Why We Need a Return to Experience Rating in EI

by Alice O. Nakamura & W. Erwin Diewert

The primary purpose of Employment Insurance (EI) is to reduce the economic damage that results from unplanned unemployment.

Markets channel resources toward businesses with products that consumers prefer, creating wealth for the market winners. However, they also channel resources away from businesses with undesired products. When a business is forced to contract or close, those laid off usually have no way of preventing this. It is the economic damage from this sort of unplanned unemployment that the EI program, like the Unemployment Insurance (UI) program it replaced, is designed to reduce.

Many view EI as needed only by workers in insecure jobs, or as an interference with free labour markets that weakens personal incentives to make needed investments in education and relocation. We argue that the need for this program is inherent to a free market economy and explain steps that need to be taken to protect EI's health.

EI as an economic stabilizer

Layoffs of workers can result in a chain reaction of economic losses. These losses begin with the income losses of the laid off workers and lead to decreases in spending by those workers elsewhere in the community. If the circle of layoffs grows wide enough, property prices will begin to drop, with associated declines in the borrowing capacity of individuals and businesses, thereby undermining their capacity for adjustment to changed economic circumstances. Government tax revenues and spending can then decline, thus deepening the downward spiral.

By cushioning the income losses of the unemployed, EI can help guard against growth in the circle of unemployment and the resulting declines in asset values.

Opportunistic planned use of EI must be curbed

We all need a well-functioning EI program. However, this program is big enough to ruin the nation's economy if it is badly managed. One sign of the program's problems is unsustainable growth in caseloads and expenditures. Evidence of this motivated the UI reforms of the 1990s and the enactment of EI (Nakamura and Diewert, 2000; Human Resources Development Canada, 1994). Researchers traced the growth of UI program caseloads and expenditures, in part, to a growth of repeat use of UI by individuals and employers.

Changes to the UI program made in the early 1970s encouraged repeated use of the program. Before then, unemployed workers were only eligible to collect UI benefits for the duration of their usual season of work. For example, a person who usually worked three months each summer could collect UI benefits for one more month if laid off two months into their usual three-month work season. This restriction was dropped in the early 1970s at the same time that variable entrance requirements and benefit periods were introduced. The rule changes allowed workers in regions with higher unemployment rates to qualify for benefits with less insured work and to continue to collect benefits for longer. This is a form of negative experience rating.

It is unknown how much these program changes stimulated repeat use of UI. However, the early 1970s saw caseloads and expenditures for the Canadian UI program accelerate. They also grew more rapidly than caseloads and expen-

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ditures for state-based UI programs in the United States. All of the state-based UI programs in the US incorporate experience rating to help curb repeat use. There, premiums are raised for companies whose workers repeatedly draw on UI benefits. In Canada, by contrast, the EI/UI premiums have always been paid in part by workers. There is a reluctance to raise the premium rates for workers who have suffered recent bouts of unemployment. Hence, instituting the usual premium-side experience rating has not been attempted in Canada. Nevertheless, there is an urgent need to counterbalance the negative experience rating features that were introduced into UI and carried over into EI.

Benefit-side experience rating: a Canadian innovation

In a 1994 report, we proposed a new type of experience rating that was designed to suit the Canadian situation (subsequently published as Nakamura and Diewert, 2000). We suggested reducing the benefits, rather than increasing the premium rate, as the risk of unemployment increased. Our recommended method for reducing the benefits for repeat users was to shorten the benefit period. This would give the person quick help in the event of job loss. The person could then apply for social assistance or other need-based programs, if appropriate. An insurance program is not a proper vehicle for dealing with problems of structural economic development and poverty problems.

As an alternative strategy, some have suggested introducing welfare-type means assessments into the Canadian unemployment insurance program. However, these take time to carry out and it is essential for the program to begin paying out benefits quickly to those thrown out of work. As well, if the program only provided insurance for the earnings of workers with limited means, most workers would not be covered and the program would be of less value as an economic stabilizer. Finally, compared with experience rating, means assessments are more intrusive (see Nakamura, Cragg, and Sayers, 1994).

The new EI incorporated two variants of benefit-side experience rating. The first, called the *intensity rule*, reduced the benefit replacement rate (the proportion of insured income to be paid out in program benefits) up to a maximum reduction of five percentage points. The second, called the *experience rating of the clawback*, applied only to higher-income workers. The experience rating of the clawback involved increases in the percent of the benefits paid out that were "clawed back." Both changes were based on EI beneficiary experience over the previous five years.

An unprecedented surplus of premium revenues over program expenditures built up in the years following the passage of EI, despite small reductions in EI premium rates. This could be an indication that the benefit-side experience rating changes were effective in helping to correct, or reduce the costliness of, the repeat use problem. Unfortunately, the experience rating provisions introduced with the enactment of EI were abruptly removed with the passage of Bill C-2 in 2001 for reasons that have since proven to be mostly unfounded.

The EI surplus

EI expenditures fell sharply following the program's enactment. However, the premium rates were not reduced in accord with the fall in program expenditures. This resulted in the build-up of a massive excess of premium revenues over expenditures, a policy failure of the Chrétien government. The main reason this was a failure is that relatively high EI tax premiums cause an unnecessary loss of employment. As minister of finance in 1994, now-Prime Minister Paul Martin stated unequivocally that high payroll tax rates kill jobs (Martin, 1994; Nakamura and Wong, 2001). Paul Martin understood the importance of keeping EI premium rates as low as possible.

Payroll taxes are efficient from a tax collection perspective, but provide an incentive for businesses to save on labour and use more of other inputs (Nakamura and Diewert, 2001). Leaving the EI premium rate higher than needed for covering program expenditures is also unfair. The average EI tax rate per dollar of earnings is higher for lower-wage workers due to the dollar limit on the earnings subject to this tax.

Large proportions of lower-wage workers are also in jobs with relatively high on-the-job accident rates, and hence high Workers' Compensation (WC) premium rates. The combined EI and WC premiums constitute a payroll tax wedge that encourages businesses and households to substitute machines, and foreign or unpaid family labour, for the labour of the lower-wage workers. This contributes to the problem of inadequate employment opportunities for workers competing for jobs with low education and skill requirements.

Conclusion

A well-functioning EI program is fundamentally important for the continued health of the Canadian economy. Those suffering unplanned bouts of unemployment need this program to provide partial replacement for income losses due to unemployment. As well, Canadians at little or no risk of unemployment nevertheless need an effective EI program to help protect the value of their assets.

It appears that the 1996 reforms effectively controlled the costs of repeat use of the program, if not the repeat use itself. Re-instituting some form of benefit-side experience rating is a way of dealing, again, with the repeat use problems that were a key motivation for the EI reform.

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Revealing Research on Auto Insurance

by Mark Mullins

In September 2003, The Fraser Institute's Ontario office initiated an auto insurance research program which to date has resulted in three separate reports. This article gives a brief overview of research to date and provides an update since the reports were published. All of the reports are available on-line at our web site, *www.fraserinstitute.ca.*

Auto insurance and vehicle collisions

The first report, *Public Auto Insurance: A Mortality Warning for Motorists*, reaches a stark conclusion: public auto insurance leads to more deaths, injuries, and property damage than private insurance because it pays bad drivers to be on the road.

The study shows that provinces where drivers are covered by public insurance (British Columbia, Saskatchewan, and Manitoba) have higher vehicle collision rates than the other provinces. There are 18 percent more deaths per person, 35 percent more deaths per kilometre traveled, 46 percent more hospital admissions, and 59 percent more young male hospital admissions, based on the latest available data from insurers and various provincial ministries.

The study examines 26 possible factors that could explain these differences and concluded that "social risk pricing," where premiums from good drivers subsidize bad drivers, is the key reason for more collisions.

The public systems are proud of the fact that they do not discriminate by age or gender—that everyone pays the same basic insurance premium. Of course, it is a fact that young and inexperienced drivers, especially males, have more accidents. When premiums are too low for high-risk drivers, too many of them drive and cause more collisions. This is the apparent source of the higher collision rates in the provinces with monopoly insurance systems. Social risk pricing also inadvertently discriminates against many safe drivers, older drivers, and female drivers.

The study also estimates the impact of moving Ontario's insurance system from a private to a public one. The imposition of social risk pricing would cause property damage collisions to rise by one-fifth. The number of young driver deaths would rise by 50 and there would be 3,900 more personal injury collisions involving young drivers.

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