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Solving the EI Conundrum

by

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During their years as prime minister and finance minister, Jean Chrétien and Paul Martin have presided over a remarkable restoration of federal fiscal health. The federal budget for fiscal year 1993/94 showed a $42 billion deficit; this fiscal year, current indications are that the budget may reach a $7 billion surplus. The employment insurance (EI) program has made a major contribution to this turnaround. While EI premium revenues fell slightly short of program costs in 1993/94, premium collections in 1998/99 will likely exceed costs by about $7 billion.

Now, however, EI's key role in improving federal finances presents the government with a problem. EI is supposed to be a social insurance program, collecting insurance premiums from employers and employees to fund benefits to workers who lose their jobs. Since 1986, the EI account has been consolidated with the rest of the budget, on the grounds that a statement of Ottawa's fiscal position that left out such a large program would be seriously incomplete. But the *Employment Insurance Act* requires that, over time, EI premiums and payouts should roughly match and that premium rates should be set accordingly. Now that several years of revenues running well ahead of expenditures have driven the *cumulative* surplus in the EI account to almost $19 billion — roughly equal to *annual* contributions — something has to give.

But what? The federal government, which wants to keep premiums high to fund other tax cuts, pay for new spending, and still leave something over to guard against a return to deficits and, with luck, pay down some debt, appears to be planning changes to the EI act that would allow the cumulative surplus in the account to keep building for the foreseeable future. Doing so, however, would expose the EI's insurance label as a fraud, raising serious questions about political accountability and even legality. The obvious alternative — to cut EI premiums by about one-third from their current level of 6.48 percent of insurable earnings[1] (3.78 percent charged to employers, 2.70 percent to employees) to 4.20 (2.45 to employers, 1.75 to employees) — would likely prevent the surplus in the account from building further. If, however, next year's surplus is also likely, given unchanged policies, to come in around $7 billion, such a premium cut would all but wipe it out, leaving no room for other tax cuts that might give more of a boost to growth and job creation and putting debt paydown out of reach.

There may be a way out of this dilemma. In our view, Ottawa should concede that EI revenue has long been used for non-insurance purposes, give employee-paid premiums that cover these other uses a different label, and remove this revenue from the program. Employer-paid premiums and interest on the cumulative surplus would continue to cover unemployment benefits and the program's legitimate administrative costs. The cumulation of funds in the EI account would cease without threatening next year's total budget surplus. And there would be room for other tax changes — most notably personal income tax cuts and selective reductions in employer-paid EI premiums for businesses with better layoff records — that would raise employment and living standards in the future. In short, it would leave federal finances on a more solid economic and political footing.

The Evolution of the EI Problem

Although recent criticisms of the misuse of EI funds have helped focus public attention on the issue, the diversion of premiums to uses other than benefits for the unemployed is a long-standing problem.

From the 1970s on, the unemployment insurance (UI) program spent money on a variety of things other than income support for laid-off workers, and Ottawa has regularly added new noninsurance wrinkles. Spending on training and other "active labor measures," for example, has expanded to make up 15 percent of the program. And with EI's hefty administrative costs, spending on items other than regular benefits now comprises more than one-third of total spending under the program. Up to 1990, Ottawa covered a portion of these costs from outside the account. In 1991, however, it began charging all such spending to premium revenues (which involved a substantial hike in the rate at the time).

Prior to the 1990s, the UI account had fluctuated between zero and substantial deficit, depending on the state of the economy. With the recovery from the 1991–92 recession and changes to EI benefits, payouts dropped, but continued fiscal pressure led Ottawa to keep premiums up, arguing that building a reserve in the account would allow rising insurance claims in the event of a downturn to be covered without a premium hike. The cumulative balance in the account turned positive in 1995 and, sometime during 1999, it will pass $20 billion — far more than is necessary to weather a recession without a premium hike. Much of this amount — all of it, if the government intends to appropriate the cumulative surplus for the regular budget — will go to purposes other than income support for workers who lose their jobs.

The Accountability Imperative

Looking at this record, one would have to say that the current concern over Ottawa's stewardship of the EI program is long overdue. Ottawa's budgets and public accounts records have a reputation as among the best — if not the best — in the world for fairly representing a government's financial position, but its treatment of the EI program is profoundly at odds with this tradition.

Continuing to collect premiums that exceed — or even simply match — current and projected payouts in the program presents a major accountability problem. If the labeling of EI premiums on Canadians' T-4 slips and in the budget, and the figures for the EI account in the public accounts turn out, with hindsight, to be a lucrative misstatement, then the line of accountability leading from the government to Canadian voters is seriously frayed.

Both Parliament and the public need clear, consistent labels on government programs in order to understand and control the nation's finances. It is hard for parliamentarians to know what they are actually voting for if programs are misleadingly named and if funds ostensibly raised for one purpose are diverted to another. And if taxpayers' paystubs and tax forms have a box for EI deductions, they are entitled to expect that these funds will be used to provide EI benefits, not something entirely different.

The same concern applies when the accumulation of funds, rather than the inflow, is at issue. Funds set aside for one purpose must not be appropriated for another simply because it becomes politically convenient to do so. Otherwise no commitment is secure: almost every number in last year's public accounts and this year's budget becomes unreliable as an indication of what the government will do tomorrow.

The hiding of a variety of payments under the EI label has had several unfortunate results. The administrative costs of the program — some $1.2 billion annually — are high. And the EI program has lent cover to the federal incursion into provincial jurisdiction over labor market development, making EI premiums a prop for Ottawa's constitutionally contentious "spending power."

Indeed, classically Canadian constitutional twists in connection with EI go further. Provincial governments pay this levy on behalf of their own employees on the grounds that the payments are social insurance premiums against unemployment. If, however, the premiums are a tax levied for a variety of noninsurance purposes, they violate the constitutional principle that the Crown must not tax the Crown.

These concerns are serious: they go to the heart of representative government and the ability of the public to hold Parliament accountable for its use of public funds. If Canadians are to consider keeping EI premiums higher than are needed to cover benefits or, even more extraordinary, to tolerate an appropriation of the cumulative surplus in the account for other purposes, there had better be some very compelling reasons for doing so.

Efficiency

What makes the government's dilemma so acute is that, in fact, keeping EI premiums high does offer some attractive opportunities.

Most obviously, keeping premiums up and doing nothing else means that Ottawa can look forward to a substantial surplus. The benefits of paying down debt are straightforward and relatively uncontroversial: interest payments will shrink, leaving more room for lower taxes or bigger programs in future, and taxpayers and the federal government will be less exposed to the unpleasant effects of unexpected interest rate increases. The sooner surpluses pay debt down, the sooner those benefits will arrive.[2]

If, alternatively, Canadians want to forgo some of the benefits of debt paydowns, opting instead for earlier, larger tax cuts to spur growth in income and employment, then it is not clear that payroll taxes should be first in line. Personal income taxes are probably more damaging to the economy. Their work-discouraging effects are more pervasive since — unlike EI premiums, which are capped at $39,000 — they affect people across the income scale. Income taxes also discourage saving and investment, while payroll taxes do not. Cutting EI premiums enough to stop the account surplus from building further in 1999 would, in revenue terms, be equivalent to cutting all three federal marginal income tax rates by a full percentage point, eliminating the 3 percent and 5 percent federal surtaxes *and* modestly increasing the basic personal exemption.[3]

There are other growth- and employment-related reasons for delaying cuts in EI premiums. The old UI program's defects, which historical evidence shows to have significantly raised Canada's unemployment rate, have inspired a number of recent reforms — calculating coverage on an hours-worked basis, reducing benefits for repeat users, and lengthening entrance requirements.[4] But more could be done. The Mintz Committee has recently made the case for experience-rated premiums — premiums set according to the history of industry or firm usage of EI.[5] Experience rating would reduce the subsidy that EI provides to layoff-prone employers, improving Canada's job market. Maintaining premiums until such a system is ready for implementation would be helpful because its introduction would then require no increases in premiums, only cuts of various sizes depending on the employer's layoff record.

Not all arguments concerning growth and jobs point the same way, however. On economic grounds alone, the GST is a better revenue source than either EI premiums or personal income taxes. In addition, the recent reforms to the Canada Pension Plan (CPP) mean that the plan's contribution rates will increase sharply, from today's 6.4 percent of covered earnings — charged half-and-half to employers and employees — to 9.9 percent of an expanded base by 2003. Although payroll taxes mainly depress wages in the long run, the short-run friction involved in passing through the employer-paid portion, when wage rates are inflexible, means that these increases will cost jobs.[6] At the very least, it would be desirable to cut EI premiums over the next few years by enough to ensure that the total payroll tax burden does not rise.

Thinking about the different ways that money is spent, when raised by EI premiums as opposed to other taxes, raises more questions about the wisdom of keeping EI premiums high. As long as the account surplus keeps building, there will be pressure to undo many of the recent EI reforms. Moreover, the current noninsurance expenditures are of questionable value. High administrative costs benefit no one except administrators themselves. Federal training and active measures have a sorry history of failure, and intrude on a task that the provinces are better able to handle.[7] Ottawa's other recent argument for keeping premiums up — to increase federal health-related spending — is completely indefensible. Using EI premiums this way not only grossly violates accountability to Parliament and to taxpayers; it also flies in the face of the need to disentangle federal and provincial responsibilities in social policy. Any province that truly feels its health-care system is suffering from under funding has an obvious solution at hand: shift spending from other programs or raise taxes. Every province has the fiscal capacity to find extra money equal to any conceivable EI-funded increase in federal transfers. There is no reason for Ottawa to raise it for them.

How's That Again?

To recap the economic case, offsetting the CPP rate increase and reining in some of the less defensible spending in the EI program make a case for cutting EI premiums. For the sake of longer-term growth in jobs and living standards, on the other hand, Canadians would benefit more from a combination of cuts in personal income taxes and budget surpluses than they would from cuts in payroll taxes.

The accountability issue is more straightforward. EI premiums are already being diverted to noninsurance uses, and to further build the cumulative EI account surplus would change the practice from a debatable misstatement to a bald lie.

A Way Out

Our proposal for resolving this conundrum has three parts.

First, to mitigate the job-killing effects of scheduled CPP contribution rate increases, we recommend staged cuts to EI premiums to offset them. CPP rates are slated to rise from 6.4 percent of covered earnings this year to 7.0 percent in 1999. Offsetting this increase would require cutting EI premiums by a similar amount, from 6.48 percent of covered earnings to 5.88 percent (3.43 for employers, 2.45 for employees).[8] In 2000, the CPP rate is scheduled to increase by another 0.8 percent of covered earnings. Offsetting this increase would involve a further cut in EI premiums to 5.04 percent (2.94 for employers, 2.10 for employees). Without other tax changes, the combined impact of these EI premium cuts would reduce by about $2 billion the federal budget surplus that would otherwise occur in 1999 / 2000.

Second, we argue for a formal relabeling of the money raised by the employee-paid portion of EI premiums, which would remove from the EI account money that does not fund income support for laid-off workers. This new label would appear on paystubs and T-4 slips, on the income tax form, and in new entries in the budget and the public accounts.

Once relabeled, this tax could be changed in other ways — the cap at $39,000 could be lifted and the rate lowered, for example, to produce the same revenue on a broader base.[9] The key point, however, is that Ottawa would no longer raise this money under the misleading claim that it is insuring Canadians against the risk of job loss.

There are two important reasons for relabeling only the employee-paid portion. First, provincial governments would no longer pay general payroll taxes to the federal government, putting the system onside with respect to the Constitution. Second, it would leave the door open to experience rating the employer-paid portion, which, as argued earlier, is much more easily done by lowering premiums for employers with good layoff records than it is by raising them for employers with bad records.

Allowing for the 0.6 percentage-point EI rate cut to offset the CPP increase, the employee-paid portion of EI premiums in fiscal year 1999 / 2000 would raise about $7 billion — approximately equal to the sum of non--insurance spending in the EI program and the amount by which the EI account would otherwise likely grow that year. With employer-paid premiums and interest on the cumulative surplus covering benefits, the accountability problem would be solved. Figure 1 shows how this proposal would affect the EI premiums that will otherwise be payable in 1999 / 2000.

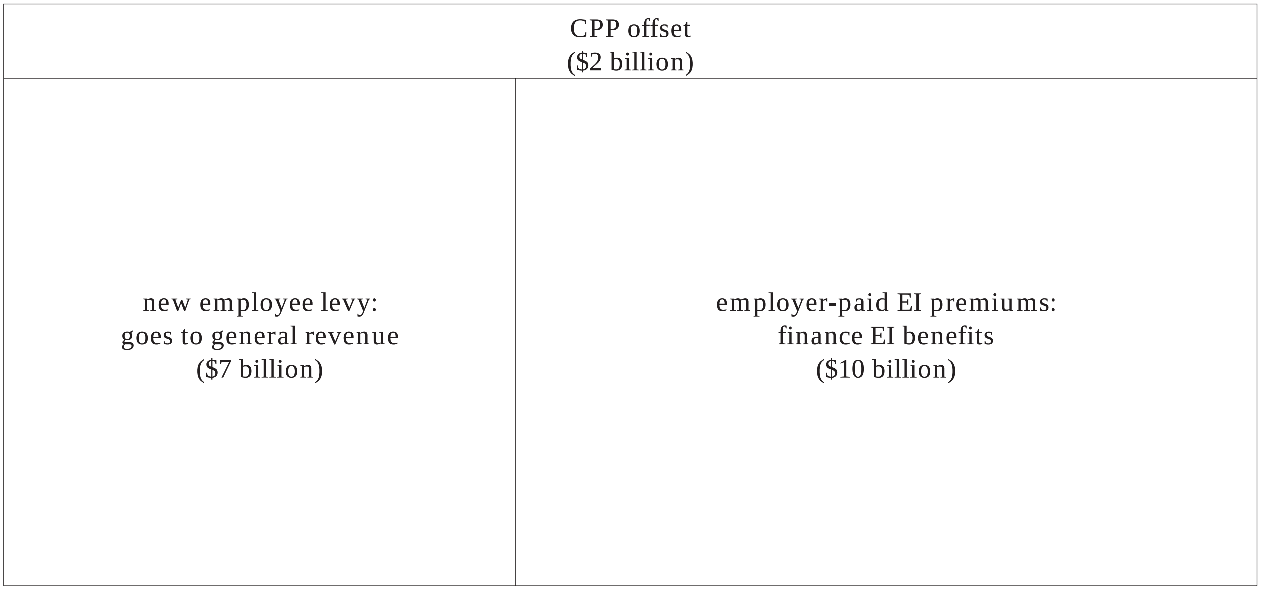
The third task would be to split the remaining federal budgetary surplus in 1999 / 2000 billion between personal income tax cuts and actual debt repayment. Both offer important benefits to Canadians, and set a further dilemma for fiscal policy. But the debate over that choice will be a happier one without the rancor surrounding the current EI debate.

Conclusion

There is a route out of the EI conundrum. First, EI premiums should be cut by an amount sufficient to offset the transitional job-killing effects of the coming CPP premium hike. Next, Ottawa must admit that a substantial part of EI premium revenue has long been diverted to purposes other than unemployment insurance, and fix the problem by relabeling the employee-paid portion as a general payroll tax. This move would stop the unnecessary cumulation of funds in the EI account, remove a source of temptation to spend, and solve a major accountability problem in the federal budget.

Such a program would leave room for other tax changes — personal income tax cuts and reductions in employer-paid EI premiums for businesses with good layoff records — that would boost growth and job creation in the future. And, by solving the EI conundrum, it would put federal fiscal policy on more secure economic and political footing.

Figure 1: *Impact of Proposed Changes on EI Premiums Otherwise Payable in fiscal year 1999/2000*



Total: $19 billion

Notes

1 The government's normal practice is to refer to EI premium rates in terms of dollars charged to the employee per $100 of covered earnings — currently $2.70. This understatement of the true cost of the program is unhelpful when considering its relationship to the budget and other taxes, so we refer here to the combined premium as a share of covered earnings — currently 6.48 percent.

2 See William B.P. Robson and William M. Scarth, *Out Front on Federal Debt Reduction: Programs and Payoffs*, C.D. Howe Institute Commentary 100 (Toronto: C.D. Howe Institute, November 1997).

3 Only broad-based personal income tax cuts are useful to consider as alternatives to payroll tax cuts. There is a little to be gained by keeping EI premium rates high in order to deliver income tax rate cuts only to low-income earners, since the tax incidences are rather similar. And while it would be hard to present high-income rate cuts as a reason for maintaining a payroll tax higher than otherwise, income-tax cuts for all would be an easier sell.

4 See Alice Nakamura, *Employment Insurance: A Framework for Real Reform*, C.D. Howe Institute Commentary 85 (Toronto: C.D. Howe Institute, October 1996).

5 See Canada, Technical Committee on Business Taxation, *Report* (Ottawa: Department of Finance, 1998). The chair was Jack M. Mintz.

6 See Peter Dungan, *The CPP Payroll Tax Hike: Macroeconomic Transition Costs and Alternatives*, C.D. Howe Institute Commentary 117 (Toronto: C.D. Howe Institute, forthcoming).

7 See Kenneth J. Boessenkool and William B.P. Robson, *Ending the Training Tangle: The Case against Federal--Provincial Programs under EI*, C.D. Howe Institute Commentary 86 (Toronto: C.D. Howe Institute, February 1997).

8 These figures assume it is reasonable to ignore the slight difference in the income bases on which CPP contributions and EI premiums are assessed. As an aside, cutting the overall EI rate by the same amount that the CPP contribution rate goes up slightly raises the employee relative to employer shares of total payroll taxes, because the employer share of EI is larger than the employer share of CPP premiums.

9 To the extent that this new tax appears less appealing, on either economic or political grounds, than other revenue sources, it could be supplemented — or even replaced altogether — by others, such as the GST.

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