# The case for stable contribution rates as a part of Employment Insurance modernization

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The Federal government has promised to modernize Employment Insurance for the 21st century and has been holding consultations to engage stakeholders and others. These have been full of suggestions for the expansion of coverage and benefits. But when it comes to financing the program the debate has been framed in terms of how to finance these suggestions, without a realization that the nature and structure of contributions are themselves also a part of the "modernization" of Employment Insurance.

There is a clear need to think not just about how to finance benefits by adjustments and tweaks to the existing contribution structure, but rather to also think about that structure and how it can itself be reformed to enhance program objectives.

**The need for better insurance offers a guiding principle for reform and practical reforms**

The challenges the Employment Insurance has faced during what is almost the first quarter of the 21st century, if not for even a decade longer back to the early 1990s, are calling for better insurance, and these imply changes not just to the structure of benefits but also to contributions.

The most fundamental role of Employment Insurance is to provide workers with income insurance during periods of job disruption, and it is the insurance part of Employment Insurance that needs upgrading and modernization. As a result, a guiding insurance principle for "Modernization" should be to align the structure of contributions to the underlying nature and causes of the risks being covered.

This implies that contributions should be structured to most efficiently and equitably to cover:

- Job risks associated with employer decisions to manage human resources, whether through changes in hours, layoffs, or even business closures;
- Family risks associated with household decisions about respite, care-giving, and skills development; and
- Collective risks associated with the interconnectedness and uncertainty of a global economy, but also with social choices, the costs of which are often disproportionately shouldered by the unemployed.

Aligning contributions with these risks, with the nature and causes of unemployment, implies some straightforward and feasible reforms.

1. Employer contributions should be used to finance Regular Benefits, and employee contributions should finance "Special" Benefits and some fraction of Part II benefits associated with skills development. The shares of total program expenditures of each of these benefits implies that the ratio of employer to employee contributions should rise from $1.40 for every dollar of employee contribution to about $1.90. But these contribution rates should also evolve gradually over time by being based on the ratio of program expenditures on Regular Benefits to those on Special Benefits. If Special Benefits become a larger share of total Employment Insurance outlays, the employee contribution share should rise accordingly.

2. Contribution rates should be relatively stable and set at a level to finance benefits associated with the underlying trend unemployment rate, evolving gradually in a way that roughly corresponds to the evolution of frictional and structural unemployment. An average of monthly unemployment rates over the past seven years, a horizon consistent with the current funding rules, would currently imply a trend unemployment rate of 7%. An average over the past five years, consistent with the usual mandate of a newly elected government, would imply the same. This is only slightly higher than the 6.5% that both rules implied in January 2020, before the onset of the pandemic, and suggests relatively constant rates even in the aftermath of a shock as big as the pandemic.

3. The program should be based on tripartite funding with Federal government contributions from the Consolidated Revenue Fund covering the expansion of benefits needed in the face of big unexpected shocks that take the unemployment rate above its trend, or to compensate for the trade-offs made in social choices like fighting inflation. At the same time, the Federal balance sheet should be strengthened by the surpluses associated with lower than trend unemployment rates.

**Employer contributions should finance Regular Benefits; Individual contributions should finance Special Benefits**

Managing uncertainty and risk is an inherent part of running a business. Things happen, and entrepreneurs must continually adjust investment, production, and employment according to their expectations of future product demand, whether idiosyncratic to their segment of the market, or broader and more sweeping that change their industry.

Taking on risk is what running a business is about. Job risks associated with these firm-level decisions can be managed through adjustments in the hours of work, temporary layoffs, permanent layoffs, as well as closures and mass layoffs.

Economy-wide employment levels vary depending upon the decisions individual employers make, and there is a good deal of variation in human resource strategies, even among employers within the same region and industry. But they all have consequences for EI Regular Benefits paid, and EI contributions made.

One comprehensive study found that only one-fifth of businesses in continuous operation over an 11-year period were never responsible for their workers collecting more EI benefits than contributions made. In fact, these employers represented almost one-half of all jobs, 60% of all EI contributions, but only 28% of benefits. At the other extreme, the six percent of employers associated with more EI benefits being paid than contributions made in each of these 11 years represented only about 6.5% of all jobs and less than 4% of all contributions, yet 28 % of all EI benefits.

These very sharp divisions in the consequences of employer decisions for the use of Regular Benefits vary between regions and across industries, with firms located east of the Ottawa River consistently being net recipients of Employment Insurance funds. This in part reflects the use of Employment Insurance as an income support program.

But these patterns are also evident within industries. It is not just that some industries in some regions are more prone to layoffs and repeated use of Employment Insurance benefits by their workers, but rather that individual employers have adopted different human resource strategies that have different implications for benefits. Even within heavily reliant EI Industries, it is a minority of firms that are disproportionately responsible for the majority of benefits and make disproportionately lower contributions.

Strict adherence to insurance principles would suggest that contribution rates be “experience-rated” at the firm level, employer contribution rates being tied to the collection of benefits of laid off employees. But this is not a practical policy reform in Canada, requiring a much more considered analysis of the trade-offs associated with the regional income support goals of the program, and with added administrative complexity.

That said, a broad interpretation of insurance principles does offer practical guidance for setting a high-level parameter of the program's financing: the ratio between employer and employee contributions. Employers should contribute at a rate tied to the fraction of benefit expenditures for which they are responsible; employees should contribute at a rate tied to the fraction of benefits for which they are responsible.

It can be imagined that this was historically the basis for the rule of $1.40 of employer contributions for every dollar of employee contribution set a half a century ago: the ratio perhaps reflecting the share of unemployment due to involuntary layoffs, job separations at the discretion of the employer, and the share due to quits, job separations at the discretion of the employee. If this is the case, then the underlying principle should be used to inform changes.

Those who quit their jobs without just cause are no longer eligible for EI benefits, so were the logic of this precedent followed the contribution share of employers would be higher. But at the same time there has been a considerable expansion of so-called "Special Benefits." In some sense, these are contingencies that workers and their families face, and are employee-initiated job interruptions. In other words, current realities would suggest that the sharing rule should, broadly speaking, be based on the ratio between expenditures on Regular and Special Benefits.

The average annual expenditure of the program from 2012 to 2019 was $22.9 billion. Regular Benefits account for 55% of this total, and Special Benefits for 25.5%. This is the great bulk of program expenditures, with Part II Benefits and program administration roughly accounting for the remaining 20%. If the expenditures for these categories are equally attributed to employers and employees, then their shares would roughly be 66%, and 34%, Fishing and Work-Sharing Benefits also being attributed to employers.

This suggests that employer contributions should be almost double employee contributions: about $1.90 for every dollar contributed by employees. This meshes with the ratio of job separations due to employer and to employee reasons. Statistics Canada data show that the number of unemployed who were temporarily or permanently laid off has on average been twice as high as the number of job leavers for personal reasons (excluding those returning to school or retiring who would not be eligible for Employment Insurance).

This logic would also suggest that the share evolve gradually as the distribution of program expenditures changes. Special Benefits have in fact been the fastest growing envelope in the program, rising from about $5 billion in 2010 to over $6 billion in 2020, while Regular Benefits fell over this decade. If this trend continues, then it can be imagined that the employee contribution share should also rise.

**Contribution rates should be stable, evolving slowly with the underlying trend in unemployment rates**

This is distinct from what the levels of contribution rates should be, and how frequently they should change. Insurance principles also offer a rough and practical guide to some parts of this discussion, suggesting that contribution rates should be held relatively constant, and not serve as the basis for financing program expenditures in the face of big shocks associated with the business cycle or other social choices that are in some sense collective, beyond the choices made by individual employers and employees.

Unemployment is caused by mismatches, in fact three different kinds of mismatches that in different ways reflect the workings of the marketplace and of public policy choices. The first two, frictional unemployment and structural unemployment, are the types to which employer and employee contributions should be directed for the provision of insurance, the third, involuntary unemployment, calls for a return to Federal Government contributions.

Frictional unemployment is a mismatch between individuals and the job vacancies for which they are qualified. A vacancy exists, but it takes time for the individual to find the job. Unemployment reflects the time needed to gather information, make applications, and negotiate the terms of an employment contract. There is uncertainty about how long the process will take, and individuals need insurance to cover the gaps between jobs associated with their search.

Structural unemployment is a mismatch between individuals and the requirements of the job vacancies that are available. A vacancy exists, but it takes time for individuals to develop the skills or move to the location of the job. Unemployment reflects the time it takes to train to qualify for the jobs that are available, or reflects uprooting and moving to another part of the country. There is uncertainty about the skills that will be required, and individuals need insurance to cover the gaps between jobs that are always changing in their nature and skill requirements.

Both of these types of unemployment reflect the workings of dynamic economies and labour markets, where thousands upon thousands of employers expand, contract, disappear or are newly born every month, where new people come of age looking for a job for the first time, others suffer layoffs from jobs they've long held, others making transitions between family responsibilities and work, while others are shifting to retirement.

Since this process involves individual firms and workers making decisions in the face of product market and family uncertainties, it is to these two types of unemployment that the contributions of individual employers and employees should be directed. While there is a good deal of churn and adjustment in the labour market, even over the course of a month, on net these types of unemployment do not change that much, or at least evolve slowly. This is the case for relatively stable Employment Insurance contributions, with their level being associated with the insurance associated with the underlying trend or base rate of unemployment, what economists refer to as the "natural" rate of unemployment.

This might be reasonably approximated by an average of the national unemployment rate over a moving window of a number of years. The current Employment Insurance funding rules determine contributions annually over a seven-year window, a rough rule of thumb perhaps referring to the imagined length of a typical business cycle. If a window this long was adopted it would suggest setting current contribution rates at a level to finance program expenditures consistent with a 7% unemployment rate. Using a shorter window of five years, a horizon consistent with the usual mandate of newly elected government, would currently imply the same thing. This is only slightly higher than the 6.5% that both rules would have implied in January 2020, before the onset of the pandemic. The implication is that contribution rates would have been held relatively constant, even in the aftermath of a shock as big as the pandemic when the unemployment rate jumped from less than six percent to over 13%.

**Collective risks and social choices call for a return to Federal contributions**

The third type of unemployment reflects a more dramatic mismatch associated with the lack of jobs, involuntary unemployment. The biggest and most consequential risk workers face is the scarcity of jobs. Sometimes workers are willing to work, are in the right place, and have the required skills, but the jobs are just not available.

This reflects collective risks associated with the interconnectedness and uncertainty of modern economies, and also with the choices we make to pursue goals other than full employment: business cycle downturns during which investment has collapsed; significant sectoral shocks that have broad regional or national consequences, like financial shocks or commodity price shocks; and social priorities like the decision to purse free trade or a priority to fight inflation that imply broad-based job destruction or slower job growth for a period.

These are not risks that insurance principles attribute to individual firms or workers, but rather are collective and reflect fundamental uncertainty. They require the collective provision of insurance. Employment Insurance "modernization" calls for better insurance in the face of these kinds of risks, involving an enhanced role for the program as an automatic stabilizer, running deficits in bad times, and surpluses in good times to support the return of the unemployment rate to its underlying trend.

Insurance principles suggest that collective risks should be covered collectively. This calls for the Federal government to contribute to the financing of the program, covering EI account deficits when the unemployment rate is above trend, and collecting the surplus when it is below.

Currently this collective responsibility is downloaded to individual employers and employees. Contribution rates are determined on the basis of a seven-year breakeven rate, forcing annual changes in them to ensure a cumulative balance in the Employment Insurance account. At times this can lead to perverse changes in contribution rates to ensure balance, forecasted increases at the onset of new unanticipated downturns before the account has recovered from previous shocks.

At the same time the Federal government can exercise discretion in the setting of rates, and recent experience shows the challenges this decision process poses for macro-economic stabilization. While this discretion may be needed, it can also have perverse consequences, the government facing calls at the onset of downturns to forestall forecasted increases, or even to cut contribution rates, but during the upturn facing political pressure to avoid the offsetting increases.

Whatever the levels of the contribution rates, employers and employees prefer stable rates. It is a misguided application of insurance principles to finance all of the risks Employment Insurance must cover through individual contributions. This sometimes necessitates ill-timed changes in rates, and engenders a political dynamic that erodes the macro-economic stabilization role of the program.

The Federal government should become a partner in EI financing, covering program expenditures during big, unforeseen, collective shocks, and in this way contributing to stable contribution rates for employers and employees.

**The Employment Insurance "Fund" as a metaphor**

The vision of a "hard" Employment Insurance account, one that is like a fund, that has to be in "balance", has led to Employment and Social Development Canada and EI stakeholders considering false policy options, and limiting the consideration of broader options that are more in line with the program's purpose as insurance program.

These include discussions about the rate at which contribution rates should change, but taking as given the seven-year break-even rule in the account. They include discussions of extending the seven-year horizon to alleviate concerns about rate changes. And they also include discussions of a "reserve" fund, a Federal government top-up to the existing state of the account to once again avoid changes in contribution rates.

These discussions have not been informed by insurance principles and an understanding of the different risks that the Employment Insurance program must cover. They implicitly assume that all unemployment risks should be covered by individual contributions, and in setting a fixed accounting horizon, whatever it is, that there is some way to imagine what the future holds, rather than accepting that big shocks are entirely unpredictable.

Aligning contributions to risks suggests:

- The contribution share of employers should rise somewhat, and it should certainly not be reduced;
- Employer and employee contribution rates should be relatively stable, set at level that finances Regular and Special Benefits associated with an underlying trend unemployment rate that currently is roughly between six and seven percent;
- The Federal government, through the Consolidated Revenue Fund, finance all the contingency associated with deficits and surpluses from a higher or lower unemployment rate.