 billion at the end of 1983, \$2.2 billion at the end of 1984 and only \$10 billion at the end of 1985. At present, low levels of net reserves are found in nearly all states. Practically every state has a major need to build reserves in the next few years to avoid a repetition of large scale borrowing the next time the economy has a recession.

Since April 1982, the federal loans to debtor state UI programs have carried interest charges. This change in the terms of federal lending

(previously loans were interest free) has had a clear effect on state behavior regarding debt repayments. Between April 1982 and December 1985, the states borrowed \$15.6 billion, but as of December 31, 1985 only \$1.6 billion of interest bearing loans was still outstanding.¹² In future years, the states will be more reluctant to borrow and incur UI debts than they were prior to April 1982.

In light of the financing problems of the early 1980s several states have recently enacted legislation to improve UI program solvency.¹³ The scale of the legislative changes has been especially large in the states with the largest UI debts. Typically the legislative changes have included both UI tax increases and benefit restrictions. Restrictions in benefit availability partly explain why insured unemployment has been usually low in the early 1980s.¹⁴

The macroeconomic developments, financing problems and legislative changes of the early 1980s all have implications for an analysis of experience rating in UI programs. Because of the recessions of 1980 and 1981-82 employers have generally experienced reductions in their trust fund balances since 1979. The fraction of employers with negative trust fund balances has risen as has the fraction of benefits paid out by negative balance employers. These changes, however, are due primarily to macroeconomic performance (the recessions and attendant increased demand for UI benefits) and not to changes in experience rating in the states. With unchanged tax schedules the fraction of payments made by negative balance employers will automatically fall as the economy recovers, benefit payments decline and trust fund reserves are rebuilt. In other words, the importance of payments made by negative balance employers strongly reflects the overall level of a state's

trust fund balance which, in turn, is strongly influenced by the business cycle. If State UI is to perform as an automatic stabilizer of the economy, trust fund balances have to fall in periods of economic recession.

Since 1969, UI programs have generally experienced a loss of trust fund reserve adequacy. The general decline in fund reserves has also contributed to an increased fraction of benefits being paid by negative balance employers. Because reserve ratio multiples¹⁵ (the common actuarial measure of fund adequacy) have trended downward, states have increasingly had to borrow in order to pay benefits during recessions. Thus, the loss of reserve adequacy has also contributed to increases in the fraction of benefits being paid from the accounts of negative balance employers.

Now that states are under strong financial pressures to avoid trust fund debts and borrowing, they are raising tax rates to replenish their trust fund balances. The tax increases have been especially large in states with negative fund balances. States need to raise revenues and one common method is to increase the flat rate taxes levied on all covered employers. This form of solvency tax is now present in several states, and typically it will be levied for only a few years until trust funds are rebuilt to more acceptable levels.

If the predominant type of tax change being made in the states was to institute flat rate solvency taxes, this would tend to decrease the potential degree of experience rating. In terms of Figure 1, the level of the minimum tax rate would rise and the point where the minimum tax rate was imposed (R_1) would also move to the left. An important point to consider, however, is what happens to the maximum tax rate (t_{neg} in Figure 1)? If just the minimum rate changes then the potential degree of experience rating would decline because the potential range of tax rate variation would be reduced.

Table 3 presents information on minimum and maximum employer UI tax rates for five years; 1970, 1980, 1982, 1984 and 1985. The data refer to rates applicable in the 50 states plus the District of Columbia. On average, minimum tax rates did increase during these years. Note that minimum rates rose between 1980 and 1984 and then declined in 1985. The simple average for the 51 programs (which weights each state equally) increased from .92 percent in 1980 to 1.23 percent in 1984 and then declined to .97 percent in 1985. The decline in 1985 is undoubtedly influenced by the economic expansion which increased trust fund balances in nearly all states. Minimum tax rates have declined due to automatic shifts in state tax schedules (in states with multiple schedules), discretionary state actions and the expiration of certain emergency taxes.

Table 3 shows that maximum employer tax rates increased substantially between 1970 and 1985 and by much more than the increases in minimum tax rates. The simple average of the maximum rates roughly doubled, increasing from 3.42 percent in 1970 to 6.96 percent in 1985. More than half of the increase occurred during 1980-85 as states were rapidly adjusting maximum rates in response to their financing problems..

In 1985 states were required by federal law to have a maximum rate under experience rating of at least 5.4 percent. The fifteen states in the 4.51-5.40 percent category of Table 3 had the minimum allowable rate for the year. The thirty-six other jurisdictions had a maximum employer tax rate that exceeded 5.4 percent in 1985. Thus the federal requirement mandating a 5.4 percent maximum rate has affected several states, but state-initiated tax changes of the 1980-84 period had a larger impact in raising maximum tax rates than did this federal requirement.

Table 3

STATE UNEMPLOYMENT INSURANCE TAX RATES FOR
COVERED EMPLOYERS, 1970, 1980, 1982, 1984 and 1985

	Minimum Employer Tax Rate (Percent)						Simple Average
	0-.20	.21-.60	.61-1.00	1.01-1.50	1.51-2.00	2.01 and Above	
1970	28	13	7	3	0	0	.35
1980	13	10	9	7	6	6	.92
1982	14	8	8	9	4	8	1.02
1984	8	8	10	8	6	11	1.23
1985	12	10	9	7	7	6	.97

	Maximum Employer Tax Rate (Percent)						Simple Average
	2.70-3.00	3.01-3.60	3.61-4.50	4.51-5.40	5.41-7.00	7.01 and Above	
1970	22	11	16	1	1	0	3.42
1980	5	8	14	8	14	2	4.83
1982	3	4	16	9	14	5	5.14
1984	0	2	12	7	16	14	6.20
1985	0	0	0	15	18	18	6.96

	Range of Employer Tax Rates (Percent)						Simple Average
	3.0 or Less	3.01-3.50	3.51-4.00	4.01-5.00	5.01-7.00	7.01 and Above	
1970	29	8	9	4	1	0	3.08
1980	15	8	7	11	9	1	3.92
1982	11	6	9	11	12	2	4.12
1984	7	5	10	6	16	7	4.97
1985	2	1	1	11	23	13	5.98

SOURCE: Data for 1970 and 1980 taken from U.S. Department of Labor, "Significant Provisions of State Unemployment Insurance Laws, July 4, 1971 and July 5, 1981" (Washington, D.C.: GPO 1981). Data for 1982 and 1984 taken from Unemployment Benefit Advisors (UBA), "Highlights of State Unemployment Compensation Laws," January 1982 and January 1984 (Washington, D.C.: UBA, 1982, 1984). Data for 1985 taken from Commerce Clearing House, Inc., Unemployment Insurance Reports (Chicago, Ill.: Commerce Clearing House, 1986), pp. 4803-04.

Because maximum tax rates increased more rapidly than minimum rates, the average range of tax rates increased sharply between 1970 and 1985. The simple average of the 51 ranges increased by .84 percentage points between 1970 and 1980, by 1.05 percentage points between 1980 and 1984 and by an additional 1.01 percentage points between 1984 and 1985. During these 15 years the average range of tax rates nearly doubled and most of the increases occurred between 1980 and 1985. Although trust fund balances declined sharply in the early 1980s and an increased share of benefits were paid by employers with negative balances, the structure of UI tax rates evolved in a direction that will cause an increased degree of experience rating in future years.

The tax rate changes shown in Table 3 describe statutory tax rate changes across all 51 state programs. Tax rate changes have been very large in the states that have experienced the most severe funding problems in the 1980s. In the ten states with the largest trust fund debts at the end of 1983¹⁶, the 1980-85 changes in average tax rates were as follows. The average minimum rate rose from .69 percent to 1.16 percent. The average maximum rate rose from 5.57 percent to 8.02 percent and the average range of tax rates increased from 4.89 percent to 6.86 percent. As a consequence of recent legislation negative balance employers in these states will pay much higher future tax rates than they did in the late 1970s.

The main conclusion of this section, then, might appear to be a paradox. If one examines benefit payments made by negative balance employers, it would appear experience rating has declined in the 1980s. This interpretation would not be correct, however, because the increase in the proportion of such payments reflects cyclical downturns and the effects of a long run decline in average trust fund balances. When the structure of

employer UI tax schedules is examined it is apparent that the range of tax rates has increased and that the potential degree of experience rating has increased because of recent changes in state tax schedules.

IV. THE DEGREE OF EXPERIENCE RATING

A departure from full experience rating as the term is used in this paper occurs whenever a \$1 increase in benefit payments to a UI claimant does not result in a \$1 increase in future payroll taxes paid by the claimant's former employer. There are two broad categories of benefit payments that signal a departure from full experience rating; noncharged benefits and ineffectively charged benefits. Before examining the question of the optimal degree of experience rating it will be useful to discuss these two benefit categories and some measurement issues.

A. Noncharged Benefits

Noncharged benefits are benefit payments that are not charged to individual employer accounts. Some of these payments arise from circumstances and conditions that are beyond the control of employers while other benefit payments are deemed to be socially desirable. The financing of these benefits is felt to be a common responsibility, independent of individual employer experiences. Therefore when such benefit payments are made, they typically are debited to a "common fund" rather than to individual employer accounts. Because noncharging is done solely on the basis of the reason for the benefit payment, it affects all covered employers regardless of the size of their current trust fund balance.

There are several possible categories of noncharged benefits. All of the following are treated as noncharged benefits in at least some states. (1) Payments made to workers who quit their last job. The worker may have served a disqualification period following the quit or may have quit for good cause and received payments immediately. In these instances, the job separation was initiated by the worker, was beyond the employer's control, and

the states have decided that individual employers should not be charged for the benefit payments. (2) Dependents benefits. Payment of these benefits reflects state concerns for benefit adequacy. Several states do not charge for dependents' benefits even though the employer is charged for the part of the family benefit paid to the former employee. (3) Payments to workers enrolled in approved training. (4) Erroneous benefit payments that are not recovered. (5) Benefit payments ruled inappropriate after an employer's appeal. (6) The state share of Federal-State Extended Benefits (EB).

The preceding list has the main categories of noncharges but it is not exhaustive. Payments to job quitters and dependents' benefits are of major importance in the overall benefit structure of some states. States were authorized to allow noncharging by a federal directive issued in 1944.¹⁷ Their policies on noncharging are not uniform so that some items in the preceding list are charged to individual employer accounts in selected states. As a consequence, the importance of noncharging varies sharply from one UI program to the next.

B. Ineffectively Charged Benefits

In a reserve ratio state, ineffective charges arise when additional charges are made against employers whose reserves have already been exhausted by previous benefit payments. These charges can be incurred by employers who are still active in a state and by employers who have ceased operations. The excess of benefit outlays over tax receipts means that each extra dollar of benefits causes their individual trust fund debts to grow still larger. Unless ineffective charges are fully matched by a common tax levied on all employers they will cause the state's aggregate fund balance to decline and may even necessitate borrowing from the U.S. Treasury to make all benefit payments.

In a benefit ratio state ineffective charges typically arise in situations when employers are taxed at the maximum rate but benefit outlays exceed their tax payments. Tax rates in such states are typically determined by benefit outlays of the preceding three years. Since employer trust fund balances do not enter into tax rate determinations, any subsequent reduction in benefit payments will cause a reduction in taxes over the following three years even if the overall state trust fund balance remains low. This situation could make benefit ratio states more vulnerable to incurring ineffective charges than reserve ratio states.

Ineffective charges have accounted for as much as 30 to 40 percent of annual benefit outlays in some states in selected years. In reserve ratio states they arise when the gradient in a state's tax rate schedule is low and/or the maximum tax rate is low and/or the maximum taxable wage per employee is low, causing tax payments to be insufficiently responsive as fund balances decline towards zero. When states have an unresponsive tax system, it is possible for individual employers to incur ineffective charges for a succession of later years. Although such employers pay higher than average taxes (as a percent of taxable payroll) total tax payments are too low when compared to benefit outlays.

Theoretically, the cumulative amount of excess benefit charges in reserve ratio states would be reflected in the absolute size of an employer's negative account balance. The negative balance could be moved towards zero by a combination of low benefit outlays coupled with high tax payments over a succession of later years. Thus there would be a continuing financial liability associated with earlier ineffective charges that would be discharged over a series of years when tax payments exceeded benefit payments. Such a

situation could be described as one of tax deferral (but with a continuing tax obligation) so long as the employer remains an active participant in the state's economy.

In practice, employers who incur ineffective charges routinely experience outright tax forgiveness, rather than deferrals, through what are called writeoffs. At the end of each fiscal year, several states automatically reduce the size of the actual negative balance to a maximum percentage of the employer's payroll, say 2, 4 or 10 percent. As a result, employers with very large negative balances are never required to make tax payments on their excessive negative balances. Through the combination of ineffective charges coupled with writeoffs certain employers completely avoid a part of their UI tax obligation. These excess benefit payments become an obligation for other covered employers, and typically they are financed by flat rate taxes paid into the state's common fund (the source of the excess benefit payments made from the accounts of negative balance employers).

C. Measuring the Actual Degree of Experience Rating

Several earlier studies have shown the importance of noncharges and ineffective charges in the benefit structures of individual states [Becker (1972), Wandner and Crosslin (1980), U.S. Department of Labor, Office of Inspector General (1985)]. Both can constitute a sizeable share of annual benefit payments. Because noncharged benefits arise from designated exceptions to the general requirement of charging benefits to individual employer accounts, their measurement is a straightforward matter. Individual employers, regardless of their current trust fund account balance, completely avoid direct financial responsibility for these charges. Noncharges can be summed and their total for the year can be measured as, say, a percentage of total annual benefit outlays.

Ineffective charges, on the other hand, frequently entail a future financial liability for employers with negative account balances. At one extreme ineffective charges in the current year are completely repaid by the excess of taxes over benefit payments in the next year. The only financial break to employers in such situations arises from the tax deferral, i.e., the present value of next year's higher taxes is less than that of the ineffective benefit charges accrued in the current year. The value of the tax deferral for employers who eventually cover all ineffective charges (and bring their account balances above zero) rises as repayment is delayed for a longer time period.

At the opposite extreme, complete tax avoidance can be achieved in states that permit writeoffs if the following two conditions are met. (1) The employer starts the year with a negative balance at the low bound permitted for negative balance employers (say minus 4 percent of payrolls). (2) The employer has benefit outlays in excess of tax payments in the current year so that there will be a writeoff in the current year. The excess benefit outlays in the current year, i.e., benefits less taxes, cause absolutely no tax increase for the employer.¹⁸ These ineffective charges typically will be paid by a flat rate tax levied on all covered employers.

Between these two extreme cases (complete employer tax liability except for the present value considerations associated with deferred tax payments and complete tax avoidance of current year excess benefit payments) lie a myriad of other possibilities too complicated in individual detail to describe here. A safe generalization, however, is that negative balance employers face a variety of situations that fall at or between these extremes. To know what fraction of the excess benefits payments from the current year gets translated

into higher future year tax obligations requires that the employer be followed longitudinally so that future taxes, benefits and trust fund balances can all be recorded to make an accurate calculation. In summary, accurate measurement of ineffective charges is made complicated by possible linkages between benefits payments in the current year and tax payments in later years.

How are ineffective charges actually measured? Studies done to date have calculated the excess of current year benefits over current year taxes paid by employers with negative balances. This technique effectively assumes that there are no higher future taxes that result from the current year's excess benefit payments incurred by these employers. Although it is easily understood why this method of measurement is used (It only requires current year data on employer taxes, benefits and trust fund balances.), it is also clear that the measurement has important limitations. By adding up such excess benefit payments (or ineffective charges) and comparing them to total benefit payments the resulting comparison gives an exaggerated impression of the non-experience-rated portion of a state's tax structure. It ignores all future tax increases caused by the ineffective charges of the current year.

In states where there are annual writeoffs of excess negative balances one can identify the range within which the actual tax forgiveness for negative balance employers is located. The lower bound is the aggregate amount of writeoffs for employers who began the year paying the maximum employer tax rate.¹⁹ The upper bound is the total amount of excess benefits paid by all negative balance employers. The true amount of tax forgiveness experienced is probably closer to the upper bound, but its measurement is a complicated problem. It would be useful to at least investigate the size of this range in order to better assess the amount of outright tax forgiveness realized by negative balance employers as a consequence of writeoffs.²⁰

If a state's UI trust fund balance remains stable for a succession of, say, five years, one could utilize data on total ineffective charges for the fifth year with more confidence. In such situations most of the tax rate adjustments to ineffective charges from earlier years would be reflected in the current year's tax payments made by negative balance employers. Even though ineffective charges from the current year would cause some higher taxes in the future there would be offsetting tax payments present in current year data that resulted from ineffective charges incurred in earlier years.

In practice, however, state trust fund balances are not stable for long periods. They closely follow the business cycle; declining in recessions and increasing during periods of economic recovery. Because the aggregate trust fund balance mirrors what is happening with many individual employers there is a strong tendency for ineffective charges to increase (as a proportion of total benefit payments) in years of economic recession. Thus, ineffective charges realized in a year like 1983, when the combined end of year net trust fund balance for all UI programs was negative, would produce an exaggerated impression of the average importance of ineffective charges incurred in a more typical year. One should not use 1983 data to draw inferences about the average extent of experience rating in the state UI programs.

D. The Experience Rating Index

As noted there are Experience Rating Index (ERI) measures that have been made in several individual states for several years. They vary from zero to unity with lower proportions indicating a larger share of total benefits being paid as noncharges and ineffective charges (from both negative balance employers and from inactive employer accounts).

Annual experience rating indices have appeared in the work of both Wandner and Crosslin (1980) and the U.S. Department of Labor, Office of Inspector General (1985), while Becker's (1972) book shows earlier data on the separate importance of noncharged and ineffectively charged benefits. All three studies show that noncharged and ineffectively charged benefits each account for a substantial share of total benefit payouts. In a sample of nine states for the period 1971 to 1978, Wandner and Crosslin (1980, Tables 2 and 3) show that noncharged benefits averaged about 16 percent of the total while ineffective charges averaged 27 percent of the total. Noncharged benefit percentages ranged from 1 to 28 percent across the nine states while the corresponding percentages for ineffective charges ranged from 2 to 48 percent. Overall, experience rated benefits accounted for only 57 percent of total benefit payouts in their data. The report of the Office of Inspector General (1985) found even lower ERIs for the years 1981 to 1983.

Specific limitations of these ERI measures should be noted. (1) They are constructed exclusively from current year benefit data. No weight is given to the higher future taxes that will be incurred by active negative balance employers due to the current year excess of benefit payouts over tax payments. (2) These ERIs automatically decline in recessions when state trust fund balances decline. The declines take place even when a state's UI tax structure (the minimum tax rate, the maximum rate and other statutory features that determine employer tax payments) is constant. Thus, declining ERIs could reflect a decreased reliance on experience rated taxes, a decrease in the overall trust fund balance or some combination of the two.

To be more reliable for their intended purpose (i.e., to measure a degree of experience rating) it would be better to use ERIs averaged over several

years rather than just one year's number. The averages should exclude years when the state's overall fund balance is very low or negative.

To this author, better measurement would be obtained from a regression analysis where the annual ERI is regressed on the year-end trust fund reserve (expressed as a percentage of total payrolls). Further, the separate contributions of noncharged and ineffectively charged benefits could be analyzed by regressions. From such regressions one could obtain standardized ERIs. These could be compared across states at a given trust fund balance. Thus by use of regressions one could remove the cyclical effects from the actual ERIs and then compare ERIs across states when fund balances were, say, 2 percent of covered payrolls. Ratios derived in this manner would give more reliable information on the experience rating component in each state's tax structure. To my knowledge no analysis of this type has yet been conducted. If it were undertaken it would help in making reliable interstate comparisons of experience rating.

E. The Optimal Degree of Experience Rating

The ERIs that have been measured for individual states show that noncharged benefits and ineffectively charged benefits often constitute a significant share of total benefit payments. To this author, the optimal degree of experience rating is generally higher than what presently exists in most states, but it falls considerably short of full experience rating. This conclusion is based on two kinds of considerations.

Federal authorities have given the states explicit authorization for noncharging several kinds of benefit payments. Some people could examine the individual noncharged benefit categories in a given state and perhaps conclude that in their opinion noncharging is not always fully justified. The general

principle of noncharging, however, is not in serious dispute. Most of these payments arise from circumstances that are either beyond the employer's control (payments to job leavers, payments to dependents and erroneous payments) or from worker activities that are deemed socially desirable (payments while undergoing approved training). There are valid reasons for noncharging in all these instances.

Because of noncharging alone it is clear that the optimal degree of experience rating is less than 100 percent. Further, departures from full experience rating will be larger in states which permit more categories of noncharges. From the empirical estimates of ERIs it appears that noncharged benefits typically constitute from 10 to 25 percent of the total. Thus, considering just noncharged benefits the optimal degree of experience rating might typically be expected to fall into the 75 to 90 percent range.

States can also have legitimate reasons for permitting some ineffective charges to be incurred each year. Consider these three reasons. (i) The benefit liabilities of inactive employers have to be paid. (ii) Random economic events may create very large and unforeseen benefit cost experiences in some industries. A state can legitimately elect to limit maximum employer liabilities by placing a maximum on the schedule of employer tax rates.²¹ (iii) To retain the interest of negative balance employers in the administration of the UI program, there is rationale for permitting some writeoffs after negative balances have become very large. Thus, a state may be expected to have some ineffective charges each year.

Once it is recognized that states may have good reasons for allowing ineffective charges, a set of related questions arise. What is a "reasonable" fraction of total annual payments that can be ineffective charges? Is the

fraction constant across states? Who has the expertise for deciding on a reasonable fraction of ineffective charges? A complicating factor is that ineffective charges rise automatically (as a fraction of total benefit payments) when state trust fund balances decline. As noted earlier there are difficult measurement issues associated with ineffective charges. (Ineffective charges incurred this year may lead to higher employer taxes next year and in later years.) Because of their cyclical pattern and the difficulties of measuring future tax liabilities, it is not easy to infer what the optimal level of ineffective charges should be. Perhaps as much as ten percent of total benefits may be a reasonable guideline (with somewhat over half of this being charges to inactive employers²²). To this author it would seem that ineffective charges would not be constant across states. It would also seem that ineffective charges arising from inactive employer accounts would be more prevalent in states where plant closings were more common, e.g., midwestern states in the 1980s. More research should be done before confident pronouncements can be made regarding the optimal fraction of ineffective charges.

From the preceding, four general statements can be made about the optimal degree of experience rating. (1) It is less than 100 percent. (2) It varies by state and depends on state decisions about eligible categories of noncharged benefits and state decisions regarding ineffective charges. (3) There is considerable uncertainty regarding the optimal fraction of benefits that a state should incur as ineffective charges. (4) Overall, an empirically based measure of a state's experience rating index (ERI) might lie in the 65 to 85 percent range. This range is suggestive. It is based on the observations that noncharged benefits typically range from 10 to 25 percent of

total benefits and my feeling that ineffective charges should generally represent no more than 10 percent of total benefit payments. States with large amounts of noncharges and ineffective charges would have ERIs closer to the low end of this range.

The actual ERIs that have been measured in recent years (Wandner and Crosslin (1980), the U.S. Department of Labor, Office of Inspector General (1985)) are generally lower than the range just identified. Although part of the reason for these low ERIs is their cyclical pattern, it is the judgment of this author that states need to increase their degree of reliance on experience rated taxes.

F. Increasing the Degree of Experience Rating

The degree of experience of experience rating in UI programs can be increased in a number of ways. Before noting specific legislative actions, however, it will be useful to first examine two distinct strategies that might be followed; increasing the range of tax rates and increasing the taxable wage base. Implementing either of the two will increase UI tax receipts from employers with high cost experiences. There are reasons to believe that increasing the range of tax rates is the more effective of the two strategies for increasing the degree of experience rating. This point deserves some elaboration.²³

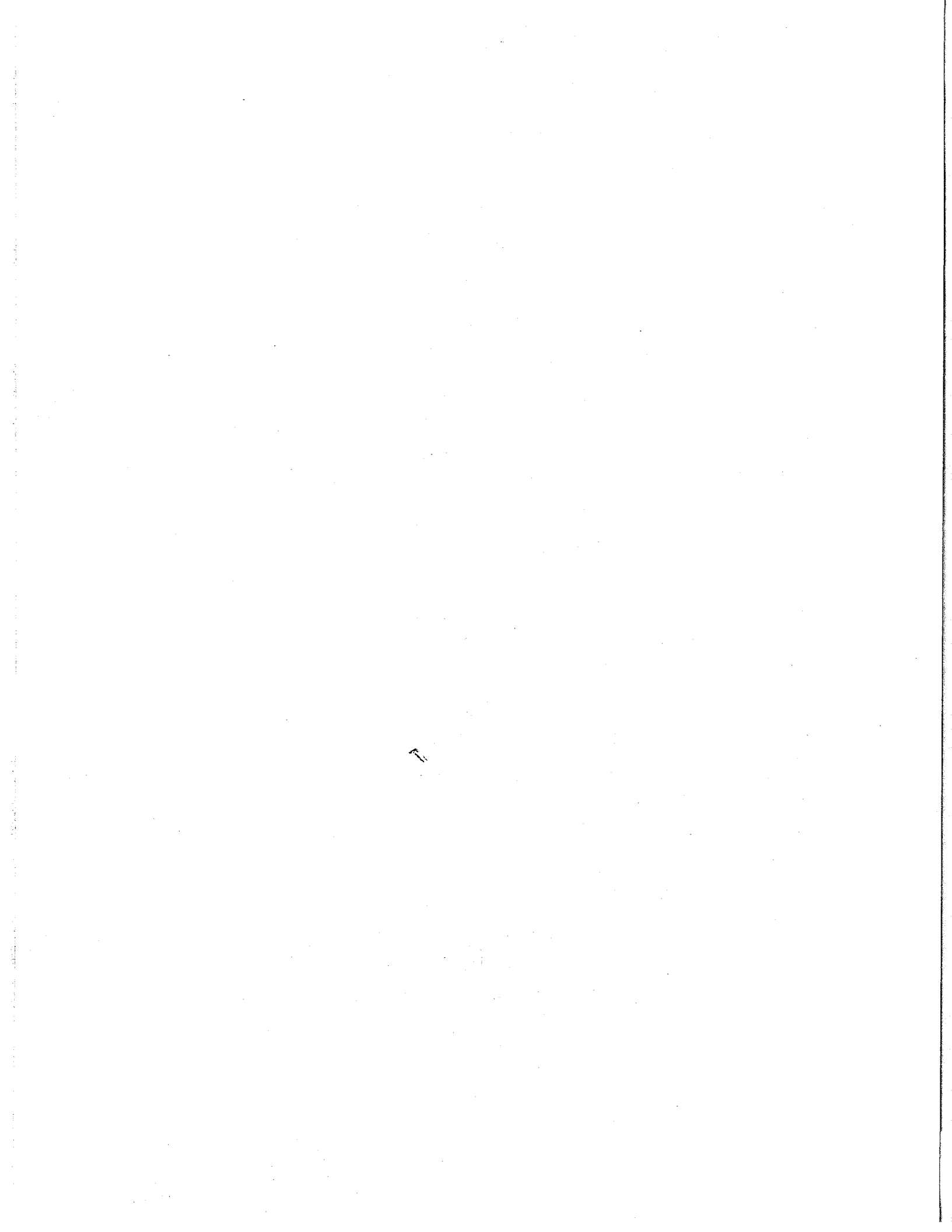
Consider a situation where employers with high benefit costs and low benefit costs both pay annual wages that range over a very wide interval. For example, among employers with high UI costs those in construction generally pay much higher wages than do employers in apparel and leather (Recall Table 2). If the range of UI taxes is increased by raising the maximum employer tax rate, all high cost employers will initially be affected in a

more similar manner than if the taxable wage base is raised. Raising the taxable wage base would have proportionately larger effects on high cost employers who pay high wages (construction) than for those who pay low wages (apparel and leather).

Raising the taxable wage base also will have disproportionate effects among low cost employers as well, i.e., affecting high wage employers more than low wage employers. For most employers taxed at the minimum rate an increase in the tax base (with the minimum rate held constant) would move them further away from full experience rating (because it would increase their tax payments by more than their benefit payments). High wage employers taxed at the minimum rate would typically end up either accumulating larger trust fund balances (in reserve ratio states) or providing larger net subsidies to other employers (in benefit ratio states).

Because of the equity issues that arise between high wage and low wage employers when the taxable wage base is increased, actions that increase the range of tax rates are more effective in increasing the degree of experience rating. As a practical matter a state may chose to raise both the maximum tax rate and the tax base (to prevent the maximum tax rate from being still higher) in order to increase the degree of experience rating.²⁴ If this is done, however, it should be accompanied by a reduction in the minimum tax rate in order to prevent high-wage-low-cost employers from experiencing large tax increases.

With the preceding as background, specific policy actions can be suggested that would increase the degree of experience rating. As noted, changes that increase the range of tax rates will be more effective than tax base increases but combinations of the two actions might be attractive in many



states. The list of suggestions will include federal as well as state policy initiatives.

Federal policy initiatives in two areas can be noted. (1) Increase the maximum range of statutory tax rates. There have been increases in maximum tax rates in several states during the 1980s, and this was aided by the federal requirement that the maximum state rate under experience rating had to be at least 5.4 percent starting in 1985.²⁵ Solvency legislation enacted in debtor states after the 1983 Social Security Amendments frequently included a large increase in the maximum employer tax rate. As noted earlier, in the ten states with the largest UI debts at the end of 1983, the simple average of the maximum tax rates in 1985 was 8.02 percent. Thus, federal legislation of the 1980s has encouraged UI programs to widen the range of statutory tax rates. (2) Increase the taxable wage base per employee. Having a higher tax base allows a state to charge higher effective tax rates to employers with low and negative trust fund account balances. Federal legislation caused the state tax bases to increase from a minimum of \$6000 in 1982 to \$7000 in 1983. For states with a tax base of \$7000, however, the taxable wage proportion was not much higher in 1984 than in had been two years earlier under the \$6000 tax base.²⁶ Although two-thirds of the states now have a tax base that exceeds the federal base of \$7000, they have shown reluctance to raise their tax bases much above \$7000.²⁷ A further increase in the federal taxable wage base could enhance not only the degree of experience rating but also the solvency of many UI programs.

Several actions could be taken by the states to increase the degree of experience rating. (1) The most obvious suggestions are to raise their maximum tax rate and to increase the taxable wage base. (2) Eliminate tax

rate limiters which constrain the maximum year-to-year change in employer tax rates. Because of limiters employer trust fund balances fall more rapidly in recessions. (3) Reduce the extent to which employers are allowed to write off negative balances. (4) Because new employers are known to have a high rate of business failure, enact taxation and security arrangements that would reduce ineffective charges caused by new employers. Two specific actions would be to set the tax rate for new employers at the average tax rate for their industry and to require out-of-state subcontractors to post security bonds as a condition for performing work in the state.²⁸ (5) When it is necessary for states to impose solvency surcharges, levy such taxes as a proportional (rather than as a flat rate) add-on to the employer's regular UI taxes. All five of these changes can be implemented by the states under their existing UI statutes. Items (1), (2), (3) and (4) from the preceding list would each cause the volume of ineffective charges to decline. The states with low ERIs and large amounts of ineffective charges should be encouraged to consider such changes.

V. THE OFFICE OF INSPECTOR GENERAL'S REPORT

An evaluation of experience rating in State Unemployment Insurance programs was completed in 1985 by the Office of Inspector General, U.S. Department of Labor (1985). The report examines the evolution of experience rating with emphasis on the time period from 1970 to 1983. Based on an analysis of data from 12 state programs the report concludes that the degree of experience rating declined substantially between 1970 and 1983. Two recommendations from the report are: i) that ETA develop and publish an index to measure the degree of experience rating in each state and ii) that ETA revise and update the ES-204 report to collect data needed to effectively monitor experience rating (U.S. Department of Labor (1985), p. 127).

The Office of Inspector General's report is a serious examination of experience rating in State UI. It points out the difficulties in obtaining comparable data across states that are useful for assessing experience rating. Included in its sample are nine programs that use reserve ratios and three that use benefit ratios to determine employer tax rates. It employs the experience rating index (or ERI, as described in Part IV) to assess the degree of experience rating by year in this sample of states. During the 1970-1983 time period a large increase was observed in the proportion of benefits paid by employers with negative account balances.

Several comments can be made on the report. My remarks are grouped into two categories; specific criticisms of the report and the report's recommendations. Despite my critical observations, I feel the report is useful and it makes sensible recommendations.

A. Criticisms of the Report

This report has weaknesses that limit its usefulness. My criticisms will focus on four areas: (1) measuring the degree of experience rating, (2) judging the optimal degree of experience rating, (3) recent changes in state tax rate schedules and (4) the linkage between experience rating and employee turnover. Several of the comments to be made here reiterate points already discussed in Parts III and IV of the paper. My criticisms in the first of these four areas are the most serious.

1. Measuring the Degree of Experience Rating

The report measures the degree of experience rating using the experience rating index or ERI. The ERI is calculated as a fraction whose denominator is total benefit payments in the state for the current year. The numerator is obtained by subtracting from total benefit payments the sum of noncharged plus ineffectively charged benefits. These fractions generally declined in the nine reserve ratio states that were studied. The ERI for the nine states combined declined from .51 in 1970 to .36 in 1983. Most of this decrease occurred between 1970 and 1974 when the ERI reached .39, and the decline was then much slower between 1974 and 1983.

There are two serious limitations in their analysis. Many active employers with negative account balances will pay increased UI taxes in future years so that some of their current year payouts are, in fact, experience rated. Because the ERI measure does not take into account any of these future year taxes, it understates the actual degree of experience rating. This intertemporal linkage between benefits and taxes is difficult to measure, but the direction of the bias caused ignoring the linkage is clear, i.e. to understate the degree of experience rating.

The most serious drawback in the measured ERIs is that they are highly dependent on the overall level of each state's trust fund balance. Trust fund balance declined in most states between 1970 and 1983 due to the effects of 4 separate recessions and other economic developments. The decline in trust fund balances reached its lowest point at the end of 1983 when net reserves across all UI programs combined fell below zero. When reserves decline there will be an increase in the proportion of employers with negative account balances and the proportion of benefits paid by negative balance employers.

To measure changes in the degree of experience rating it would be best to have data where the overall level of a state's trust fund balance was held constant. If a state has a constant trust fund balance in two years and a lower ERI in the second year one can infer with confidence that the degree of experience rating had declined. In this situation, the state's trust fund position is unchanged but a larger proportion of total benefits is being paid by negative balance employers (who will undoubtedly escape some of the tax obligations associated with their current year benefit payments).

The data presented in the report do not control for the effects of changing trust fund balances. Because trust funds declined sharply between 1970 and 1983, the measured ERIs change both because the degree of experience rating was changing and because the trust funds were declining. It is my impression that the latter explanation is the more important of the two. It should be recognized and some estimate of the size of the trust-fund-level effect should be made. As it is currently written, the report exaggerates the extent of the decline in experience rating for these 12 state programs. I think the extent of the exaggeration is substantial, but have not tried to make estimates.

2. Judging the Optimal Degree of Experience Rating

There are several valid reasons why a state would not want to experience rate 100 percent of its benefit outlays. Noncharged benefits that arise from payments to persons who quit their jobs should not be charged to individual employer accounts. Employers should not be financially liable for job separations that they did not initiate.

Part IV of this paper has already discussed noncharged benefits and ineffectively charged benefits. Chapter 5 in Becker's book (1972) contains a more complete discussion of these topics. Because there are valid reasons for noncharges and ineffective charges, the optimal degree of experience rating is less than 100 percent. The Office of Inspector General's report should acknowledge the valid reasons for having noncharged and ineffectively charged benefits. As written, the report seems to suggest that UI should be financed by taxes that are 100 percent experience rated.

3. Recent Changes in State Tax Rate Schedules

An important determinant of the degree of experience rating is the potential range of employer tax rates which is present in a given state. A wider range of tax rates will be associated with a higher degree of experience rating. As trust fund account balances decline there can be a larger increase in employer taxes when the state's tax schedule allows employer tax rates to increase over a wider range.

In the period from 1980 to 1985 were large increases in the range of tax rates in many State UI programs. Table 3 of Part III showed that the simple average of the range of tax rates in 51 states increased from 3.92 percentage points in 1980 to 5.98 percentage points in 1985.

Increases in the range of tax rates have taken place mainly because the states have raised maximum statutory tax rates in the 1980s. Much of the motivation for these state actions has been a desire to increase the solvency of State UI programs. The federal requirement that each state's maximum statutory rate under experience rating must be at least 5.4 percent starting in 1985 has also contributed to widening the range of tax rates.

The recent changes in State UI tax rate schedules will increase the degree of experience rating in future years. The Office of Inspector General's report does not pay sufficient attention to these developments. Between 1980 and 1985 the degree of experience rating has probably increased, but their report conveys precisely the opposite impression.

4. The Linkage Between Experience Rating and Employee Turnover

There undoubtedly is a linkage between the degree of experience rating and the amount of employee turnover that is initiated by employers. Employers will lay off more workers when they face small financial penalties for such layoffs. The report cites five separate studies that have investigated this relationship.

While the findings of these studies are generally reasonable some of their limitations should also be pointed out. Most serious is the fact that none of the studies actually knew the UI benefit status of the unemployed workers or the marginal cost of the layoffs (through experience rated taxes) that the employers had initiated. Topel's study has the most elaborate methodology for measuring these tax costs, but it can easily have measurement errors.

In general, these studies are less convincing when read in their entirety than when their conclusions are quoted as in the Office of Inspector General's

report. The Appendix to this paper has detailed comments on four studies (including Topel's) that have examined the relationship between experience rating and employee turnover.

B. The Report's Recommendations

Several recommendations made in the Office of Inspector General's report are useful. Two classes of recommendations should be highlighted.

The report makes suggestions for changing the content of the ES-204 reporting form. If the suggestions are implemented the U.S. Labor Department would have an improved capability for measuring the degree of experience rating, both across time and across all states (not just the reserve ratio states). The suggestions (to record employer taxes and trust fund balances on the ES-204 and to provide for a reconciliation of employer accounts with the state's general account) are most reasonable. If this information were to be collected, meaningful comparisons of ERIs across states could be made.²⁹

The report makes several suggestions for desirable state-level changes that would enhance the degree of experience rating. Some examples are: i) raise the maximum tax rate for employers, particularly negative balance employers, ii) tax new employers at a rate that reflects average industry cost experiences, iii) reduce or eliminate so-called write-offs for employers with large negative account balances iv) eliminate tax rate limiters which restrict year-to-year tax rate increases when trust fund balances are declining and v) increase the taxable wage base per employee.

Both types of suggested changes would command wide support among persons familiar with UI programs. Enactment of the tax changes would also enhance the future solvency of UI programs. If the ES-204 reporting suggestions were implemented they would improve our ability to monitor the degree of experience rating in the individual states.

To summarize, the Office of Inspector General's report has some serious shortcomings. Most serious, it exaggerates the extent of the decline in the degree of experience rating that occurred between 1970 and 1983. Despite its shortcomings, however, its recommendations should be given serious consideration.

FOOTNOTES

1. See Chapter 17 in Haber and Murray (1966) for more discussion about the objectives of experience ratings.
2. The sixteen states included in Table 1 are Arkansas, California, Florida, Georgia, Iowa, Kansas, Kentucky, Louisiana, Maine, Mississippi, Minnesota, Oregon, South Carolina, Vermont, Washington and Wisconsin. Nebraska, South Dakota and Tennessee were omitted for lack of data with two digit SIC detail. In Michigan and New York, the positive net subsidies for the period of the study totaled \$4.11 billion compared to the negative net subsidies of only \$.25 billion. Data on positive and net subsidies by state appear in Table 2 of Munts and Asher (1980).
3. A discussion of the relative merits of raising the maximum tax rate and increasing the taxable wage base is given in Section F of Part IV.
4. The material on UI payroll tax incidence to be discussed in this part of the paper draws heavily on Chapter 5 of Vroman (1983). References to the theoretical and empirical public finance literature on payroll tax incidence are contained in text and bibliography of that book.
5. For example, there are papers by Baily (1980), Hagens and Hambor (1980) and Vroman (1974). Respectively, these papers conclude there is no backward shifting, full backward shifting and partial backward shifting of employer payroll taxes. Employer UI taxes were not distinguished from other employer payroll taxes in these studies.
6. There have been other empirical studies of this topic, but these four papers are, in my judgement, the most important and influential.
7. See Feldstein (1978), p. 840. The total unemployment rate for men aged 25-54 in March 1971 was 4.2 percent. Those on temporary and permanent layoff constituted 38 percent of the total for this demographic group.
8. Some two digit industries were combined in the tabulation. Thus in Table 2, industries with SIC codes 07-09, 15-17 and 78-79 were combined. The tabulation had cost detail for 52 industries.
9. The calculations assumed: (i) the excess of benefits over taxes was 3.0 percent of taxable payroll across all construction industries; (ii) taxable payrolls were 45 percent of total payrolls in construction (the U.S. average in 1977 for all industries) but 70 percent in the low wage apparel and leather industries; and (iii) payroll as a percentage of total compensation is the sum the pay for time worked and paid leave percentages shown in Table 2. Under these assumptions, the increase in UI taxes as a percentage of total compensation was 1.13 in construction, .47 percent in apparel and .36 percent in leather.
10. Besides increased UI taxes, the employer might incur other costs such as severance pay and costs of continued health insurance coverage for a

- temporary period. There also could be future recruitment and training costs. In a recession, however, the recruitment and training costs would be less relevant since laid off workers would find it difficult to secure other jobs. Full consideration of UI taxes and these other layoff-related costs does not change the fact that wage costs and most fringe benefit costs associated with the worker's employment would end as soon as the layoff takes place.
11. Data on borrowing and reserves are published by the UI Service of the U.S. Department of Labor. For one summary of reserves and borrowing in recent years, see Table 1 in Vroman (1985b).
 12. See table 5 in U.S. Department of Labor (1986).
 13. The motivation to enact such legislation was especially strong in debtor states because the 1983 Social Security Amendments gave them an explicit quid pro quo: reduced and deferred costs of debt repayment in return for enacting legislation to improve solvency. Legislation in ten states with very large debts is described in Chapter 2 of Vroman (1986).
 14. See, for example, Burtless and Vroman (1984).
 15. The reserve ratio multiple measures trust fund balances relative to the potential demand for benefits. A common measure of actuarial soundness is that the multiple should be at least 1.5. The ratio of the fund balance to covered wages in the current year should be at least 1.5 times the ratio of benefit payments to total payroll from an earlier high cost period of benefit outlays.
 16. The ten states are Pennsylvania, Illinois, Michigan, Ohio, Wisconsin, Texas, Louisiana, New Jersey, West Virginia, and Minnesota. Their tax rates for 1980, 1982 and 1984 appear in Table 4 of Vroman (1985a).
 17. See U.S. Department of Labor (1944).
 18. The details of this example have been chosen in recognition of the fact that some states' tax schedules call for progressively higher tax rates as negative account balances become larger. Other states levy only a single tax rate on all negative balance employers. In these states, complete tax avoidance is realized on all current year writeoffs for employers who started the year with a negative account balance.
 19. Again, note that when states charge only one tax rate on all negative balance employers (regardless of the size of their negative balance) this amount would be total writeoffs to all negative balance employers.
 20. This author is not aware of studies that have done these calculations.
 21. One discussion of the arguments for having a maximum tax rate in UI programs is found in Becker (1972, p. 20).
 22. Payments from inactive accounts exhibit an obvious cyclical pattern. Also, they probably are more important in states experiencing below average rates of economic growth. Thus it may be that the optimal degree

of experience rating is lower in such states when compared to states with faster rates of economic growth.

23. One discussion of raising the maximum tax rate and raising the taxable wage base as alternative ways to increase the degree of experience rating is given in Becker (1972, pp. 22-24).
24. The solvency legislation enacted in Michigan at the end of 1982, for example, called for both a higher maximum tax rate and an increase in the tax base. Besides having a solvency objective, this legislation also was intended to increase the degree of experience rating in the state.
25. Recall the tax rate data displayed earlier in Table 3.
26. In California, for example, that taxable wage proportion was .363 in 1982 and .378 in 1984. The corresponding proportions were .341 and .351 in New York for these same two years.
27. In 1986, thirty-three states plus the District of Columbia and the Virgin Islands had tax bases about \$7000. However only fifteen jurisdictions had tax bases above \$10,000 and just three had tax bases above \$15,000 (Alaska, Hawaii and Idaho). For one analysis of tax bases in the states see Chapter 3 in Vroman (1986). High tax bases are generally found only in states where the tax base changes automatically in response to increase in the average weekly wage.
28. In 1986, ten states tax new employers at the average rates for their industries. An additional five states tax new construction employers at the average industry rates while taxing other new employers at a standard rate. Four states (Louisiana, Vermont, Wisconsin and Wyoming) have bonding requirements for out-of-state subcontractors.
29. Because employers do not routinely know their individual trust fund balances in benefit ratio states, the reporting recommendations would be more difficult to implement in such states than in reserve ratio states.

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**Appendix: Unemployment Insurance Taxes
and Employee Turnover**

Incomplete experience rating of employer UI taxes can lead to increased rates of employee turnover. When employers do not pay the full marginal costs of layoffs, they may be induced to make more layoffs than they would under full experience rating. There have been several theoretical and empirical analyses of the linkage between imperfect experience rating and employee turnover. The main theoretical work was done by Baily (1977), Brechling (1977) and Feldstein (1976).

From a policy standpoint the relevant question is the size of the effect on employee turnover. Several empirical studies have examined this issue. Some of their conclusions have already been noted in Part III of the text. From among all the empirical studies this appendix reviews four: Brechling (1981), Feldstein (1978), Halpin (1980) and Topel (1984). They were selected as being the most important of the empirical investigations.

Feldstein (1978) attributes fully half of temporary layoff unemployment to the current financing structure of the UI program. Four aspects of his paper are important to examine: (i) the definition of a temporary layoff, (ii) the estimation of weekly UI benefits and of UI benefit status, (iii) the assessment of employer experience rating, and (iv) the estimated effect of UI on temporary layoff unemployment.

The data base for the analysis was the March 1971 Current Population Survey (CPS). This file records each person's employment status, unemployment status, and reason for unemployment in March 1971 along with their work experience and earnings for calendar year 1970. Among those unemployed in March, the reason for unemployment (job loser, job leaver, reentrant, new entrant) is known. Job losers fall into two categories: those on layoff and

"other" job losers. There are two subcategories within layoffs: temporary layoffs (persons with a definite recall date within thirty days), and indefinite layoffs (those who do not have a definite recall date or a definite date more than thirty days away). The counts of the various groups of job losers in March 1971 were as follows: temporary layoff--179,000; indefinite layoff--739,000; and "other" job losers--1,734,000.

Feldstein (1978, p. 834) asserts that persons on temporary layoff account for about half of all job losers. He defines all persons on layoff as being on temporary layoff. An examination of data from various years, however, suggests that persons on layoff typical account for 30 to 35 percent of job losers. Since the vast majority of workers on layoff are persons on indefinite layoff should they all be considered as temporary layoffs? At the time of their interviews, many unemployed persons in this category do not know if or when they will return to their former jobs. It seems reasonable to conclude that persons who behave as if they are on temporary layoff account for less than 30 percent of all job losers. A percentage closer to 25 percent may be a reasonable estimate.

The questions from the March 1971 labor force survey yield no direct information on worker UI benefit status at the time of the survey. This problem is present in all months with the exception of special supplemental surveys such as the May 1976 Survey of Job Seeking Activities. (See Rosenfeld (1977).) To compute the replacement rate used in the temporary layoff estimating equations (weekly UI benefits as a proportion of after-tax weekly wages) several steps are necessary. (1) The annual work experience data for calendar year 1970 must be manipulated to produce an estimate of high quarter earnings and other base period earnings variables. (2) Simulated base period earnings must be compared to State UI earnings requirements to determine

eligibility and the level of weekly benefits. (3) Those simulated to be eligible must be assumed to be in benefit status in March 1971. Even if the potential weekly benefit amount were correctly simulated, one must also assume that the worker: (i) was aware of his or her eligibility, (ii) had applied for benefits, (iii) had not been disqualified, and (iv) had not exhausted benefits. Chances for errors in simulating eligibility and benefit status abound.

Two other points might cause the skeptical reader to question the study's statistical results. When the simulated data were used to estimate UI program outlays for March 1971, the estimated total was \$540 million (p. 836). This was 14.3 percent below actual program outlays of \$630 million. At the micro level a higher error rate would be expected since offsetting errors net out in the simulated program total. The second cautionary signal is provided by the modest explanatory power of the estimating equations. The R^2 's fall in the neighborhood of .02. Almost all of the variation in temporary layoff unemployment is left unexplained by the regressions. In equations with low R^2 's there could be biased regression coefficients due to specification errors.

The prevalence of imperfect experience rating is central to the argument that the UI program fosters temporary layoff unemployment. Fully experience rated firms should exhibit lower temporary layoff rates than other firms. Because the CPS is a household survey, however, it cannot produce any evidence about the degree of experience rating of the firms which initiated the unemployed workers' layoffs. No direct empirical link between extent of experience rating and probability of layoff is established in Feldstein's study. Since the degree of experience rating is known to vary by industry, it would seem that one could use industry and other controls to simulate experience rating in a manner similar to the simulation of UI benefits.

Feldstein's paper does not report the results of any efforts in this direction.

How then does this analysis derive the conclusion that the UI program is responsible for upwards of half of temporary layoff unemployment? The regressions do show that higher replacement rates are associated with a higher probability of unemployment. The product of the mean replacement rate and the replacement rate regression coefficient equals roughly half of the overall layoff unemployment rate. Thus, he concludes that the UI program is responsible for half of this unemployment rate.

To summarize, the potential impact of imperfect experience rating on temporary layoff unemployment is not at issue. A lower rate would be expected if the UI program moved to full experience rating. What is at issue is the size of the effect. Feldstein's research can be challenged on at least three grounds: (i) the definition of temporary layoffs, (ii) potential errors in the simulation of UI eligibility and benefit status, and (iii) failure to establish an empirical link between the degree of employer experience rating and the probability of a temporary layoff. It would seem that the empirical evidence in Feldstein's research is weak.

Halpin (1980) updated Feldstein's analysis using CPS-based layoff unemployment data from 1976. He replicated Feldstein's equation specifications but added tax rate variables applicable to employers in the states where the workers had been previously employed. The tax rate variables were taken from state tax schedules (the minimum rate, the rate for a zero account balance and the penalty rate applicable to employers with negative account balances, i.e. t_{\min} , t_0 and t_{neg} as shown in Figure 1 of Part II.) In multiple regressions Halpin found that the tax rate variables had significant effects and that tax rates dominated benefit replacement rates as determinants of layoff unemployment. Note that the CPS data base has information on the

worker's unemployment but no direct information on the worker's UI benefit status, the level of benefit payments or the marginal cost of layoffs incurred by the former employer. The actual position of the employer on the state's UI tax schedule was not known and may not have been well approximated with the statutory tax schedule data that actually were used.

The most recent important research project in this vein was conducted by Topel (1984). His was a larger scale and more ambitious undertaking than the Feldstein and Halpin projects. Like their earlier efforts, the primary data base was the CPS, but Topel's data covered a five year period (1977-1981) and had a total of 76,000 micro observations. Topel's effort was also more ambitious in that the estimating equations focused on workers in four separate labor market states (employed as well as temporary layoff unemployment, permanent layoff unemployment and quit unemployment) and the determinants of transitions between these states.

Topel concluded that a large fraction of unemployment is caused by imperfect experience rating of employer unemployment insurance taxes. For men aged 20-65 the average unemployment rate during 1977-81 was 5.16 percent. Of this total 1.49 percentage points (or 29 percent) was due to imperfect experience rating. Before accepting this finding, however, there are some methodological questions that should be examined.

Four points should be emphasized. (1) The UI benefit status of the unemployed was not known. It was assumed that all unemployed workers who were full time labor force participants in the previous calendar year were UI recipients. From tabulations of matched CPS data where UI benefit status was known (the May 1976 Survey of Job Seeking Activities) it is clear that not even all job losers (much less job leavers) collect UI benefits. Reciprocity proportions increase as unemployment duration lengthens, increase with age and

they vary systematically from one state to the next. Undoubtedly he has made errors in assigning benefit status at the micro level. Given his methodology the typical error would be to assign benefit status to some unemployed men who were not beneficiaries. Such errors would be especially likely in 1980 and 1981 when there was a noticeable falloff in the fraction of the unemployed who collected UI benefits.

(2) The study notes a high positive association between (simulated) UI benefit replacement rates and unemployment rates. Both of these variables are associated with low wages. It is not clear that causation runs from replacement rates to unemployment rates (as he assumed) or that the use of dummy variables (as described on p. 44) is an adequate control for the potential simultaneous equations bias. Many of the low wage unemployed workers with high simulated replacement rates would not be expected to be UI beneficiaries.

(3) Topel expended considerable resources in attempting to measure the degree of employer experience rating. The tax data that were used were taken from five states (California, Oregon, Arkansas, Mississippi and New York) and then applied to all 37 jurisdictions where employer taxes are based on either reserve ratios or benefit ratios. Although the exact procedure used to attribute the degree of experience rating is outlined only briefly in the paper (the technical appendix is only one page long), it is clear there can be measurement errors in the assignment procedures that were used. The degree of experience rating on a micro level has more variability than what was assigned by Topel's procedures.

(4) The estimation of the various transition probabilities is based on an assumption that the U.S. labor market was in equilibrium during the 1977-81 period. Given the strong economic expansion of 1977-79 followed by downturns

in 1980 and 1981-82 one can be skeptical of this assumption. The range of variation in the overall unemployment rate for the men in his sample in these years was from 3.78 percent in 1979 to 6.16 percent in 1981. The 1981 unemployment rate was 63 percent higher than the 1979 rate. To the extent that the labor market was not in equilibrium it could affect the estimated parameters of the transition probabilities.

A second problem is also created by the assumption of labor market equilibrium. Topel's technique for measuring the degree of experience rating utilizes two unemployment rates (UMAX and UMIN) that place bounds on experience rated unemployment. These unemployment rates are calculated from the maximum and the minimum rates in each state's tax rate schedule and from other parameters assumed to be taken from a labor market that is in equilibrium. To the extent that this equilibrium assumption is not valid, the calculations as to the degree of experience rating will contain errors. (See Topel (1984), pp. 18-21.)

Based on these limitations in methodological procedures one can question the accuracy of the estimated effects of imperfect experience rating on unemployment. In CPS data one does not know the unemployed worker's benefit status and no study completed to date has known the actual degree of experience rating of the workers' former employers. This criticism applies to Feldstein (1978) and Halpin (1980) as well as Topel (1984).

A recent empirical analysis by Brechling (1981) examined the effects of state experience rating provisions on layoff rates and other variables (rehire rates, weekly hours and duration of unemployment). He used state data, disaggregated by industry, to study the determinants of labor turnover for the 1962-1969 period. Experience rating variables, however, were taken from state tax schedules for these eight years, and not from the experience of firms in

the individual industries. Thus, errors could arise in assessing the degree of experience rating. Despite this methodological problem, Brechling found evidence that state experience-rating practices affected labor turnover. For example, lower labor turnover rates were found in states that applied higher penalty tax rates to firms with negative unemployment insurance account balances. Applying a larger penalty for high levels of past turnover reduced current turnover.

Generally, Brechling's analysis concluded that greater reliance on experience rating would reduce layoffs and employee turnover. Three aspects of the paper are noteworthy. First, he is careful to caution readers about this results: "...while the results are most encouraging, no finality is claimed for them at this stage" (p. 202). He observes that an analysis based on micro data (rather than state-industry aggregates) would have been preferable. Second, he does not attempt to estimate the magnitude of the effect of imperfect experience rating on observed unemployment. Third, questions can be raised about Brechling's use of experience rating parameters as exogenous variables in the empirical analysis. To the critical reader, all three suggest that caution be exercised in using these research findings.

In a relatively new research area such as the one being discussed, it will take time before a consensus emerges which is based on the findings of several distinct efforts. The experience rating provisions of UI could have a measurable effect on temporary layoff unemployment. Until more work has been completed, however, one should be cautious; both in accepting the findings of this reserch and in using the reseach to make specific policy recommendations.

PART B

MANUAL TRANSMITTAL LETTER NO. 1460

U.S. Department of Labor Employment and Training Administration Washington, D.C. 20210	CLASSIFICATION
	UI
	CORRESPONDENCE SYMBOL
	TEURA
	DATE
	January 4, 1988

DIRECTIVE : MANUAL TRANSMITTAL LETTER NO. 1460

TO : ALL STATE EMPLOYMENT SECURITY AGENCIES

FROM : DONALD J. KULICK
 Administrator
 for Regional Management *DJ Kulick/cy*

SUBJECT : Employment Security Manual, Part III,
 Sections 0800-0879, ETA 204, Experience
 Rating Report

1. Purpose. To transmit revised reporting instructions for the ETA 204, Experience Rating Report.

2. Background. The National Office recently has reviewed the subject report and made revisions reflective of current national and State needs and data uses. Changes include reconfiguration of data in Section B and the addition of data elements to Section C. Additional changes of a minor nature were made throughout the section. Accordingly, this manual section is being reissued in its entirety.

The new data elements required in Section C of the ETA 204 form provide the basis for determining an experience rating index (ERI); the index will allow for the evaluation of the extent to which benefits or benefit wages in States are effectively charged. Specifically, the ERI represents the percentage of benefits which are effectively charged to taxable employer accounts and is calculated as follows, using the revised ETA 204:

$$(1 - ((IEC + IAC + NNC) / BEN)) * 100$$

where,

IEC = Ineffective Charges: Section C, Column 8, Total All Subject Accounts

IAC = Inactive Charges: Section B, item 6(a)(2)

NNC = Noncharges: Section B, item 6(b) plus item 7(b)

BEN = Benefits: Section B, item 5 minus item 7(a)

RESCISSIONS	EXPIRATION DATE
	Continuing

DISTRIBUTION

The ERI will be calculated by the National Office on an annual basis. The ERI will be published in the Handbook of Financial Data, an Unemployment Insurance Program Letter, the Quarterly Unemployment Insurance Compilation and Characteristics (QUICC), and any other publication deemed appropriate.

3. Effective Date. The changes are effective with the report for rate year 1988, due in the National Office the 30th day of the fifth month of such rate year.

4. OMB Approval. These reporting requirements have been approved by the Office of Management and Budget according to the Paperwork Reduction Act of 1980 under OMB No. 1205-0164, expiring September 30, 1990.

5. Instructions for Manual Maintenance.

Remove and Destroy:
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0824-0830 R-03/83
0830-0860 R-11/82

Insert:
0800-0860 R-12/87
0861-0874 12/87

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Reports and Analysis
Experience Rating Report, ETA 204

0800
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0800-0814 INTRODUCTION

0800 Form ETA 204, Experience Rating Report

A. Facsimile of page 1, Form ETA 204

Experience Rating Report

U.S. Department of Labor
Employment and Training Administration



State _____ Rate Year Ending Date _____ Computation Date _____ Type of Rating System _____ OMB No. 1205-0164 Expires 09/30/90

Section A. All Subject Accounts: Number and amounts of total and taxable payroll

	Number as of:	Amount of total payroll for 12 months ending:	Amount of taxable payroll for 12 months ending:
1. Taxable Accounts		\$	\$
a. Eligible			
b. Ineligible			
2. Reimbursable Accounts			
3. Subject Accounts with positive or zero balance (States using reserve ratio)			
a. Eligible			
b. Ineligible			
4. Subject Accounts with negative balance (States using reserve ratio)			
a. Eligible			
b. Ineligible			

Section B. Summary of Benefits Paid, Charged, and Noncharged

	Amount
5. Total Benefits (or Benefit Wages) Paid, during 12 months ending:	\$
6. Taxable Employer Accounts	
a. Charged	
1. Active	
2. Inactive	
b. Noncharged	
7. Reimbursable Employer Accounts	
a. Charged	
b. Noncharged	
8. Comments	

Signature _____ Title _____ Date _____

Part III
0800-0999

Reports and Analysis
Experience Rating Report, ETA 204

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0800 Form ETA 204, Experience Rating Report--continued

B. Facsimile of page 2, Form ETA 204

State: _____ Rate Year Ending Date: _____ Schedule Used: _____
 Taxable Wage Base, during 12 months ending on computation date (if changed during the period, so indicate): \$ _____
 Taxable Wage Base, during rate year: \$ _____
 Employee Contributions, 12 months ending with the computation date: \$ _____
 If an add-on tax or surtax is included in the tax rate below, show the rate (_____) and indicate (by circling) if the tax is: Uniform / Variable / Credited to employer accounts / Non-credited to employer accounts. Comments: _____

SECTION C. ALL TAXABLE SUBJECT ACCOUNTS, SELECTED DATA BY EXPERIENCE FACTOR

EXPERIENCE FACTOR	TAX RATE	NO. OF ACCOUNTS	TOTAL PAYROLL (000)	TAXABLE PAYROLL (000)	BENEFITS CHARGED (000)	EST. CON-TRIBUTIONS (000)	INEFFECTIVE CHARGES (000)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)

ELIGIBLE-REGULARLY RATED BY FACTOR

(LIST RATES STARTING FROM LOWEST TO HIGHEST. USE AS MANY LINES AS NEEDED. SEE SECTIONS 0850-0859 FOR DETAILS.)

SUBTOTAL

ELIGIBLE-SPECIALLY TAXED BY FACTOR

SUBTOTAL

TOTAL ELIGIBLE

TOTAL INELIGIBLE

TOTAL ALL SUBJECT ACCOUNTS

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0800-0999 Experience Rating Report, ETA 204 R-12/87

0802 Purpose of the Report. The data submitted annually on the ETA 204 will enable the Employment and Training Administration (ETA) to project revenues for the Unemployment Insurance (UI) program on a State by State basis and to measure the variations in assigned contribution rates which result from different experience rating systems. When used in conjunction with data from the ES 202 report, "Employment, Wages, and Contributions", the ETA 204 data will assist in determining the effects of various factors (e.g., seasonality, stabilization, expansion, or contraction in employment and payroll, etc.) on the employment experience of various groups of employers.

Also to States and the National Office, the data will provide an early signal for potential solvency problems, be useful in analyzing factors which give rise to the potential problems, and permit an evaluation of the effectiveness of the various approaches available to correct the problems detected. Moreover, the data are required as a basis for estimating State average tax rates for the rate year. Finally, the data are the basis for determining an experience rating index; the index will allow for the evaluation of the extent to which benefits in States are effectively charged, noncharged, and ineffectively charged. Comparisons among States and in a single State over time will be possible.

Thus, the foregoing information is of value to ETA in analyzing statutory provisions regarding experience rating, in preparing recommendations or advising States on proposed legislation involving experience rating, and in responding to inquiries from State agencies, employer groups, unions and others. Further, the data are a vital part of a State's management information system and a tool for the administrator and legislators to assess the State experience rating system.

0804 Submittal of Data and Due Date

A. All States permitting rate variations based on experience rating (i.e., have experience rating systems in place) should submit a completed ETA 204 report. If experience rating is suspended for a given year, only page 1 of the report needs to be submitted (See section 0810).

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0800-0999 Experience Rating Report, ETA 204 R-12/87

0804 Submittal of Data and Due Date--continued

- B. Computer printed output may be used in place of the supplied report form if the output is set up in the same format and data items are clearly labeled.
- C. The ETA 204 report is due in the National Office of ETA on the 30th day of the fifth month of the rate year to which it relates.
- D. The original of each report should be sent to the National Office of ETA, addressed to:

U.S. Department of Labor
Employment and Training Administration
Attn: TSVR, Room S-5306
200 Constitution Avenue, N.W.
Washington, D.C. 20210

A copy also should be sent to the appropriate Regional Office.

0806 Definitions. Following are definitions of terms as used for purposes of the ETA 204 report:

A. All subject accounts

1. The accounts referred to in the ETA 204 report should consist only of the accounts of those active employers (see H below) who were declared accountable or subject prior to either the beginning of the new rate year or the date designated by law as the computation date. Accounts of State or local governments, or their instrumentalities, or other units which make payments in lieu of contributions on a reimbursable basis should be included only in Sections A.2., B.5., and B.7. of the report. These reimbursable accounts should be excluded from all other entries. If selection of the accounts in terms of either of the above dates is not procedurally feasible, an alternate date may be chosen, as described in 2 below. Thus, all accounts for employers who were declared accountable or subject to the State law prior to the date chosen, and who were active in all

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0806 Definitions--continued

or part of the 12-month period covered by the report and were charged or chargeable for benefits (or benefit wages) during that period, should be included. All subject accounts for active employers declared accountable or subject on or subsequent to the date chosen should be excluded.

2. If any date other than the effective date of the new rate year or the legal computation date is used as a basis for counting the active accounts for this report, or if the 12-month period used in counting benefit payments ends on a date other than the computation date, a notice to that effect should be forwarded to the ETA National Office (Attn: TSVR) for approval at least 30 days prior to the preparation of the report. A statement should be included as to why the effective date of the rate year or the legal computation date will not be used, and a justification should be given of the adequacy of the selected date.
- B. Total payroll. Total payroll is the total amount of wages paid or payable (depending on the wording of the State law) to covered workers by employers subject to the provisions of the State unemployment insurance law for services performed during the 12 months ending with the computation date. Total wages includes both taxable wages, defined in C below, and the amount of wages which is in excess of the wages subject to the contribution provisions of the State law.
- C. Taxable payroll. Taxable payroll is the part of total payroll defined in B above, which is subject to the contribution provisions of the State unemployment insurance law.
- D. Eligible accounts. An account (see A above) is termed eligible if it has had a sufficient period of experience as of the computation date to qualify for an experience rating computation under State law. Accounts delinquent in paying contributions

0806 Definitions--continued

and accounts which have been suspended from coverage (but not inactivated) because of the temporary cessation of operations should be included in the "eligible" category. Examples would include accounts with sufficient experience which have been assigned a special rate, such as delinquent accounts to which the maximum rate has been assigned, or seasonal employers who qualify for special rates as well as accounts which qualify by reason of rates assigned as a result of formula computations under the regular experience rating provisions of a State law.

- E. Ineligible accounts. An account (see A above) which does not meet the definition for eligible accounts in D above should be considered ineligible. Therefore, an ineligible account is one which has had an insufficient period of experience as of the computation date to qualify for an experience rating computation.
- F. Benefits (or benefit wages) charged. The total amount of benefit payments (or benefit wages) charged to an employer account is termed "benefits (or benefit wages) charged".
- G. Benefits (or benefit wages) not charged. The total amount of benefit payments (or benefit wages) not charged to the account of any employer is termed "benefits (or benefit wages) not charged".
- H. Active employers. An active employer is an employing unit (single or multiple) which has been declared subject to the State unemployment insurance law and which has not been subsequently inactivated (see I below) or declared no longer subject as the result of a legal termination of coverage.
- I. Inactive employers. An inactive employer is one for which contribution reports are no longer receivable because the employing unit has ceased business in the State. (Note that suspensions of coverage for seasonality are not inactivations.) If a State has no specific guideline as to when an

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0806 Definitions--continued

employer is to be considered inactive, it may assume that suspension of operation for more than 12 months is sufficient to declare an employer inactive.

- J. Amount of account balances. (Reserve ratio States only.) The balance shown on each employer's account, i.e., total contributions minus total benefit charges, is termed a positive balance if the figure is positive or zero and a negative balance if the figure is negative.
- K. Tax rates. The rates under which the accounts are to be classified in section C should be the final assigned rates upon which contributions will be paid (including solvency and other rate adjustments, where applicable, but excluding employee contributions) after all adjustments, both individual and overall, have been made, and which (1) reflect the effect of employer voluntary contributions on such tax rates, and (2) are effective at the beginning of the rate year.
- L. Regularly rated accounts. An eligible account is termed "regularly rated" in section C if the rate assigned to the account resulted from a formula computation (of an experience factor) under regular experience-rating provisions of the State law.
- M. Specially taxed accounts. An eligible account is termed specially taxed in section C if the rate assigned to the account did not result directly from a formula computation under regular experience-rating provisions of the State law. Examples would be (1) an account which has shown a negative balance for a specified period of time and to which a special rate has been assigned, (2) an account of a seasonal employer which has been given a special rate provided by law or regulation, or (3) a State or local government entity taxed at a rate not resulting directly from experience. A brief citation of applicable law should appear on the face or the back of the table.
- N. Computation Date. The date as of which employers' experience is measured for the purpose of

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0800-0999 Experience Rating Report, ETA 204 R-12/87

0806 Definitions--continued

determining tax rates.

- O. Rate Year. The year for which the rates that were determined on the computation date apply. For example, a State that computes its experience rates as of June 30, 1987 (the computation date) to be applied beginning January 1, 1988, would show a 1988 rate year.

- 0810 Assignment of Standard Rate to All Employers. If a State agency does not, for any reason for any specific rate year, permit rate variations based on experience rating, a notice to that effect should be submitted to ETA. Page 1 of the ETA 204 report should be completed and submitted with the notice.

- 0814 General Reporting Instructions. At the top of page 1 of the report, enter the State name, rate year ending date, computation date, and type of experience rating system (reserve ratio, benefit ratio, benefit wage ratio, or payroll declines). At the top of page 2, enter the State name, rate year ending date, schedule used (if applicable), taxable wage base in effect during 12 months ending with the computation date (indicate if base changed during the 12 months), the taxable wage base in effect during the rate year, employee contributions (if any), and information on surtaxes.

The data required in sections A, B, and C should follow the format set forth in section 0800, but may be submitted on larger sheets if additional space is required. If more than one page for Section C is needed, each page should be identified as to State and rate year. The layout in section 0800 may be modified to meet the requirements of State ADP equipment. Any additional detail already programmed for State agency use may be included in these tabulations. If additional detail is already programmed for any of the items included in sections A and B, copies of tabulations containing this detail may also be submitted with the report on form ETA 204. Specific instructions are given in the following sections only to the extent necessary to supplement the titles of items, sections, and columns on the report.

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0800-0999 Experience Rating Report, ETA 204 R-12/87

0820-0824 SECTION A. ALL SUBJECT ACCOUNTS: NUMBER AND AMOUNTS OF TOTAL AND TAXABLE PAYROLL

- 0820 General Instructions. Entries in columns 1, 2, and 3 for items 1, 2, 3 and 4 and their subitems should be made in accordance with definitions in section 0806. Enter at the top of columns 1, 2, and 3, respectively, the date when subject accounts were counted for this report, the ending date of the 12-month period used in measuring total wages, and the ending date of the 12-month period used in measuring taxable wages. The latter two dates should be the same.
- 0821 Item 1. Taxable Accounts. Entries in item 1, columns 1-3, should relate to taxable subject accounts. (See section 0806 A 1.)
- A. Item 1.a. Eligible accounts. Entries in this item should relate to those subject accounts included in item 1 which meet the definition of eligible accounts in section 0806 D.
- B. Item 1.b. Ineligible accounts. Entries in this item should relate to those subject accounts included in item 1 which meet the definition of ineligible accounts in section 0806 E.
- 0822 Item 2. Reimbursable Accounts. Entries in item 2, columns 1-3 should relate to reimbursable subject accounts only as defined in section 0806 A 1.
- 0823 Item 3. Subject Accounts with Positive Balance. Entries in this item, applicable only to States using reserve ratio systems, should relate to accounts with positive (or zero) balance as defined in section 0806 J.
- A. Item 3.a. Eligible accounts. Entries in this item should relate to those subject accounts included in item 3 which meet the definition of eligible accounts.
- B. Item 3.b. Ineligible accounts. Entries in this item relate to those subject accounts included in item 3 which meet the definition of ineligible accounts.

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0823 Item 3. Subject Accounts with Positive Balance
--continued

The sum of the entries in items 3.a. and 3.b. should equal the entry in item 3.

0824 Item 4. Subject Accounts with Negative Balance.
Entries in this item, applicable only to States using reserve ratio systems, should relate to accounts with negative balance as defined in section 0806 J.

A. Item 4.a. Eligible accounts. Entries in this item should relate to those subject accounts included in item 4 which meet the definition of eligible accounts.

B. Item 4.b. Ineligible accounts. Entries in this item should relate to those subject accounts included in item 4 which meet the definition of ineligible accounts.

The sum of the entries in items 4.a. and 4.b. should equal the entry in item 4.

The sum of the entries in items 3 and 4 should equal the entry in item 1, for States using reserve ratio system only.

0830-0832 SECTION B. SUMMARY OF BENEFITS (OR BENEFIT WAGES) PAID, CHARGED, AND NONCHARGED

0830 Item 5. Benefits (or Benefit Wages) Paid, During 12 Months Ending: on Computation Date. Enter the ending date (usually computation date) of the last 12-month period used in the formula to measure benefit charges, and the total amount paid (both charged and noncharged) during the period. Include any benefits paid which impact the State trust fund accounts, (e.g. benefits under regular State UI, the State portion of Extended Benefits, and the State's liability for combined wage claim (CWC) payments). Exclude benefits paid under any program other than the State unemployment insurance program (e.g., benefits paid to Puerto Rican sugar workers). Exclude CWC payments for which other States are liable. In States using the benefit wage ratio system of experience rating, total benefit wages should be entered instead of total benefits. This entry should include items 6 and 7.

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0831 Item 6. Taxable Employer Accounts. Enter the amount of benefits (or benefit wages) included in item 5 which is attributable to taxable employer accounts.

A. Item 6.a. Charged. Enter the amount of benefits (or benefit wages) included in item 6 which were shown as a charge to any taxable employer's account. Exclude amounts which were charged during the 12-month period but removed before computing the experience rate.

1. Item 6.a.1. Active. Enter the amount of benefits (or benefit wages) included in item 6.a. which, as of the date shown in item 5, were charged to the account of an active employer. (See section 0806 H.)

2. Item 6.a.2. Inactive. Enter the amount of benefits (or benefit wages) included in item 6.a. which, as of the date shown in item 5, were charged to the account of an inactive employer (see section 0806 I); i.e., that part of item 6.a. which is not included in item 6.a.1.

B. Item 6.b. Noncharged. Enter the amount of benefits (or benefit wages) included in item 6 which is attributable to taxable employer accounts but is not charged to such accounts. Exclude CWC payments for which other States are liable.

0832 Item 7. Reimbursable Employer Accounts. Enter the amount of benefits (or benefit wages) included in item 5 which is attributable to reimbursable employer accounts.

A. Item 7.a. Charged. Enter the amount of benefits (or benefit wages) included in item 7 which, as of the date shown in item 5, is charged to reimbursable employer accounts. See section 0806 F.

B. Item 7.b. Noncharged. Enter the amount of benefits (or benefit wages) included in item 7 which, as of the date shown in item 5, is attributable to reimbursable employer accounts, but

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0832 Item 7. Reimbursable Employer Accounts--continued

is noncharged, i.e., that part of item 7 which is not included in item 7.a. See section 0806 G.

0850 FACTORS AFFECTING DATA REPORTED

0850 Comments. Comments should be provided to explain any significant administrative, legal, or economic factors which may affect the data reported. If necessary, these comments may be continued on the reverse side of page 1 of the report or on a separate page.

- A. Administrative factors affecting data reported on the tabulation. Describe any administrative factors such as rules and regulations which may affect the data reported in such a way that they will lack comparability with data submitted on prior reports or on current reports submitted by other State agencies. Also, note variations in the date of mailing contribution rate notices to employers. If a State agency has alternative rate schedules applicable under different conditions of the fund, it should describe the statutory provisions imposing the rate schedule in effect for the year covered by the report and indicate, if possible, how the effective rate schedule ranks in "favorableness" with alternative schedules provided by the law. If, for any specific rate year, no reduced rates are assigned, the reason for such action should be reported.
- B. Legal factors affecting data reported on tabulations. Describe any legal factors such as new laws or amendments to the State unemployment insurance law which may affect the data reported in such a way that they will lack comparability with the data submitted on prior reports or on current reports submitted by other State agencies.
- C. Economic factors affecting data reported on tabulations. Describe any economic factors, such as recession in key industries or major plant closings, which may affect the data reported.

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0860-0867 SECTION C. ALL TAXABLE SUBJECT ACCOUNTS: SELECTED DATA

- 0860 Column 1. Experience Factor. Enter the experience factor or combination of experience factors (e.g., solvency factor or State experience factor, etc.) which determines the tax rate shown in column 2. List the experience factors such that the corresponding tax rates in column 2 start with the lowest rate first. If experience factor intervals and corresponding tax rates exceed 30 in number, two section C tabulations should be submitted. The first tabulation, to be labeled section C-1, should use the actual tax rate in column 2. The second tabulation, to be labeled section C-2, should use tax rate intervals of not less than 0.20 percent in column 2. Only the lower value of the range should be displayed. The upper value will be assumed from the lower value of the next range.
- 0861 Column 2. Tax Rate. Enter the employer tax rate (see section 0806 K) which corresponds with the experience factor shown in column 1, lowest rate first.
- 0862 Column 3. Number of Accounts. Self explanatory.
- 0863 Column 4. Total Payroll. See 0806 B.
- 0864 Column 5. Taxable Payroll. See 0806 C.
- 0865 Column 6. Benefits Charged (Adjusted Benefit Wages Charged). In reserve ratio and benefit ratio States, for each rate group including the ineligible accounts, enter actual benefits charged during the 12 months ending with the computation date. Since benefits charged by rate group are not available in benefit wage ratio States, a proxy for benefits charged should be developed as follows: for each rate group including ineligible accounts, the proxy for benefits charged should equal total benefit outlays attributable to active taxable employer accounts times the ratio of benefit wages charged for the group to total benefit wages charged. In States using payroll decline formulas, columns 6 through 8 should be blank.

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0866 Column 7. Estimated Contributions. Estimated contributions due for each rate group, including ineligible accounts, should equal column 2 times column 5. This column and ineffective charges in column 8 will be adjusted by the National Office if the taxable wage base for the 12 months ending on the computation date differs from the taxable wage base for the 12 months ending for the rate year. Also, this column total and the ineffective charges total will be adjusted at a later date based on actual contributions due shown in the ES 202 report for the relevant period.

0867 Column 8. Ineffective Charges. For each rate group including ineligible accounts, ineffective charges should equal column 6 minus column 7. If the remainder is zero or less, enter zero.

0870-0874 CHECKING THE REPORT

0870 General Check

- A. The State name, rate year ending date, and other required data should be entered in the appropriate spaces at the top of both pages of the report form.
- B. The name and title of the State agency head or his/her designated representative should be typed in the appropriate spaces at the bottom of page 1 of the report, and the signature should be placed immediately above the typed name. Only the original need bear a handwritten signature.

0871 Section A

- A. A date should be entered in the heading of each of columns 1, 2, and 3.
- B. The entry in item 1 for each of columns 1, 2, and 3 should equal the sum of the entries in items 1.a. and 1.b.
- C. Dashes should be entered in each of columns 1, 2, and 3 for items 3 and 4 and each of the subitems in reports from States which do not use a reserve ratio system. There should be numerical entries in

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0871 Section A--continued

each of these items and subitems in reports from States using a reserve ratio system. The entry in item 3 in each column should equal the sum of the entries in items 3.a. and 3.b. The entry in item 4 in each column should equal the sum of the entries in items 4.a. and 4.b.

- D. Entries in column 2 should be greater than or equal to entries for the corresponding items in column 3.
- E. The sum of the entries in items 3 and 4 should equal the entry in item 1 (for States using reserve ratio systems only.)

0872 Section B

- A. There should be a date as well as a dollar amount entered in item 5.
- B. The sum of the entries in items 6 and 7 should equal the entry in item 5.
- C. The sum of the entries in items 6.a. and 6.b. should equal the entry in item 6.
- D. The sum of the entries in items 6.a.1. and 6.a.2. should equal the entry in item 6.a.
- E. The sum of the entries in items 7.a. and 7.b. should equal the entry in item 7.

0873 Comments. If necessary, explanatory comments may be continued on the reverse side of page 1 of the report or on a separate page.

0874 Section C

- A. Data for columns 4 through 8 should be shown in thousands.
- B. Subtotals and totals are not required for columns 1, 2, 6, and 7.

Experience Rating Report

U.S. Department of Labor
Employment and Training Administration



State _____ Rate Year Ending Date _____ Computation Date _____ Type of Rating System _____ OMB No. 1205-0164
Expires 09/30/90

Section A. All Subject Accounts: Number and amounts of total and taxable payroll

	Number as of:	Amount of total payroll for 12 months ending:	Amount of taxable payroll for 12 months ending:
1. Taxable Accounts		\$	\$
a. Eligible			
b. Ineligible			
2. Reimbursable Accounts			
3. Subject Accounts with positive or zero balance (States using reserve ratio)			
a. Eligible			
b. Ineligible			
4. Subject Accounts with positive or negative balance (States using reserve ratio)			
a. Eligible			
b. Ineligible			

Section B. Summary of Benefits Paid, Charged, and Noncharged

	Amount
5. Total Benefits (or Benefit Wages) Paid, during 12 months ending:	\$
6. Taxable Employer Accounts	
a. Charged	
1. Active	
2. Inactive	
b. Noncharged	
7. Reimbursable Employer Accounts	
a. Charged	
b. Noncharged	

8. Comments

Signature _____ Title _____ Date _____

PART C

UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 42-89

U.S. Department of Labor Employment and Training Administration Washington, D.C. 20210	CLASSIFICATION
	UI/ERI
	CORRESPONDENCE SYMBOL
	TEURA
	DATE
	July 6, 1989

DIRECTIVE : UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 42-89

TO : ALL STATE EMPLOYMENT SECURITY AGENCIES

FROM : DONALD J. WHITICK
 Administration
 for Regional Management

SUBJECT : Experience Rating Index for Rate Year 1988

1. Purpose. To transmit the first annual Experience Rating Index (ERI) for States for rate year 1988.

2. Reference. Manual Transmittal Letter No. 1460 and Change 1.

3. Background. The Department of Labor has long been interested in experience rating and the degree to which States have used experience rating in their tax programs. An Experience Rating Index (ERI) was first suggested by the National Commission on Unemployment Compensation as written in their July 1980 Studies and Research compilations. The idea was further developed by the Office of Inspector General (OIG). On August 16, 1985, the OIG issued an audit report, based on the experience of 12 States, citing a decline in the level of experience rating in the Unemployment Insurance (UI) tax system. The report recommended that the Employment and Training Administration (ETA) revise the State Employment Security Agencies' (SESAs) reporting of experience rating to provide for data which would enable the development and publication of an ERI. The OIG stated that this ERI would provide a measure of the relative degree of experience rating in the States' UI tax systems.

The UI Service contracted with Dr. Wayne Vroman to examine experience rating in general and review the OIG report in particular. In April 1986, Dr. Vroman's report, "Experience Rating in Unemployment Insurance: Some Current Issues" was delivered to the Department. The report concluded that the OIG's report had exaggerated the extent

RESCISSIONS	EXPIRATION DATE
	July 31, 1990

DISTRIBUTION

of the decline of experience rating that occurred between 1970 and 1983. Vroman further concluded that the OIG recommendations should be given serious consideration. These recommendations included changing the ETA 204 reporting form such that an ERI could be calculated for each State as well as several suggestions for desirable State level changes that would enhance the degree of experience rating. His report stated that if this information were to be collected, meaningful comparisons of ERIs across States could be made.

Manual Transmittal Letter No. 1460 revised the reporting instructions for the ETA 204, Experience Rating Report. The revisions were in response to the OIG audit and required in order to collect the information necessary to calculate an ERI for States.

4. Discussion. Attachment I shows the Experience Rating Index by State for rate year 1988. This is the first year of this report that will be produced and distributed annually.

The ERI is a relative measure of the degree of experience rating in State UI programs. Specifically, it represents the percentage of benefits effectively charged to taxable employers. It is emphasized that the ERI is best suited as an indicator of the change in the level of experience rating in a single State over a period of time in terms of economic fluctuations and law changes. It is less useful as a comparative measure among States because of the uniqueness of State laws governing financing.

Two States have pointed out that the index is an incomplete description of a State's experience rating system since it ignores fund balances and reports on only one year rather than cumulative experience.

The ERIs shown on Attachment I were calculated by the National Office using ETA 204 data submitted by States for the 1988 rate year. At this point, the ERIs are considered final. If States provided updated information by the required due date, the ERIs have been revised. Information not available (INA) is shown for those States which did not have the needed data at this writing. In some cases, INA indicates States that have a June 30 rate year ending date and had already completed the ETA 204 report for rate year 1988 prior to receipt of the revised instructions. In other cases, INA reflects States for which all the data needed are not available because of involvement in automation projects, etc. In addition, the information needed to calculate an ERI is not available

for Alaska (a payroll declines system) and Puerto Rico (uniform tax system). In benefit wage ratio States, benefit charges attributable to inactive employer accounts and noncharges were estimated based on benefit wage data. The ERI is also being published in the UI Data Summary and any publications deemed appropriate. A sample ERI calculation, with accompanying definitions, is shown in Attachment II.

Initially, the National Office intended to adjust the ERIs for States in which the taxable wage base changed between the computation year (12 months ending on the computation date) and the rate year. However, a review of several States with wage base changes showed that the impact, when the base change was small, was relatively minor and except for a few States, the taxable wage base change was less than ten percent. Accordingly, adjustments have not been made. However, depending on the magnitude and direction of a taxable wage base change, the ERI would have been slightly higher or lower if the impact of a change in the base had been considered and the ERI adjusted. The taxable wage base change in Hawaii was substantial, from \$15,600/16,500 during the computation year to \$8,700 during the rate year. Accordingly, the ERI would have been approximately 10 percent lower than that shown if the impact of the base change had been considered and the ERI adjusted.

5. Action. SESAs should examine their experience rating provisions in light of their ERI and may wish to consider strengthening experience rating when proposing legislation. Some examples of changes that would enhance the level of experience rating include: (1) raise the maximum tax rate for employers, particularly negative balance employers, (2) tax new employers at a rate that reflects industry cost experiences, (3) reduce or eliminate so-called write-offs for employers with large negative balances, (4) eliminate tax rate limiters which restrict year-to-year tax rate increases when trust fund balances are declining and (5) increase the taxable wage base.

6. Inquiries. Direct inquiries to the appropriate Regional Office.

7. Attachments

- I - Experience Rating Index by State
- II - ERI Sample Calculation

EXPERIENCE RATING INDEX
BY STATE
RATE YEAR 1988
(\$ thousands)

<u>STATE</u>	<u>IEC</u>	<u>IAC</u>	<u>NNC</u>	<u>BEN</u>	<u>ERI</u>
Alabama	\$ 32,755	\$ 3,929	\$ 19,791	\$191,877	71%
Alaska	INA	INA	INA	INA	INA
Arizona	INA	1,528	17,536	120,634	INA
Arkansas	25,900	15,756	27,294	133,796	48
California	548,983	0	150,327	1,660,430	58
Colorado	72,714	27,092	24,587	225,035	45
Connecticut	INA	11,002	24,109	167,369	INA
Delaware	INA	INA	INA	INA	INA
Dist. of Col.	21,314	8,931	887	58,616	47
Florida	10,531	36,658	37,808	262,103	68
Georgia	24,915	15,979	66,671	235,093	54
Hawaii	1,608	3,870	6,999	43,557	71
Idaho	18,807	2,616	11,770	74,127	55
Illinois	170,731	28,026	232	1,180,791	83
Indiana	22,204	6,485	4,557	178,028	81
Iowa	4,079	13,871	14,270	143,393	78
Kansas	5,119	27,451	23,720	156,769	64
Kentucky	12,310	11,955	5,263	139,466	79
Louisiana	226,880	45,161	16,985	506,838	43
Maine	6,807	2,416	8,961	48,031	62
Maryland	INA	11,305	39,703	206,162	INA
Massachusetts	99,906	33,692	50,157	410,287	55
Michigan	92,654	56,176	20,123	833,671	80
Minnesota	INA	36,595	25,780	299,351	INA
Mississippi	36,291	11,297	18,287	111,201	41
Missouri	44,788	829	43,083	230,324	61
Montana	10,521	5,763	3,227	42,057	54
Nebraska	8,743	2,248	6,872	46,161	61
Nevada	6,574	10,386	7,414	71,105	66
New Hampshire	INA	20	1,103	INA	INA
New Jersey	INA	61,975	21,454	635,178	INA
New Mexico	16,148	10,940	11,551	79,638	51
New York	123,506	81,457	8,129	1,054,181	80

<u>STATE</u>	<u>IEC</u>	<u>IAC</u>	<u>NNC</u>	<u>BEN</u>	<u>ERI</u>
North Carolina	56,252	21,516	35,376	211,422	46
North Dakota	8,163	4,000	2,933	39,304	62
Ohio	INA	40,478	32,885	652,475	INA
Oklahoma	26,571	INA	INA	367,958	INA
Oregon	38,273	19,304	32,873	218,069	59
Pennsylvania	INA	INA	INA	INA	INA
Puerto Rico	INA	INA	INA	INA	INA
Rhode Island	1,668	2,589	11,605	62,282	75
South Carolina	6,771	8,146	25,289	96,791	58
South Dakota	1,687	1,367	1,562	11,310	59
Tennessee	INA	28,124	20,261	172,410	INA
Texas	245,855	167,206	144,543	1,188,042	53
Utah	9,909	9,559	14,448	86,730	61
Vermont	3,389	1,333	3,465	27,040	70
Virginia	24,097	7,951	15,397	134,934	65
Virgin Islands	INA	INA	INA	INA	INA
Washington	42,159	49,234	51,262	359,999	60
West Virginia	0	17,755	4,764	136,064	83
Wisconsin	12,965	11,670	7,714	324,307	90
Wyoming	22,979	8,107	6,232	60,198	38

IEC = Ineffective Charges
 IAC = Inactive Charges
 NNC = Noncharges
 BEN = Benefits
 ERI = Experience Rating Index
 INA = Information Not Available

ERI SAMPLE CALCULATION

$$\text{ERI} = (1 - ((\text{IEC} + \text{IAC} + \text{NNC}) / \text{BEN})) * 100$$

where,

IEC = Ineffective Charges: ETA 204, Section C, Column 8,
Total All Subject Accounts

IAC = Inactive Charges: ETA 204, Section B, item 6(a)(2)

NNC = Noncharges: ETA 204, Section B, item 6(b) plus item
7(b)

BEN = Benefits: ETA 204, Section B, item 5 minus item 7(a)

$$\text{ERI} = (1 - ((15,143 + 8,900 + 995) / 61,395)) * 100$$

$$= (1 - (25,038 / 61,395)) * 100$$

$$= (1 - .41) * 100$$

$$= 59\% \text{ of benefits effectively charged}$$