AIMS Commentary
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Using a wrench as a hammer:

Why EI is the wrong tool to respond to loss of income in an economic downturn

Robin F. Neill
Adjunct Professor, Economics, University of Prince Edward Island
Chair of AIMS Board of Research Advisors

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Executive Summary

In this commentary Robin Neill, Chair of the AIMS Research Advisory Board discusses the creation of assistance for the unemployed in Canada and shows how, by getting the program name wrong we immediately distracted ourselves, and regrettably the program itself, from our true purpose. He argues that today's economic challenges offer us the opportunity to make things right.

First, he argues that for assistance for the unemployed to work at all, we need to recognize that there are three core types of unemployment: frictional, structural and cyclical. And that a single program simply can not respond effectively to all of them.

He suggests that we maintain the current employment insurance program and operate it as true insurance against only structural and frictional unemployment. That means anyone who earns income (part time, full-time, self employed) would be able to access benefits (if you pay in, you get out) but those benefits and the premiums you pay would be adjusted for your known risk of unemployment (if you are in an industry where you tend to be unemployed more, you (and your employer) pay higher premiums, and for your insurable earnings (if you earn more, you pay higher premiums). This fund would not be general revenue to the government but would be handled, and regulated, much as any other insurance fund is, to the benefit of the policy holders.

To respond to cyclical unemployment, which was our original intent with unemployment insurance, he argues for federal borrowing and temporary income relief and training expenditures - similar in fact to the training programs included in the recent federal budget, but without the restriction of having to qualify for EI first. Cyclical unemployment is unemployment like that being experienced by many unemployed Canadians today. The bad news good news of cyclical unemployment is that it is painful, but temporary. He argues that for this type of unemployment both its occurrence and its duration are hard to predict. Training allowances and income replacement

should therefore be set to reflect the circumstances and should last as long as the downturn requires. Such a program of "compensatory income support or CIS" would be a complement to, not a replacement for, EI.

EI would be a risk based service to deal with structural and frictional unemployment. CIS would deal exclusively with economic tsunami's like the current global economic downturn and would see benefits go up when the economy is in crisis and disappear entirely when the economy is booming. This ensures that the program does not increase beyond our means to support it and that it acts, by definition, in what economists call a "countercyclical" way - both significant contrasts to the current program.

Background

In the early 1940s, Canada's Parliament legislated unemployment insurance to ameliorate any return of the conditions that had obtained during the depressed years from 1929 to 1939. Between 1940 and 2006, in the absence of such conditions, federal governments shaped the program to meet a number of other purposes growing out of changed and changing conditions. By the 1990s, the program – renamed employment insurance (EI) in 1996 – was so bent out of shape that it had become, in effect, a dysfunctional tax. Now, in 2009, when many fear the return of conditions that approach those of the 1930s, it may be possible to focus EI on its original purpose. The rest of this paper explains both why this would be desirable and how it should be done.

However, before we get into the details, a note of caution for readers. In the face of Statistics Canada's admission that current estimates of the level and types of unemployment are unreliable, any Employment Insurance scheme will have to remain a fudge. When the program itself is a fudge, as it now is, it is not likely that administratively reliable estimates will be produced. A true catch 22 that makes achieving informed public policy in this area far more difficult but not impossible.

Given the current structure of the program, it is not surprising that the Premier of Ontario proposes that most of the revenue be spent on retraining. It is also not surprising that, at the same time, the Canadian Labour Congress focuses on the extent to which the revenue extracted from workers in the form of premiums exceeds the pay-out, and demands an increase in the latter. These proposed reforms are based on the deficiencies of the current confused program. They are not based on an analysis of what the program should be accomplishing.

Only when the nature of different kinds of unemployment is taken into account can appropriate reform be proposed; and only then can Statistics Canada begin to develop a system for gathering reliable information on the level and types of unemployment (Heather Scoffield, "Statistics Canada Acknowledges Survey's Large Margin of Error", *Globe and Mail*, January 9, 2009, p. B3).

A Brief History of Employment Insurance

From the beginning EI has not been insurance in the normal business sense of the term. Premiums have not been graded to a defined risk of unemployment in different lines of work (a process known as "experience rating"), but have been an undifferentiated tax on the employed and their employers. Moreover, for most of the life of the program, the revenue derived from it has not been invested in a permanent fund to meet future demand. Rather, it has been treated as general government revenue and EI has been treated as a "pay-as-you go" program. While the purpose of the tax is laudable, its impact on employment has been self-defeating, and the consequent contraction of its revenue base when economic activity slowed was the exact reverse of what sensible economic management required.

In 1994, about 75% of the administratively defined unemployed received benefits and the pay-out was about $20 billion. In 1995, during a period in which the federal government was reducing its debt, the length of time EI claimants were required to be in previous employment was increased, and applicants were disqualified for having been fired or for voluntarily quitting employment. By 1999, about three percent of earned income was taken in premiums, and only about 40% of the administratively defined unemployed received benefits. In 2000, the EI program took in approximately $14 billion and paid out about $7 billion in benefits. It cost about $1 billion to administer, and returned a surplus of $5.5 billion to the federal government which was subsequently paid into an EI fund.

In 2005, the Canada Employment Insurance Commission, consisting of four persons appointed for a term by the federal government, was mandated to set the EI premium to correspond to the payout needs of the program. Following the report of the Commission, in 2006 the premium was reduced from $1.94 to $1.87 per $100 of insurable earnings, and the limit of insurable earnings was capped at $39,000. This meant that employers and employees, who paid almost equal premiums, would pay $12 billion less than they paid in 1994, when the premium was about $3.70. In 2007, the premium was further reduced to $1.80. The government announced in the February 2008 budget that the Employment Insurance Fund would be renamed and reduced in size, with the difference going to general revenue. The size of the fund before the announcement, however, was purely notional, because much of it was "loaned" to the government. What the federal government did, in fact, was formalize splitting the premiums two ways: a) a premium to finance benefits, and b) a payroll tax that went into general revenues by way of a "loan".

These changes, in themselves, do not constitute grounds for criticizing the program – some were warranted on very plausible grounds – but they do indicate that there was a continuing sense that change was needed. Over the years, however, changes have been made that were not warranted – such as regionally-extended benefits and funding of maternity leave – so that EI became a kind of Christmas tree program. The problem was that from the very beginning, while its aims were laudable, the program was ill-conceived, and it became increasingly bastardized by laudably aimed but ill-conceived changes during the long period of relatively stable economic growth over the 1950-2006 period.

Reforms, growing out of new demands or a general sense that something was wrong with EI, either were not to the point or not politically acceptable. Mild reforms in the 1990s, reducing the incentive to engage in seasonal work, for example, earned the initiating Government severe electoral losses in Atlantic Canada and Quebec. In general, however, reform failed because circumstances were not conducive to appropriate fundamental change.

The Purposes of the Unemployment/Employment Insurance Program

The EI Program retains its original purpose, to support those who are unemployed through no fault of their own but because of a general downturn in economic activity (cyclical unemployment). Since the mid-1950s, it was intended to function as a NeoKeynesian "automatic stabilizer" of the general level of economic activity, keeping consumption up when the private sector economy goes into a slump. When, in the 1960s, it was perceived that the Canadian economy was not a homogeneous plain on which a single federal Keynesian stabilization policy would do all that seemed to be needed, the program was enlisted to assist in regional development and support, and to compensate for regional disparities in income.

In the 1970s, when stagflation characterized the early stage of the advent of the information economy, the program was burdened with retraining those experiencing unemployment consequent upon technological obsolescence (structural unemployment), and easing job search for those experiencing unemployment due to an increase in turnover of firms in a period of economic change (frictional unemployment). Through all of these phases, from first to last, however implicitly, the program was meant to transfer wealth from the "rich to the poor".

Distortions through Time

In the 1990s, when downsizing, privatizing, and promoting of market efficiency became popular, most economists denied the possibility of an acceptable result with so many different purposes driving the EI program. Nonetheless, the absence of much cyclical unemployment stood in the way of a clear focus in reform of the program. In short, the program's flaws were recognized, but an appropriate correction was not enacted.

In a 1994 study, for example, McGill University's Chris Green[1] asserted that the Canadian Unemployment Insurance program was dysfunctional because, instead of giving short run support to those in difficulty from a general downturn in economic activity, it was giving long run support to those in difficulty due to a relative decline in their productivity. It was being used to support people in regions with long term low paying employment, thereby inhibiting efficient allocation of resources away from such regions. In fact, according to Green, the rate of unemployment in Canada, as a whole, was significantly higher in the substantial economic expansion of 1987-89 than it had been in the mild expansion of 1982-83. He offered this as clear evidence that Unemployment Insurance was targeting problems other than those generated by a general downturn in economic activity. Rather than solving the general problem of unemployment, it was perpetuating it. Green concluded that Unemployment Insurance should not be used for regional support and development.

In the same study, Fred Lazar[2], of York University, argued that the program was dysfunctional insofar as it taxed (collected premiums) in a pro cyclical rather than a counter cyclical way, because, at times, premiums had been raised in economic downturns. When the need for payout increased, premiums set in times of low unemployment were incapable of meeting the need. So, just when it was appropriate to raise overall demand, the program instead reduced incomes. Granted, the incomes of the unemployed, and presumably the level of their consumption, rose in rough proportion, but that was just robbing Peter to pay Paul, and overall consumption was unaffected. In addition, Lazar presented evidence showing that retraining paid for through the Unemployment Insurance program had not reduced the level of unemployment in Canada. He concluded that the program, as constituted, was not a counter cyclical stimulus and it was unsuccessful as an instrument for retraining.

A Situation Conducive to Radical Reform

The period of slow growth and inflation, in the 1970s and 1980s, was characterized by high levels of unemployment that broached the double-digit range. There was concern about "deindustrialization" as the service sector expanded, and there were fears that the emergence of computerization would lead to "out-sourcing" and a reduction of the work force in the goods producing sector of the economy.

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[1] Christopher Green, "What Should We Do with the UI System?", in *Unemployment Insurance: How To Make It Work*, The Social Policy Challenge 2, by Christopher Green et al. (Toronto: C.D. Howe Institute, 1994).

[2] Fred Lazar, "UI as a Redistributive Scheme and Automatic Fiscal Stabilizer" in *Unemployment Insurance: How to Make It Work*, The Social Policy Challenge 2, by Christopher Green et al. (Toronto: C.D. Howe Institute, 1994).

Further, as manufacturing began to move to newly developing countries, Ontario and the US Midwest became a region of depressed industries. Despite such bouts of faltering growth, however, the period after World War II saw nothing comparable to the circumstances of the 1930s. The problems certainly were sufficient to raise fundamental questions about the EI program, but the response only diverted it from addressing cyclical unemployment to tackling structural and frictional unemployment instead. Now, in 2009, however, circumstances are no longer those of the long period of relatively steady economic growth between 1950 and 2008. What was just a bad foretaste in the 1980s has arrived as a repulsive mouthful in 2009.

Financial markets have seized up in consequence of inexperience with the actual risks associated with highly sophisticated new investment vehicles, such as collateralized debt obligations, default swaps, and subprime mortgages. Newspapers are shrinking in the face of emerging alternative instruments of communication. Goods manufacturing has faltered due to obsolete organization and competition from recently developed economies. Ballooning prices in housing, petroleum products, minerals, agricultural products, and in the stock market, all produced by a speculative increase in credit, have collapsed. In short, the expansionary bubble has popped, threatening a deep economic recession in 2009. The conditions of the 1930s seem to be returning, not in detail, but in generality and severity.

That is to say, the conditions necessary for fundamental reform of employment insurance have arrived.

Anatomy of a Flawed Program

In fact, when unemployment insurance was adopted, the conditions that prompted it had already passed. The measure had been intended to ensure that labour would not be bludgeoned in the next depression as it had been in the preceding one, but the timing of the legislation was determined by the need to enlist the support of labour in a desperate war effort. As a result, the program was implemented without due consideration of the circumstances out of which its purpose arose, of the program's not being an insurance program in the usual sense of the term, and indeed, of the fact that it ought not to have been an insurance program in that sense.

Usually insurance premiums are paid against a thin, random, calculable chance that things will go wrong: a house catches fire, a ship is lost in a storm, two automobiles collide on a snowy night. Some accidents of this sort that are more likely than others – for example, that a motorcycle will be destroyed when it is ridden by a male between the ages of 17 and 23 – and such eventualities are insured on payment of a higher premium, calculated on the higher probability of things going wrong. Further, even in the case of high risk activities, there is an assumption that misadventure will be spread thinly through a population, most of which will not suffer misadventure and so will not require a payout from the insuring agent.

In the middle of a war, when the British North America Act was amended to give the federal government the responsibility for – and the right to tax in order to fund – assistance for the unemployed, the targeted need was not expected to be thinly distributed throughout the population. Although not everyone would require a payout, many would, and almost all would be at risk of requiring it. Further, based on the experience of the1929 crash, the timing of the need for payout was going to be unpredictable. A reliable estimate of the risk of such sudden, system-wide losses of income, if not non-existent, was not available to government in 1929; and the experience of 2008 has confirmed that it is still not available to government.

Usually, premiums paid into an insuring agent are invested in a permanent fund from which payment is made when necessary. There was no such fund established to support Unemployment Insurance in 1942. Premiums, like income and sales taxes, were treated as contributions to general revenue. Without the general revenue and borrowing power of the federal government to call on, unemployment insurance in Canada would have been a Ponzi scheme, with payout being financed by current premiums.

The Roots of Reform

The motivation for compensatory income support in a general economic slump is unassailable: loss of work and income is a cost that some bear as the economic system accommodates technical and organizational improvements that generate long term increases in system-wide welfare. Everyone in the economy benefits from this self-correcting process of the market system, so all should bear the cost of the adjustment, not just those who, set upon by forces they cannot control, find themselves unemployed.

The cost of technical and organizational advance is periodic wide-spread unemployment and loss of income. However, the source of revenue to compensate for the uneven distribution of this cost ought not to be self-defeating. It ought not to contribute further to the loss of work and income. It ought not to be a tax on employment. Yet the current EI system taxes and discourages employment and reduces income in attempting to rectify a situation brought on by unemployment and loss of income.

Raising the funds to pay benefits by an increase in general income or consumption taxes would have the same effect on demand throughout the economy, but the burden of the tax would not lie on employment itself. Further, if the federal government were instead to raise the funds to pay benefits by borrowing, the payout would be a short run stimulus to overall demand. When unemployment returned to its normal rate, the cost of repaying the loan, born by general taxation, would lie evenly on all economic activity, and would be drawn from the larger output brought about by the very advances that entailed the costs.

If Government borrowing supports those who are unemployed as a result of a slump in general economic activity, this is consistent with EI's secondary role as a built-in stabilizer of general economic activity. Taking premiums from employers and the employed during a recession does nothing to make funds available for investment and consumption. On the other hand, funding support for this kind of cyclical unemployment through debt increases demand, while paying off the debt when recovery is established reduces the possibility of over-expansion. In this way, debt-supported cyclical loss of income would be compensatory twice over: it would compensate those who bear the costs of long term increases in general welfare, and it would compensate for periodic deficient demand in the private sector, which is the essence of an economic slump. Accordingly, such debt-supported compensation for cyclical unemployment should not be called unemployment insurance, but compensatory unemployment support.

How much should be paid out in compensation and for how long is not self-evident. Convention has it that the payout should be about 60% of an individual's lost income, a problematic notion analogous to the idea that those who had higher-paying skills before unemployment should receive a higher retraining subsidy. As well, in the present program the length of payout is legally set at a number of weeks, the implication being that the depressed conditions causing unemployment will pass by that time, which is absurd. The payout should last as long as economy-wide depressed conditions are the cause of unemployment.

That payout in compensation for lost income and for retraining should match previously earned income implies an entitlement to a certain standard of living. It implies that workers belong to classes, and that a class system should prevail in the compensation for cyclical unemployment and in re-employment in the emerging new economy, regardless of ability to be productive in that economy. It would be more in line with efficient allocation of resources if payout was the same for all – say, 60% of the national average income of workers, however difficult that may be to estimate. The same principle should apply with respect to workers who are categorized as cyclically unemployed until they can find employment of the type and income level that they have lost. In a changing technological environment those jobs might not exist, and the talents of workers may not be such as to warrant their previous level of income.

Frictional unemployment – unemployment associated with the normal turnover of enterprise and labour in a healthy market economy – is a matter of calculable probability in different age groups and different types of jobs, which argues for some kind of experience rating with respect to EI premiums. Depending on the degree of risk, those who face a need for a payout due to frictional unemployment should pay different premiums. For example, some construction-related jobs are more likely to experience periods of unemployment, and workers who choose such work because it pays more – operators of certain kinds of equipment, for example – should pay higher premiums. Younger, less skilled workers who experience higher rates of unemployment than “old hands” should also pay higher premiums.

In short, those who are personally prone to unemployment, because of subjective behaviour rather than objective conditions, should pay higher premiums, just as is the case with those who have repeated automobile accidents. A private insurance scheme based on the user pay principle would inhibit strategic behaviour on the part of the employed. It would prevent those in high-paying unemployment prone jobs from poaching on the premiums paid by workers in less-well paid, uninterrupted employment.

It is true that the present EI system draws a higher premium from highly-paid seasonal jobs than from lower-paid year round jobs, but the higher premium is an everywhere-applied portion of higher pay, and is not set according to the predictable higher risk of unemployment. Further, under the present arrangement, those who pay higher premiums based on higher incomes receive a greater benefit, again indicating the primacy of the principle of income size over the principle of risk of unemployment. It is an element in the current confusion in the EI program, however, that the level of insurable incomes is capped, presumably to prevent the level of income principle from too much overriding the risk of unemployment principle.

Regionally extended benefits (when not a bribe to ensure re-election of the party in power) should be a matter for private and government investment, not a compensation for lost income. There may be grounds for regional development programs, such as those encouraged by the federally sponsored regional economic opportunities agencies. They are generally paid for by debt and are repaid (or should be repaid) out of increased productivity.

Regionally-extended EI benefits, however, are an assertion of entitlement to live in a certain place and work at a certain employment regardless of economic circumstances and the cost to the general public. To pay higher benefits or to pay benefits on lower qualifications in regions of relatively high unemployment on the putative grounds that the cause is a general downturn in economic activity is illogical. There may be grounds in justice for some form of equalization, but that should not be confused with the need for compensatory income support program during a general economic downturn.

In general, retraining programs, like regional development and support programs, or any other investment in increased productivity, should be paid for out of private and public debt. If retraining does not generate a return within the normal bounds of risk, it is inefficient, and should not be undertaken, or, if already undertaken, it should be discontinued. Regional development and retraining programs, when efficient, generate a return to both individuals and the government – individuals benefit from higher incomes, while governments benefit from increased income and sales tax revenues. It is reasonable, then, to remove such programs from a government compensatory income support program, but not entirely from government participation. In this case some kind of shared investment scheme involving perhaps federal, provincial, and local governments, and individuals would be appropriate.

Conclusion

With fears that economic conditions are threatening to return to something like those of the 1930s, fundamental reform of employment insurance at last has a chance of being placed on the agenda. Unemployment is rising (particularly in Ontario) as the overall output of the economy falls. Government revenues and the value of assets in the funds of public and private insurance schemes are falling, exposing the weakness of either a tax-supported or a premium-based fund-supported program. Some other source is needed for the funds to compensate those who, though no fault of their own, lose jobs as the economy reorganizes to exploit a more productive technological base.

Where unemployment is caused by a mismatch between skills and available jobs (structural unemployment) or is the result of the normal turnover of enterprise and labor (frictional unemployment) some form of private/public investment or insurance scheme is called for. Even in times of system-wide unemployment caused by a slump in the overall level of demand there exists both structural and frictional unemployment, so even then both should be measured and dealt with appropriately.

The level of unemployment due to the general slump in demand (cyclical unemployment) should also be measured, but the consequent loss of income should not be compensated for by an insurance scheme. Rather, compensatory income support should be paid for by federal government debt; and the debt should be repaid out of federal income and sales tax revenues when reorganization of economic activity has raised productivity and the level of overall demand has returned to the full-employment level.

Robin Neill

Robin Neill is Chair of the AIMS Board of Research Advisors, and Adjunct Professor, Economics at the University of Prince Edward Island & Carleton University. Neill holds a B.A. and M.A. in Political Economy from the University of Toronto and a PhD. in Economics from Duke.

Atlantic Institute for Market Studies

Barrington St., Ste. 1302 Cogswell Tower,
Halifax NS B3J 3K1
phone: (902) 429-1143 fax: (902) 425-1393
E-Mail: aims@aims.ca www.aims.ca