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EMPLOYMENT INSURANCE PREMIUMS: IN SEARCH OF A GENUINE RATE-SETTING PROCESS

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INTRODUCTION

Implemented in 1996, the *Employment Insurance Act* (EIA) enacted a number of fundamental changes to Canada's unemployment insurance system. One of these reforms was supposed to establish a new financing regime that would maintain relatively stable premium rates over the course of a business cycle. The 1996 premium rate-setting process was suspended in 2001, when an amendment to the EIA established that the Employment Insurance (EI) premium rate for 2002 and 2003 would be set by the Governor in Council on the recommendation of the ministers of Human Resources Development and Finance. During this period, a new premium rate-setting process was to be developed and implemented in order to address the concerns expressed by many about the growing so-called "reserve" in the Employment Insurance Account. This reserve is expected to reach roughly $45.6 billion by the end of the 2003-2004 fiscal year.(1) As the government was not prepared to implement a new premium rate-setting process by the end of 2003, it announced in the budget on 18 February 2003 that the premium rate for 2004 would be set at $1.98 per $100 of insurable earnings.(2) The government also announced that it would accept submissions from the public on a new premium rate-setting process until 30 June 2003.

A REVIEW OF RECENT RATE-SETTING PRACTICES

Prior to the 1996 EI reform, the premium rate was set (under the *Unemployment Insurance Act, 1971*) each year so as to cover the adjusted basic cost of unemployment insurance (UI). This amount was equal to the average basic cost of benefit plus (minus) any

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(1) Human Resources Development Canada, *2003-2004 Estimates, Part III*, p. 57.

(2) Bill C-28, An Act to implement certain provisions of the budget tabled in Parliament on February 18, 2003, Part IV (assented to on 19 June 2003).

amount required to remove or reduce a deficit (surplus) in the Unemployment Insurance Account. The average basic cost of benefit was equal to a three-year average of UI costs.(3)

The biggest drawback associated with this approach was that premiums sometimes increased at the bottom of the business cycle, a time when employers are laying off workers and unemployment is rising. Hence, the pro-cyclical nature of this rate-setting process served to raise the cost of labour at a time when lower labour costs were needed to stimulate job growth and to reduce the unemployment rate.(4) This perverse result is evidenced by the data presented in Figure 1, which depicts percentage changes in both the unemployment rate and the premium rate from 1973 to 2002. Of particular interest here are the concurrent increases in these rates, as shown in quadrant "A."

The UI premium rate's heightened adverse impact on the demand for labour during the years 1976, 1981, 1983, 1990, 1991 and 1992 was further exacerbated by the fact that the tax base on which the premium rate was applied increased rapidly due to an indexation formula that grossly overstated the wage inflation of the late 1970s and early 1980s.(5) When this indexation formula was introduced in 1972, maximum weekly insurable earnings were comparable to average weekly earnings. Between 1983 and 1993, however, average weekly earnings (industrial composite) increased by 45.6%, whereas maximum weekly insurable earnings increased by 93.5%. Today, maximum weekly (annual) insurable earnings are $750 ($39,000), unchanged from their introductory levels in 1996.(6) A new indexation formula was

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(3) More specifically, the *average basic cost of benefit* was equal to the average total UI costs (including administration costs) for the three-year period that ended concurrently with the second year preceding the year for which the average was computed. For example, the average basic cost of benefit in 1994 was equal to the average cost of UI for the years 1990, 1991 and 1992. The *premium rate* that would cover the average basic cost of benefit was the statutory or minimum premium rate that could be established in a given year. The statutory premium rates for employees and employers, expressed as a dollar amount per $100 of insurable earnings, were equal to 41.6% and 58.4% respectively of the premium rate needed to cover the average basic cost of benefit.

(4) It is difficult to establish who ultimately bears the cost of employer premiums: employers may bear it in the form of reduced profits; consumers may bear it in the form of higher prices; and/or employees may bear it in the form of lower wages. Empirical estimates appear to suggest the existence of backward shifting, although it is unlikely that payroll taxes are shifted fully to workers, even in the long run. See J. Kesselman, *Financing Canadian Unemployment Insurance*, Canadian Tax Paper No. 73, Canadian Tax Foundation, Toronto, April 1983; and B. Dahlby, "Taxation and Social Insurance," in R. Bird and J. Mintz, eds., *Taxation to 2000 and Beyond*, Canadian Tax Foundation, Toronto, 1992.

(5) Under UI, the formula for setting maximum annual insurable earnings reflected the average rate of increase in annual earnings over the most recent eight-year period, with a two-year lag due to data unavailability.

(6) The 1996 EI reform reduced maximum annual insurable earnings to $39,000, down from $42,380 in 1995.

introduced in 2001, but it will probably be many years before this formula produces an increase in maximum annual insurable earnings.(7)

In an effort to eliminate the ill effects of the pro-cyclical UI premium rate-setting process, section 66 of the EIA required the Employment Insurance Commission, subject to the approval of the Governor in Council on the recommendation of the ministers of Finance and Human Resources Development Canada, to establish a premium rate each year. That rate was to ensure, to the extent possible, enough revenue to cover the Employment Insurance Account's estimated liabilities over a business cycle and to maintain relatively stable premium rates throughout the same period. If premium rates are relatively fixed, the government is exposed to more fiscal uncertainty, as there is no mechanism within the Consolidated Revenue Fund (CRF) to establish a real separate reserve from which to draw to finance one or more year-end deficits in the Employment Insurance Account. Hence, the CRF must cover periods when EI expenditures exceed revenues. Depending on its extent, such a revenue shortfall could substantially undermine the fiscal position of the government.(8)

During 1996 to 2001, when section 66 of the EIA guided the premium rate-setting process, a strong economy contributed to unprecedented year-end surpluses in the Employment Insurance Account. As illustrated in Figure 2, this gave rise to a cumulative surplus that, as previously mentioned, is projected to exceed $45 billion by the end of the 2003-2004 fiscal year. Throughout this period, many expressed growing concern about the size of the cumulative surplus in the Employment Insurance Account, as it became increasingly apparent that this reserve more than met the objectives of section 66 of the EIA. This opinion was premised largely on the Chief Actuary's report on EI premium rates for 1998, in which he concluded that

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(7) Maximum yearly insurable earnings (MYIE) will remain unchanged until (52) x (**A**) x (**B**) exceeds $39,000, where: **A** = the twelve-month average (ending on 30 June of the preceding year) of monthly average weekly earnings; and **B** = the ratio of **A** to the twelve-month average (ending twelve months prior to 30 June of the preceding year) of monthly average weekly earnings. If the amount produced by this calculation exceeds $39,000, then MYIE for that year would be that amount rounded down to the nearest multiple of $100. MYIE for years subsequent to this would be equal to MYIE in the preceding year, before rounding down to the nearest multiple of $100, multiplied by **B**. If this amount is not a multiple of $100, it too must be rounded down to the nearest multiple of $100. The average weekly earnings referred to in this calculation are the industrial aggregate for the nation as a whole, as estimated and published monthly by Statistics Canada. The calculation, as outlined above, for the year 2003 is $35,586, or $35,500 after rounding down to the nearest multiple of $100.

(8) This risk was recognized by the Standing Committee on Finance in its report entitled *Budget 2000, New Era … New Plan* (December 1999). The Committee concluded that as long as a "look-back" provision is in place, the setting of premiums within the context of section 66 of the Act would seriously disrupt the overall management of the federal government's budget.

at the upper limit, a cumulative surplus of between $10 and $15 billion would be sufficient to cover program costs over a 15-year period as well as facilitate premium rate stability (i.e., an average premium rate of between $1.95 and $2.10 per $100 of insurable earnings).(9) Despite this finding, the government continued to allow the cumulative surplus to grow, prompting the Auditor General of Canada to raise concerns about the government's compliance with the EIA.(10)

In 2001, the EIA was amended and a new section 66.1 allowed the Governor in Council, on the recommendation of the ministers of Human Resources Development and Finance, to set the EI premium rate for 2002 and 2003. This change suspended the premium rate-setting process described above. The government also announced that during this period it would undertake research and conduct public consultations on the creation of a new premium rate-setting process, to be implemented by the end of 2003. As public consultations had not occurred by the February 2003 budget, the government set the premium rate in 2004 at $1.98 per $100 of insurable earnings and reiterated its intention to conduct consultations on a new premium rate-setting process. This new process is supposed to be in place by the beginning of 2005. The budget also established five premium rate-setting principles to guide the consultations:

- premium rates should be set transparently;
- premium rates should be set on the basis of independent expert advice;
- expected premium revenues should correspond to expected program costs;
- premium rate setting should mitigate the impact on the business cycle; and
- premium rates should be relatively stable over time.(11)

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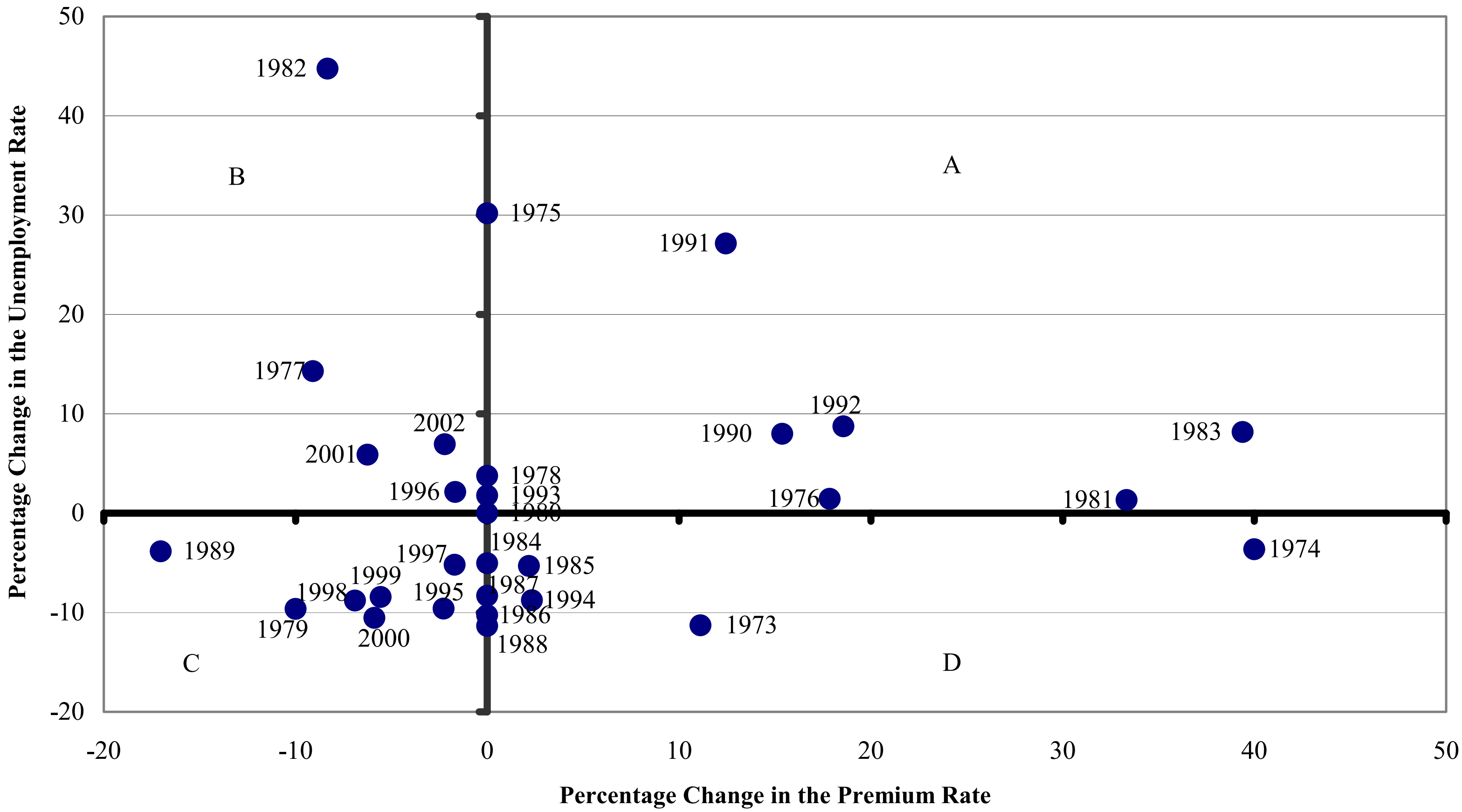
(9) Human Resources Development Canada, *Chief Actuary's Report on Employment Insurance Premium Rates for 1998*, pp. 9 and 10 of 16 (see http://www.hrdc-drhc.gc.ca/ae-ei/loi-law/ca1998/report.shtml).

(10) In the Financial Statements of the Government of Canada for the 1999-2000 to 2002-2003 fiscal years, the Auditor General of Canada (AG) expressed concern about the size and continued growth of the cumulative balance in the Employment Insurance Account. In the Financial Statement for the 2002-2003 fiscal year, the AG stated that the EI surplus had grown to $43.8 billion by 31 March 2003 and expressed disappointment that the government chose to prolong the suspension of section 66 of the *Employment Insurance Act* for another year. Furthermore, the AG strongly urged the government to resolve the long-standing issue of excessive EI premium rates.

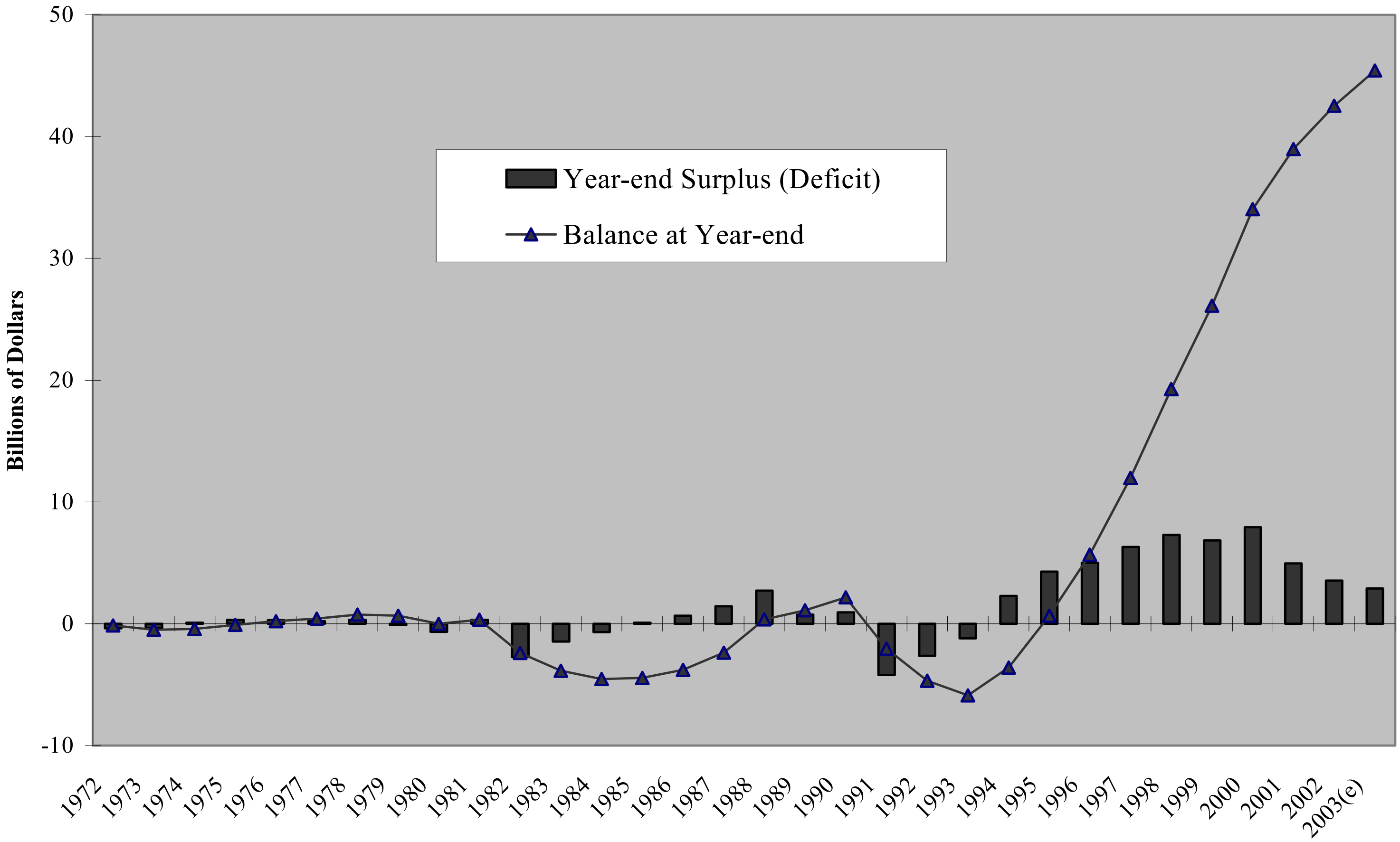
(11) Department of Finance, *The Budget Plan 2003*, 18 February 2003, p. 183. It should be noted that the last three principles are essentially captured in section 66 of the EIA.

Figure 1 – Percentage Change in the UI/EI Premium Rate and the Unemployment Rate, 1973 to 2002



Sources: Human Resources Development Canada, Statistics Canada and the Library of Parliament.

Figure 2 – Status of the Employment Insurance Account, 1972 to 2003



Note: (e) = estimate
Sources: Human Resources Development Canada and the Library of Parliament.

THE CONSULTATIONS

Interested parties were invited to participate in the EI premium rate-setting review consultation process between April and August 2003. Groups and individuals had until 30 June 2003 to make a submission. In addition, several roundtable meetings involving representatives of business and labour, experts and EI Commissioners were held during the summer of 2003.[(12)] As expected, a variety of views were expressed regarding the five premium rate-setting principles outlined above. The following provides a brief summary of the Overview Report that was posted on the Department of Finance's Web site.[(13)]

Principle 1: Premium rates should be set transparently.

This principle generated the most commentary from stakeholders. Labour representatives who participated in the consultations expressed the view that the EI Account should not be consolidated with the Accounts of Canada, and that EI funds should be managed by an independent arm's-length organization. Most business groups also supported the notion of maintaining a separate, independently managed EI Account. Both business and labour supported a stronger, more independent EI Commission, with better representation among employers and employees. In the interest of greater transparency, many participants felt that the underlying information used to establish premium rates, including information provided by EI's Chief Actuary, should be made public. Some groups also suggested that the government should repay the cumulative surplus in the EI Account over a period of time. Some business representatives maintained that the cost of special benefits should not be considered in the rate-setting process. Many consultation participants did not support a "push-button" automatic premium rate calculation.

Principle 2: Premium rates should be set on the basis of expert advice.

Consultation participants were in general agreement with this principle. Many felt that there was a continued role for EI's Chief Actuary, mainly as an advisor to the

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(12) Some 28 submissions were received from individuals, and business and labour representatives. Some of these submissions can be viewed at http://www.fin.gc.ca/activty/consult/eirates_e.html.

(13) See http://www.fin.gc.ca/consultresp/Summaries/eiratesSum_e.html.

Commission. In addition to the Chief Actuary, participants suggested that expert advice should also be sought from employers, employee groups, economic forecasters and other knowledgeable parties, including the Office of the Auditor General of Canada.

Principle 3: Expected premium revenues should correspond to program costs.

Although there was wide agreement that expected EI revenues should cover program costs over some specified period of time, such as a business cycle, many participants who commented on this principle identified the need for a reserve in order to mitigate pro-cyclical movements in EI premium rates. However, it was noted that if the government continues to control the program, then EI should remain in the Accounts of Canada.

Some participants felt that the size of the reserve should be calculated as some proportion of program costs. Moreover, it was generally felt that the government should be very specific about the costs that EI revenues are supposed to cover. Expected program costs should also consider non-cyclical contingencies such as the effects of the September 2001 terrorist attacks and SARS.

While many consultation participants agreed that rates should be set on a forward-looking basis, there was less agreement on whether the current cumulative surplus should be factored into future rates.

There was also some discussion of adopting experience-rated premiums (i.e., premium rates related to the lay-off behaviour of firms), as well as moving away from a specified-purpose tax to a general payroll tax.(14)

Principle 4: Premium rate-setting should mitigate the impact on the business cycle.

There was a consensus among consultation participants that premiums should not be set pro-cyclically. Moreover, as previously noted, a majority of participants favoured a forward-looking rate-setting process. Once again, some participants called for the creation of a

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(14) The rationale for moving to a general payroll tax appears to be rooted in the view that when individuals make a specific contribution to EI, they feel entitled to EI benefits, and this leads to a "moral hazard" problem. This reasoning is unclear, given that the current EI rules impose a total disqualification on those who leave their jobs voluntarily without just cause. In any event, it was pointed out that a general payroll tax might make it difficult to relate benefits to earnings, and the federal government does not have the ability to levy a general payroll tax on provincial government entities.

reserve to eliminate the need to raise EI premiums during a downturn. Another view called for the establishment of a long-term, low, and stable premium rate, with the government covering the increase in EI costs during periods of economic weakness. Some expert participants noted that by setting a break-even premium rate over the course of a business cycle (or at least a long time horizon), annual adjustments to the rate would probably be small. In terms of this approach, "bygones would be bygones" and the concept of a cumulative surplus would disappear. Although this approach does not entail any of the governance or accounting problems associated with establishing a real reserve, it was noted that most private-sector forecasters do not provide "business cycle" projections.

Principle 5: Premium rates should be relatively stable over time.

This principle produced the second-greatest amount of commentary, and all participants agreed that EI premium rates should be stable over time. While labour representatives suggested that the best way to achieve stability is through a reserve, there was no support for raising rates to establish a new reserve. Some business representatives also agreed that a reserve would allow for premium rate stability and that, given the existing cumulative surplus, rate stability in the future should be assured. With regard to future rate changes, some business representatives indicated that it would be helpful to have more time to adjust to a new rate and suggested that the EI rate for the coming year be set in September or October at the latest.

CONCLUSION

The consultations are now complete, and the federal government is presumably in the process of drafting legislation for a new EI premium rate-setting process. As this new process is supposed to be in place by the beginning of 2005, a proposed amendment to the EIA is imminent.