THE ADMINISTRATION OF MERIT RATING UNDER POOLED-FUND LAWS

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While a Fellow of the Social Science Research Council, Mr. Kidd, now at Princeton University, made a detailed study, The Administration of Automatic Merit Rating Under Pooled-Fund Laws, from which this article is drawn. The study was made in consultation with members of the staff of the Bureau of Research and Statistics of the Social Security Board, though the interpretation of State laws and the conclusions are those of the author. Copies of the complete study are available for administrative use on request addressed to the Bureau of Research and Statistics, Division of Unemployment Compensation Research.

Merit rating—a device to differentiate contribution rates of individual employers on the basis of their previous employment experience—is ordinarily advocated on the ground that it provides an incentive to stabilize employment. This argument, it should be noted, implies that individual employers can prevent unemployment among their workers and that they will make their utmost effort to do so only if an incentive is provided—assumptions which have been hotly debated. Proponents of merit rating have argued also that it is unfair to require employers whose workers are seldom or never unemployed to pay contributions which will be used to compensate workers who were formerly employed by others.

Questions as to the extent to which employers are responsible for unemployment among their workers or as to the equity of requiring flat contributions to a pooled fund are not within the scope of this article. Discussion is limited to the probable effects of present legal provisions upon stabilization of employment and upon administration of unemployment compensation systems under State laws which provide for merit rating and for a completely pooled fund.[1] Use of merit rating in conjunction with a pooled fund represents a compromise: Such a system, it has been argued, maintains, on the one hand, the differentiation of employer contributions found in employer-reserve systems and, on the other, the wide sharing of risks embodied in the pooled-fund principle. This combination, it is declared, tends to encourage stabilization of employment by individual employers and also protects the solvency of the State fund.

The Merit-Rating Formula

Provisions of the several acts which provide for merit rating in conjunction with a completely pooled fund are varied and complex. They follow, in general, a certain broad outline.

The differential contribution rate is based upon the employment experience of the individual firm. For this purpose, that experience is measured by comparing the contributions made by each employer to the pooled fund with the benefits paid from the fund to workers formerly in his employ. The excess of each employer's contributions over benefits charged to him is called the *employer's reserve balance*. In order to determine the rate applicable to each employer, the experience of large and small concerns is reduced to a comparable form by dividing the employer's average pay roll into his reserve balance. The figure obtained is the *employer's reserve ratio*. Information needed to compute this ratio—contributions credited, benefits charged, and average pay roll—is recorded on the *employer's merit-rating account*. This account is kept merely to compute contribution rates and has no bearing upon benefits payable from the pooled fund.

After comparable ratios have been computed, contribution rates reflecting the employer's employment experience are assigned by relating the amount of the employer's contribution to the fund directly to the size of his reserve ratio. Fifteen different schedules are used in the State laws to determine the contribution rates applicable to employers whose reserve ratios reach a certain

[1] Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Louisiana, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, South Carolina, Tennessee, Texas, Utah, West Virginia, and Wyoming. The dates upon which merit rates will become effective in these States range from Jan. 1, 1941, to Jan. 1, 1943. Because of significant differences in theoretical bases, provisions of law, and techniques of administration, neither individual reserve laws, laws under which a portion of contributions is pooled, nor laws under which the criteria for rate differentiation are fixed by the State agency are included in this discussion.

level. Two of the fifteen will illustrate the divergence between the schedules written into the State acts. For Colorado the reserve ratios and contribution ratios are related as follows:

Reserve ratio (percent)	Contribution rate (percent)
0.0–7.4	2.7
7.5–9.9	1.8
10.0 and over	.9

For Connecticut, on the other hand, these relationships are as follows:

Reserve ratio (percent)	Contribution rate (percent)
0.0–7.4	2.7
7.5–9.9	2.5
10.0–12.4	2.0
12.5–14.9	1.5
15.0–17.4	1.0
17.5 and over	.0

Finally, since the operation of differential rates may in certain circumstances endanger the solvency of the pooled fund, operation of the machinery of rate adjustment is modified by provisions which are intended to protect the solvency of the pooled fund. In general, these provisions attempt to safeguard the fund by imposing higher than normal rates upon employers who have a negative balance in their reserve accounts and by blanket restrictions upon rate decreases when the condition of the fund makes reductions in its income unwise. The safeguarding provisions are open to objection on the ground that they will be ineffective rather than that they will be difficult to administer.

The use of "benefits charged" as a measure of the employer's employment experience was carried over directly from the employer-reserve laws. In those laws the financial condition of *each employer's* reserve fund is of paramount importance and is related directly to contributions paid by each employer and benefits paid to his workers. In a pooled-fund law, the financial status of the fund is not determined by benefits paid to workers formerly employed by a given employer and contributions paid into the fund by that employer. To maintain the solvency of the fund, total contributions paid into the pool by all employers must exceed total benefits paid. If differential contribution rates in a pooled fund are desirable, the standards governing rate differentiation need not be those designed to measure the financial status of an individual employer's account.

In a pooled fund the standard for rate differentiation might more logically be one which measures employment stability rather than the hypothetical financial experience of each employer under the act, and also the achievement rather than the existence of stability. The experience ostensibly measured by the reserve-ratio formula is hypothetical because under a pooled-fund law benefits are not paid out of individual employer funds. The reserve ratio (contributions credited minus benefits charged, divided by average pay roll) is not a measure of the stability of employment in an establishment because only the experience of those workers is considered who are covered by the act, become unemployed, and receive benefits. Furthermore, the amount charged against a given account depends upon the number of employers by whom the worker was employed, the chronological sequence of employment, and the total amount of benefits received. In most cases these factors are beyond the control of the employer.

No system of merit rating has been based on actuarial studies of employment experience. The basic data for such estimates are in most cases not in existence. In no State have estimates been made of the characteristics of establishments which would pay reduced or increased rates—the number of such establishments, their size, industrial classification, location, and so on. The financial and wider economic effects of the existing merit-rating provisions are, therefore, matters of speculation. On the other hand, the nature, if not the precise range, of most of the administrative difficulties that may be caused by merit rating can be foreseen.

Bookkeeping Problems Created by the Rating Formulas

To arrive at each employer's contribution rate under the existing laws, three principal items of information must be recorded by the State agency; namely, each employer's contributions for all past periods, each employer's pay roll for the last 3 and the last 5 years, and benefits charged against each employer's account for all past periods. Existing employer reports supply the basic payroll and contribution information, and a relatively slight addition to and rearrangement of internal procedures will yield the necessary averages and totals. Unfortunately, the basic element of the reserve-ratio formula—benefits charged—promises to be a fertile source of administrative difficulties. Space limitations permit only a brief discussion of some of the major problems.

Perhaps the most complex phase of the merit-rating problems is the distribution of charges among employers' accounts. If an eligible worker accumulated benefit rights while in the employ of a single employer, his account alone could be charged with benefits. But if a worker has accumulated benefit rights while in the employ of several employers, some method of distributing the assumed "responsibility" for unemployment must be found. Very little data indicating the proportion of charged benefits wh ch will be split among two or more employers (or ignored in the charging process) exist. The difficulty of making split charges will be much more than proportional to the number of such charges.

Three methods of distribution, each of which is objectionable on administrative and logical grounds, are incorporated in the laws. Two States will charge only the account of the most recent employer; others will also charge the next most recent employer if only a small amount of wages was earned from the most recent employer. Most laws provide that all employers who employed the benefit recipient after the beginning of his base period shall be chargeable. A single State, California, provides that benefits shall be charged against the accounts of all employers within the worker's base period in the same proportion that wages earned from each bears to total wages earned during the base period. Each of these methods can be rationalized as more "equitable" or "reasonable" than the others. The purpose of the charging clauses is not perfect justice but a distribution of charges which will provide a maximum incentive for stabilization. The idea that an employer can "justly" be charged only with those benefits the rights to which were accumulated in his service is a concept arising out of the application of the employer-reserve principle to employers who are covered by a pooled-fund law.

More important than abstract principles are the problems that will arise when the actual distribution of charges is begun. Several difficulties can be anticipated in States which may charge more than one employer. When the most recent employer is chargeable, the amount chargeable against his account cannot be computed until wages for the quarter in which the last employment occurred have been submitted to and recorded by the agency. In the absence of full, regular, and accurate employer reports, it will be difficult, and in some cases impossible, to identify employers other than the most recent one. Unless accession and separation dates are supplied by the employer on his pay-roll report for every separation and accession for every worker during the reporting period it will be impossible to find the worker's sequence of employment with different employers. The sequence of employment will be particularly difficult to find if two or more spells of employment with the same employer, separated by a spell of employment with another employer, occur during the same quarter. In this case it may be impossible to apply the criterion used in many laws—earnings with the most recent employer amounting to more than a specified multiple of the weekly benefit amount—in order to determine the potential liability of the next most recent employer. Some States may find that a wage and separation report covering the lag and current quarters will solve this problem.

Determination of the exact amount to be charged, aside from the determination of the sequence of chargeable employers, will be a second major source of administrative problems. The laws are so worded that each employer is liable, roughly, for the amount of benefit rights the worker accumulated while in his employ. This amount is his maximum potential liability with respect to any worker. The amount actually charged will depend upon the recency of the worker's employment with him and upon the total amount of benefits received. Determination of the amount of each employer's liability will be complicated by the payment of benefits for partial unemployment. Are the benefits to be charged against the wages earned during the spell of partial unemployment, or only against wages earned before the spell of partial unemployment began? The vague and conflicting rationalizations underlying the charging clauses provide no sure basis for a decision. As has been indicated, the sum of all charges is a questionable basis for a formula intended to measure stability of employment. Furthermore, the volume of detailed calculations and transfers from one record to another which are necessary to compute charged benefits will necessitate setting up an entirely new procedure in most agencies.

In establishing this procedure, charges against employers' accounts must be extracted from a record of the worker's employment experience. In some States this record is not kept in a form which is well adapted to the computation of charges. The interval between the payment of a check and the charging of that check against an employer's account may range from 1 day to 1 year. In general, it will prove to be relatively expensive to charge back each check as a separate unit unless the charging process can be integrated with checkwriting. On the other hand, postponement of all charging until just before rates for the next year are computed would put an unnecessary peak load on the agency. As a compromise between these two positions, charging as a unit the benefits paid for a spell of compensable unemployment has been suggested. The worker's most recent wages may determine the amount chargeable against the most recent employer, but benefits may be paid in some States before the wage information which determines the distribution of charges is available. Therefore, charging must, in many cases, be postponed until wages for the most recent quarter are posted. For this purpose, a suspense file of charges may be required.

Total charges against a given employer's account, furthermore, can be obtained only by cumulating all charges that have been made as the result of benefits paid to former employees. Either by manual or mechanical sorting, charges derived from individual records which, in most States, are not listed in employer sequence must be totaled for each charged employer. Computation of charges to the exact penny will create, on a somewhat smaller scale, the same problems that have been met in the computation of benefits to the penny. Types of bookkeeping equipment, routing, and timing of the charging procedure must dovetail as smoothly as possible with the available equipment and procedures of the agency.

After the three elements of the formula have been recorded, computation of each employer's reserve ratio is a matter of simple arithmetic. Even after rates are computed, one major problem must be met in 23 States where the laws contain a clause reading, "each employer's rate for the 12 months beginning January 1, shall be determined on the basis of his record up to the beginning of such calendar year." It will be impossible under these laws to compute rates before the employer's first contribution for the new year is due. A lag period of 3 or 6 months inserted between the end of the experience period and the date upon which rates based upon that experience become effective may solve this problem.

The Effect of Merit Rating Upon Relations of State Agencies, Workers, and Employers

The administrative burden of merit rating will not be determined entirely by the increased complexity which the present schemes of rate differentiation introduce into bookkeeping procedures. While workers will be directly affected by merit rating only insofar as employers become more vigilant in detecting unallowable claims and contesting debatable claims, each employer has a strong, direct interest in the size of his reserve ratio. These interests are such that they may in some instances conflict with the public interest as determined by the State agency. Many problems would be common to any scheme of merit rating; others arise out of specific clauses in State acts.

Rules adopted by State agencies for determining part-time work and partial unemployment may raise differences of opinion between employers and the unemployment compensation commissions. Although these two provisions were designed in 14 States covered by this survey to deal with distinct types of employment experience, differentiation will, in practice, be a difficult matter. When the law provides for merit rating, the employer has a strong incentive for declaring all workers whose hours are reduced to be "part-time" rather than "partially unemployed" workers because part-time workers, who may be working for the same number of hours and receiving the same compensation as partially unemployed workers, will receive no benefits. The commissions must determine the length of the period during which full-time workers must work at reduced hours before they cease being partially unemployed and become part-time workers.

If both seasonal and merit-rating provisions exist in a law, employers will press for a definition of seasonal workers' rights to benefits which will relieve them of a maximum amount of benefit charges. The State agency will be forced to regard the adequacy of benefit payments and also the equity of different methods of defining seasonal workers' rights to benefits. Some situations calling for a decision by the commission will arise even after the seasonal period of operation is fixed. For example, if some of the workers of a seasonal employer obtain benefits in his off season, should any portion of the benefits paid to any of these workers be charged against his merit-rating account?

The State agency may be required to notify "interested parties" of the initial determination of a claim. Many laws are ambiguous on this point. They may be interpreted to mean that interested parties must be notified only of the decision of the body which decides *disputed* claims. "Interested parties," moreover, is a term not explicitly defined in the laws. Actually, any employer who paid wages to the employee after the beginning of his base period has an interest in the initial determination of a claim because his account may be charged if benefits are paid. Employers likewise have an immediate interest in the determination of the claims, because they may be able to supply evidence which might result in disallowance. Notification of all employers whose accounts might be charged involves an undue administrative expense. In spite of the possibility that all chargeable employers may be declared to be interested parties, such general notification is extremely difficult, if not impossible, unless the State agencies require separation notices.

As a matter of policy, the commissions may find it desirable to notify employers of benefits actually charged against their accounts soon after benefits have been paid. Whether or not this course is followed will depend, first, upon the number of employers who decide to maintain records of their own merit-rating accounts as a means of checking the records of the State agency and, second, upon the urgency with which they request information on charged benefits from the agency.

The cause for leaving the employment of an employer—once the validity of the claim has been established and the necessary waiting and disqualification periods have been served—does not affect the charging process. Employers will generally believe that only benefits paid to *workers whom they discharge for lack of work* are chargeable against their accounts. It will be the duty of the State agencies to remove this source of misunderstanding.

As time passes, changes occur in the size, ownership, control, and financial status of enterprises. Each of these changes may involve the disposition of the employer's accumulated contribution and benefit experience. Suppose that an employer sells his business outright. Does the purchaser acquire the merit-rating account of the seller? A similar question will arise when control of an enterprise changes hands through a transfer of part of the assets or through bankruptcy proceedings. The question of continuing an existing merit-rating account or of setting up a new account will also arise if an employer, after being covered by the law, ceases to be subject and then returns to a covered status.

Employers who have distinct units of operation which are more unstable than the remainder of their operations may, in order to avoid liability for benefit charges, contract out such unstable work to enterprisers who are more or less dependent upon them. The task of determining which of such concerns are in reality separate enterprises and which are mere subterfuges will fall to the commissions.

The definition of "employer" offers still another difficulty. In many States, for purposes of merit rating, "employer" may be interpreted to mean "establishment." Where such an interpretation is adopted, employers whose operations taken as a whole are stable, but whose instability is concentrated in a particular establishment, may be expected to set up separate accounts for the unstable portion of the business. The lack of symmetry between the clauses which stipulate the conditions under which rates higher or lower than normal will be imposed will make this course profitable to such employers. The wisdom of allowing such subdivisions of risks must be decided by the State agencies.

If subcontractors are declared to be liable for contributions, the fly-by-night activities of some of these enterprisers will complicate the charging process. In any case where an employer has gone out of business or has ceased to be subject, it will be difficult to note that fact in such a manner that charges will not continue to be made against his nonexistent account.

The manner in which merit rating should be publicized in order to obtain employer cooperation is a problem of policy which confronts each State agency. During the interval between the passage of the laws and the date when rates are to be altered, the possibility of rate decreases has been used by many State agencies to induce employers to comply more fully with legal requirements, and to obtain fuller cooperation in the submission of data for special investigations. When rate increases are imposed, or anticipated rate decreases are not realized, employers may complain that the effects of the law have been misrepresented. Furthermore, the desirability of merit rating on any basis and the administrative feasibility of a reserve-ratio method of rating are open to question. Agencies which stress rate reductions under a reserve-ratio formula in dealing with employers may find themselves embarrassed if any major revision of merit rating or a change in the method of rating proves desirable.

The Cost of Merit Rating

Only the most tentative plans for coping with the accounting problem of merit rating have been made, and the laws are subject to amendment before merit rating becomes effective. Moreover, the form and content of the records upon which the merit-rating computations are based are undergoing constant revision. If the formal procedures had been finally decided upon, a less tangible but very significant factor—the quality of the personnel in the State agencies—would cause large variations in the bookkeeping costs of merit rating. In spite of the impossibility of stating the precise dollar administrative costs of merit rating, a rough estimate of these costs in any State can be made by comparing the volume and type of operations to be performed for merit rating with those necessary to pay benefits. Such a comparison indicates that the merit-rating clauses considered in this paper will add appreciably to the administrative cost of unemployment compensation.

Conclusion

The purpose of merit rating—i. e., adjustment of employer-contribution rates on the basis of previous employment experience—does not require use of a reserve-ratio formula. If, however, that method is to be followed, it seems clear that certain changes are necessary. If measures which will allow some simplification of the internal processes required for merit rating—either by modifying the reserve-ratio method or dropping it entirely—are not adopted through amendment of the State laws, the State administrative agencies may be expected in many instances to ignore the letter of the law in order to prevent a break-down of the merit-rating mechanism.

Some of the changes which might be made in the reserve-ratio formulas in order to render them less of an administrative burden are indicated in the preceding paragraphs. These might include:

1. Interposition of a lag period of 3 or even 6 months between the end of the experience period and the effective date of rate changes.

2. Rewording of the laws in order to eliminate ambiguities, as, for example: definition of the status of benefits paid to partially employed workers with respect to charging against employers' accounts; clearer definition of the sequence in which employers' accounts become chargeable; more precise definition of concurrent employment.

3. Limitation of benefit charges to the last employer or, at most, against the two most recent employers.

4. Charging not the exact amount of benefits paid but a rounded-off amount, an average benefit amount, or a fixed sum for each compensable spell.

The list could be extended; but it can be safely assumed that the cost of merit rating cannot be significantly reduced, either by changes in the laws or by the adoption of refined bookkeeping methods, without drastic changes in the existing reserve-ratio formulas.

As long as benefits charged against employers' accounts are an element in the computation of merit rates, the basic problem of deriving employer charges from a worker's record will exist. In addition, the difficulty of cumulating total charges against a single employer's account from the charges recorded upon each worker's account will confront any bookkeeping system because of the relationship between wage credits and the amount chargeable against the employer's account. Finally, the simpler tasks of setting up an account of all charges made against the employer's account and maintaining a merit-rating account for each employer must be performed by whatever accounting method is adopted in the State agencies. The prospective administrative advantages and disadvantages of various alternative rating schemes do not come within the scope of this article.

Finally, it must be noted that, if the reserve-ratio formulas are altered or abandoned, considerations of administrative convenience will be only one among many factors. It is possible that the existing clauses will be ineffective; that unjustifiable penalties or bonuses to employers will arise; that the income of the pooled funds will be reduced; that the benefit formulas on which the merit-rating clauses are based will be revised; and that emphasis will be placed by employers upon reduction of benefit claims without a corresponding regularization of employment. All these possibilities indicate that a basic revision of the present rating schemes may be required.

STATE DIFFERENTIALS IN PRICES PAID BY FARMERS FOR FAMILY LIVING

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Data on differentials in the costs of living of the various States have long been needed. As Federal-State programs have been developed, under the Social Security Act and other legislation, to cope with social and economic problems, the need has become more acute. In cooperation with other Federal agencies, the Social Security Board is exploring the possibilities of developing new data in this field.

Several Federal agencies collect data regularly on retail prices in the States and compute indexes of costs of living. The Bureau of Agricultural Economics publishes a periodic index [1] of prices paid by farmers for commodities used in family living, and the Bureau of Labor Statistics issues periodic indexes [2] showing retail prices in selected cities and changes in urban living costs. The Works Progress Administration published a study [3] for 1935 on urban differentials which supplemented the Bureau of Labor Statistics studies. No Federal agency, however, had published State differentials for either rural or urban populations, and the obvious difficulty of combining rural and urban data has impeded efforts to develop composite State indexes of costs of living.

At the suggestion of the Social Security Board, the Bureau of Agricultural Economics consented to process its unpublished data on prices of goods purchased by farmers for living, provided that some technical assistance could be furnished by the Board. As a result an index was constructed showing State differences in such prices as of March 15, 1938, and has recently been published by that Bureau.[4]

In the compilation of the State indexes the same commodities and weights were used as in the Department of Agriculture's United States index of prices paid by farmers for commodities used in living. The value of this fixed market basket of consumer's goods, at United States average prices for March 15, 1938, was taken as 100. These commodities include 94 selected foods, clothing, household supplies, furniture and furnishings, fuels, automobiles, and other important commodities purchased for use in rural living. The State averages of commodity prices used in constructing the index were compiled from retail price data reported from more than half the counties of the United States; these data are obtained periodically from cooperating retailers throughout the United States as a part of the regular reporting service of the Bureau of Agricultural Economics. In devising the State indexes, the consumption weights for individual commodities and for commodity groups based on budgetary proportions were kept constant for all States.

The resulting index, therefore, reflects only actual differences in prices paid by farmers. The basic price data, however, do reflect existing differences in the quality of articles bought in various parts of the country, as each respondent was asked

* Bureau of Research and Statistics, Division of Economic Studies. The study on which this article is based was made from published and unpublished data of the Bureau of Agricultural Economics, U. S. Department of Agriculture.

[1] U. S. Bureau of Agricultural Economics. *The Agricultural Situation, A Brief Summary of Economic Conditions.*

[2] U. S. Bureau of Labor Statistics. "Retail Prices," and "Cost of Living," *Monthly Labor Review.* (Series.)

[3] Works Progress Administration. *Intercity Differences in Costs of Living in March 1935, 59 Cities.* Research Monograph XII, 1937.

[4] U. S. Bureau of Agricultural Economics. Press release, July 29, 1938.