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An Alternative to Employment Insurance

Perspective for Atlantic Canada

By Justin Hatherly

Halifax, Nova Scotia,

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Table of Contents

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Justin Hatherly is a public policy analyst and commentator. Originally from Nova Scotia, he grew up in Hong Kong and is able to speak both Mandarin and Cantonese. Later, he earned a BA (Honours) in Political Science at McGill University, where he also served as a Campus Fellow for the Atlantic Institute for Market Studies. In addition to his degree in Political Science, while at McGill, Mr. Hatherly also pursued studies in economics. Mr. Hatherly has worked as a research assistant for several organizations, including the Canadian Taxpayers Federation, the Manning Foundation and the Justice Centre for Constitutional Freedoms. His research interests include monetary policy, labour and immigration.

Acknowledgements

Executive Summary

Canada is the only industrialized state to vary Employment Insurance (EI) benefits by region. For EI zones with high unemployment, the benefits last longer and contribution times are shorter. While seemingly compassionate, this system fosters dependence on short-term seasonal work. It also discourages labour mobility, worsens productivity, and provides a disincentive to employment. Regional variance has damaged Atlantic Canada, in particular, by fostering dependence on EI.

This study explains EI's economic effects and proposes reforms for a safety net with fewer economic distortions. The author recommends that the tax-and-transfer model be replaced by a compulsory personal security account (PSA), backstopped by a common fund. The PSA system is based on compulsory EI savings accounts in Chile and consists of these features:

• Payroll deductions go into an individually-owned account.

• An independent investment board invests contributions in a stock index.

• Persons who lose work through no fault of their own can draw 55 percent of their wages for 24 weeks, provided they had contributed for 960 hours.

• Those with insufficient savings receive benefits from a common fund, financed by general revenue. However, they incur a negative balance and must pay back the government before contributing to their PSA.

• Upon retirement, benefits become the property of employees who could withdraw savings, roll them into a pension or bequeath them to heirs.

By eliminating regionally variable benefits, the PSA system eliminates regional labour market distortions and disincentives to labour mobility. Evidence from Chile suggests that as workers would effectively be spending their own money, they would have greater incentives to find work more rapidly.

Another benefit is the PSA system's positive distributional consequences in helping lower-income groups build wealth. Canadians in the bottom two quintiles have low net worth and experience little growth in aggregate wealth. The PSA system would help them establish considerable savings.

This paper's proposed reform aims to encourage more efficient economic decision-making and resource allocation, while still providing adequate support for unemployed workers.

In sum, the present EI system does not strike an appropriate balance between equity and efficiency and contributes to a multitude of economic problems. Reforming the program is a necessary step to improving long-term economic prospects. This paper's proposed reform aims to encourage more efficient economic decision making and resource allocation, while still providing adequate support for unemployed workers.

Introduction

Employment Insurance (EI) is a federal income support program that provides a degree of income security for Canadian workers who lose their jobs through no fault of their own. Financed by payroll taxes levied on employees and employers, the EI system is Canada's primary support for displaced workers. In the 2015/2016 fiscal year, EI accounted for 6.5 percent of federal expenditures.

However, the program unfortunately does much to elevate unemployment rates, exacerbate deep-seated economic challenges, and worsen regional inequalities. In particular, the EI program has stymied economic prosperity and convergence in Atlantic Canada, the poorest region of the country, thus striking a poor balance between equity and economic efficiency.

The government of William Lyon Mackenzie King was the first to successfully pass Employment Insurance (then called Unemployment Insurance). EI was then structured in a manner that provided only temporary relief for the poorest workers. Eligibility criteria were stringent and seasonal workers were excluded because their inclusion would serve as a moral hazard and induce excess collections among this segment of the labour force.

In 1971, Pierre Trudeau's government dramatically enhanced benefits and loosened eligibility criteria. These criteria also became more differentiated along regional lines, as benefit levels and entrance requirements became linked to variables such as local unemployment rates under a system known as variable entrance requirements (VER). This expansion contributed to growing disparities in the interregional use of EI and served to effectively transfer significant wealth from prosperous Central and Western Canada (where most provinces pay more in payroll taxes than they receive in benefit expenditure) to the less affluent Atlantic Provinces. Though certain elements have been reversed (such as the ability of workers who quit their jobs to claim benefits), the 1971 Trudeau policy forms the basis of current EI legislation.

Easier access to benefits worsens the regional differences in unemployment rates and leads to an ossification of the labour market. Seasonal patterns of work have become entrenched while much of the population in beneficiary provinces experiences declining attachment to the regular labour market over time.

This study explains how the EI system works, outlines its disproportionate regional impact on Atlantic Canada, and provides a literature review of its economic effects and consequences. We conclude by advocating an overhaul of EI that moves the program

away from a conventional tax-and-transfer-model to one built on compulsory savings accounts. These accounts would be financed by employers and employees and could be drawn down during periods of unemployment. Chile has successfully adopted this approach.

Most economic research suggests that personal EI savings accounts help to ensure a safety net for unemployed workers while reducing work disincentives and other labour market distortions. Moreover, such accounts would likely increase lower-income Canadians' absolute and relative levels of wealth by allowing them to accumulate savings over the course of their working lives. Under the present system, workers have no claim to any surplus contributions they have made while employed.

The purpose of EI reform is to increase the prospect of sustained economic growth in Canada by moving to a uniform national system built on private savings. While one could conceivably design a reform proposal that maintains the current tax-and-transfer model, personal savings accounts have the added benefit of spreading asset and capital ownership throughout the spectrum of income distribution. The positive changes are economic and social. These accounts will allow many people, presently dependent on state support, to build their own wealth.

Moreover, EI reform as proposed in this policy study would greatly benefit Atlantic Canada, which is disproportionately dependent upon EI and short-term unstable work. Atlantic Canada also records substantially lower rates of personal savings than the rest of the nation; as the proposed reform is built on a system of compulsory savings, it might contribute to boosting savings rates in the region.[1]

It is clear that EI reform would benefit the whole country. In particular, Atlantic Canada needs a program that will not leave it excessively reliant on government support and short-term seasonal employment. EI reform could be a critical first step in restoring hope to a region long blighted by sub-optimal economic performance and relatively poor long-term prospects.

I. Background on Employment Insurance

The Origins of Employment Insurance

Unemployment Insurance was originally part of R. B. Bennett's "new deal" social reform legislation in the depths of the Great Depression in 1935.[2] However, the legislation was struck down as unconstitutional by the Judicial Committee of the Privy Council (JCPC, then Canada's highest organ of judicial appeal) in 1937 on the reasoning that both "employment" and "insurance" fell within provincial jurisdiction under the British North America Act of 1867.[3] In the wake of the Depression, the Mackenzie King-led government enacted a constitutional amendment that added "Unemployment Insurance" to the list of exclusive federal powers. The constitutional amendment was followed by the 1940 *Unemployment Insurance Act* that established Canada's first national EI program.

King's program was built upon classic insurance principles. At first, EI covered only the 40 percent of the labour force that consisted of non-governmental regular workers with incomes of less than $2,000.[4] Seasonal workers (say, in fishing) were excluded on moral-hazard grounds, given fears that they would need to claim EI for an extended period every year and were thus uninsurable.[5] To receive benefits, workers were required to have paid in for 180 days over the previous two years while payroll taxes were equal to 1.8 percent of insured earnings (up to the average industrial wage) for employees and employers.[6] The federal government also partially financed the program by providing funds equivalent to 20 percent of premiums and was liable for general administrative costs. Total benefits were relatively modest at the level of 34 times the 1.8 percent premiums; this effectively worked out to a replacement ratio of 60 percent of insured earnings.[7] EI recipients were then limited to one day of benefits for each five days of contributions in the preceding five years (or one year of benefits for five years of continuous employment).

Coverage increased throughout the 1940s and by the decade's end, around 50 percent of the labour force was covered. However, during the 1950s and 1960s, the program began to move away from sound insurance principles, as seasonal workers such as fishermen became eligible for benefits.[8] This created moral hazard and laid the basis for increasing unemployment rates in communities heavily reliant on seasonal work. Where once such workers may have found off-season employment or saved frugally to provide for non-working months, by the middle of the 1960s they could rely on EI as a guaranteed income support.[9]

Despite the program's gradual expansion, benefits were still relatively modest and eligibility requirements remained stringent through the tenures of prime ministers Louis St-Laurent and Lester Pearson. The most consequential set of changes (which in many respects form the current architecture of the EI program) came in 1971, when Pierre Trudeau's government passed the *Unemployment Insurance Act.* Under the new legislative regime, coverage became effectively universal and even encompassed segments of the labour force for whom the probability of unemployment remained relatively low (such as government employees).[10] The program's scope was expanded beyond an income replacement scheme for unemployed workers, with social benefits such as payments for sickness and maternity added.

The 1971 legislation also sharply reduced entry requirements from 24 weeks to eight. In 1977, the eight-week requirement gave way to variable entrance requirements of anywhere between 10 and 14 weeks. The 1977 changes divided the provinces and territories into multiple EI regions. The weeks of work one had to contribute to collect benefits varied, based upon factors such as the local unemployment rate (the higher the unemployment rate, the less one had to pay in for and the longer one could collect). Over the course of the 1980s and 1990s, the minimum VERs were raised to 12 to 20 weeks in response to growing concerns about program cost and work disincentives that easy access to EI benefits encouraged.

In 1997, an hours-based approach replaced the weekly VERs. Today, minimum contribution requirements can range from as low as 420 hours in regions of 13 percent or higher unemployment to 700 hours in regions with an unemployment rate of six percent or below.[11] Such disparate eligibility requirements lead to a great degree of horizontal inequity. For example, consider two workers who have paid into the program for 500 hours.[12] One in a high unemployment EI region would likely be eligible for EI while one in a lower unemployment EI region could receive no benefits at all. Canada is the only major industrialized nation to vary unemployment benefits in this way.

The 1971-present premium structure levies payroll taxes on employers at a rate of 1.4 times those paid by employees up to an insurable earnings threshold.[13] In 1971, premiums were set at a level to sufficiently finance regular benefits (i.e., total spending net of social and fishing benefits) at a four percent national unemployment rate. The federal government financed the costs above the four percent rate from general revenue, as well as the costs of social benefits delivered through the EI system. The generosity of benefits also expanded dramatically. Replacement ratios for insured earnings were raised from 60 percent to 75 percent for beneficiaries with dependents and 66 percent for those with no dependents. For the first time, workers who quit (as opposed to being fired or laid off) could claim benefits.[14]

The 1971 act epitomized EI's transformation from a social insurance program to a redistributive transfer program. When compared to earlier forms of EI, the act sharply moved away from sound insurance principles. For instance, by the mid-1970s it became easy for those in high unemployment regions to rely on benefits for up to 42 weeks of the year after 10 weeks of work.[15] This discouraged seasonal workers from finding stable, regular employment and led to perverse feedback loops. In regions with the lowest VERs, many workers would supply labour for the minimum time necessary to claim benefits, which led to elevated rates of structural unemployment. Moreover, by the end of the 1980s, a seemingly structural gap of about two percent appeared between Canadian and American unemployment rates.[16]

Given easier eligibility, longer benefits, and higher replacement ratios, it should come as little surprise that EI costs exploded after 1971.[17] While the run-up in costs may have surprised the architects of the new system, to many economists the beneficiaries' reaction would likely have been particularly surprising. As demonstrated in the table below (Figure 1), total outlay (in nominal Canadian dollars) increased from $1,123 billion in the 1971-1972 fiscal year to $19,419 billion in the 2015-2016 fiscal year.

Figure 1

Total Expenditure on EI Benefits ($millions, nominal)

Source: https://www.fin.gc.ca/frt-trf/2016/frt-trf-16-eng.pdf.
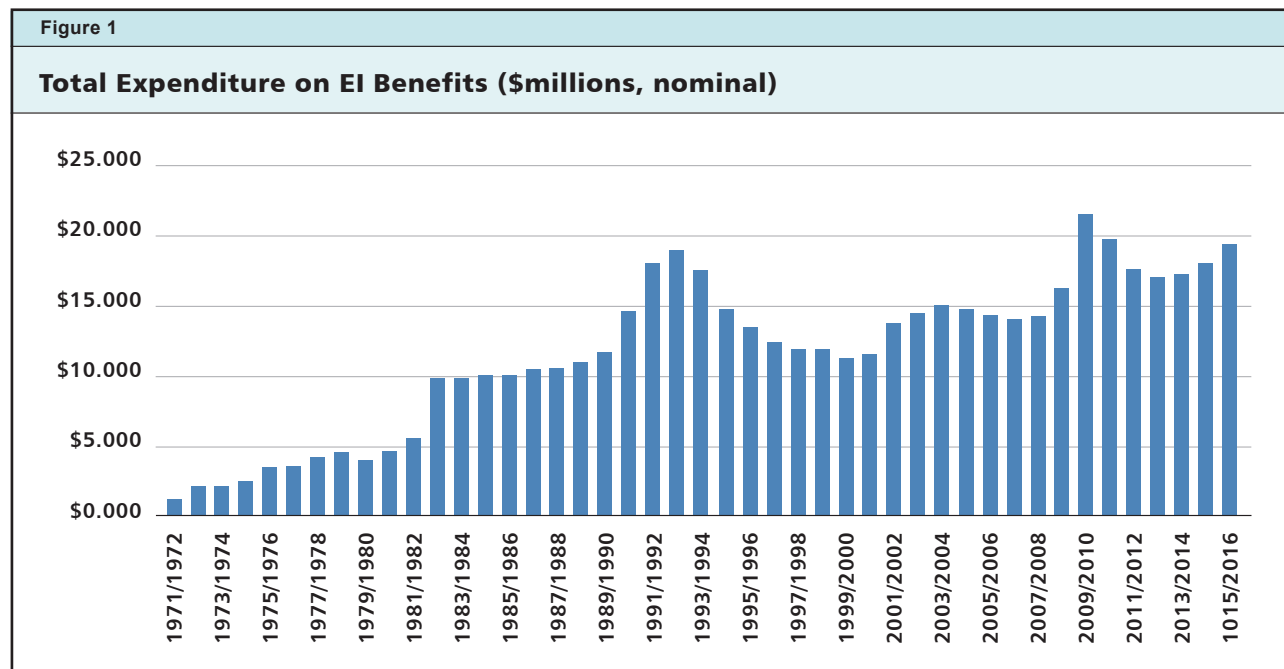
Percentage Increase in Nominal EI Expenditure (1971/1972 to 2015/2016)	Percentage Increase in Real (Inflation Adjusted) EI Expenditure in Constant 2016 Canadian Dollars (1971/1972 to 2015/2016)
1629.20%	195%

Author's own calculations, see Appendix.

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This represents a 1,629 percent increase in nominal terms and a 195 percent increase in real terms when adjusting the 1971-1972 figures for 2016 prices. Looking at annual spending levels and growth, it becomes evident that such sustained increases are largely unrelated to the business cycle. While it is natural for expenditures on transfer payments to rise during periods of slower economic growth, standard economic theory would predict that in periods of economic expansion, expenditures would begin to fall with reduced need as employment increases. However, the data in Figure 1 suggest that the growth in EI expenditure has been structural. For example, in the aftermath of the 1981/1982 recession and the early-1990s recession, expenditure never returned to its pre-recession levels and in fact continued to increase.

In response to EI's increasing strain on the public purse, the Mulroney government began efforts to control costs. By 1990, workers who had quit or attempted to claim benefits on strike became ineligible and government levied sanctions on repeat claimants.[18] Furthermore, the government ended its supplemental contributions to the program from general revenues. From 1990 onward, benefits were to be entirely funded by premiums collected from employees and employers. The replacement ratio of insured wages to benefits eventually fell to 55 percent, where it stands today.

In 1996, as part of its efforts to reduce the federal deficit and to reduce the perceived economic distortions the program brought about, the Chrétien government passed the *Employment Insurance Act,* which also changed the program's formal name to Employment Insurance. The 1996 legislation had three core features: stricter entrance requirements for new entrants to the labour force, an intensity rule that reduced benefits for repeat claimants, and a clawback of benefits from higher-income earners.[19] While these features helped to moderate excessive use of the EI system, their unpopularity proved costly for the Chrétien Liberals, who lost many seats in areas of Atlantic Canada whose residents were dependent on EI benefits. Consequently, over the course of 2000-2001, the intensity rule and the clawback of benefits from higher-income earners were repealed. Many economists and social policy experts thought the 1996 legislation failed to grapple with the program's core defects: regionally variable entry requirements and benefit levels that severely distorted labour supply decisions and increased structural unemployment rates in certain parts of the country.[20]

With the rollback of many of the 1996 reforms, today's system largely resembles the one implemented in 1971. While some features have changed (for instance, the disqualification of workers who quit their jobs and the end to the subsidy from general revenue), entry requirements and benefit duration vary on regional grounds. As we will see later, EI's current design poorly serves Canadians. It plays a role in elevated

unemployment levels in parts of the country (particularly Atlantic Canada), possibly contributes to a poor productivity growth performance, and leads to significant interregional redistributions of wealth.

How the EI System Works

In 2017, workers who quit their jobs or are fired for misconduct are not eligible to claim EI. Benefit levels consist of a replacement ratio (the percentage of insured wages that an individual can expect as a weekly benefit) of 55 percent of average weekly insurable earnings.[21] As of 2017, the maximum insurable earnings level stands at $51,300.[22]

To finance EI benefits, payroll taxes are assessed against insured earnings. Premium rates for employees stand at $1.63 for every $100 of insured earnings, while for employers, the payroll tax is currently set at $2.82 for every $100 of insured earnings.[23] Since 1971, employer payroll tax rates have been levied at a rate of 1.4 times employee contributions.[24] In principle, premiums are to be adjusted to deplete any surplus or close any deficit in EI expenditure. In practice, however, many governments have maintained premium rates at a level greater than necessary to fund expenditures. For example, in the 1990s, the Chrétien government used surplus EI revenues to reduce the federal deficit.[25]

Despite a uniform national replacement ratio, eligibility for EI and the duration of benefits vary dramatically by region. Canada is divided into 58 EI regions based on local unemployment rates.[26] As a regional unemployment rate rises, the hours of work that one must contribute to the program decline. Eligibility standards and minimum hours that one must contribute for to receive benefits differ substantially. As Eastern Canada has higher than average unemployment rates, eligibility criteria in that region tend to be lower.

Minimum contribution periods and benefit duration are tied to the unemployment rate in each EI region. The higher the unemployment rate, the less one must pay for benefits and the longer one may receive benefits. This divergence in entry standards is known as a variable entrance requirement (VER). Benefit calculations vary by VER as well. To calculate weekly benefit levels, the EI program considers the best or highest earning weeks that one has contributed to the program. Yet, in regions with less stringent VERs, fewer weeks are used to calculate this number. While the replacement ratio is constant nationwide, the best weeks provision effectively provides higher proportional benefits in high unemployment regions, as only the very highest earning weeks are used in benefit calculation.

As a result, two workers in identical circumstances, with equivalent private resources and contribution hours, can be treated very differently by the EI system. For example, a worker in London, Ont., with (at the time of writing this paper) a 6.2 percent regional unemployment rate, would need to contribute for a minimum of 700 hours before receiving a maximum of 38 weeks of benefits.[27] In contrast, a worker in eastern Nova Scotia, which has an unemployment rate of 13.6 percent, would need only contribute for 420 hours to receive up to 45 weeks of benefits.[28]

Thus, it is evident that the EI program violates the principle of horizontal equity, namely that individuals with similar resources facing similar circumstances be treated in the same manner.[29] Yet, a worker in eastern Nova Scotia who had earned $10,000 and contributed for 500 hours would be eligible to claim benefits while the unemployed worker earning the same amount who had contributed to the program for an equal time in London would receive nothing.[30]

The Regional Impact of EI

While EI is a national program, its impact on Canada varies dramatically when considered regionally. This section's purpose is to understand better how the program interacts with various regional economies. The data clearly show that EI use and dependence are most heavily concentrated in the Atlantic Provinces. In contrast to the rest of the nation, claims are more frequent and cumulative benefit payments far exceed contributions. In effect, EI transfers resources away from Central and Western Canada to the Atlantic Provinces.

Since 1976, the average unemployment rate in Atlantic Canada has been far greater than the national average. Figure 2 shows that from 1976 to 2016 unemployment has averaged 12.54 percent in the Atlantic Provinces, while averaging only 8.31 percent nationally.

Figure 2

National (Canada) Average Unemployment Rate and Atlantic Canadian Average Unemployment Rate, 1976 to 2016

Source: https://www.fin.gc.ca/frt-trf/2016/frt-trf-16-eng.pdf.
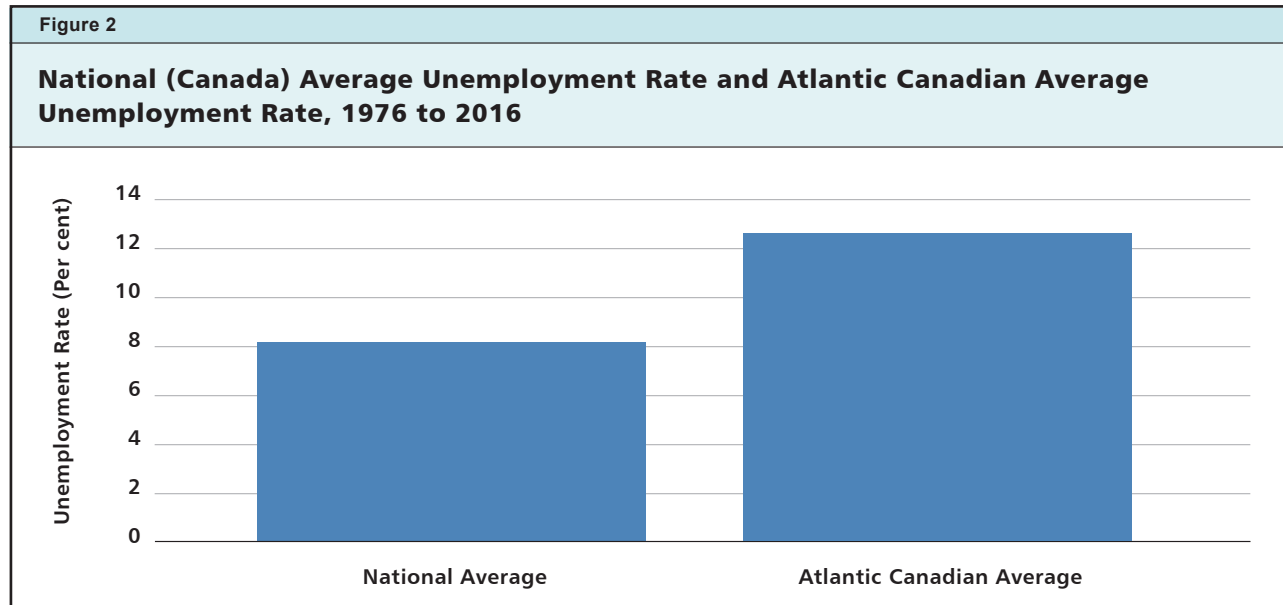
Figure 3 shows that this is hardly because of an anomalous province with high unemployment rates that distort the regional figures. From 1976 to 2016, unemployment averaged 16.01 percent in Newfoundland and Labrador, 12.4 percent in P.E.I., 10.45 percent in Nova Scotia, and 11.32 percent in New Brunswick. The 40-year period suggests that these elevated figures do not simply reflect fluctuations in the business cycle or shocks to particular sectors, but instead reflect a sustained structural problem.

Figure 3

Average National and Provincial Unemployment Rates, 1976 to 2016

Source: http://www.stats.gov.nl.ca/statistics/labour/pdf/unemprate.pdf.
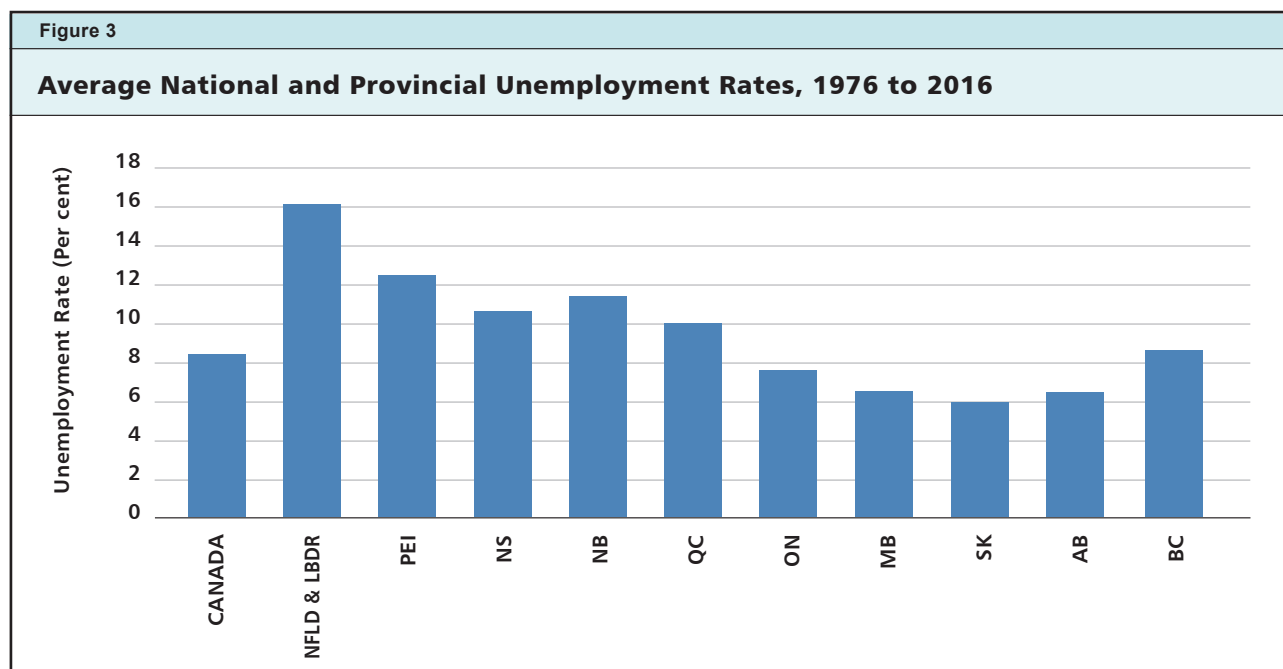
Consequently, a disproportionate reliance on the EI program accompanies higher than average unemployment rates. As Figure 4 shows, Atlantic Canada has been a net beneficiary of the program. From 1981 to 2010, Newfoundlanders and Labradorians received $14.3 billion more in benefits than they paid in EI payroll taxes, residents of P.E.I. received a net benefit of $2.9 billion, Nova Scotia received a $5.2 billion net benefit, and New Brunswickers received an $8.7 billion net benefit. Ontario, Alberta, Manitoba, Saskatchewan, and British Columbia cumulatively contributed tens of billions of dollars more in EI taxes than they received in benefits. While the Atlantic figures (apart from Newfoundland and Labrador) are less than those for Quebec (the other province where program expenditure exceeded contributions), this is somewhat misleading. Given their smaller populations, it is evident that the Atlantic Provinces received greater expenditure than any other province or region on a per capita basis.

Figure 4			
Net Contribution to EI Program, 1981 to 2010, by Province			
	Benefits Received (Billions of Canadian Dollars, nominal)	Premiums Paid (Billions of Canadian Dollars, nominal)	Net Contribution (Billions of Canadian Dollars, nominal)
NL	20.4	6.1	-14.3
P.E.I.	4.5	1.6	-2.9
NS	16.7	11.5	-5.2
NB	18.3	9.6	-8.7
QC	105.9	99.2	-6.7
ON	100	175.2	75.2
MB	10	15.5	5.5
SK	8	12	4
AB	26.2	44.1	17.9
BC	43.3	53.9	10.6

http://www.statcan.gc.ca/pub/13-018-x/13-018-x2011001-eng.htm. Note: Total figures are result of author's calculation.

Given the regional deficit between benefits and expenditures, it should come as no surprise that the proportion of the population claiming EI benefits is far greater across Atlantic Canada than the rest of the nation. As Figure 5 shows, between 2010 and 2014 an average of approximately 18.2 percent of Newfoundlanders and Labradorians claimed EI benefits. In contrast, the national average stands only at around 7.2 percent.

Figure 5						
Proportion of Population Claiming EI Benefits, 2010 to 2014						
	2010	**2011**	**2012**	**2013**	**2014**	**Average Percentage of Population Claiming EI (2010-2014)**
NFLD	0.19623658	0.188424816	0.181232786	0.173508605	0.171255629	18.2%
P.E.I.	0.184149974	0.176897763	0.171078026	0.161939137	0.157441439	17%
NS	0.111445716	0.108897169	0.105720663	0.099328273	0.096247829	10.4%
NB	0.146299552	0.143157783	0.140226249	0.133400896	0.130486908	13.9%
QC	0.107848485	0.101228125	0.098463262	0.090059414	0.092800502	9.8%
ON	0.068411549	0.005987009	0.056631644	0.054180259	0.053295644	4.8%
MB	0.065245346	0.05784095	0.055588215	0.052560175	0.052921536	5.7%
SK	0.059338517	0.054269287	0.051297492	0.048950669	0.049416518	5.2%
AB	0.062042993	0.053271722	0.048554985	0.046917145	0.046622884	5.1%
BC	0.071662662	0.064510121	0.05968383	0.055865703	0.055084095	6.1%
Canada	0.082340169	0.074939769	0.071236127	0.068032693	0.066756762	7.2%

http://www5.statcan.gc.ca/cansim/a26?lang=eng&id=2760034, and author's calculation.

EI beneficiaries are more likely to use the program frequently in a short time period. Frequent claimants, defined as those who have claimed benefits three times in each five-year period, made up 62.4 percent and 43 percent of recipients in Newfoundland and Labrador and Nova Scotia respectively between 2008 and 2010. These figures are several times higher than those for Alberta and B.C. of 7.5 percent and 14.2 percent during the same time. Figure 6 shows the data on the proportion of frequent claimants during this period. This was not due to an asymmetric economic shock that did greater damage to Atlantic Canada. From 2008 to 2010, all provinces faced an economic slowdown due to the global financial crisis. The fact that such a great

Figure 6			
Frequent EI Claimants by Province, 2008 to 2010			
Province	**Total Claimants**	**Frequent Claimants**	**Percentage Who Are Frequent Claimants**
NL	90,233	56,290	62.4%
P.E.I.	24,100	14,353	59%
NB	92,433	45,320	49%
NS	88,967	38,107	43%
QC	552,400	197,207	35.7%
SK	46,733	9,533	20.4%
MB	62,367	11,497	18.4%
ON	666,433	101,133	15.2%
BC	248,333	35,287	14.2%
AB	171,900	12,980	7.5%

https://www.canada.ca/en/employment-social-development/programs/ei/ei-list/reports/monitoring2012.html, and author's calculation.

percentage of EI beneficiaries in the Atlantic Provinces during this period were classified as frequent claimants suggests that EI usage must have been far greater there when compared to the rest of the country even prior to the late 2000s recession.

Moreover, when considering data between the years 2011 and 2012, it becomes evident that dependence on EI is even greater than a general analysis might suggest, because of the inclusion of maternity and sickness benefits. Figure 7 demonstrates that in these years, reliance upon the unemployment benefit portion of EI was far greater in Atlantic Canada than nationally. For instance, in both Newfoundland and Labrador and P.E.I., over 80 percent of expenditure for EI payments was for spells of unemployment. By contrast, in Ontario, just over 60 percent of expenditure was for unemployment benefits, while the remainder went to social EI benefits during the same period. The data from Figure 1 and Figure 7 suggest that because of the above-average Atlantic Canadian unemployment rate between 1976 and 2016, use of the unemployment-benefit component of EI in the region exceeds receipt of unemployment benefit expenditure nationally.

Figure 7			
Composition of Benefits Between Unemployment Benefits and Social Benefits, 2011 to 2012 (Nominal Dollars)			
Province	**Amount Paid**	**Unemployment Benefits**	**Social Benefits**
NL	891,000,000	88.18%	11.82%
P.E.I.	225,000,000	81.31%	18.69
NS	805,000,000	78.78%	21.22
NB	848,000,000	78.24%	21.76
QC	3,564,000,000	88.6%	11.41
ON	5,203,000,0000	60.59%	39.41
MB	452,000,000	56.49%	43.51
SK	378,000,000	54.8%	45.2
AB	1,346,000,000	49.93%	50.06
BC	1,906,000,000	63.25%	36.75

https://www.canada.ca/en/employment-social-development/programs/ei/ei-list/reports/monitoring2012.html, and author's calculation.

Again comparing data from the 2011 to 2012 period, Figure 8 further demonstrates Atlantic Canada's disproportionate use of EI. During this period, Nova Scotia, which contained only 2.7 percent of all eligible members of the labour force, received 5.1 percent of benefit payments. In New Brunswick, with only 2.1 percent of eligible workers, benefit expenditure represented 5.4 percent of the national total. The multiple of the percentage national EI expenditure to the percentage of the eligible labour force was several times greater in the Atlantic Provinces, while most other provinces received a percentage of expenditure that was roughly equal to or less than their percentage of eligible workers. The contrast is starkest when Atlantic

Figure 8

EI Claims and Benefit Payments Against Covered Employees, 2011 to 2012

Province	Percentage of Total EI Claims	Percentage of Covered Employees	Percentage of Benefit Payments	Percentage of Benefits Payments as a Multiple of Percentage of Covered Employees
NF	4.6	1.4	5.7	4.07
P.E.I.	1.3	0.4	1.4	3.5
NS	4.7	2.7	5.1	1.9
NB	4.9	2.1	5.4	2.8
QC	27.9	22.8	22.7	0.99
ON	31.5	38.3	33.1	0.86
MB	3.1	3.8	2.9	0.76
SK	2.3	3.1	2.4	0.77
AB	7.6	12.2	8.6	0.71
BC	11.8	12.8	12.1	0.95

https://www.canada.ca/en/employment-social-development/programs/ei/ei-list/reports/monitoring2012.html, and author's calculation.

Canada is compared to the western provinces. The multiples for Alberta and British Columbia between 2011 and 2012 were 0.71 and 0.77 respectively. In Nova Scotia and Newfoundland and Labrador, they stood at 4.07 and 1.9 respectively.

The data clearly show that Atlantic Canada displays a unique dependence on the EI program. This dependence manifests in numerous ways. A greater proportion of the population in Atlantic Canada relies on the program, the amount of expenditure on EI benefits in the region far outstrips cumulative EI payroll taxes, the percentage of frequent claimants in each of the Atlantic Provinces exceeds the national average, and all four provinces receive a greater percentage of expenditure than the percentage of the eligible labour force they contain.

The economic literature provides several insights as to why this is the case. One obvious cause is the higher average unemployment rates persisting in the region over the past 40 years. However, EI's design might reinforce this dependence and perpetuate high unemployment rates in a perverse feedback loop. Lower eligibility standards and more generous benefits create incentives for more frequent and habitual use of the EI program.[31] The chances of a person using the program repeatedly increase sharply after the first claim. Moreover, regionally disparate benefits form a disincentive to moving elsewhere to find employment.

Thus, the design of EI in certain respects makes reliance on it a structural feature of the Atlantic economy. As we will see in the next section, this excessive reliance is costly economically. While the general economic effects doubtless apply to the whole country, it is inevitable that the effects on the regional labour market and economy are greater in Atlantic Canada.

II. The Economic Effects of Employment Insurance

A wealth of economic evidence indicates that the present architecture and design of EI leads to substantial economic problems and labour market challenges in Canada. Notably, through its regionally variable benefits, EI discourages labour mobility from job-poor to job-rich regions. This likely perpetuates growing regional disparities in unemployment rates. That is, regardless of the national or regional business cycle, there are consistent and growing gaps in structural unemployment rates between areas with generous VERs (such as Nova Scotia), which offer easier eligibility through lower entry requirements, and those with stricter entry requirements.

By exacerbating labour shortages and providing substantial cross subsidies to seasonal industries, EI likely contributes to Canada's relatively poor productivity performance when compared with the United States. Finally, several studies also suggest that workers in certain regions of Canada base many of their labour supply decisions around the availability of EI benefits and that benefit availability might discourage personal savings.

The purpose of this section of the paper is to consider the literature on the economic effects of EI, in Canada and internationally. The review of the evidence strongly suggests that EI reform is imperative to improve economic efficiency and reduce unemployment rates.

Unemployment Insurance and Unemployment

Employment insurance is intended to offset some wage income lost by employees who lose their jobs.[32] An additional secondary goal is to act as a countercyclical automatic stabilizer for national and regional economies. By ensuring that laid-off workers receive some form of income support, the EI program can help maintain aggregate demand for goods and services by sustaining consumer purchasing power and thus stem a vicious cycle of declining demand that induces further job cutbacks.[33] Some also contend that the financial support EI provides can help promote productivity by allowing workers the financial means to take their time finding employment that best deploys their skills, leading to a more efficient allocation of resources.

However, EI programs also have a secondary impact. A basic economic principle is that when an activity is subsidized, the beneficiaries tend to increase their engagement in that activity.[34] By giving jobless workers replacement income, EI in effect also

subsidizes joblessness. The benefits provide a disincentive to recipients from looking for work or finding jobs as quickly as they otherwise might without EI payments. Extending this analysis, one can logically conclude that the more generous or longer lasting the unemployment benefit, the longer it takes EI beneficiaries to find jobs.[35] Thus, it should not be particularly surprising that in provinces such as Newfoundland and Labrador, where benefits last longer, structural unemployment rates tend to be higher than in other parts of the nation. The reduced incentives for job search and other behaviour are largely driven by two factors: the availability of EI and an increase in the reservation wage demanded by workers on EI.[36]

Without EI, unemployed workers would have to rely on social assistance, charitable groups, their own savings, or their families. However, access to EI reduces the relative price of leisure and raises the relative cost of work.[37] EI benefits essentially make it easier for people not to work and to minimize their job search efforts. EI also raises a given worker's reservation wage,[38] which is the minimum wage level or total compensation at which someone is willing to accept new employment. Being provided with a supplemental source of income means the worker raises his or her wage expectations.

Workers on EI can thus become more selective about the type of employment they will take and the wage at which they expect to be compensated. This can lead to some workers refusing to take available employment as they might feel working conditions are unattractive or that the going wage is insufficiently lucrative relative to EI to justify accepting the job offer.[39]

Several insights become clear. First, the longer EI benefits last, the longer a worker is likely to remain unemployed. Second, holding duration constant, the greater the replacement ratio (the extent to which EI replaces wages) the longer unemployment spells tend to last and the higher the reservation wage.

A 1990 study by economist Bruce Meyer supports the above assertions. Meyer found that when looking at American unemployment data, a 10 percent increase in the replacement ratio leads to average unemployment spells increasing by 1.5 weeks.[40] In addition, Meyer contends that the chance of a person on EI finding employment increases rapidly as the benefits approach exhaustion.[41] According to his empirical data, Meyer estimates that the likelihood of an unemployed person on EI finding employment approximately triples as the duration of remaining benefits falls from six weeks to one week.[42] Furthermore, a 1997 study by Mark Gritz and Thomas MaCurdy found that in the U.S., the average length of unemployment spells was around 14.6 weeks for workers eligible for EI, but only 6.6 weeks for workers who did not qualify.[43]

Atlantic Canada also has the dubious distinction of having relatively high rates of youth unemployment compared to other provinces. While certain studies have attributed this to factors such as high minimum wages (particularly relative to Atlantic Canadian median wages), it is reasonable to conclude that the same disincentives to find employment that the EI system produces also contribute to high levels of youth unemployment in Atlantic Canada.[44]

These theoretical and empirical analyses help to explain the persistently higher average rate of unemployment and EI dependency in the Atlantic Provinces. Given that many EI areas across Atlantic Canada allow workers to claim benefits for longer periods (maximum weeks) and contribute to the program for fewer hours (minimum hours contributed), it should be unsurprising that the labour market effects of EI seem to be most pronounced in that region.

None of this is to suggest that individual EI beneficiaries are uniquely lazy. It merely implies that fundamental economic insights hold true. People respond to incentives. Thus, given the easier eligibility of EI and relatively higher generosity in Atlantic Canada, average unemployment rates tend to be higher across the region.

Labour Shortages, Mobility, and Productivity

In the years prior to the post-2014 crash in commodity prices, many Canadian commentators focused on labour shortages that were developing across Western Canada.[45] In the rapidly expanding resource sector and those indirectly related to it, employers were finding it difficult to satisfy their demand for labour across the skills spectrum.[46] Many employers, seemingly unable to find qualified Canadian workers, increased their reliance upon the temporary foreign workers program. Such actions soon drew controversy, as many pointed to high unemployment rates in Eastern Canada and suggested that such employers instead fill jobs with the ranks of unemployed Canadians.[47] However, despite this seeming paradox (high pockets of regional unemployment and large numbers of job vacancies), a rational explanation exists. Economic evidence suggests the EI program provides disincentives for workers to move from job-poor to job-rich regions of the country.[48]

Disincentives to labour mobility are intrinsic to the EI system. In a high unemployment region such as much of Nova Scotia or Newfoundland that has a low VER, it is possible for a worker to qualify for benefits after 420 hours of work and to receive benefits for up to 50 weeks. By contrast, a person living in a high employment region with a more stringent VER might have to contribute for over 700 hours and may only receive benefits for, say, 19 weeks.

Such a system inherently discourages labour mobility.[49] For instance, an unemployed Canadian moving from a region with high unemployment to a lower unemployment region might have difficulty finding long-term employment. If such a person feels compelled to access EI, he or she may be unable to receive benefits (due to insufficient contributions to merit qualification in this EI region) or receive benefits for a shorter period.[50] Easy access to EI benefits in certain regions itself deters migration by providing a system of income support that can sustain an individual with only infrequent periods of short-term work.[51] While it is difficult to quantify the exact magnitude of this effect, most scholars are confident that the regionally variable nature of benefits discourages workers from moving to areas of the country where employment opportunities might be more lucrative.[52] This inevitably exacerbates regional differentials in the unemployment rate and leaves economically expanding regions often facing a deficit of workers.

Defenders of the status quo contend that the rationale behind the current system is sound. They argue it is more challenging to find work in EI regions with high unemployment rates and thus it makes sense for access to benefits to be easier than elsewhere. Despite the laudable intentions that underlie such sentiments, this view fails to consider the effect the maintenance of existing policy (with its inbuilt disincentives to migration) has upon national economic performance. One of Canada's greatest economic difficulties is its relatively poor productivity performance, particularly when compared with the U.S.[53]

Between 2004 and 2014, annual Canadian labour productivity growth came in at only 0.9 percent annually.[54] Over the same period, American labour productivity growth averaged 1.2 percent annually.[55] While such differences may appear trivial, compounded over time they lead to serious consequences such as increasing divergence in per capita income and living standards between the two nations.[56] The efficient allocation of factors of production (including labour) to more productive uses is critical to achieving sustained increases in productivity.[57] By discouraging migration, EI effectively can limit the productive capacity of Canada's most rapidly growing and value-adding industries and regions.[58] If more productive industries face recurring labour shortages and are prevented from expanding sufficiently rapidly, this will over the long run project lower productivity growth and less aggregate national output.[59]

These disincentives are hardly limited to interprovincial migration. Given that unemployment rates and the duration of EI benefits can vary dramatically among different parts of a province, these disincentives to mobility can also occur within provinces.[60] For example, certain scholars find that access to EI can dissuade workers from taking full-time employment in another part of the province. In May 2012, for

example, a call centre in Port Hawkesbury, N.S. closed due to an inability to find full-time staff. This was despite a regional unemployment rate that exceeded 15 percent.[61]

Slower productivity growth means lower living standards for all Canadians. While the design of the EI program is far from the sole cause of the U.S.-Canada labour productivity gap, it likely plays a contributing role. Therefore, a well-designed reform could facilitate greater convergence in productivity levels and assist in accelerating Canadian labour productivity growth. Whatever the intentions of the status quo, the disincentives to labour mobility built into EI, because of regionally variable benefits, take a significant toll on economic performance for the country.

Cross Subsidies, Seasonal Employment, and Further Potential Effects on Productivity Growth

Perversely, the EI system might effectively encourage layoffs and lead to considerable cross-subsidization of industries. In Canada, unlike the U.S., EI employer payroll taxes are not experience rated, meaning they are not adjusted to account for the likelihood that an employer might lay off an employee.[62] Under experience rating, if a business has a frequent history of laying off workers, it will face a higher payroll tax rate.[63] In effect, experience rating ensures that EI operates on grounds more akin to insurance principles as payroll taxes internalize the probability that a firm will lay off its workers. This encourages firms to stabilize their employment and discourages them from shifting the costs of unemployment to the rest of society.[64]

In the Canadian context, some employers might infrequently lay off workers, yet still face the same tax burden as those whose employees frequently depend on the EI system.[65] Employers with larger cyclical or seasonal variations in their businesses (say, in agriculture) tend to rely heavily on temporary workforces and thus impose the most costs on the public treasury. In seasonal industries, intermittent layoffs often make good business sense because the cost in payroll taxes to the employer is generally less than the value of EI to the employee. In the absence of the EI system, it is likely that seasonal employers would have to offer a wage premium relative to firms in competing industries to retain staff so they could compete with employers offering more stable, year-round employment.[66]

Thus, the failure to experience rate means that employers and employees in seasonal industries will draw far more heavily on EI benefits, but pay far less than other firms in taxes and are in effect benefiting from cross subsidies.[67] The lack of experience rating in EI undercuts natural market incentives (higher wages in seasonal industries) to address this problem and acts as a subsidy to employers in seasonal or highly volatile industries.[68]

Cross subsidies have two primary effects on the broader economy: first, they likely depress productivity growth within seasonal industries; second, they can lead to a preference among workers with a disproportionate number of employers for seasonal work rather than full-time, year-round employment.

These effective cross subsidies distort the relative price of labour and capital facing a seasonal firm. The existence of EI allows such firms to offer lower wages than they would otherwise need to offer to retain their employees. This likely leads to the relative price of labour falling and the relative price of capital rising because lower wages mean that labour appears relatively cheaper than capital. It is possible that cross-subsidized seasonal firms have an artificial incentive to over-employ labour and under-employ capital. Consequently, the fact that seasonal industries tend to be more labour intensive could contribute to lower firm-level productivity levels and productivity growth among seasonal industries.

EI's availability to seasonal workers potentially reduces their incentives to find more stable work.[69] It is true that, apart from fishermen, the EI system is not explicitly available to seasonal workers. Yet, the fact that a worker can qualify for benefits with relatively few hours of contributions means that the EI system does include seasonal workers, who have shorter annual work histories. This inevitably leads to a great degree of moral hazard. By definition, workers in seasonal industries have greater incentives to rely regularly upon EI during the off-season. With an EI system that was experience-rated and regionally neutral (with one set of uniform eligibility standards and benefit duration), the fact that seasonal employers would have to offer higher wages to maintain a given workforce would likely reduce their long-run demand for labour as they became more capital intensive.[70] Thus, with fewer job opportunities in seasonal industries, and without a regionally distortive EI system to rely on, seasonal workers would face greater pressures to find more lucrative full-time employment opportunities.[71]

The EI system distorts pay structures and employment decisions and leads to the cross-subsidization of seasonal industries that rely on EI to make temporary layoffs more palatable to their workforce. The distortions of relative factor prices likely lead to less capital intensity and less firm-level productivity growth. Finally, the easier access to benefits in certain high-unemployment EI regions creates a dependency on seasonal employment and a disincentive to find more stable employment.

Suppression of Personal Savings

Individuals save for a variety of reasons. One potential driver of personal savings is precaution against risks such as unemployment. Economists Eric Engen and Jonathan Gruber contend that "precautionary saving is a significant, and perhaps the most important, determinant of individual wealth accumulation."[72]

However, collective provision of EI benefits directly undercuts this critical motive for personal savings. With publicly provided benefits, individuals face less need to save privately to protect themselves against unemployment. When surveying U.S. data, Engen and Gruber conclude that raising EI replacement ratios by 10 percentage points lowers median wealth to income ratios by approximately seven percent.[73] In effect, access to EI could possibly lead workers to substitute away from private savings to collective benefits. While, to our knowledge, little empirical work has been done on the relationship between EI in Canada and private savings rates, literature regarding the relationship of Canada Pension Plan (CPP) benefits to household savings rates can help us infer some potential effects.

In a 2015 study, the Fraser Institute considered the effect of an increase in CPP contribution rates and household savings. The study concluded that holding other variables such as demographic shifts constant, a one percent increase in CPP benefits was associated with a 0.895 percentage point drop in household savings.[74] In effect, the rise in public provision of benefits, entailed by the increased CPP payroll tax, induced a contraction in private savings as households remained content with their intertemporal allocations between present and future consumption.[75] EI is in certain respects similar to CPP. Consequently, it is reasonable to expect that at the margin, the public provision of EI induces a substitution away from private savings to deal with possible risks such as unemployment.

EI's probable effects on household savings rates create several potential problems for the economy because savings represent deferred consumption. Saved resources are used to finance investment, which stimulates greater production in the present, more rapid output, and productivity growth, and thus greater consumption in the future. In a market economy, savings that are channelled into capital investment raise overall productivity and ultimately wages and living standards. Critics of such analysis may posit that since Canadian firms have access to sophisticated and liquid capital markets, they could rely on foreign savings to offset any decline in domestic savings. But as Martin Feldstein and Charles Horioka have shown, even if foreign assets and investments generate higher rates of return, many investors prefer to invest capital in their home countries.[76] Therefore, if EI similarly contributes to lower household savings rates,[77] the program would indirectly contribute to lower levels of investment and growth.

Regional Dispersion in Unemployment Rates

Since the end of the early 1990s recession, Canada's general labour market performance has improved tremendously. Despite the global financial crisis, unemployment rates peaked at the relatively modest level of nine percent before falling back to a range of between six to eight percent.[78] Even with the substantial shock to Canada's terms of trade brought about by a sharp fall in global commodity prices after 2014, the national unemployment rate stands (at the time of writing this paper) at 6.6 percent. This is a far cry from the double-digit unemployment rates that characterized economic life for much of the 1980s and 1990s.[79]

However, despite a generally healthy labour market, there has been a growing divergence in regional unemployment rates since the 1990s.[80] That is, even with a comparatively low national unemployment rate and healthy employment growth, there are sustained long-term pockets of regional unemployment.[81] In a healthy labour market, it is natural to expect that all other things being equal, some workers in more poorly performing regions will migrate to better performing regions, where their chances of finding sustained employment are greater. In a flexible labour market with few frictions, this arbitrage process would continue until the opportunities for employment across the country had roughly converged.[82] One would then expect that interregional differences in unemployment rates would diminish over time. However, as a study by Colin Busby and David Gray reveals, when considering Canada's recent labour market history, the opposite appears to be true. This implies that a variety of factors seem to inhibit labour mobility within Canada.[83]

Busby and Gray compare regional unemployment rates in 1987 and 2010. A weak relationship between the two variables would suggest that convergence tended to occur.[84] A strong relationship (in which the 1987 rate could be used to predict the 2010 rate) would suggest that the region in question had persistent unemployment problems. The data suggest that disparities in unemployment rates have grown within high unemployment regions while remaining roughly constant in lower unemployment regions.[85] Thus, in effect, certain parts of the country, irrespective of the business cycle at a given moment, experienced continuous high levels of unemployment and have fallen even further behind.[86]

Analysis shows that these blighted regions are primarily rural areas located in Atlantic Canada with high numbers of seasonal workers who are the most frequent repeat claimants of EI benefits.[87] EI is unlikely the sole cause of growing regional unemployment dispersion. However, Busby and Gray conclude — given these areas' sustained levels of unemployment, most of which tends to fall within EI regions with generous benefits — that regionally variable eligibility standards and benefit

duration discourage mobility and sustain long-term unemployment in parts of the country. Busby and Gray also argue that low entry qualifications in some parts of the country encourage distortive labour supply decisions. Consistent with the empirical work David Card conducted in the 1990s, they find that these pockets of persistent unemployment contain a greater proportion of workers who supply labour at a rate equivalent to EI qualification. That is, some workers in these regions tend to work for roughly the number of weeks needed to claim EI and then rely on benefits once they are available. In these cases, EI is not a temporary safety net, but a perpetual source of income that distorts the labour supply.

The persistence of elevated regional unemployment rates further bolsters arguments that EI impedes labour mobility and that the design of the program contributes to higher unemployment.

III. The Need for an Equitable and Efficient EI System: The Case for Personal EI Savings Accounts

EI's existing design fails to adequately balance economic efficiency and social equity. It is thus imperative to consider possible reforms that could provide workers with an adequate safety net while minimizing adverse economic and regional impacts.[88] In 2002, Chile moved away from a pay-as-you-go EI system to one built upon compulsory savings by employees and employers.[89] Chilean workers and employers were required to fund personal savings accounts used to finance benefits when an employee faced unemployment.[90] The labour market's response to such changes suggests that the reform improved incentives to work and moderated the distortions prevalent within the Canadian EI system.[91]

We will first seek to understand the broad parameters of the Chilean system. We will then review the literature regarding its impact on labour supply decisions and work incentives. Following this, we will outline the broad framework for a shift to a personal savings-driven variant of EI in Canada. Finally, we will demonstrate why a fundamental shift to savings accounts is a superior reform to simply tinkering with the program's existing benefit structure and eligibility rules. While a move toward savings accounts is unquestionably a market-oriented reform, it contains certain elements that should make it attractive to those who support redistributive policies. Designed correctly, EI savings accounts could have positive distributional effects by allowing those in lower income quintiles, who now generally have low levels of net worth, to build up assets that can be used in retirement or left to their heirs.

How the Chilean System Works

Prior to the introduction of compulsory EI savings accounts, the Chilean government attempted to address the social and economic costs of unemployment through a range of regulatory and transfer programs.[92] The two primary methods to support unemployed workers were a non-contributory benefit financed from general revenues and restrictive regulation that limited employers' ability to fire workers.[93] However, by the early 2000s, Chilean policy-makers saw clear problems with the regime.

The restrictive labour market regulation, characterized by mandatory severance payments for displaced workers, was a major impediment to sustained employment growth. This was because severance increased the cost of hiring a worker and

inhibited labour market adjustments. Although this helped maintain job stability for incumbent workers, it increased employers' reluctance to hire new workers.[94] While job stability levels were high, rates of job creation were low and the average duration of unemployment remained high.[95] Additionally, many in the Chilean government felt that the non-contributory unemployment transfer payment provided inadequate benefits to unemployed workers (benefits ranged from US\$12 to US\$25 and lasted for up to 12 months).[96]

Since 2002, EI in Chile has been built upon compulsory savings accounts. The system includes virtually all workers except government employees, domestic workers, apprentices, retirees, and minors. Funding is derived from employee contributions (0.6 percent of average monthly wages over the preceding 12 months, up to US\$2,000), and employers (2.4 percent of average monthly wages over the preceding 12 months, again up to US\$2,000).[97] Of the 2.4 percent employer contribution, 1.6 percent is placed in the individual employee's personal savings account, while 0.8 percent is transferred to a collective government-run Solidarity Fund.[98] The Chilean government also contributes to the Solidarity Fund out of general revenues. In the event of unemployment for any reason, including resignation, an employee is entitled to benefits paid for from the accumulated balance in his or her account.

Benefits are paid at a fixed replacement ratio and their maximum duration is a uniform five months.[99] There are no regionally adjusted benefit schedules. Workers with insufficient balances in their accounts to pay for their own unemployment spells are eligible to receive benefits from the Solidarity Fund;[100] but to receive benefits, a worker must have contributed to an EI savings account for a minimum of 12 months.[101] The worker must also be unemployed for up to one month prior to drawing benefits from his or her account or the Solidarity Fund.[102] Any accumulated balance in a Chilean EI account is the employee's private property and cannot be used to finance other government spending.

Chilean EI: A Brief Review of the Evidence

Economic theory suggests that personal EI savings accounts are likely to minimize the moral hazards that plague traditional EI programs such as Canada's.[103] Any benefits that a worker receives constitute his or her private property.[104] With EI in Canada, workers have no ownership over their contributions and any surplus contributions made are not remitted in retirement. It makes good economic sense that personal savings accounts provide an incentive to rapid job search and lower reservation wages because benefits are financed from a stream of income that the worker can claim on in the future.[105]

Although neither the Chilean nor the Canadian EI plan is experience rated, the Chilean program does not arbitrarily base qualifications and benefits on regional grounds.[106] This means there are no disincentives to migrate or that there is an implicit preference for seasonal over year-round employment. However, until recently, few data were available to vindicate or discredit economic theory when dealing with the Chilean EI program. Fortunately, a proliferation of studies over the past several years can help us test some of these assumptions.

In 2010, Gonzalo Hartley, Jan van Ours, and Milan Vodopivec endeavoured to understand the incentive effects for beneficiaries undertaking a job search in Chile. Analyzing Chilean EI recipients' transitions to work, the authors find that the greater the sum in an EI savings account prior to an unemployment spell (and thus the lower the potential that a beneficiary will have to rely upon the Solidarity Fund), the higher the probability of finding employment and rapidly ending the use of their funds.[107]

Observing the recipients' behaviour, the authors contend that users of the Chilean program who rely entirely upon their own savings to finance a period of unemployment find work more quickly than recipients who take some support from the Solidarity Fund.[108] Speedier acquisition of employment among non-Solidarity Fund users led the authors to conclude that the individual nature of the account is critical.

Because workers know that upon retirement they have a claim to any accumulated amount in their accounts, they have greater incentives to find work rapidly, as a failure to do so means reducing the resources available for future consumption.[109] That growing account size is associated with even more rapid re-employment reinforces this finding. In effect, the bigger the account, the less chance the worker will have to rely on the Solidarity Fund. Consequently, the worker faces even greater incentives to find employment quickly to preserve the contents of the account.[110]

A separate set of studies also demonstrates that the program's design does not include perverse regional distortions the way the Canadian EI program does. Gaps in long-run regional Chilean unemployment rates are not nearly as persistent as in Canada and tend to converge over time. This suggests that the arbitrage process has been taking place as expected.[111] The Chilean model also avoids the implicit subsidization of seasonal work that riddles the Canadian EI program. As eligibility standards and benefit duration are uniform, there is no obvious preference for workers to undertake seasonal employment as there may be in a Canadian EI region with a low VER. Furthermore, given that benefit receipt requires 12 months of contribution, it is exceedingly difficult for workers to access their benefits if their employment history largely consists of seasonal work.

The evidence seems largely to confirm what economic theory would instruct about the incentive effects of EI savings accounts. Unless one draws from the Solidarity Fund, the beneficiary is spending his or her own money. The EI account system increases job search activity and lowers reservation wages. By treating all beneficiaries equally, the program does not lead to incentives that differ regionally and thus maintains a good balance between economic efficiency and equity. The scheme's compulsory nature protects workers from the economic and psychological costs of unforeseen unemployment. The Solidarity Fund also ensures that the poor, many of whom might initially have more meagre savings accounts than others, are still protected. Chileans with inadequate savings can still receive EI benefits on the same schedule and duration as those drawing from their own accounts.

Outline for a Canadian Reform Program

The Chilean experience suggests it is possible to reform EI through personal savings accounts. The goals of such a reform proposal are to design a safety net for unemployed workers that reduces the disincentives to work and labour mobility that stem from the design of the current EI system. It is essential that the program structure and benefits be uniform across the country to eliminate regional distortions. While some may worry that a system of personal EI accounts might undermine the program's redistributive nature, this need not be the case. Designed correctly, an EI system funded by compulsory savings could lead to positive distributional benefits for lower-income groups by allowing them to accumulate a substantial degree of wealth over the course of their working lives.

The system would have three pillars: EI savings accounts called personal security accounts (PSA), a common fund to ensure workers with inadequate savings could draw upon publicly provided payments as a last resort, and a PSA investment board that would oversee the system in a manner similar to CPP and the Quebec Pension Plan.

Each worker and the worker's employer would contribute to a PSA account. Insured earnings would remain at current levels with a maximum in 2017 of $51,300. At the beginning of each year, the ceiling for maximum insurable earnings would rise with the change in inflation (as measured by the Consumer Price Index) for the preceding year. Employer and employee payroll taxes would contribute an amount of two percent on wages up to the maximum insurable earning threshold. As accounts would be fully funded by employers and employees, there would be no need to adjust contribution rates to cope with accumulating surpluses or emerging deficits in the EI fund, as is currently the case. Nor could the government unilaterally alter benefit levels or divert

funds to other purposes, as all contributions would be placed in individual accounts.

Contributions to the account would be managed by an independent fund operating at arm's length from the government and run by investment professionals. The PSA fund would invest contributions in a weighted index of stocks and bonds while holding some contributions in cash to pay benefits, with a fiduciary duty to attempt to maximize returns for contributors.

While some might argue for a system in which contributors individually manage their own investments, there is reason to be cautious of such an approach. Given the information asymmetries between fund managers and most investors, it is possible that private entities responsible for managing contributions might act imprudently. This worry is magnified by the social insurance nature of even a privately run PSA system. Because the system is set up to provide unemployment benefits for the workforce, fund managers would be aware that a government bailout would probably meet any sudden loss of wealth in the PSA system. Thus, there is a dangerous possibility that those responsible for managing individual PSA investments could invest in a mix of assets that are sub-optimal and riskier than desirable.

To be eligible for benefits, a worker would have to have contributed for up to 960 hours (the equivalent of six months on a standard 40-hour work week). Those who voluntarily left their prior employment would be ineligible. Benefits would be provided at the existing replacement ratio of 55 percent of insurable earnings and payable for a uniform 24 weeks (the current level in the U.S.).

If a worker had inadequate contributions to finance such benefits, they would receive equivalent payments at the same rate from the common fund. The federal government would provide funds from general revenue to finance this supplemental safety net. However, the common fund payments would in effect serve as a loan. Upon expiration of benefits, all contributions that would have normally gone to the PSA would instead be used to pay down the accumulated negative balance. Upon paying down that balance, a worker would be required to make additional contributions of at least 480 hours (three months) into their PSA before being eligible to make further claims against the PSA system. In all cases, total contributions would have to amount to six months before another claim is made. For example, if a worker had accumulated a negative balance and took two months to pay down the accumulated liability, he or she would be required to make contributions for at least 640 hours (or four months), before being permitted to make another claim. Such regulations are essential to ensure that contributors build up savings in their accounts and do not regularly turn to the common fund safety net to finance spells of unemployment.

Upon retirement, contributing workers would be entitled to any remaining balance within their PSA. Funds could be taken in a lump sum or rolled into an RRSP-style pension. Since preferences regarding retirement differ, it would be necessary to set a fixed age at which one could claim the balance of the account. It seems reasonable to set this age at 65, when individuals become entitled to CPP benefits. If the CPP age rises, the PSA retirement age would rise simultaneously to maintain symmetry. At death, beneficiaries would be entitled to pass any remaining amount on to heirs or otherwise dispose of the funds as they see fit.

EI reform along these lines would bring numerous benefits. First, by providing uniform benefits and eligibility standards, it would remove existing incentives for short-term seasonal employment and eliminate disincentives for regional migration. More workers would face incentives to move to areas where jobs were available. This would reduce labour shortages and narrow persistent long-term dispersion in regional unemployment rates. Increased labour mobility to expanding regions of Canada will ensure a more efficient allocation of resources and presumably faster income and productivity growth. Compulsory contributions to the PSA would expand the pool of savings available to finance investment. As PSA contributions would be invested, they could provide financing for Canadian firms seeking funds. This would be particularly important for a region such as Atlantic Canada which has relatively low levels of investment as a share of its economy.[112]

Moreover, with a uniform benefit structure that is somewhat less generous than the existing one available to workers in EI regions with low VERs, reservation wages would likely decline and job search activities would intensify. Such features would contribute to shorter unemployment rates and put downward pressure on national unemployment rates.

The Chilean experience suggests that as workers would effectively deplete a future income stream the longer they remained unemployed, they would have additional reason to minimize their use of the PSA system and have greater interest in remaining continually employed and quickly returning to work. The longer one remained unemployed, the less the PSA would be worth. To paraphrase economist Milton Friedman, no one spends his or her money more prudently than when they are spending it on themselves.

Finally, it is evident that some form of transition arrangements would have to be made to move from the current system to the PSA program, as it will take some time for employees to accumulate sufficient funds in their accounts to pay benefits and most of the labour force has paid EI taxes for years. To finance benefits in the interim, we recommend that the federal government arrange a five-year transition period

where EI taxes would be converted to PSA contributions and any benefits for current eligible workers be financed through some mix of federal spending cuts, borrowing, asset sales, or some form of dedicated, temporary tax (perhaps a one percentage point rise in the GST). After the five-year period ended, the existing EI system would be abolished and all workers would be required to rely on their PSAs or the common fund.

By eliminating regionally varied benefits, Canada would fall in line with existing practice throughout the industrialized world. The PSA would provide a better balance between economic efficiency and social security. It would reduce distortions brought about by the EI system while maintaining a robust safety net for unemployed Canadians.

Why Not Other Alternatives?

It is perfectly possible to reform EI in a way that removes present labour market distortions while keeping the tax-and-transfer model. For example, to remove disincentives to job search and regional labour mobility, one could simply enact uniform eligibility standards and benefit duration.[113] The case for the PSA over other less radical reform proposals rests on two arguments: 1) the ability to allow lower-income groups, with low levels of net worth to accumulate substantial wealth, and 2) to minimize the future burden on public old age transfer programs.

The PSA is more than an income replacement program. Accumulated funds in a PSA would allow workers who are relatively prudent to save substantial sums. As contributions would be invested in stocks and bonds, over a working life such savings would compound and help workers build substantial assets to leave to their heirs or fund their retirements.

Let us take the case of three workers, earning $50,000, $30,000, and $20,000 respectively the first year. As Figure 9 shows, we assume an average annual return on investment of four percent and an increase in the nominal dollar value of contributions of two percent annually.

If they were to remain continuously employed for 30 years, the worker earning $50,000 in the year the PSA program was implemented would have accumulated assets of $139,180. The worker earning $30,000 would have accumulated $84,000 and the worker earning $20,000 would have $56,000.

The chosen assumptions are prudent and realistic. Between 1970 and 2015, the average rate of return on annual investments in the Toronto Stock Exchange has

been approximately 10 percent. Given current trends in nominal wage growth and the indexing of maximum insurable earnings to inflation, it is realistic to assume that contributions would grow at two percent per annum (the midpoint of the Bank of Canada's inflation target). Thus, it becomes clear that even with market fluctuations, if contributing workers remain regularly employed, the value of assets in their PSAs would grow considerably.

Figure 9		
Potential Value of PSA Accounts at Various Income Levels		
Income Level, Canadian Dollars	Amount Contributed Year On (4% Payroll Tax Rate)	Return if Continuously Employed for 30 Years, (nominal)
50,000	$2,000	$139,180
30,000	$1,200	$84,000
20,000	$800	$56,000

Note: Assumes four percent rate of return and contributions that grow annually with CPI inflation of two percent.

Amassing such substantial savings would benefit all Canadians, and it would particularly benefit lower-income Canadians. For example, according to Statistics Canada, between 2005 and 2012, the median net worth of the poorest 20 percent of Canadians remained constant at $1,100 (in constant 2012 dollars). In addition, the percentage of total net wealth held by the poorest 20 percent of the income distribution in Canada remained the same at -0.1 percent. While most of those in lower quintiles do not remain there throughout their working lives, there are unfortunately some who spend most or all of their lives in the lowest quintile. Consequently, the sums accumulated in a worker's PSA would greatly benefit the poorest workers by helping raise the absolute levels of wealth available to those most vulnerable.

Savings in a PSA could be used to fund a more comfortable retirement, finance a family member's education, or engage in entrepreneurial ventures. This stands in stark contrast to the existing EI program in which workers, who may have paid tens of thousands of dollars in taxes over the course of their working lives, get none of their surplus contributions back.

The restrictive conditions on benefit withdrawal and duration mean it is unlikely that most Canadians will have insufficient employment over a lifetime to accumulate significant levels of assets. Rather, they would have strong incentives to resort to the PSA system only when faced with few other alternatives.

Figure 10							
Net Worth Data in Canada for 2005 and 2012							
	Net Worth by Quintile, 2005	Total Net Worth, 2005	Median Net Worth, 2005	Net Worth By Quintile, 2012	Total Net Worth, 2012	Median Net Worth, 2012	Median Net Worth, 2005-2012
	%	Millions of Dollars	Dollars	%	Millions of Dollars	Dollars	% Change
All Units	100	5,530,309	168,700	100	8,073,585	243,800	44.5
Lowest Quintile	-0.1	-7,234	1,100	-0.1	-10,826	1,100	0
Second Quintile	2.3	124,739	42,400	2.2	180,292	56,100	32.3
Third Quintile	8.4	465,147	168,700	9	728,655	245,000	45.2
Fourth Quintile	20.2	1,118,333	410,900	21.5	1,735,014	575,500	40.1
Highest Quintile	69.2	3,829,524	981,400	67.4	5,440,451	1,380,000	40.6

Note: All data in 2012 constant Canadian dollars. http://www.statcan.gc.ca/daily-quotidien/140225/t140225b003-eng.htm.

With an aging population and a growing dependency ratio, the cost of transfer payments such as Old Age Security and the Guaranteed Income Supplement is expected to rise. As these costs increase, they will place a growing squeeze on federal resources. This would reduce resources available for other spending programs of national import. The PSA system could increase financial security among the elderly and make sensitive, cost-reducing reforms to age-related entitlement spending more politically possible.

The PSA model is superior to reforming the existing tax-and-transfer model of EI. While both options could conceivably reduce the distortionary labour market effects of Canada's EI program, only the PSA offers the opportunity for higher levels of savings and wealth creation for all Canadians.

Conclusion

Employment Insurance was created with laudable intentions. In a civilized country, few would wish to deny workers, unemployed through no fault of their own, a form of temporary income replacement. However, numerous revisions to the law have woven a web of perverse incentives, harming Canada's economic prospects. Regionally variable benefits perpetuate employment in seasonal industries and drive up joblessness in the poorest parts of Canada. The incentives that EI recipients face generally discourage labour mobility. Far from protecting Canadians from the worst ravages of the ebb and flow of the business cycle, EI has impeded economic convergence and fostered regional disparities.

While acknowledging the system's flaws, some readers may be skeptical about the need for EI reform from an Atlantic Canadian point of view. They might argue that because EI represents a mass fiscal transfer to the Atlantic Provinces, reform will leave the region poorer. Such views make some superficial sense, but are largely myopic. A reform of EI that minimized its distortive features may leave Atlantic Canada with less transferred money in the short run; the long-run change in incentives would bring improved employment growth and overall economic performance.

However, the case for reform is not simply economic. A failure to address EI's flaws could corrode political unity in Canada. Western Canada, which according to our data serves as a net contributor to the program, can resent the perpetual transfer of resources that EI entails. Moreover, the fact that an unemployed worker in a province such as Alberta faces stringent eligibility requirements and less generous benefits fuels horizontal inequities. Hostility towards EI could undermine Atlantic Canada's position in Confederation and its ability to secure interprovincial co-operation.

Efforts to reform EI are likely to be met positively by other provinces. An overhaul could lead to less tension surrounding interregional issues such as equalization. EI reform could therefore potentially provide a dual benefit to Atlantic Canada by improving its economic situation and its political relations with other provinces. EI reform is good economics and good national politics.

Canada, and particularly Atlantic Canada, can do better. A move towards a PSA system would ensure a safety net for the unemployed. It would also promote equity while doing less damage to efficiency. It is a promise of wealth and savings to those who have little of either. The outlined reforms are meant to lay the ground for a brighter future.

Appendix

Explanation of Calculations for the Potential Value of PSA Accounts:

Let *A* be the accumulated amount after *n* years. Let *P* be the first deposit, taking place after year one (we assume each subsequent deposit occurs at the end of each year). Let *i* be the annual return on investment and *r* represent annual growth in contributions to PSA accounts.

Then *A= P(1+i)^n-1+P(1+r)(1+i)^n-2+P(1+r)^2(1+i)^n-3……P(1+r)^n-2(1+i)+P(1+r)^n-1*

(The reason is that the first deposit will compound over *n-1* periods, the second deposit over *n-2* periods etc. and the nth deposit over 0 periods. The first deposit is *P*, the second deposit *P (1+r)* and the third *P (1+r)^2* and so forth. The n-1th *P (1+r)^n-2* and the nth deposit is *P (1+r)^n-1.*

We therefore have: *A= P((1+i)^n-1+(1+r)(1+i)^n-2+……… +(1+r)^n-2(1+i)+(1+r)^n-1)*

Let *S= ((1+i)^n-1+(1+r)(1+i)^n-2+…….. +(1+r)^n-2(1+i)+(1+r)^n-1)*

S(1+i)/(1+r)= ((1+i)^n+(1+i)^n-1+(1+r)(1+i)^n-2……(1+r)^n-2(1+i))

Thus S(1+i)/(1+r) − S= (1+i)^n-1 − (1+r)^n-1

Thus S((1+i)/(1+r) − 1)= (1+i)^n-1 − (1+r)^n-1

Thus S= ((1+i)^n-1 − (1+r)^n-1))/((1+i)/(1+r) − 1))

Thus A= P((1+i)^n − (1+r)^n-1))/(1+i/1+r) − 1) for the value of the PSA account after a given period of time assuming no withdrawals.

Explanation for Conversion of Nominal EI Spending Growth to Real, Constant Dollar, EI Spending Growth:

To calculate the real increase in EI spending between 1971/1972 and 2015/2016, divide CPI in 2016 by CPI in 1972: 128.4/21.9 and multiply the result by 1971/1972 EI spending amount. This converts the figure into 2016 constant dollars which allows for measuring percentage increase in real terms.

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