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Communiqué

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Canada's new employment insurance a step in the right direction, says C.D. Howe Institute study

Bill C-12, which ushers in Canada's new employment insurance (EI) program, is complex, carefully crafted legislation that could bring much-need reform to the unemployment insurance system, concludes a *C.D. Howe Institute Commentary* released today. The EI reforms address problems that many commentators have long been trying to bring to the public agenda, and are a solid foundation for other reforms to improve the economic and social health of Canadians in the years to come.

The study, *Employment Insurance: A Framework for Real Reform*, was written by Alice Nakamura, a business professor at the University of Alberta.

The former unemployment insurance (UI) program "did not meet the standards of fairness for either an insurance program or an income transfer program," Nakamura reports. The warping of insurance principles meant that individuals at higher risk of unemployment could pay less for more, "a relationship that is the opposite of the usual one between insurance payments and risk," she says.

The new EI will be closer to a true insurance program than its predecessor, with some of the former income support provisions weakened or eliminated, Nakamura suggests. The move toward insurance will result in much more even-handed treatment than under the former UI program.

Nakamura says that two structural reforms in particular move toward an insurance-based program: the switch from weeks of work to hours of work; and a new intensity rule, where the replacement rate for insured earnings will fall with increased use of the program over time. The change to weeks of work "is a forward-looking provision that will improve program coverage in the years to come," Nakamura argues. The new intensity rule, she says, "will go a long way toward changing the course of the old UI program, which was becoming an unwieldy mix of regional equalization and federal welfare transfers."

Nakamura also notes a second structural reform that increases experience rating for higher income users with more stringent clawback provisions. Full experience rating would obviate the need for these clawbacks, she says, but since it seems unlikely that EI will ever be fully experience rated, "some clawbacks will always be needed."

Nakamura also foresees a successful phase-in for EI: "It is important to recognize the value of introducing structural program changes so that, initially, there are minimal changes in program impacts…[t]hat is what is being done under Bill C-12." This phase-in strategy will give necessary future modifications a sound basis on which to build and will reduce apprehension about the program changes for participants, Nakamura says.

"It is a beginning, but only that," Nakamura concludes. "[t]he promise of Bill C-12 can either be realized or lost over the next few years in the process of phasing in the new provisions of the program."

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C.D. Howe Institute
Institut C.D. Howe

Communiqué

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La nouvelle assurance-emploi canadienne représente un pas dans la bonne direction, affirme une étude de l'Institut C.D. Howe

Le projet de loi C-12 qui introduit le nouveau régime d'assurance-emploi du Canada, est une mesure législative complexe et soigneusement conçue qui pourrait apporter une réforme indispensable au régime d'assurance-chômage, conclut un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. Les réformes de l'assurance-emploi cernent des problèmes que de nombreux commentateurs tentent depuis longtemps d'amener à l'ordre du jour, et elles forment une base solide pour permettre à d'autres réformes d'améliorer la santé économique et sociale des Canadiens dans les années à venir.

L'étude, intitulée *Employment Insurance: A Framework for Real Reform (L'assurance-emploi : un cadre de travail pour une véritable réforme)* est rédigée par Alice Nakamura, professeure en administration à l'Université de l'Alberta.

L'ancien régime d'assurance-chômage « ne répondait pas aux normes d'équité qu'exige un régime d'assurance ou un programme de transfert de revenus », indique Nakamura. La déformation des principes d'assurance se traduisait par le fait que les individus qui étaient le plus susceptibles de se retrouver au chômage payaient moins et obtenaient plus, « une relation qui est le contraire de la corrélation habituelle entre les cotisations d'assurance et le risque perçu », dit-elle.

La nouvelle assurance-emploi se rapprochera davantage d'un véritable régime d'assurance que son prédécesseur, car certaines des anciennes dispositions de soutien du revenu ont perdu de leur vigueur ou ont été éliminées, suggère Nakamura. Ce changement aboutira à un traitement beaucoup plus impartial que celui de l'ancien régime d'assurance-chômage.

Nakamura affirme que deux réformes structurelles en particulier visent un régime axé sur l'assurance : le remplacement des semaines de travail par des heures de travail; et une nouvelle règle de l'intensité, où le taux de remplacement de la rémunération assurable diminuera avec l'utilisation accrue du régime sur une période de temps. Le changement touchant aux semaines de travail « est une disposition axée sur l'avenir qui améliorera la protection future offerte par

le régime » soutient Nakamura. La nouvelle règle de l'intensité, dit-elle « aidera beaucoup à changer le cours de l'ancien régime d'assurance-chômage, qui était en voie de devenir un assortiment trop compliqué de péréquation régionale et de transferts fédéraux d'assistance. »

La deuxième réforme structurelle que mentionne Nakamura est celle qui accroît les taux fixés pour les utilisateurs à revenus plus élevés avec des dispositions de récupération plus rigoureuses. Une pleine fixation des taux particuliers éviterait le besoin de ces dispositions de récupération, affirme-t-elle, mais puisqu'il semble improbable que l'assurance-emploi soit jamais pleinement tarifée, « certaines dispositions de récupération seront toujours nécessaires ».

Nakamura prévoit également une mise en œuvre progressive réussie de l'assurance-emploi : « Il importe de reconnaître le mérite d'introduire des changements structurels du régime afin que dans un premier temps les répercussions soient minimales [...] et c'est ce que l'on accomplit dans le cadre du projet de loi C-12 ». Cette stratégie de mise en œuvre progressive donnera aux futures modifications nécessaires une base solide à partir de laquelle on pourra bâtir, et permettra d'apaiser les inquiétudes des individus concernés par les changements apportés au régime, ajoute Nakamura.

« C'est un début, et seulement un début, conclut Nakamura. La promesse du projet de loi C-12 pourra soit se réaliser, soit se perdre au cours des années à venir dans le cadre du processus de mise en œuvre progressive des nouvelles dispositions du régime ».

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Employment Insurance:

A Framework for Real Reform

by

Alice Nakamura

Bill C-12, which ushers in Canada's new employment insurance (EI), is complex, carefully crafted legislation that has the potential to bring much-needed reform to the country's unemployment insurance (UI) program.

The major changes are structural, being geared to returning the program to a true insurance program, one that will be more fair to all participants than the old UI program, which had become a clumsy mix of insurance and income transfer, satisfying the fairness criteria of neither.

Unfortunately, much public reporting about Bill C-12 has been superficial, pitting the financial and business sector against the champions of compassion toward the less fortunate. Yet the bill actually addresses problems both sides have long been trying to bring to the public agenda, and it has the potential to advance the interests of both sides, with growing benefits for the economic and social health of Canada in the years to come.

Main Findings of the Commentary

- Beginning in 1971, revisions to the old unemployment insurance (UI) program made it possible for seasonal workers to collect benefits during their "off" periods, and for workers in regions with high unemployment rates to qualify for benefits with fewer weeks of covered employment and to receive benefits longer than workers in regions with low unemployment rates. In other words, individuals at higher risk of the insured hazard of unemployment could pay less to qualify for larger benefits — a relationship that is the opposite of the usual one between insurance premium payments and risk.
- The result of this warping of insurance principles has been income transfers that were patently unfair to the workers and employers making them.
- The old UI program did not meet the standards of fairness for *either* an insurance program or an income transfer program.
- The new employment insurance (EI) program that will come from Bill C-12 will be closer to a true insurance program that treats all participants even-handedly.
- The most important reforms of Bill C-12 are structural. They include:
  - A switch from using weeks of work to hours of work as the main unit of account for the program.
  - A new intensity rule, whereby the replacement rate for insured earnings (that is, the amount of benefits) will fall with increased use of the program over the previous five years.
  - More stringent clawback provisions whereby laid-off workers with relatively high incomes will repay greater amounts of the benefits they collect. Those amounts will rise with increased use of the program over the previous five years.
- With the broader coverage that the new rules permit, EI will also be better able to act as an automatic economic stabilizer, helping to prevent initial layoffs due to an economic downturn from spiraling into more layoffs and depression.
- The next few years will be the crucial period for the new EI program. Its structural changes have been carefully planned to produce minimal initial program impacts. Once the public becomes familiar and comfortable with the new structure, the program could be tightened and the payroll tax rates further reduced.

It has become fashionable for social analysts of all political stripes to complain about the ineffectiveness of governments. Politicians are pictured as scrambling to ride the emerging waves of public concern and policy fads, without the understanding or the political will required to frame and put in place significant reform measures. Government bureaucrats, on the other hand, are depicted as seeking to minimize their workloads and potential job insecurity by steadfastly resisting real innovation and pushing instead for conventional readjustments of existing programs when social or financial problems make some sort of change a necessity.

To the extent that there is truth in these caricatures or in the charge that governments are ineffective in dealing with pressing problems of public policy, it is important to notice public policy successes when they occur.

The hope that an accomplishment can provide a procedural model for future reform efforts, thereby improving their effectiveness, is one motive for this Commentary. I see the enactment of Lloyd Axworthy's Employment Insurance Bill C-12 as a public policy success story, so far at least. Its true worth will be determined, through the nature of the adjustments made, during the extended phase-in period planned for the new program.

A second motive for this Commentary is to help to raise public understanding of three key reform measures in Bill C-12. Public understanding of them is still generally poor. One reason is that these measures are genuine innovations, and things that are truly new are always difficult to understand at first.

Also, the sorts of factual details and program design considerations that are important for understanding these reform measures have not captured the interest of the media and hence have not been adequately reported or discussed. The media have instead focused on reporting reactions to the bill without probing to discover how well those interviewed understand the legislation. Yet the reforms for which Bill C-12 lays a foundation are more likely to succeed if there is greater public understanding of why they are needed.

Bill C-12 replaces Canada's old unemployment insurance (UI) program with a new program called employment insurance (EI). To understand why Bill C-12 is important, one must first understand certain basics about the old UI program. I begin by outlining them. My next section sets out two alternative sets of principles that can be used to evaluate the old UI program and the new EI one: principles of fairness in a user-funded insurance program and in a public income transfer program. The third section considers the bill's three main structural reforms. The fourth describes the advantages of a two-stage process for phasing in major structural changes. The fifth section provides my conclusions and looks to the future.

The Old UI Program

The primary purpose of the old UI program was to provide partial income replacement for covered workers who had lost their jobs. The federal Parliament voted on the rules governing the program, which was administered by the Department of Human Resources Development. These institutional basics are unchanged by Bill C-12.

The new program differs greatly from the old one, however, in how coverage and eligibility for benefits are determined. Excluded from coverage under the old UI program were jobs that provided less than 15 hours of work per week or that paid less than $163 per week, hours of work over a per job cap on earnings of $815 per week, and self-employment.

For the unemployed who had accumulated sufficient weeks of covered employment, the old UI program provided income replacement at the rate of 55 percent of insured weekly earnings (60 percent for low-income earners with dependent children) for a maximum of 10 to 50 weeks, depending on the number of weeks worked in the previous year and regional unemployment conditions. In addition, the program paid for education or training and other employment services for some benefici-

aries (indeed, to permit completion of education or training programs, income replacement benefits were sometimes continued beyond the maximum that otherwise would have applied). Qualifying for benefits under the old program required working at a UI-covered job for at least a specified number of weeks. That qualifying period varied from 12 weeks for workers in regions with an unemployment rate of 13 percent or more to 20 weeks for workers in regions with an unemployment rate of 6 percent or less.

Under the new program, the benefit replacement rate will be unchanged for most workers, but poor families with dependent children (those also receiving the Child Tax Benefit) will receive additional help. Also, the maximum number of weeks for which benefits can be received is now 45 rather than 50.

Under the old program, individuals who had exhausted their weeks of unemployment benefits without finding work could apply for income support and other assistance from the provincial welfare programs, which were (and are) family means tested and funded out of general federal and provincial tax revenues. This will still be true under the new program.

The old UI program was funded entirely by employer and employee payroll taxes on gross wage and salary earnings from covered employment, which is also the case for the new program. In 1995, an employee paid $3 per $100 of earnings, up to the weekly cap on insurable earnings with an annual maximum contribution per worker of $1,271. The UI employer tax was 1.4 times the employee tax, with maximum annual contributions of $1,780 for each employee.

By law, the tax rate for the old UI program was adjusted periodically so as to ensure that the program was self-financing. The statutory rate was set according to the financial state of the UI fund over the previous three years so that the insured earnings base for the program would cover the expected benefit and administration costs. (A long period was used for determining the statutory tax rate to try to ensure that it would not have to be raised substantially during a recession — an objective that was not always realized.)

The statutory rate could be overridden by legislative amendment for specific purposes. Lately, the actual tax rate has been kept high enough to build up a fund surplus to draw on in the next recession. Nevertheless, Bill C-12 modestly reduces both the employee and the employer payroll tax premiums.

The old UI program was not always paid for entirely with payroll tax revenues (and thus was not always entirely user funded). Before 1990, the federal government helped to support the program out of general federal tax revenues. This approach had been justified in the 1971 UI Act as helping to cover the costs of any unemployment beyond frictional unemployment (specified in the act as unemployment greater than 4 percent) and of the fishing benefits and regionally extended UI benefits introduced in the 1971 Act. It was not intended that these benefits would be paid for solely by program participants. During economic downturns, the added federal contribution made the program a more potent automatic stabilizer than it is now (though it still plays an important role in that regard).

Before the 1971 revisions to the UI Act, there had been a closer relationship between participants' payments into the program fund and the benefits they could draw when unemployed. For example, those with jobs that were seasonal could not collect UI during off seasons, and fisheries workers were entirely excluded.

In addition, the 1971 revisions made it possible for workers in higher unemployment regions to qualify for benefits with fewer weeks of covered employment and to receive benefits longer than those in lower-unemployment regions. The introduction of these changes made it so that individuals at higher risk for the insured hazard — unemployment — could qualify for greater coverage at a lower, not a higher, cost. As explained below, this relationship is the opposite of the usual one between required premium payments and systematic risk in private insurance programs.

Two Sets of Principles

The I in UI (and in the new EI) stands for insurance. Insurance programs involve a pooling of risk among participants. All pay into a fund from which those who suffer the insured peril are then compensated. This compensation may — and often does — exceed the individual beneficiaries' totals of the contributions to the insurance fund.

Notice that having fair insurance coverage is not the same as having individual rainy day accounts that individuals can eventually use for other purposes if the insured peril does not occur (or if what they paid in is not fully used to cover their peril-related damages). True insurance means that those covered by the program who are unlucky and suffer the insured peril can draw out more than they paid in, according to stated rules. But those who are lucky and never suffer the peril must be satisfied with having enjoyed the peace of mind of knowing they were insured.

A Fair Insurance Program

For a user-funded insurance program to be intrinsically fair to all of the individual participants, it must satisfy two properties:

1. The insured peril must be an unforeseen and undesired event.

2. Either the premiums or the benefits must be *experience rated*. That is, the premiums must cover the *expected* benefits for each participant. Experience rating is accomplished by assessing higher premiums for those known to be at systematically higher risk of the insured peril *or* by reducing the level of coverage for the same group.

When workers take jobs known to provide only part-year work and do not line up other work in the off periods, unemployment is not an unforeseen event (although it may be undesired). In this situation, the risk of unemployment in the off periods is 100 percent. If the premiums charged for such a known risk do not fully cover all benefits to be paid out for it, program participants who do not have a great risk of suffering the peril will be making an income transfer to those certain to suffer it.

As already noted, the old UI program permitted workers in regions with higher unemployment to qualify for benefits sooner and to receive them longer than those in regions with lower unemployment. Yet all workers and their employers were assessed the same premium rates per $100 of covered weekly earnings. Of course, workers in higher-unemployment regions tended to have fewer weeks of covered employment, so their annual total UI premiums tended to be lower on average than those of workers in lower-unemployment regions. Thus, those who were at higher risk of the insured peril and were expected to receive greater amounts of benefits often paid less for this coverage than those at lower risk with lower expected benefit claims.

Thus, the old UI program did not satisfy either of the two principles of a fair user-funded insurance program. Program participants were not treated in an even-handed manner.

A Fair Income Transfer Program

Of course, many people with intermittent employment truly cannot find other work. Canadians have demonstrated, time and again, that they are willing to make personal sacrifices to provide financial assistance to others who are in need. Most economically self-sufficient Canadians are willing to be taxed to provide income support payments for those who are without other means of support. This generosity, however, has three basic — if not always explicit — conditions:

1. Those needing help should be willing to shoulder the same burdens, to the extent they are able, that those providing the help must bear.

2. The transfer payment recipients should not have a higher standard of living than those being taxed to provide the help.

3. Charitable public programs should be paid for with funds from progressive taxation (that is, those who have more should contribute at a higher rate — the Robin Hood principle) and certainly not from regressive taxation.

The old UI program violated all three of these conditions of fairness for a public income transfer program. The easiest way to see this is through a hypothetical example.

Consider two workers in UI-covered jobs. One had a regular ten-month job and made little or no effort to find other work for the annual two months of temporary layoff. The other worked year round. Suppose that the first worker was employed 40 hours per week, four weeks per month, at $20 per hour, making a total of $32,000 for ten months of work each year. Under the old UI program, he or she could probably collect two months of full unemployment benefits each and every year during the off period.

Suppose that the second person worked 40 hours per week, four weeks per month, at only $10 per hour, for all 12 months every year. He or she earned only $19,200 annually but was taxed each year to provide a transfer payment to the first person who made one and two-thirds times as much.

Because the first worker was not willing to work all 12 months, condition 1 was violated (a type of violation difficult to prevent by regulation without intrusive surveillance). Because the worker who received the income "replacement" had a better material standard of living than the second worker, even without the benefit payments, condition 2 was violated. And since covered workers paid UI taxes only on the portion of their earnings that were below the UI earnings cap, condition 3 was also violated in some respects.

Insurance or Income Transfer?

In brief, the old UI program, although nominally an insurance program, had assumed many aspects of an income transfer program. And it was losing support from the workers and employers who were paying for it because it failed to adhere to the principles of fairness either for insurance or for income transfer programs.

A program that satisfies the principles of fair user-funded insurance and that treats participants even-handedly has potential for broad user support. Also, it will tend to discourage inappropriate claims by the way in which future premium rates or coverage levels are adjusted for those who collect benefits, a feature that will help to keep the program affordable and let it be run without intrusive investigation except in unusual cases. In contrast, income transfer programs require means testing and ongoing verification of recipient claims in order to counter the temptations posed by untied transfers and to assure those being taxed to provide this support that the conditions of fairness for an income transfer program are being met.

The old UI program had none of the built-in protections against abuse of the program rules or intent that experience rating provides in most private insurance programs. Rather, it ignored insurance principles on the basis of well-meaning appeals that many participants were genuinely in need of income transfers.

Yet the old UI program did not satisfy the principles of a fair income transfer program either. It did not involve family means testing, on the legitimate grounds that this would be unacceptable for an insurance program.

I believe that a choice must be made between insurance and income transfer principles for the EI program and that the former are the right ones. The program covers much of the Canadian workforce and must have broad coverage if it is to continue to play the important macroeconomic stabilization role it has in the past. Means testing for such a large program would be prohibitively expensive and unacceptably intrusive. Also, many workers who are fairly well off want insurance coverage for unexpected spells of joblessness, much as many well-off individuals want and buy homeowners' insurance. From a societal perspec-

tive, the program will be a more effective automatic stabilizer if it provides coverage for all workers — not just the working poor.

In addition, it is fundamentally unfair to fund pure income transfers from the present payroll tax base. The fact that workers pay no tax on earnings exceeding the insurable maximum is reasonable from the perspective that no insurance coverage is provided for earnings above this maximum, but it is not reasonable if the tax is also used to pay for public income transfer programs. The same is true of excluding nonwage earnings from the tax base.

Of course, the choice to move EI in the direction of a program operated under social insurance principles means that safeguarding Canada's provincial welfare and other income transfer programs is a crucial, though unstated, complement to the Bill C-12 reforms.

The Bill C-12 Reforms

Bill C-12 introduces three key structural reforms that open the way for the new EI to become a user-funded insurance program that is fair to all participants and that will serve Canada well as an automatic stabilizer:

1. A switch from using weeks of work to hours of work as the main unit of account for the program.

2. The new intensity rule, whereby the replacement rate for insured earnings will fall with increased use of the program over the previous five years.

3. The new clawback provisions, which will result in repayment of greater amounts of the benefits collected by those with relatively high incomes, with the maximum repayment rising with increased use of the program over the previous five years.

My main reasons for supporting each of these reform measures follow.

Hours of Work as the Unit of Account

The first key reform sets the minimum qualifying period at 420 to 700 hours of work (depending on the region's unemployment rate), rather than 12 to 20 weeks. This shift to using hours, not weeks, of work as the main unit of account is a forward-looking provision that will improve program coverage in years to come for several reasons.

First, by excluding jobs offering less than 15 hours of work per week, the old UI program provided businesses with a monetary incentive to chop up full-time jobs into mini-jobs — jobs for which the UI payroll taxes were avoided. The change to an hourly unit of account eliminates this perverse incentive.

Second, part-time employment (that is, jobs offering less than 35 hours of work per week) is on the increase for other reasons as well and will probably continue to grow faster than full-time employment even with the adoption of EI. Under the rules of the old UI program, growth in the portion of total employment that was part time would erode program coverage.

The many reasons this outcome was undesirable include the associated erosion of the automatic stabilization functions of the program. When Canada slips into an economic recession, workers who are laid off must cut back on their expenditures far more severely if they are ineligible to collect some sort of earnings insurance benefits. They and their families suffer personal damage, and large decreases in the expenditures of laid-off workers translate into lower levels of sales and more layoffs. This spiral of layoffs leading to sales decreases that lead to more layoffs can result in deep economic depression.

The value of an unemployment relief program as an automatic stabilizer depends on broad coverage. The move to an hourly unit of account will help reverse the erosion of coverage that has been resulting from the increasing amount of employment in part-time jobs that were ineligible for coverage under the old program rules.

Third, the change will lead to greater equity of treatment between part-time and full-time workers. This is increasingly important in an economy in which growing numbers of workers can find employment only in part-time jobs, though they may be working full time when their hours on all their jobs are counted.

Finally, the move to an hourly unit of account will result in more even-handed treatment of part-year workers and will help to bring the taxes that individual workers pay into the insurance fund more into line with the expected benefit payments. Recall that, under the old UI program, a worker in a region with high unemployment could qualify to receive benefits if he or she was laid off after a minimum of 12 weeks in a UI-covered job of just 15 hours per week. That is, a worker could qualify for benefits with just 180 hours of UI-covered work if that work was arranged so that it comprised the needed 12 weeks of UI-covered employment. A fellow worker who put in ten hours a day and seven days a week for ten weeks might have paid the UI payroll tax on all 700 hours of earnings. Although the second worker had almost four times as many hours of work than the first, the ten weeks of covered employment were not enough to qualify for benefits if he or she was laid off.

Workers of the first sort were systematically treated more generously under the old program than workers of the second sort, in contradiction of the principles of a fair user-funded insurance program. In contrast, under the EI program, all covered workers in regions where the unemployment rate is 13 percent or more will need 420 hours of insurable employment to qualify for benefits. Thus, the second of the workers above, the one who paid EI tax on 700 hours of work, will qualify for benefits, while the first, who paid the tax on only 180 hours of employment, will not. This accords better with the principles of a fair user-funded insurance program.

A similar example can be constructed for a lower-unemployment region. Under the old UI program in a region with an unemployment rate of 6 percent or less, qualification for benefits required 20 weeks at a job offering at least 15 hours of work per week. That is, a laid-off worker could collect benefits after paying the payroll tax for a minimum of 300 hours of work. A fellow worker with ten weeks of 70 hours per week employment would have paid the UI tax on 400 more hours of work but would not have qualified for benefits if laid off. The relative treatment of the two workers was at odds with the principles of a fair insurance program. But under the new EI program, the second worker will qualify for benefits, while the first one will not qualify.

The Intensity Rule

Under the new EI intensity rule, the benefit replacement rate will drop by one percentage point with each added 20 weeks of benefits collected over the previous five years, down to a minimum of 50 percent. This reform will go a long way toward changing the course of the old UI program, which was becoming an unwieldy mix of regional equalization and federal welfare transfers in a social insurance program format. (It was the changes in the 1971 UI Act that enabled seasonal workers to collect UI during their off seasons. UI program administrative data show that the numbers of workers availing themselves of this provision has had a clear upward trend since 1971.)

The intensity rule will help re-establish UI/EI as a true social insurance program — one that has important social externalities but nevertheless provides those paying for the program with insurance coverage that represents fair personal value for their money.

The rationale for the change is that those who have collected benefits for more weeks in the recent past are at greater risk of making future claims. This rationale is the same one used to justify higher car insurance costs for those who have had recent accidents resulting in insurance claims. (Raising the costs of insurance has been the usual way of implementing experience rating in private sector insurance programs.)

In the United States, state-administered UI programs are also experience rated, but by raising the premiums in response to recent UI claims. UI programs in the United States differ somewhat from state to state, but all of them are funded solely by employer payroll taxes, unlike UI/EI in Canada, which is funded by both employer and employee payroll taxes. The UI programs in the United States are experience rated by charging higher tax rates to employers whose workers have made more UI claims in the recent past.

Yet charging higher rates to struggling businesses that have had to lay off workers could worsen worker employment prospects. And it would certainly be unacceptable in Canada to charge recently unemployed workers higher tax rates, thereby further reducing their incomes from work.

Experience rating workers, by reducing the amount of coverage provided for those with more weeks of prior claims, rather than by raising premium rates, is a totally new — and I think better — way to experience rate a worker- and employer-funded unemployment insurance program. Immediate costs are not raised for the workers (or employers) who are already facing immediate financial problems. And those workers who exhaust their EI coverage or find the benefits too low to live on can apply for full or partial welfare support. Unlike the situation in the United States, where welfare is mostly for single mothers, all sorts of people can and do apply for and receive welfare support in Canada. Administrative records for recent years reveal that many of those who exhausted their UI benefits went on welfare, and many other UI recipients received supplemental welfare assistance.

Some people oppose the worker experience rating instituted in the new EI program on the grounds that it is employers, not workers, who "cause" unemployment. But consider household theft insurance. It is municipalities, provinces, the federal government, and Canada's legal institutions that control most of the factors that affect crime levels. Yet it is still householders who pay the premiums, and households that are experience rated.

Experience rating workers in the new EI program will help to curb employer as well as worker abuses of the program's rules and intent. Employers can shift their labor costs onto an unemployment relief program only to the extent that their workers are eligible to collect its benefits.

The Clawback Provisions

The new EI program will include expanded clawback provisions, the purpose of which is to counteract potential repeat use of the program by well-off Canadians — repeat use that goes beyond the fair insurance use that these users have paid for. Basically, the clawback provisions increase the degree of experience rating for higher-income program participants, making the program more nearly self-policing for them.

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If the parameters of the intensity rule were set so as to achieve full experience rating, the EI payroll taxes would cover the full expected benefits for all categories of beneficiaries — those with upper incomes as well as those with more modest incomes. Such full experience rating would obviate any need for clawbacks. Although the new EI program involves some direct experience rating, it is far from being fully experience rated. Indeed, the replacement rate will fall only by, at most, five percentage points with increased use of the program over a moving five-year period, parameter values that introduce only a small degree of experience rating.

It may be increased over time, but it seems likely EI will never be fully experience rated. Thus, some clawbacks will always be needed.

A Sound Phase-In Strategy

Changes to important public programs inevitably cause apprehension. Even when most people see clearly that the changes are needed, they worry about unforeseen consequences. Successful phase-in strategies for new programs are a way of managing change-related apprehension and of achieving orderly, efficient change.

In designing phase-in strategies, it is important to recognize the value of introducing structural program changes so that, initially, there are minimal changes in program impacts. That is, the parameters of new program structures should be set initially so that any changes in program impacts are quite small. Once the new structures have been accepted, then the program parameters can be adjusted gradually to achieve the desired changes in financial impacts. That is what is being done under Bill C-12, which introduces major structural changes with modest initial dollar impacts on participants.

Consider, for example, the intensity rule in Bill C-12. The Canadian unemployment program has never before involved any form of experience rating. Thus, it is appropriate to introduce the intensity rule with a very modest and delayed schedule of decline for the benefit replacement rate. This is why the replacement rate falls only to 50 percent under Bill C-12, and why all workers will start out in the new program with a figure of zero for use of the program over the previous five years. Once the structural change has been accepted, the steepness of the schedule of decline for the benefit replacement rate can be increased.

Similarly, the move to hours of employment as the basic unit of account will be implemented with parameter values that intentionally leave eligibility requirements largely unchanged for program participants who have been working 35 hours per week.

The business sector may be disappointed that the immediate EI payroll tax rate reductions are quite small. Yet it would be short-sighted to let this attitude undermine support for the phase-in strategies that are an integral part of Bill C-12. Some delay in achieving the desired tax reductions is definitely worthwhile if it allows important structural changes to be made.

Closing Remarks

Bill C-12 provides a new structural foundation for unemployment/employment insurance in this country that will facilitate broader coverage, better control of costs without more intrusive investigative and regulatory control, and more even-handed treatment of participants. It is a beginning, but only that. The promise of Bill C-12 can be either realized or lost over the next few years in the process of phasing in the new provisions of the program.

The debate over Bill C-12 has been highly polarized, with defenders of the financial and business sector on one side and champions of charity toward the less fortunate on the other. Yet those who take the time to understand this complex, carefully crafted bill will find that it addresses important problems of the old UI system, problems that both sides have been trying to bring to the attention of the public and political leaders.

Bill C-12 addresses these concerns in an integrated, internally consistent manner. It is

a bill that holds the promise of advancing the interests of both sides, with growing benefits for the economic and social health of Canada in years to come. Those who are able to see this promise must help others to see it too, so that it is not lost through misunderstanding or a softening of political support.

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The paper builds on a number of others I have published and on a wide literature on the topic. Further references can be found in my Presidential Address to the Canadian Economics Association, published in the *Canadian Journal of Economics* (November 1995).

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