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***Backgrounder***

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# Employment Insurance:

*What Reform Delivered*

David Gray

## **The Backgrounder in Brief**

*Basing the employment-insurance qualification period on hours of prior employment was an important structural reform, and the employment patterns of frequent users were very sensitive to even incremental changes in EI program parameters. Still, overall claims did not decline as much as expected.*

## ***About the Author***

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It has been almost six years since Parliament passed Bill C-12, replacing the unemployment insurance (UI) regime with the far-reaching *Employment Insurance (EI) Act*. The 1996 legislation constituted the most sweeping reform since the *UI Act* of 1971. Now, there is enough evidence to assess the impact of the reforms on unemployment and examine developing patterns. The policy objectives of Bill C-12 were stated quite explicitly, and the results are measured by two research sources, the annual EI monitoring and assessment reports, generated by the EI commission, and a series of rigorous, scientific, and focused policy evaluation studies commissioned by Human Resources Development Canada (HRDC). In this *Backgrounder* I treat five of the many changes that were implemented in order to examine how they measure up to the policy goals.

Overall, there is some evidence that frequent recourse to regular EI benefits has diminished somewhat, although long-term dependency is still pervasive in segments of the labour force. Some indicators of EI use, such as the proportion of claimants who exhaust their entitlements, that is, the maximum number of benefit weeks that they can receive, and the proportion of them that are actually received, have been reduced. The government has extended coverage in a fashion that most observers would view as more equitable and less arbitrary, and it has removed entirely one of the major distortions of employment patterns.

The two primary conclusions from this study are:

- Overall use of regular EI benefits was not reduced by as much as might have been expected given the favorable labour market climate that prevailed during much of the period.
- Seasonal workers are able to lengthen their qualifying employment spells to a certain extent when the EI system pressures them to do so.

The intensity rule, which was gradually being phased in between 1997 and 2000, was totally repealed in 2001 by Bill C-2. This legislation also significantly weakened the claw-back mechanism because first-time users were exempted from it, and the ceiling that applied to the total amount of benefit that could be clawed back was reduced. Other less salient elements of Bill C-12 include a decline in the level of maximum insurable earnings (MIE) to \$750 from \$845, followed by a freeze until 2001, which subsequently dampened the growth in EI benefit levels. Initially this constituted an 11-percent drop in EI benefits for those reaching the MIE. The maximum duration of the benefit period was reduced to 45 weeks from 50. The discussion that follows is limited to the major provisions listed above.

## **Statistical Summary of EI between 1997 and 2002: A Global Decline in Use, Yet Divergent Trends Among User Types**

On the aggregate level, the total number of claims for regular benefits declined by 8.3 percent between fiscal years 1997 and 1998 (the first full year of the new EI regime) and 2000 and 2001, followed by a significant increase in 2001/2002 that coincided with an economic slowdown.<sup>1</sup> Given the macroeconomic climate of fairly strong GDP growth and generally favourable labour market conditions, one might expect that the total amount of regular EI benefits paid out would decline

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<sup>1</sup> The source of the information presented in this section is the series of annual EI Monitoring and Assessment Reports.

sharply, but between 1997/1998 and 2000/2001 they declined only by about 11 percent to \$6.8 billion from \$7.7 billion (current dollars). An examination of the structure of EI use patterns reveals some divergent trends. There is an almost 20-percent decline in the level of frequent user claims from 1997/1998-to-2000/2001, without an upturn during the slowdown that occurred in 2001/2002.

Furthermore, the share of EI claims accounted for by frequent claimants exhibits a steady downward trend, falling to 34 percent from 41 percent. There is a smaller decline (10 percent) in occasional user claims until 2000/2001, followed by a major upturn in 2002. In contrast, it is noteworthy that the number of first-time claimants rose in relative terms and showed a huge jump in absolute terms in 2002. A possible explanation is that the strong labour market conditions that prevailed in 1999 and 2000 helped many workers at the margin of the labour force, such as youthful ones and some with non-standard employment patterns, to qualify for EI benefits. Some of them subsequently lost their jobs.<sup>2</sup>

Despite what appears to be a fairly resilient level of overall activity in the EI program over this period, some indicators suggest that those who did file claims reduced their receipt of EI benefits. The average duration of a claim fell to 20.5 weeks from 21.8, and the percentage of total entitlement received (which ranges from 20 to 45 weeks) fell to 65.1 percent from 67.3 percent. There is a set of broad indicators of EI program activity in Table 1. Figures 1 and 2 illustrate changing patterns among new EI claimants.

## **Impact of the Major Provisions of Bill C-12**

To assess the impact of a change in any social insurance program on take-up rates and program-use patterns, it is important to take account of other influences, such as labour market conditions, demographic attributes, prior labour market history, and prior program participation status. To that end, the Evaluation and Data Development Branch of HRDC commissioned almost two dozen rigorous, scientific, empirical studies that evaluate the impact of particular aspects of Bill C-12 on EI use patterns. Much of the analysis that follows is based on their findings.

### *New Entrants and Re-Entrants to the Labour Force (NEREs)*

The NERE provision was introduced to address the concern that there was a tendency for some new entrants to fall into what is known as the EI trap, establishing a cycle of dependency. It was also designed to discourage those who are out of the labour force from basing their labour-supply decisions on the availability of EI benefits. As was the case with the former regime, these workers face uniform entry requirements nationwide, which were raised to 26 weeks from 20.

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2 A strong labour market has dual and conflicting effects on EI program activity, generating fewer of the traditional users who experience layoffs from long-term jobs, while facilitating eligibility for workers with less stable employment patterns. This underscores the point that any analysis of EI program activity levels, such as the number of new claims filed, must take account of two separate events. First, there is the separation from a job of a worker, conditional on attaining eligibility, which triggers the EI claim. Second, there is the prior outcome of attaining employment experience sufficient to qualify.

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**Table 1:** *Indicators of EI Program Activity — Regular EI Benefits, Post Reform Period*

Fiscal year ending 31 March:	1998	1999	2000	2001	2002
Number of new claims	1,498,000	1,488,000	1,361,000	1,372,000	1,480,000
Frequent claimants	616,000	585,000	526,000	500,000	500,000
Occasional claimants	475,000	470,000	431,000	442,000	475,000
First time claimants	407,000	433,000	405,000	430,000	505,000
Total amount of benefits (dollars)	7,717,000	7,753,700	7,026,100	6,834,100	8,008,000
Average weekly benefits (dollars)	277	282	283	297	305
Average duration of claim (weeks)	21.8	21.0	20.6	20.5	NA
Percent of total entitlement received	67.3	64.8	64.8	65.6	65.1

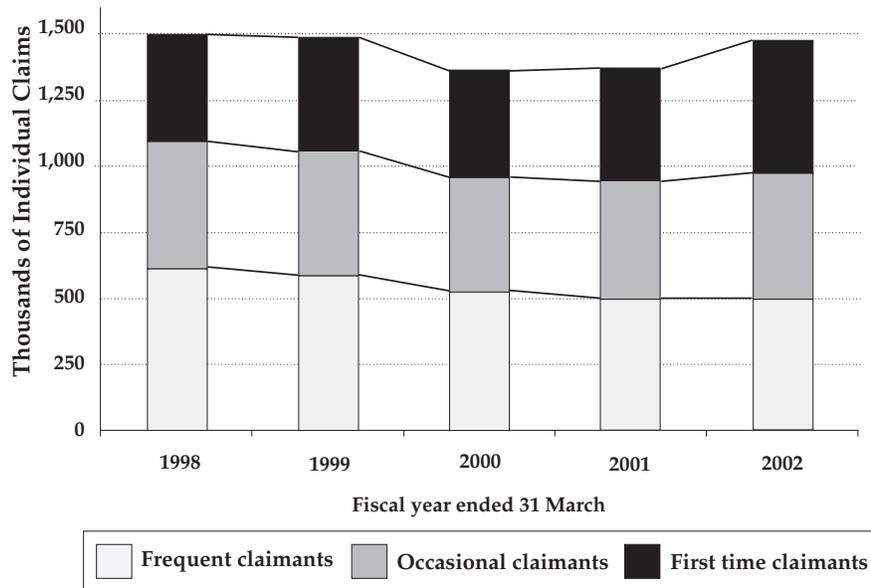
Notes: All figures are tracked by fiscal years commencing on April 1 and ending on March 31 of the following year. All amounts are denominated in current dollars. Special EI benefits and expenditures associated with Employment Benefit and Support Measures (EBSMs) are not included. Frequent claimants in the year of observation are defined as those having filed separate EI claims in three of the past five years, while occasional claimants are defined as those having filed separate EI claims in one or two of the past five years, exclusive of first-time claimants.

Source: Annual EI Monitoring and Assessment Reports. The lag for reporting the average duration of completed EI spells is about 18 months.

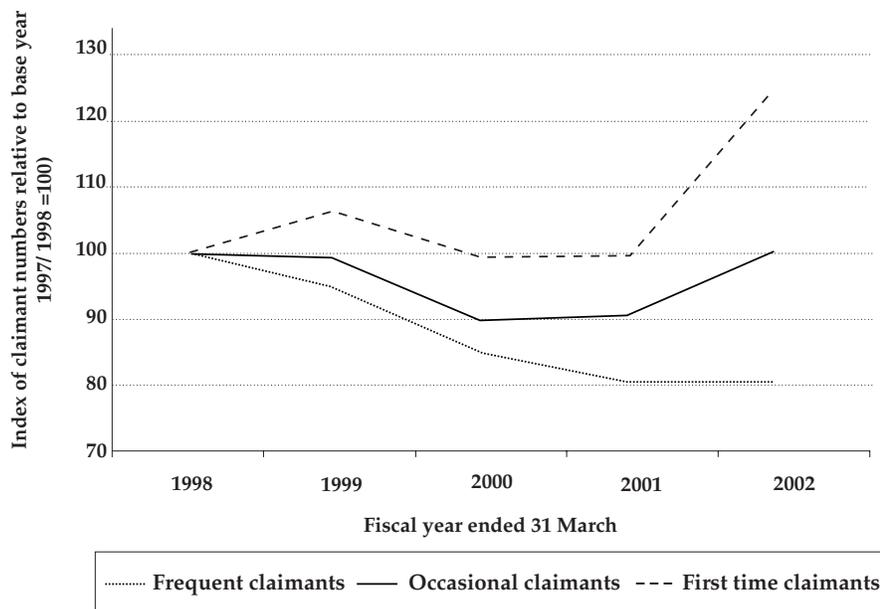
Kapsalis (2000) and Phipps and MacPhail (2000) analyse the impact of this reform on access to benefits rather than on the longer-term question of dependency. They point out that it is difficult to assess the impact of higher entry requirements for NEREs because of the simultaneous change of first-hour coverage. While NEREs now need more hours of work to qualify, raising the bar for attaining eligibility, all hours regardless of the length of the work week count towards gaining eligibility, thus lowering the bar. As a result, it is problematic to construct the counterfactual of how many NEREs under the former UI regime would not have qualified for EI benefits as a result of this particular reform and vice versa.

Under both regimes, among job losers, NEREs tended to be half as likely as non-NEREs to qualify for benefits. Phipps and MacPhail (2000) conclude that the net effect of the two policy changes was only a slight reduction in access to EI benefits compared to the UI regime, which would render it slightly more difficult for a NERE to become a frequent user. The question of the effect of this provision on the incidence of frequent use remains unanswered and might require an elaborate empirical study tracking NEREs over longer time periods. On the other hand, it appears to have contributed slightly to the policy objective of reducing

**Figure 1:** *EI Program Indicators — Number of New EI Claimants by Year and Type*



**Figure 2:** *EI Program Indicators — Trends in EI Claimants by Year and Type*



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frequent use, and is certainly consistent with the stated objective of aligning EI benefits more closely with contributions.

### *EI Benefit Calculation*

A method known as the divisor rule appears to be providing a strong incentive to prolong qualifying employment spells by two weeks. This provision has been controversial, and the Standing Committee on EI reform recommended its elimination in 2002. The minimum divisor ranges from 14 weeks in maximum entitlement regions to 22 weeks in regions with the lowest unemployment rates. In 1999/2000 and 2001/2002, 97 percent of EI claimants across Canada worked at least two weeks longer than the minimum required to qualify for EI benefits in their region, compared to 96 percent during the last year of the UI regime, thus avoiding having benefits reduced. In the Atlantic region, 5.8 percent of EI claimants were affected by the divisor rule. Though there are no evaluative studies that focus directly on that issue, this evidence seems to suggest that this provision is meeting its objective of encouraging individuals to work longer.

Because of the effectiveness of this minor reform in meeting its objective, it might be advisable to strengthen it by raising it at the margin. Many seasonal workers probably would be able to meet the higher entry requirements, and those who could not would still qualify, although for lower benefits. The same incentive could be delivered more transparently and perhaps more equitably, however, by a sliding scale for the replacement rate. A relatively low replacement rate would apply to those who barely met the entry requirements, while the replacement rate would increase progressively with the length of the qualifying employment spell up to the standard rate of 55 percent. This is consistent with the oft-cited policy objective of aligning benefits more closely with contributions for the current unemployment spell.

It should be noted that the implementation of the divisor rule served to highlight another distortion that is inherent in the EI system. For workers with variable employment patterns, the inclusion of small weeks (short work-weeks with correspondingly low levels of earnings) can significantly lower the weekly benefit amount (WBA) by raising the divisor (in proportionate terms) by more than the level of insurable earnings. This can provide a strong disincentive to work extra weeks with short hours. Since early 1997, a pilot project called the small-weeks initiative was created to enable claimants to exclude altogether weeks of under \$150 in earnings from the calculation of their WBA. In 2001, this provision was extended to the entire EI regime. It is expected to remove more of the disincentive to accept very short-term job offers involving work of this nature.

### *Hours-based System for Qualification*

This reform constituted a major structural change in the EI regime. Previously, the week was the unit of account for qualifying for UI benefits. Each insurable week had to last at least 15 hours, but no account was taken of the length of work week beyond that threshold. This created distortions in employment patterns regarding

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**Table 2:** *Summary of the Major Provisions of Bill C-12*

Provision	UI program before 1996
1. <b>New Entrants and re-entrants to the labour force (NEREs): defined as those who have minimal or no labour-market attachment over the past two years.</b>	Required 20 weeks of prior insurable earnings to qualify, the equivalent of 700 hours. <sup>3</sup>
2. <b>EI Benefit Calculation (the divisor rule): The weekly benefit amount (WBA) is based on the total insurable earnings over the 26-week qualifying period; WBA is divided by the divisor, which is equal to the greater of a) the number of weeks that were actually worked, or b) the minimal entry requirements plus two weeks.</b>	WBA for a claimant that barely met the minimal entry requirements, was calculated as total insurable earnings over the qualification period divided by the minimal entry requirements.
3. <b>Hours-based system for qualification (first-hour and first-dollar coverage).</b>	Workers' weekly earnings were not eligible for UI coverage unless they exceeded \$150, with 12-to-20 weeks of work required to establish a claim depending on the local unemployment rate.
4. <b>Experience Rating ('Intensity Rule'): a special type of experience rating procedure that applied directly to recipients rather than to firms.</b>	Did not apply.
5. <b>Graduated Benefit Repayment Provisions ('Clawback'): sliding scale for repayment entails some experience rating.</b>	UI benefits received by higher-income users subject to some minor clawback.

<sup>3</sup> Hours are converted to full-time work-weeks at a rate of 35 hours per week.

**Table 2:** *Summary of the Major Provisions of Bill C-12 continued*

EI program after 1996	Rationale	Author's assessment of impact
Required 26 weeks of prior insurable earnings to qualify, the equivalent of 910 hours.	"Discourage a cycle of reliance:" ensures that workers, especially young people, develop a significant attachment to the labour force before collecting EI benefits, and "returns insurance principles to the system: have to make reasonable contribution to system before collecting benefits."	Reduced access for NEREs, and may eventually serve to diminish frequent use through a reduction in the number of first-time claimants.
The denominator of the WBA is now augmented by 2; the divisor ranges from 14-to-22, depending on the local unemployment rate.	"Create a strong incentive to work more than the minimum amount of time to qualify for benefits."	Encouraged recipients to lengthen qualifying employment spells; suggests that within limits many seasonal claimants can work longer each year.
Eligibility attached to hours worked rather than weeks worked; 420- to-700 insurable hours (depending on the local unemployment rate) set as the minimal threshold.	"Remove inequities and anomalies of weeks based system," and to implement a "better measure of time worked" so that all hours count.	Eliminated incentive to create jobs with very short employment spells; reduced impact of EI program on the choice between weekly hours and length of employment period; reduced inequities on access; allowed claimants to work multiple jobs; allowed access to more workers with non-standard jobs.
Reduces the benefit rate (normally 55 %) by 1 percentage point for each group of 20 weeks of EI benefits collected in the past five years, up to a maximum of 5 percentage points.	"Discourage use of EI as a regular income supplement rather than insurance for times of unpredictable job loss", and to "create a better balance between contributions made and benefits received."	Provided incentive to reduce the number of benefit weeks received; might eventually serve to reduce frequent use by reducing generosity shown to frequent users.
Required 26 weeks of prior insurable earnings to qualify, the equivalent of 910 hours The denominator of the WBA is now augmented by 2; the divisor ranges from 14-to-22, depending on the local unemployment rate. Eligibility attached to hours worked rather than weeks worked; 420- to-700 insurable hours (depending on the local unemployment rate) set as the minimal threshold. <sup>4</sup> Reduces the benefit rate (normally 55 %) by 1 percentage point for each group of 20 weeks of EI benefits collected in the past five years, up to a maximum of 5 percentage points. EI benefits are repaid at a rate of 30% above an earnings threshold, to a maximum amount that is 30% of the benefits paid. The maximum amount of benefits to be repaid varied between 50% and 100% according to the extent of the EI claims history.	Render the system "fairer and more accurately reflect insurance principles," and "discourage repeat use of EI by those with high levels of annual income."	Provided incentive to reduce the number of benefit weeks received; strengthened progressivity of the redistributive element of EI.

4 For those with fewer than 20 weeks of benefits collected in the past five years, the earnings threshold was lowered from an annual level of \$63,750 to \$48,750. For those with more than 20 weeks of benefits collected in the past five years, the earnings threshold was lowered from an annual level of \$63,750 to \$39,800.

the mix between the number of weeks and the length of the work week. First, there was an incentive on the part of certain workers and companies to truncate work weeks at 14 hours in order to be exempted from paying UI contributions. Second, there was an incentive in high-entitlement regions to spread out a given number of hours of work among more weeks with fewer hours. The weeks-based system also spawned some glaring inequities in coverage, such as the case of multiple-job holders who could not combine the hours worked to gain eligibility.

Because short work weeks counted the same towards qualifying for UI as long ones, it was quite possible for two individuals in the same geographical area working the same number of total hours to have different entitlements. Someone working relatively few long weeks could fail to meet the entry requirements, while someone else working many short weeks would qualify. This particular facet of the reform package received wide support and is uncontroversial.

One would expect these provisions to have an impact on the distribution of all jobs according to the length of the work week, especially in labour markets with a high concentration of non-standard employment patterns or with a high EI entitlement. Specifically, the share of jobs with very short work weeks (fewer than 15 hours) might decline, and the share of jobs with long work weeks (more than 35 hours per week) would rise. In sectors with less stable employment patterns, one may expect a commensurate reduction in jobs within the 15-to-34 hour work category.

Freisen and Maki's analysis (2000) validates these predictions; they find a decrease in the share of jobs with fewer than 20 hours per week, an increase in the proportion of jobs having 20-to-34 hours per week, no net change in the proportion involving 35-to-38 hours per week, and an increase in the proportion involving more than 39 hours. These effects are most marked in the Atlantic provinces. One implication is that: "The declining share of jobs requiring fewer than 15 hours per week suggests that the hours-based system under EI has eliminated a significant distortion in some employment decisions under UI" (p. 5). They also conjecture that under the EI regime, many workers have some margin of flexibility to adjust their working patterns over time to increase their eligibility and entitlement for EI benefits.

The findings of Green and Riddell (2000) and Sweetman (2000) are essentially in agreement. Among workers with stable and standard employment patterns, the distribution of usual-working-hours per week under the EI regime did not change. Among workers with unstable, part-year jobs, and perhaps seasonal jobs, the new hours-based system tended to benefit workers in long-hour jobs, but not those in short-hour jobs. There is some evidence of seasonal workers bunching more of their hours in long weeks in order to attain eligibility over a shorter qualifying period. All of these shifts, however, are far more marked among men than among women. Overall, the switch to the EI system led to a small increase in overall eligibility for people who were laid off either temporarily or permanently, although there were some gainers and losers. Sweetman (2000) estimates that 5.1 percent of all job separators who were ineligible for benefits under the UI regime became eligible under EI, while 2.8 percent of all job separators became ineligible.

The stated objectives for this provision were essentially to remove what were widely considered to be inequities and anomalies for coverage. It appears as

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though coverage was broadened somewhat, but whether it became fairer is a somewhat subjective question. The central thrust of the reform and much of the subsequent policy debate is based on the view that broader coverage is desirable, while others believe that access should be tightened for workers qualifying for benefits on short durations of employment.<sup>5</sup> Most observers, however, would view some of the discrepancies in coverage under the former regime as arbitrary. Furthermore, on the grounds of labour market efficiency, since a major distortion in employment decisions has been substantially reduced, the EI program is more neutral than the UI regime in shaping employment durations and working hours.

The rather developed state of research on this element suggests that the change from a weeks-based system to an hours-based system was warranted. That this element of Bill C-12 had such a strong impact on employment patterns is remarkable and confirms a central theme of the literature on UI — the important role of the EI program parameters in shaping employment patterns. The sharp response to this change suggests that further changes in other eligibility criteria, such as maximum benefit entitlements, minimum entry requirements and benefit calculation mechanisms, would likely cause significant changes in employment patterns that would blunt some of the remaining distortions.

### *Experience Rating*

The intensity rule was intended to reinforce the insurance principles of the UI regime that are undermined by repeat use, as well as to strengthen the progressivity of the benefit structure. According to the annual EI Monitoring and Assessment Reports, the number of EI claims affected by the intensity rule rose from 318,018 during the 1997/1998 fiscal year (representing 20.9 percent of all claims) to 606,090 two years later (representing 43.7 percent of all claims). Although the financial penalties were slight, the rule had a wide scope of application.

Van Audenrode and Fortin (2000) suggest that after its implementation, workers tended to end their EI claims a week earlier to avoid the intensity rule, and that would reduce their future entitlements. Specifically, they discern a spike in the probability of leaving EI regime after an 18-week benefit period, as the threshold for the rule was 20 weeks. Nevertheless, the difference in overall usage among all EI claimants attributed to the intensity rule was only a fraction of a benefit week. This phenomenon was much more marked among repeat users. It should be noted that the data interval for their study included only the first two years after the rule was implemented over a period during which it was being gradually phased in. Thus the eventual impact would likely have been stronger. Overall, the evidence suggests that this provision did influence the behaviour of claimants and did reduce payouts slightly, which is consistent with the objective of reinforcing insurance principles.

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<sup>5</sup> Many of these analysts would probably not object to broader coverage if it were based loosely on insurance principles and was actuarially fair.

This element of the reform package was very unpopular in Atlantic Canada, and the federal government came under intense pressure to rescind the intensity rule, which indeed occurred in 2001 with the passage of Bill C-2.

The stated objectives of Bill C-12 mentioned reinforcement of insurance principles a number of times, but with the repeal of the intensity rule and the blunting of the claw-back mechanism, there is virtually no link between the contributions to the regime and the expected benefits received over a multiple-claim timeframe. A worker's EI claims history is thus irrelevant for future claims. Because of the policy rationales that are stated in reference to provision numbers 1, 4, and 5 (fourth column of Table 2), it may be appropriate to reconsider the issue of employer-based experience rating, as suggested by Poschmann and Robson (2001) and Finance Canada's (1998) report of the Technical Committee on Business Taxation. The committee recommended a partial experience-rating system involving reductions in the contribution rates for companies with infrequent past recourse to layoffs, without increases in premiums for any firm. It may be more politically feasible than experience rating on employees because it will not stigmatize and directly penalize workers.

### *Graduated Benefit Repayment Provisions*

There are no evaluative studies that focus directly on the claw-back measure. According to the 2000 EI Monitoring and Assessment Report, its scope was narrower than that of the intensity rule; the number of EI claims affected was 144,160 in 1999 (for a total repayment of \$184,000,000) and 115,368 in 1998, representing approximately 10 percent of all EI claims. With the passage of Bill C-2, the vast majority of EI claimants are exempt from any claw-back. For those claimants who are still affected, the amounts that are paid back are lower. Nakamura (2000) makes a strong case in support of the claw-back mechanism based on tax-cum-benefit progressivity and insurance principles. Although the implementation of employer-based experience rating would not address the progressivity issue, it would address the latter issue.

### *Global Assessment of Impact*

Jones (2000) and LaCroix and Van Audenrode (2002) evaluate the global impact stemming from the joint effects of all of the provisions of Bill C-12 on two important measures of EI use, namely unemployment durations and EI benefit periods. Based on similar econometric modeling techniques, these studies have consistent findings. Average unemployment spells were shortened considerably (by approximately 1.5 weeks), and the lengths of EI benefit periods were slightly reduced. A notable exception is the case of working adults younger than 25; for the older age groups they were weaker among men than women.

## **Conclusion**

The EI reforms of 1996 did bring about some meaningful structural change to the program. Although the EI program parameters still do not have a neutral effect on

the length of work weeks or on employment spells, particularly in labour markets situated in high-entitlement regions, a significant distortion was removed as a result of the implementation of first hour coverage. Furthermore, the coverage was broadened to include more workers with non-standard employment patterns. Although that plank in the reform package may not foster long-run independence, it removes a source of inequity in program access.

The remaining major elements of the package constituted incremental changes to benefit calculation mechanisms and entry requirements. These changes appear to have achieved cost savings, and may have contributed to a decline in frequent use of the EI program as well as shorter average benefit periods. The divisor rule and the first-hour coverage provisions altered the incentives involving the accumulation of work experience needed to qualify — specifically in reference to the number of hours required and the mix between hours and weeks. It appears that in response to these incentives, many of the affected workers are able to a certain extent to adjust their length of employment and to exhibit some flexibility as to its timing.

The policy recommendations for future reform initiatives include the following:

- The program parameters should be modified on the margin, with an eye toward prolonging qualifying employment spells, perhaps through strengthening the divisor formula. This change would work to raise the ratio of weeks worked to weeks of EI benefits received, which is consistent with the insurance principals that are evoked in Bill C-12.
- Experience rating should be revisited in the form of an employer-based plan involving reductions in premiums. This change would bolster the labour market slightly and discourage the use of EI as a recurrent income supplement, which is also consistent with the insurance principals that are evoked in Bill C-12.

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