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Backgrounder

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Reprogramming the EI Cash Machine:

Matching Employment Insurance Premiums and Payouts

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A crucial source of Ottawa's recent fiscal strength comes from its collecting employment insurance (EI) premiums that far exceed program requirements. Persistent federal dependence on EI premium money will worsen the political, legal, and accountability problems that already surround the EI program. The solution is to fund regular EI benefits out of employers' contributions and convert the unneeded employees' share to a payroll tax that is understood to underpin general government spending rather than being tied to insurance uses. Meanwhile, the employer premium rate should be lowered for firms whose employment practices produce relatively few EI claims.

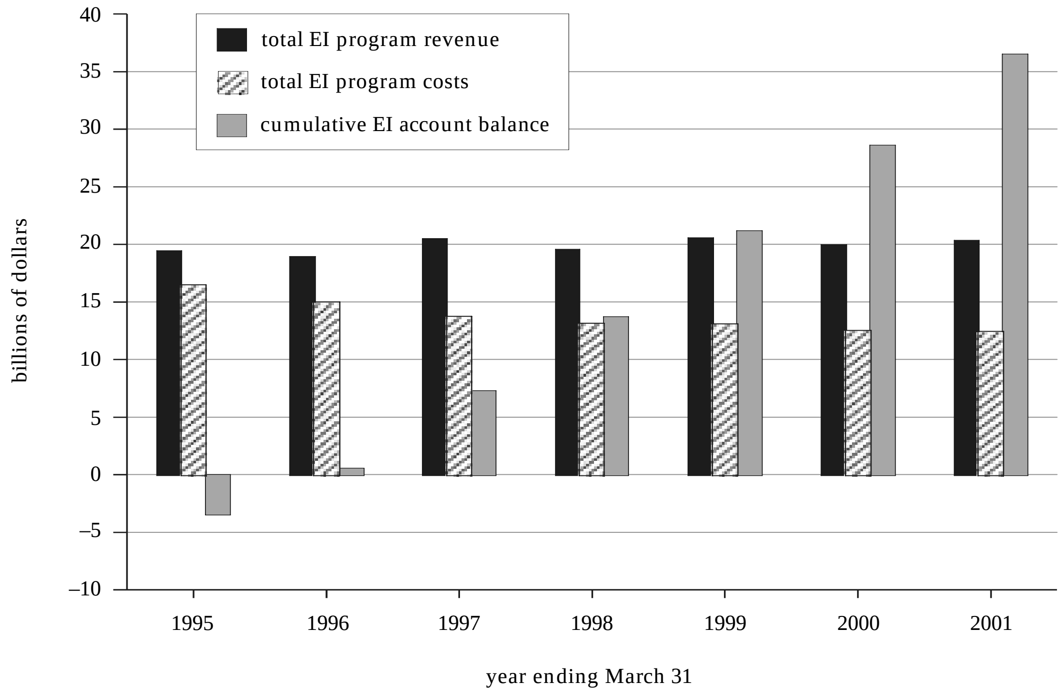
Ottawa's recent turnaround from unsustainable deficits to sizable surpluses is a story with an awkward sidebar. Much of the fiscal improvement has depended on the collection of employment insurance (EI) premiums that far exceed benefits paid out. While keeping premiums high has protected the overall fiscal balance, the habit has also produced an intolerably large balance in the account from which EI program spending is notionally funded.

The economic rationale for building reserves in the EI account has been to avoid nasty premium hikes when an economic slump increases benefit payouts. Now, however, the EI account holds more than $36 billion (see Figure 1), twice the amount that program administrators say is needed to fund benefit entitlements without increasing premiums, even in the event of a sharp and prolonged rise in the unemployment rate. At the current premium rate of 5.4 percent of insurable earnings,[1] the account's holdings will continue to rise, undermining the already shaky positioning of EI as a social insurance program that protects workers in the event of unexpected job loss.

The large account balance has weakened political support for earlier money-saving reforms that had attempted to add insurance-like features to EI — in particular,

1 The rate for 2001 consists of $2.25 paid by employees and $3.15 billed to employers for each $100 of insurable earnings (the insurable earnings maximum is $39,000).

Figure 1: *Employment Insurance Program Revenues, Spending, and Account Balance, 1995–2001*



Source: Canada, Human Resources Development Canada, *Chief Actuary's Report on Employment Insurance Premium Rates*, various years.

employee-based "experience rating" to reduce payments to high-income repeat users (see Nakamura 2000). The insurance program now lacks any way to link the net cost of coverage to the likelihood of making a claim on it.

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More potently, the rising EI account balance fuels demands to put the money toward expensive new benefit schemes or non-insurance uses. These demands have already led to more generous maternity coverage, for example, and many more expanded benefits are in the works. The May 29, 2001, report of the House of Commons Standing Committee on Human Resources Development — which recommended dramatically lower entrance requirements, extended benefits for older workers, increased coverage for self-employed workers, and numerous other spending measures that would indeed reduce the growth of the balance in the EI account — would divert the program further from its core function.

Furthermore, when premiums persistently exceed payouts, they cease being social insurance contributions and become more like ordinary payroll taxes. This transformation may in itself be economically damaging: an insurance premium looks and feels like a payment for any necessary service, but payroll taxes drive a wedge between what employers pay and what workers take home, discouraging work in the above-ground economy. The transformation is also questionable from a legal point of view: while one level of government can impose social insurance premiums on the employees of another, levying payroll taxes on provincial employers falls afoul of the constitutional prohibition on one level of government taxing another.

The broader economic issue, however, is that the larger the non-insurance aspects of EI become, the more the program subsidizes industries and regions where the prospects for stable, well-paying jobs are poor, at the expense of industries and regions where the prospects are good — hardly a sound strategy for future prosperity.

The most straightforward solution, reining in EI cash collection by reducing the premium to a level more commensurate with program spending,[2] would undermine the federal government's fiscal plan, hurting the prospects for potentially more beneficial tax cuts and threatening a return to deficits. The task, then, is to remodel the EI program to rejuvenate the program's social insurance role, while preserving Ottawa's fiscal gains.

Better Design

A quick review of the major components of EI payouts and revenues reveals the outlines of a potential solution to this problem.[3]

The original insurance intent of EI has become submerged over time.

Looking at payouts, it is readily apparent that the original insurance intent of EI — as measured by the relative importance of temporary benefits paid to workers who have unexpectedly lost their jobs — has become submerged over time. In the early 1970s, regular benefits constituted more than 90 percent of total payouts. Since then, items such as earnings supplements, family-related benefits, and training grants to provinces have grown in importance. Regular benefits — defined broadly so as to include regionally extended benefits, the extra weeks of coverage that vary with the local unemployment rate — now account for less than 60 percent of total spending on the EI program (Figure 2). Even if EI premiums were to balance total payouts over time, therefore, the premiums would be funding far more than simple insurance against the risk of job loss. Much of the collection would be plain payroll tax, rather than a fee for service.

On the revenue side, the key feature is the size of employers' contributions, which now exceed total regular and sickness benefits by well over $2 billion annually (Figure 3). In other words, the social insurance core of the EI program, administrative costs, *and* the beginnings of a genuine fund that would finance the program through lean years could be managed through employers' premiums alone.

An attractive solution to the EI conundrum, then, would be to split the program in two. Employers could continue to fund the insurance side of the program, excluding supplementary non-insurance-type benefits. Employees' premiums, on the other hand, would become a general payroll tax, entering the federal government's consolidated revenue fund to be spent by the same democratic processes that guide other federal programs.

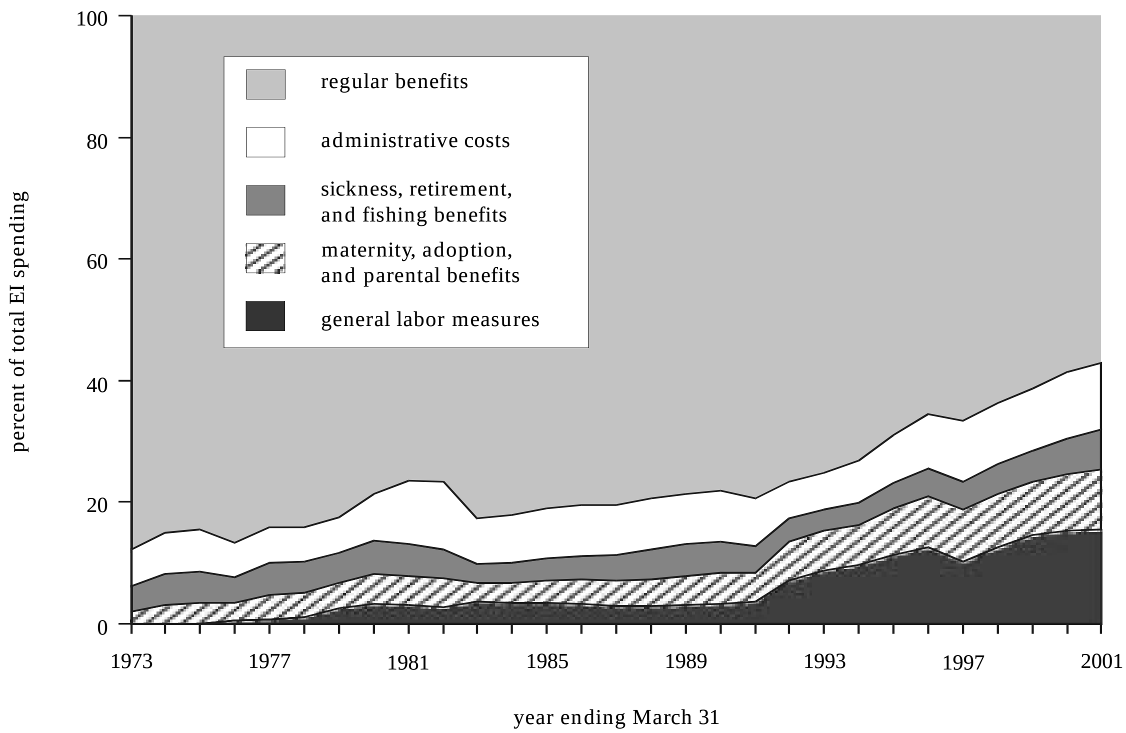
Better Performance

This reform offers a variety of improvements. With only employers' contributions entering the EI account, the pace at which the surplus is growing would slow, braking

2 According to the EI program's chief actuary, the premium rate could be dropped to 4.34 percent and set there indefinitely without threatening a deficit in the EI account. This approach was recommended by the Senate Social Affairs, Science and Technology Committee in its May 3 report to the Senate, in which it expressed concern about the federal government's rate-setting policy and the enormous size of the EI account.

3 This mechanism was earlier highlighted in Boessenkool, Poschmann, and Robson (1998).

Figure 2: Growth of *Non-insurance Components of Total Employment Insurance Spending, 1973–2001*



Sources: Statistics Canada, CANSIM database; and authors' calculations.

The switch to exclusive employer financing would increase the attractiveness of employer-based experience rating

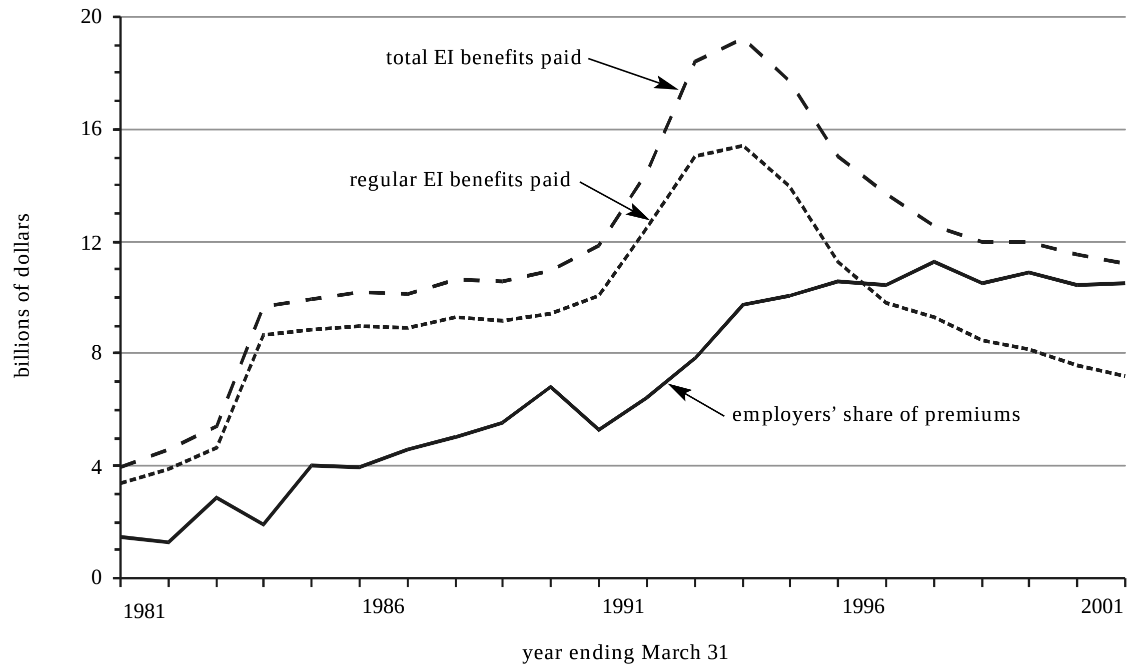
the ever-present drive to expand benefits. The contribution of the EI program to the tax wedge, as well as the threat of a constitutional challenge, would diminish.

The switch to exclusive employer financing would increase the attractiveness of another programming change: employer-based experience rating that would reduce premiums for firms that generate fewer claims than others. This change would be fairer to firms that lay off fewer workers, and it would encourage firms not to lay off their employees,[4] just as firms are rewarded for good safety practices by having their workers' compensation premium rate lowered. When implemented through lower EI premium rates for stable employers, experience rating can deliver significant macroeconomic benefits without attracting the powerful political opposition that was the recent undoing of employee-based experience rating.

Transforming employee contributions into a general employee-paid payroll tax raises another possibility. Decoupled from the EI program's cap on insurable earnings, the employees' payroll tax could be uncapped and the rate lowered (from 2.25 to 1.63 percent), thus raising the same amount of money more efficiently from a broader base and levering the burden of the tax slightly more toward higher-income workers.

4 Thus, for example, firms will tend less to manage their production cycles so as to maximize the EI contribution to workers' annual pay packages. By reducing the subsidy to high-layoff businesses, EI reform could lower the unemployment rate: US studies indicate that the partial experience rating used in most states reduces the unemployment rate by at least 1 percentage point (Canada 1998).

Figure 3: ***Employment Insurance Benefits and Premiums, 1981–2001***



Sources: Canada, Human Resources Development Canada, *Chief Actuary's Report on Employment Insurance Premium Rates*, various years; Statistics Canada, CANSIM database; authors' calculations.

Last, but certainly not least, such a change would improve accountability. Reprogramming the EI cash machine would bring many political and economic benefits, but truth in labeling is, in a key sense, the most important. It is rare that a reform offers such a combination of improved social insurance, fiscal prudence, and honest accounting. It is time the federal government considered it.

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