



# THE DESIGN OF EMPLOYMENT INSURANCE IN A FEDERATION

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APPLIED PUBLIC POLICY RESEARCH  
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# Executive Summary

The challenges of designing Canada's Employment Insurance system are explored in this paper. Special attention is paid to the balance between redistribution and insurance within the system. Avenues for reform are highlighted by analyzing the systems of similarly situated countries: OECD countries with some multi-level governance. Recommended reforms for Canada include funding the program from general taxation as opposed to contributions from workers; eliminating regionalization of benefits; improving the income tax system to deal with variability of earnings; and introducing a two-tiered system to attend to the differing needs of the short-term unemployed and the longer-term unemployed. The desire for co-ordination of efforts between federal and provincial levels of government centre on this two-tiered system to ease the transition from the federal EI program to the provincial social assistance programs, as well as harmonizing training, making this a provincial responsibility. In order to improve on the insurance function of EI, introducing a charge on firms that are repeat users is also recommended.

# The Design of Employment Insurance in a Federation

Robin Boadway & Jean-Denis Garon

**T**his paper explores the issues that arise in designing an unemployment insurance program in a federation. In keeping with Canadian usage, we use the term Employment Insurance (EI) when discussing the Canadian case and switch to the more general term “unemployment insurance” (UI) when discussing other countries. UI is the term used virtually everywhere else and better captures the event being insured. EI impinges on federalism in a number of ways, and it is useful at the outset to identify them to indicate the scope of our interest.

First and foremost, EI is by the Constitution an exclusive legislative responsibility of the federal government.<sup>1</sup> Although the meaning of EI is not defined by the Constitution, including whether it must be contributory in nature, its generally accepted purpose is to provide partial income replacement for workers who become involuntarily unemployed. In addition, it assists workers with finding suitable new employment. EI also provides special benefits for maternity and parental leave, compassionate leave, sickness leave and training.

Several structural elements of EI have provincial or regional consequences, even though the rules are defined without explicit reference to the provinces. Eligibility requirements (hours of insurable work) and duration of benefits both vary with the unemployment rate in designated regions spanning the country. This affects the generosity of EI among provinces, especially since regions do not cross provincial borders. Eligibility requirements are greater for new entrants (the so-called 910 rule), and that has a differential impact across provinces owing to differences in the demographic composition of provincial workforces and the nature of employment. The preferential treatment of fishers relative to other self-employed groups favours provinces that rely more on the fishing industry. Similarly, because of the uniform contribution and benefit rates across the country, some industries systematically benefit more from EI than others. Those with high rates of EI usage, such as seasonal industries or industries facing more volatile demands for their products, tend to draw on the system more than they contribute, while industries with relatively low layoff patterns pay more than they contribute. Provinces with persistently higher unemployment rates tend to benefit relative to others, and this is exacerbated by the regional differentiation mentioned above. Finally, there are special benefits for low-income families that naturally benefit low-income provinces more than others.

While regular EI benefits seem clearly to fall within the federal government’s constitutional jurisdiction, that may not be so clear for extended benefits and training. Even though extended benefits for maternity, sickness and compassionate care involve leaving one’s job, it is not so

obvious that such policies should all be the sole domain of the federal government. Indeed, agreements with the provinces have effectively turned over to the provinces responsibility for training EI recipients. This raises the question as to whether training programs offered by the provinces should be conditioned on whether participants are EI recipients or not.

EI also assumes a federalism dimension to the extent that it is related to provincial programs. The effect of a program at one level of government may depend in part on the design of programs at the other. Moreover, there may be scope for coordination of program design. We have already mentioned training, where there may be obvious synergies between the training of EI recipients and of other unemployed workers. More generally, provincial social assistance and federal EI both serve segments of the unemployed population. Those who are ineligible for EI may be eligible for social assistance. To the extent that programs are coordinated, moving from one to the other can be facilitated, and sizeable gaps in coverage of those unable to find jobs can be avoided. As well, economies in monitoring and information exchange can be achieved by administrative cooperation and coordination.

EI can also affect provinces through its economic impact. Provinces benefit from the insurance provided by EI against regional economic shocks because of the ability to pool risks nationally. In that regard, it complements Equalization, which insures against volatility in provincial government revenues. As well, the EI system insures against aggregate or nationwide shocks more effectively than the provinces could. The advantage the federal government has in insuring against regional and national shocks is a main reason why it is a federal responsibility.

The EI system also has an effect on the development of regional economies. To the extent that some industries are favoured relative to others, such as those with more frequent and more predictable claims, activity in those sectors is encouraged. Over-reliance on such sectors, such as the fisheries or tourism, may influence the pattern of industrial development — and the provinces' strategies of economic development — in particular regions. As a consequence, migration may be affected by EI if potential migrants are employed in EI-favoured industries. On the other hand, to the extent that EI finances job search by the unemployed, which is one of its purposes, it might actually encourage mobility of workers among industries and regions.

Finally, it should be recognized that there are other elements of implicit insurance against the volatility of earnings, whether due to unemployment or not. The income tax system acts as a form of insurance to the extent that tax liabilities rise and fall with income. This is potentially important for the self-employed, although its efficacy depends on the extent to which tax losses are refundable when earnings become negative. For some workers, the family serves as an important form of insurance given that families can pool incomes. By the same token, one's social network and the voluntary sector can be sources of support for distressed workers.

The Income tax-transfer system is also relevant for workers who have become permanently displaced from their jobs. When they are eventually re-employed, it is often at a lower wage. While EI is relevant for addressing the immediate needs of displaced workers when they become unemployed and for assisting them in finding jobs through training and employment services, its role is not to deal with persistent inequalities. The redistributive role of the tax system is meant to address market inequalities, whether they are due to differences in the earnings potential of workers throughout their lives or those that arise as a result of a sudden loss of earning power due to displacement.

In the remainder of this paper, we consider the issues that arise in designing EI in a federal setting such as Canada's. This presupposes an understanding of the role of EI as a component of social policy. We begin with a discussion of the rationale for EI from a normative perspective. We argue that, in addition to insuring against involuntary unemployment, EI should play a redistributive role. It should especially target low-income workers for whom self-insurance is difficult and costly. This is followed by a recounting of the way in which EI is designed and delivered in other federations. Practices vary widely. EI can be contributory or tax-financed, or some combination. Varying degrees of responsibility of the federal and provincial/state levels of government can be found. EI may or may not be coordinated with welfare, and the two may be combined. And, eligibility and duration rules vary widely, but in all cases, monitoring for compliance is an important part of program design. The wide variety of practices elsewhere confirms that many options for reform are available. We then turn to a discussion of design issues and policy options. Our judgment is that a number of reforms should be considered, including:

- Reinforce the redistributive component of the program by moving to general-revenue financing and conditioning benefits on family income and responsibilities
- Address better the needs of the longer-term unemployed by establishing a second tier of need-related benefits
- Establish a common set of rules nationwide by eliminating regional differentiation of benefits and special treatment of self-employed fishers
- Introduce some experience rating to the contribution rates of firms that are repeat users of EI via temporary layoffs
- Disentangle training from EI so that eligibility for EI is not a criterion for training
- Improve the ability of the tax-transfer system to insure the self-employed and displaced workers
- Stress the importance of monitoring by EI administrators for continuing eligibility

## 1. Normative Underpinnings of EI Policy

Although our main focus is on the design of EI in a federal setting, it is important first to understand the role played by EI as a component of government policy. This will have a bearing on federalism aspects of EI policy. Two dimensions of EI's role are particularly relevant, and will underpin the discussion in this section. One is that EI incorporates redistribution as well as insurance elements, or equivalently equity versus efficiency elements. We return to the reason for that below. The other concerns the neglected importance of program administration for the integrity of the program, from the point of view of both redistribution and insurance. Put simply, EI programs that provide reasonable levels of social protection should be attractive enough to potential recipients that initial and continuing access must be fairly and effectively monitored for eligibility, and for encouraging the transition to employment. Similar issues arise in other social protection programs, particularly those delivered by the provinces.

The main purpose of EI is to insure against unexpected and involuntary job loss and the loss in earnings that entails. The important presumption is that at least some of those who are covered

by EI are unable, or choose not, to insure against this particular form of earnings volatility through other means. Private insurance is presumably incapable of providing adequate insurance against involuntary unemployment or earnings volatility for well-known reasons of moral hazard and adverse selection. One feature of EI makes this problem particularly apparent. Reasonably full insurance would smooth income across employed and unemployed states, and this would almost certainly entail workers being better off when involuntarily unemployed than when employed, given that leisure accompanies unemployment. Given the difficulty of observing when workers are involuntarily unemployed, and choose to remain unemployed, this alone precludes private firms from providing full EI. This point is worth emphasizing because it highlights the importance of monitoring the unemployed for both initial and on-going EI eligibility.

The public sector has a distinct advantage in dealing with these information problems, and it is important to recognize that at the outset. The government can and does mandate participation in EI, which private insurance could not do. This may be justified as a response to both behavioural issues — workers choosing not to enrol if participation were voluntary — and adverse selection issues — markets not functioning because bad risks drive out good ones. In addition to mandating participation, the government can exercise some coercion to obtain relevant information. It can screen applicants to determine eligibility, for example, to learn whether applicants were likely to have been laid off as opposed to having quit their job or been fired. It can monitor EI recipients to verify with varying degrees of accuracy that they are actively searching for jobs and accepting those offered, and can assist them in job search. Program administrators can also learn something about the personal circumstances of applicants, such as their family income, in the event that this affects the size and duration of their benefits. They can also oblige or offer financial inducement for recipients to engage in training programs. Administrative discretion is at the heart of the EI system, and is relevant for considering potential roles for federal and provincial governments.

The importance of the administration of EI reflects a relevant distinction between EI and other programs. Like social assistance, EI is a standalone program that differs in its form from the tax-transfer system, including the various refundable tax credits. The tax system — not just income taxes, but sales and excise taxes as well — is administered on a self-reporting basis, whereby liability for taxes or eligibility for refundable tax credits is reported in the first instance on a taxpayer's own tax return. Verification then relies on ex post random audits and penalties for misreporting. Given the low incidence of penalization and the limited size of the penalties for misreporting, paying taxes is to a large extent a voluntary exercise that, fortunately, most Canadian taxpayers seem to undertake honestly.<sup>2</sup>

In contrast, EI and social assistance eligibility are determined by ex ante gate-keeping methods and are monitored on a continuing basis ex post. Moreover, the implicit penalties for misrepresentation or violating the rules are large relative to incomes for those involved compared with the tax system. The advantage of this system is that, apart from possibly keeping errors to a minimum and presuming dishonest rather than honest behaviour, it allows the system to be flexible and responsive to changes in circumstance of recipients. This is an important feature of an insurance system, and allows the system to be based on a broader set of criteria than simply income.<sup>3</sup>



The need for responsive program administration applies regardless of the extent to which EI incorporates redistributive relative to insurance objectives. The case for EI including an insurance element is clear. Job loss entails an abrupt fall in earnings that, if uninsured, would translate into a sharp drop in consumption. To the extent that the risk of consumption volatility can be avoided, workers would be better off and would be willing to pay to avoid that risk. Under a pure insurance system, the risk of unexpected job loss and the expected length of unemployment would be reflected in each worker's EI premium. Setting those so-called fair insurance premiums is practically infeasible because of the difficulty of determining the true probability of involuntary unemployment and its expected duration, although as discussed below, some elements of job-loss risk could be imperfectly incorporated into premiums.

At the same time, there are arguments for EI incorporating a significant redistributive element alongside any insurance component. Given that full EI is not feasible, the fallback for workers is to self-insure against the contingencies of job loss, that is, to take actions to smooth their consumption in the event of job loss. Self-insurance can take various forms, including precautionary saving, adjustments to consumption patterns, and personal borrowing. The unemployed can also draw on financial or material assistance from family members or social and community networks. These same responses are required to deal with other sorts of inter-temporal smoothing requirements, such as retirement, changes in family circumstances and the need for lumpy expenditures. Persons who have low incomes, and especially those who do not have recourse to high-income family members, find it more difficult and costly to self-insure than others. They have less asset wealth to cushion themselves against adverse outcomes and less access to capital markets, and it is more costly for them to adjust their consumption patterns. Moreover, low-income persons may face relatively high volatility of employment and earnings, given their lower skills and attachment to employers, and might find re-employment more difficult. For such persons EI is most important. There are thus good reasons for the net benefits of EI to be proportionately higher for low-income persons, especially those from low-income families. This constitutes the redistributive role of EI.<sup>4</sup>

The argument that EI should assume a redistributive role in addition to providing insurance against job loss implies that there are important judgments to be made about program design, and these have a bearing on the relation between EI and other federal and provincial programs. To what extent should financing, eligibility and benefits reflect redistribution as opposed to insurance principles, given that the two will conflict? Although addressing this issue is beyond the scope of this paper, it is worthwhile outlining some of the considerations that are relevant for judging how redistribution might be enhanced on the one hand and how the insurance properties might be improved on the other. This will inform our subsequent discussion of the design issues relevant in a federal setting.

The current system neither achieves effective redistribution nor deploys insurance-based contribution and benefit principles. Contributions are proportional to insurable earnings up to a maximum. While they are related to the size of benefits one is entitled to if unemployed, they are not related to the probability of unemployment or its expected duration as insurance principles would dictate. Some workers contribute with little chance of being eligible for benefits. The main features of EI that are meant to reflect insurance principles are the regional differentiation of eligibility and duration rules based on regional unemployment rates and the higher eligibility requirements for new entrants (the 910 rule). These are crude measures that



are both imperfect and give rise to anomalies that could be considered unfair, as discussed in a later section.

The redistribution in the EI system is limited as well. The upper bound on insurable earnings is redistributive to the extent that a higher proportion of actual earnings are replaced for lower-income compared to higher-income workers. In addition, there are two explicit elements of redistribution. One is the EI Family Supplement, which increases the benefits paid if family income is less than \$25,921 (in 2010), if there are children, and if either spouse receives the Canada Child Tax Benefit. Benefits can rise up to 80 per cent of insurable earnings depending on the number of children, and is clawed back as income increases. At the upper end, up to 30 per cent of EI regular benefits must be repaid if the recipient's annual income exceeds \$54,000. These measures, though limited, at least accept the principle that progressivity can be built into the EI benefit structure. Otherwise, there is very limited targeting of net benefits to low-income workers. The benefit to low-income workers is itself compromised by the relatively low (55 per cent) replacement rate of insurable earnings. The upper bound on contributions implies that they are a regressive form of taxation. Benefits do not reflect the ability of workers to self-insure. For example, apart from the two measures just noted, they are generally not related to a worker's income, family income or assets. Eligibility requirements, especially for new entrants, are relatively more onerous for low-income workers given the greater difficulty they might have in securing permanent employment. Finally, EI recipients, like those on provincial welfare, are allowed to earn a limited amount of income. In the case of EI, the maximum allowed is \$50 per week, although this was increased temporarily for 2009-10 to \$75 per week. Earnings above that are taxed back at a 100 per cent rate.

The consequence of the current design of the EI system is that, as opposed to being comprised of a combination of insurance and redistribution, it mainly redistributes among groups of workers regardless of their income. Those who face low risk of layoff contribute more than their expected claims, while those who are likely to be repeat claimants are net beneficiaries. This is exacerbated by regional differentials in eligibility and duration to the extent that there is persistence in regional unemployment differentials, and by stricter eligibility requirements for new entrants to the extent that those having trouble meeting the requirements pay into the system with little chance of drawing benefits. In addition, there are incentive effects that might further detract from the insurance properties of EI, such as the tendency for some firms to engage repeatedly in temporary layoffs because of the implicit EI subsidy,<sup>5</sup> or the incentive for employers, including provincial governments, to employ workers just long enough to meet eligibility requirements.<sup>6</sup>

There are measures that should be taken to improve both the insurance and redistribution properties of EI. Experience-rating should be used to reduce the ability of repeat users to benefit from the system. Financing should be made more progressive, as could the structure of benefits. We return to these issues when we consider priorities for reform.

## 2. The Federal and Provincial Interest in EI

EI is a federal government program, but it exists alongside other federal and provincial programs that address related objectives and serve some of the same citizens. In this section, we briefly outline the interests of the federal and provincial governments in the design and delivery of EI, and identify areas of potential conflict and commonality. In the next section, we review how other federations have designed programs to deal with the unemployed.

Section 91(2A) of the Constitution Act 1982 succinctly confers exclusive legislative authority of the Parliament of Canada over ‘unemployment insurance’, without elaborating on what unemployment insurance entails or its scope of application. There are sound economic reasons for EI being a federal responsibility. Involuntary unemployment is largely a consequence of shocks to the economy on either the demand or supply sides. They can be permanent shocks leading to structural unemployment, or transitory ones leading to temporary unemployment. These shocks can be mainly idiosyncratic shocks hitting different regions of the country unexpectedly, but with roughly equal chances. Or, they can be aggregate shocks that affect most regions of the economy simultaneously. In either case, the federal government is better placed to address the unemployment caused by the shocks. In the case of regional shocks, the federal government can pool the risks across the whole economy, insuring those regions particularly hard hit with unemployment from a national pool of revenues. The federal government alone can also address aggregate unemployment shocks that affect all regions of the economy.

More generally, the federal government can be taken to have a responsibility for achieving minimal national standards of redistributive equity or social citizenship. This is not an absolute objective, and depends on the extent of social consensus for nationwide solidarity. Depending on the extent of that consensus — which is a political matter — the provinces might also pursue varying degrees of provincial solidarity. The federal government addresses national standards of redistributive equity partly through its progressive income tax-transfer system whereby all persons of a given income level are treated comparably no matter where they reside. The Equalization system is also a policy instrument intended to facilitate national social solidarity by making it possible for provinces to provide comparable levels of public services while at the same time allowing them to pursue their own provincial standards of equity. To the extent that EI is a redistributive program, it addresses similar objectives. A national unemployment insurance system achieves a common standard of redistributive equity for those whose income temporarily falls due to job loss, especially lower-income workers.

The federal government similarly assumes some responsibility for fostering efficiency in the Canadian economic union, which includes the unfettered mobility of workers from one region to another. This is particularly important for unemployed workers since migration from one province to another often involves some temporary unemployment. An EI system defined on a national basis can facilitate the inter-provincial mobility of labour, which is an important source of flexibility in an economy subject to regional and sectoral shocks.

The Constitution does not specify what is meant by unemployment insurance or what its scope should be, and there is no well-established international definition to serve as a guide. Must it be a contributory social insurance scheme whereby eligibility depends on one’s contributions, or can it be a program financed out of general revenues and based on elements of need

in addition to past earnings? To what extent must it be based on insurance principles whereby contributions and benefits are to some extent related to the risks associated with being unemployed? Must it be only for persons who are involuntarily unemployed, or can it include those who choose to leave their job temporarily for childbirth or care-giving? To what extent should it include measures to assist persons to find a job, such as through training or employment services? And, to what extent might its eligibility and benefit structure be based on characteristics unrelated to employment income, such as family income, asset wealth, and health? These are all key issues in designing EI, and it is not clear to what extent any of them are constrained by the Constitution.

Despite the fact that the Constitution makes EI an exclusive federal legislative responsibility, the provinces have an interest in how EI is designed and delivered, not only because their employed residents are mandated to participate in the program, but also because of the interface that exists between EI and provincial programs, especially social assistance. Moreover, by its very nature, EI has interprovincial redistribution implications, since it is not based on insurance principles.

At a very general level, the provinces have an interest in, or even a responsibility for, the well-being of all their residents, including especially those most in need. This is explicit in Section 36(1) of the Constitution Act, 1982, which expresses the joint commitment of the federal Parliament and the provincial Legislatures to pursuing equality of opportunity, economic development and the provision of basic public services to all citizens.<sup>7</sup> More generally, provinces may regard redistribution and social insurance as being among the more important objectives they should pursue. The bulk of provincial spending, including welfare, health and education, is essentially redistributive in nature.

More specifically, the provinces have an obvious interest in the design of EI, given its relation with provincial social assistance programs. Unemployed low-income persons who have exhausted their benefits for EI, or who have not satisfied the eligibility requirements, may become welfare recipients. This means that the eligibility and duration rules for EI have a direct bearing on provincial welfare obligations. From the perspective of the persons involved, a smooth transition from EI to welfare is important, so any coordinating arrangements that would facilitate that transition are relevant. One might argue that the federal government has an incentive to move the unemployed from EI to the provincial welfare system on this account. More generally, the federal government may not fully take account of changes in the EI program on provinces' financial situations. By the same token, provinces have an incentive to game the system by finding employment of a sufficient length of time for welfare recipients in order to make them eligible for EI and so move them from provincial welfare programs to the federal EI system. To the extent that training accompanies the EI system, the provinces' interest in transferring individuals from provincially-funded income security programs to federally-funded EI is further enhanced.

In practice, the transition from EI to welfare may be especially difficult for various reasons. Eligibility for welfare may include stringent asset requirements that oblige the unemployed to draw down their past savings before accepting welfare. For persons who have been employed for a long time before being laid off, this is a difficult requirement. Application for welfare itself might take some time and effort, and applicants might be deterred from applying, especially

if there is some stigma associated with accepting welfare. The consequence is that a number of persons might be between EI and welfare with no means of support other than from family, from volunteer organization, and from limited federal and provincial refundable tax credits. Such persons may end up being a burden on the provinces if they fall into dire circumstances, like homelessness, crime and indebtedness, including to unsavoury lenders.

The absence of insurance-based contribution rates in the EI system leads inevitably to inter-provincial redistribution. Sectors that are prone to higher expected rates of unemployment, such as seasonal industries or the fishery, will benefit at the expense of those with lower expected rates, such as those that depend more on service industries. Since different provinces' industrial structures will differ persistently, there will inevitably be implicit ongoing redistribution from low-unemployment to high-unemployment regions, putting the industries in the former at a relative disadvantage.

This inter-provincial redistribution is exacerbated by some further factors. One is the proportion of the unemployed who are eligible for EI. Different provinces might have different proportions of unemployed persons who have been part-time or self-employed workers, or new entrants who have not worked a sufficient number of hours. Not only are these persons not insured against volatile incomes, they may also be candidates for welfare. The system of regionally-differentiated benefits and eligibility works to the systematic disadvantage of some provinces to the extent that differences in regional unemployment rates are persistent and are due to predictable seasonality.<sup>8</sup> These differences might in fact contribute to the persistence of the high unemployment rates in certain regions. As we discuss further later, the regional unemployment rate might not be the most accurate way of estimating the difficulty of getting a job. Finally, low-payroll provinces have higher Equalization entitlements, while the advantage they obtain from greater EI transfers is not taken into account.

Taking a fiscal federalism or subsidiarity perspective, standard arguments about the assignment of functions would favour some provincial role in EI, albeit more in its delivery than its design. The provinces are responsible for virtually all other targeted transfers and public services delivered to individuals on the basis of eligibility and monitoring. They have a natural advantage in administering such systems in terms of local knowledge, accountability, potential for innovation, fiscal and yardstick competition (the ability of citizens to judge their province's performance by observing the performance of neighbouring provinces), and overcoming information problems associated with management (so-called agency problems). Moreover, as mentioned, there is an advantage in coordinating the delivery of EI with social assistance since recipients may move from one program to the other. Provinces also have some advantage in administering other services that accompany EI, such as training and employment services. Indeed, these services may also be part of provincial welfare programs, since the provinces have an interest in getting employable persons back into the workforce, especially the long-term unemployed.

In considering how to exercise these provincial interests, either in cooperation with the federal government or alone, a fundamental question is how to make provincial participation consistent with the federal government's exclusive legislative responsibility for EI. We return to this issue later.

### 3. Experience and Reforms in Other Countries

The design of economic policy is influenced by institutional constraints, and this is especially true in countries with several levels of government. It is therefore not surprising that there are significant differences in unemployment insurance (UI) across federations.<sup>9</sup> Policies must agree with the constitution, which defines the specific responsibilities of each tier of government. In the special case of social insurance policies, historical concerns must also be taken into account. For example, the specific way in which UI schemes are implemented is strongly influenced by the past involvement of labour unions and social or religious agencies. Nonetheless, all federations face common challenges of equity, efficiency and program administration, and the option to centralize or decentralize always lies at the heart of policy discussions.

This section reviews the characteristics of UI programs in other OECD countries where multi-order governance is of particular importance. We focus mainly on three aspects that are especially relevant to policy debates about the Canadian EI system. The first is the extent to which UI programs are centralized or decentralized. If decentralization occurs, it may only involve an element of payments to the unemployed, such as to the long-term unemployed. The second is to what extent UI programs are coordinated with some other components of social insurance, mainly social assistance and public pensions. In some cases, governments have developed integrated transfer programs for employable persons incorporating both UI and welfare for the long-term unemployed. In other cases, UI may be kept separate from welfare, but with some features that smooth the transition from one program to the other. Third, we inquire into whether and how UI benefits are linked to past contributions to a specific UI fund and, when it is not the case, how UI benefits are financed. Other basic elements of program design will be noted where relevant, such as rules about eligibility and duration, including the role of monitoring, and the extent of regional differentiation in benefits.

We focus on a sample of seven countries consisting of Germany, Australia, the United Kingdom (UK), Belgium, Spain, Switzerland and the United States (US). These encompass federations of varying degrees of centralization, a multi-tiered country (Spain) and a unitary state that is in the process of devolving some fiscal responsibilities (UK). These countries illustrate the diversity of practices that one observes, as well as some commonalities. Among other things, they indicate what reforms are possible. The sources for country information are listed in the References.

#### Germany

The German UI system, as well as its system of welfare benefits, is fully managed by the federal government. Common rules apply across the country, even though unemployment rates differ significantly among regions. It has recently undergone a major reform aiming to provide different resources to the employable and unemployable individuals. Since 2005, UI and welfare have been merged and a single jobseekers' allowance for all workers who have been employed fulltime has been implemented. With this program, involuntarily unemployed workers can first claim contributory benefits for between 6 and 24 months depending on the length of their contribution period. (Contributions must have been for at least 12 months.) When contributory benefits are exhausted, they can turn to the so-called UI2 program. It provides them with

needs-based benefits financed by general tax revenues which can last for an indefinite period of time if the individual is still unemployed and in need. The UI2 program is means-tested, and need is monitored by the federal government every six months. This also allows it to implement a harmonized training and educational policy according to which young persons (up to 25 years-old) who claim the jobseekers' allowance are immediately placed into jobs or training for a fixed-term with qualification possibilities. A separate social assistance program still exists, but only for those unable to work.

## **Australia**

In Australia, the UI and welfare programs are also exclusive responsibilities of the federal (commonwealth) government. Both systems are fully integrated, to a much greater extent than in Germany. The system of income support consists of a single need-based, means-tested unemployment assistance program. It is funded by general taxation revenue, so benefits and eligibility are not based on any type of earmarked contributions. Benefits can be claimed for an unlimited period of time but they come with strong monitoring requirements. Claimants must be unemployed, and must either be actively searching for a job or be involved in an activity that will improve their employment prospects, such as training or continuing education. They must also be available and willing to accept suitable work. As well as being fully centralized, the Australian program applies uniformly across the nation without regional differentiation.

## **United Kingdom**

The UK is a unitary state, though some responsibilities have been devolved to Northern Ireland, Scotland and Wales. It is the national government that provides the unemployed with financial support. For those who are able to work and are actively searching for work,<sup>10</sup> two distinct types of Jobseekers' Allowance (JSA) exist.<sup>11</sup> The first type is a system of contribution-based JSAs, which can be claimed by those who have paid enough National Insurance Contributions (NICs) during the past two years. NICs are earnings-based and are paid by all workers in order to finance the contribution-based JSA as well as other social insurance programs, including State Pensions, Bereavement Allowances, and Employment and Support Allowance. These contribution-based benefits can be claimed for up to 182 days. The level of weekly benefits is fixed and depends on the claimant's age (one level for 18-24 year olds and another for the 25-plus) and on whether the claimant gets regular revenues from a private (occupational or not) pension plan or from a part-time job. No other source of income (such as savings, other financial assets or spouse's earnings) is taken into consideration. Those claimants who are still unemployed after having claimed 182 days of benefits, as well as those who do not qualify for the contribution-based JSA, turn to the second type of benefits.

The second benefit is the income-based JSA. It is available to all low-income persons who are unemployed and not eligible for a contribution-based JSA, including the self-employed. To claim this benefit, the claimant must meet with a program administrator who determines the levels of benefits on a case-by-case basis. The weekly benefits that can be claimed are constrained by a maximum that depends on whether one is single, and whether one is younger than 25. Because this is an income-tested program, the benefits one can claim are further re-



duced as a function of savings, part-time work earnings, pension revenues, and spousal revenue. Once all these sources have been taken into account, it is quite possible for an unemployed person to be left without the right to claim benefits. If he has the right to do so, he can claim them for an unlimited period of time, subject to satisfying various monitoring requirements.

Three other relevant elements of the UI program in the UK should be noted. First, although self-employed individuals can contribute to National Insurance, this does not give them the right to claim either contribution-based or income-based JSAs. Second, if an individual can claim any of these benefits, a waiting period of three days applies. Finally, although the eligibility for contribution-based JSAs depends on past NICs, these contributions are not earmarked to a specific social insurance program, and the level of benefits are in no way related to either past earnings or on the level of past contributions.

## **Belgium**

Belgium is a federation where two distinct support programs exist, one for the unemployed, whether short- or long-term, and the other for individuals who are unable to work. All workers and their employers must pay social security contributions. The self-employed also contribute to social security, though their eligibility for benefits is limited as discussed below. As in the UK, these contributions serve several purposes and are not earmarked. Payments to the social security system are collected by the National Office of Social Security which redistributes them to funds dedicated to Invalidity Insurance, National Pensions, Family Allowances, and the National Employment Office in support of their respective financial needs. The federal government then supplements these contributions with subsidies. This system keeps the contribution system simple but prevents UI benefits from being closely conditioned on one's past contributions.

The basic allowances an unemployed person can claim is equivalent to 35 per cent of insured earnings, subject to a daily and a monthly maximum and minimum. These maxima and minima depend on whether one is living alone, and whether one has family responsibilities (children). Those involuntarily unemployed can claim benefits for an unlimited period of time, but the maximum benefit falls after 6 months and again after one year (called the first, second and third periods). Monitoring for job search and training also become more stringent after one year. Interestingly, the job placement of the unemployed is under the responsibility of four different agencies, one each for Brussels, Wallonia and Flanders and the German-speaking community.

Welfare payments can only be claimed by those unable to work. These are means-tested benefits (called 'integration income benefits') and recipients must satisfy some strict conditions. More precisely, they must not be in a position to acquire means of support through their own effort or in some other manner (including household income), and must have exercised their entitlement to all other benefits. In contrast with the UI program, which is federal, integration income benefits are decentralized and provided by each commune through agencies called 'Centres Publics d'Action Sociale' (CPAS). Their financing is shared between communes and the federal government, whose share is 50 per cent to 65 per cent depending on the number of claimants. This generates many public debates in Belgium.



One notable feature of the Belgian system is that UI contributions are mandatory for the self-employed, and there is some access to benefits in the case of loss of livelihood through what is called the Independent Workers Regime. To be eligible, one must be engaged in a professional activity (including farming) for which the worker is not tied with a labour contract. One has also access to the Regime if working for an independent worker without a labour contract (a ‘helper’). The level of contributions is set by a federal organization (the INASTI) but payments are collected by so-called social funds for independent workers which are established as not-for-profit organizations. The contributions depend on whether the independent activity is one’s primary or secondary occupation and are paid on a quarterly basis based on declared profits of the previous year, subject to administrative revision. The program gives independent workers the right to a minimal revenue replacement in case of bankruptcy, public health insurance, invalidity insurance and access to public pensions, and gives some benefits if they have to take care of a parent who is in palliative care. However, no proper income replacement is provided in case of job loss, and some level of self-insurance is therefore required.

## Spain

In the countries studied so far, the UI and welfare programs are well-coordinated because (with the exception of Belgium) the federal or central government has the ultimate constitutional responsibility for both of them. The advantages of integration are substantial, particularly in terms of implementing monitoring and training policies efficiently and consistently, and ensuring seamless transition between UI and welfare. However, even if full integration is always not possible because sub-national tiers of government are responsible for last-resort financial help, coordination is still possible, especially to smooth the passage from EI to welfare.

Spain is one such country where social protection and security are the responsibility of the autonomous regions whereas UI is under the federal government, and some amount of coordination exists. The UI program consists of two tiers, both managed by the federal government. The first tier is a contributory UI system. Contribution is mandatory, benefits are based on past contributions, and eligibility is based on requirements such as the duration of the working period. A claimant must have contributed for a minimum of 12 months in the 6 years preceding the legal status of unemployment. The duration of benefits is limited to up to 540 days, depending on age, contributions and other criteria. When these benefits are exhausted, the unemployed can claim benefits from the second tier of the federal program. These are akin to welfare payments and are called ‘Minimum Income for Insertion’, with eligibility being subject to an income test. The goal of this second tier is therefore not primarily consumption smoothing, but rather to provide the longer-term unemployed with minimal purchasing power. When these two tiers are exhausted, those remaining unemployed can claim welfare from the provinces, or autonomous regions.

This system is interesting for several reasons. The two-tier federal program eases the transition from one program (UI) to another (regional welfare payments). The unemployed are kept in the federal program for a longer period, and undergo the transition from contribution-based benefits to income-tested benefits there. This allows the federal government to monitor job search and training for a longer period, even after contributory benefits are exhausted. It is also

likely to reduce the number of longer-term unemployed who, for different reasons, would not be likely to claim welfare benefits. Claiming means-tested welfare benefits can be a stigmatizing process relative to claiming UI, and making the transition within the UI program can reduce that stigmatization. Low uptake of welfare by eligible unemployed (so-called Type-I errors) can also occur because of limited information or high costs of application, and these can be reduced by having a means-tested tier in the UI system. Finally, the second-tier with income testing may induce some harmonization of welfare rates among provinces and subdue the race to the bottom. However, the extended length of UI requires the federal government to be willing to bear some of the costs of welfare.

## **Switzerland**

In some countries, the level of coordination between welfare and UI is more limited. This is the case in Switzerland, a notably highly decentralized federation. Surprisingly, the Swiss UI system is supervised by the federal government under the ‘Loi Fédérale sur l’assurance-chômage obligatoire et l’indemnité en cas d’insolvabilité’. All workers are required to contribute to the program, except for the self-employed.<sup>12</sup> Contributions are made by both workers and employers in the case of regular employment. Just as in the UK and Belgium, the workers’ payments are used to finance several social security programs (called the ‘pillars’ of social security). In case of unemployment, benefits are equivalent to 80 per cent of insured earnings (or 70 per cent for individuals without children) and are not means-tested. As with virtually all other UI programs, claimants must be searching for employment. Benefits are calculated on a daily basis and the number of insured days of unemployment depends on age and on the duration of past contributions. More precisely, one can claim up to 400 days of benefits if one has contributed at least 12 months, or 520 days if one has contributed for 18 months and is at least 55 years-old or is on disability or accident insurance.<sup>13</sup> The Swiss program does not insure individuals during a waiting period of five days, starting on the first day of unemployment.

Although the Swiss program is regulated by a federal law, its administration is substantially decentralized to UI funds in the Cantons that can be under the supervision of either the public sector or of trade unions. Granting authorities are managed in the Cantons by the ‘commissions tripartites’ that manage the application of labor laws. When UI benefits are exhausted, a Swiss worker can, if necessary, seek help from welfare systems that are decentralized and established by each Canton. The eligibility rules as well as the generosity of these programs vary from one Canton to the next, but most of them perform job search and training monitoring, and seek to reintegrate workers in the job market.

## **United States**

Social assistance and UI systems are also relatively uncoordinated in the US. In contrast with what we observe in most other developed federations, UI is the responsibility of the states, whereas welfare is a shared responsibility. Social assistance programs are means-tested, temporary, often in-kind, and implicitly targeted to help women with children. For example, the Supplemental Nutrition Assistance Program (the food stamp program), is under shared responsibility and aims to provide direct help to low and no-income families. The federal

government defines the broad rules and pays the benefits, whereas the program is administered by the states. Another program, the Temporary Assistance for Needy Families is under state responsibility. It aims at providing income assistance to needy families with children, and one can benefit from it for at most 60 months in a lifetime.<sup>14</sup>

UI programs differ among states in several regards: earnings required for eligibility, contribution rates, levels of benefits (including the replacement rate, the maximum and the minimum benefits), and the potential duration of benefits. All states, however, require claimants to be potentially employable and to be willing to work. Workers are left on their own once they have exhausted their claim for contributory benefits, since no long-term unemployment assistance program exists. If workers are still unemployed, they must rely on their own resources unless they are eligible for state welfare programs.

Because of the decentralized nature of UI, benefits, contributions and eligibility parameters vary across states. One interesting aspect of this system is that each firm receives different treatment under state UI programs because employers' contributions are determined using experience rating. According to this approach, each firm's contributions depend on its risk of layoffs, which is calculated using past experience. As noted by the OECD, the formulas used to calculate contributions vary significantly across states (OECD, 2004). However, the federal government (Department of Labor) determines the minimal contributions of employers, which is currently 5.4 per cent of insurable earnings. A second source of regional variation also comes from the federal government's special benefits that can be claimed by unemployed individuals in high-unemployment states (United States Department of Labor, 2004). This measure, called 'extended benefits', provides unemployed workers with 13 additional weeks of benefits when a state is experiencing high unemployment.<sup>15</sup>

## **Lessons of International Comparison**

Some general observations from our cross-country comparison can be noted. First, relating the amount and level of benefits to the size of past contributions is not the rule. When this is the case, it is done in a rather indirect way due to the fact that social security contributions tend to be linked to income. Earmarked financing of UI funds is not the rule either. Employed workers are eligible for UI, but not the self-employed except in a very restrictive sense in Belgium. Also, regional differentiation in the determination of benefits and contributions seems to be more an exception than a rule. Only the United States deploys some level of regional differentiation. Thus is due to the fact that UI is under states' responsibility, but also because the federal government implements a program of extended benefits for high-unemployment states. Most countries' waiting periods tend to be much shorter than Canada's, which lasts for two weeks. There is a tendency in European countries to fund jointly several parts of the social security systems. Some distinct features that are found in some programs include the possibility for UI recipients to earn some income, and the existence of two-tier systems consisting of a first tier of contributory benefits and a second tier of means-tested benefits, where the means-testing might include spousal income.

## 4. Design Issues in a Federation

The above discussion indicates that different countries adopt very different approaches to UI design, its relation to welfare, and the role of sub-national governments. This breadth of experience suggests that various options are available for reforming the Canadian EI system depending on one's view of the rationale for EI and the existence and effectiveness of complementary social programs for dealing with employment volatility. There are also different ways of dividing responsibilities between governments and, where necessary, harmonizing programs. In this section, we review some options that could be considered for EI reform in Canada. We begin with some key design issues for EI in general. These will set the stage for considering issues specific to a federal system.

### Redistribution versus Insurance

A prior question is the balance between redistribution and insurance in EI. The argument for enhancing the redistributive role comes from the rationale for a public EI system, which is to provide insurance for job loss for those unable to self-insure at a reasonable cost. A case can be made for EI providing higher net benefits for low-income workers on these grounds, especially since full insurance is not feasible.

The existing system is roughly self-financing in the aggregate. The proportional contribution rate combined with the uniform benefit structure implies that EI redistributes from low-expected-unemployment to high-expected-unemployment workers. It does not fulfill a needs-based redistributive role except to the extent that workers in jobs with high-expected unemployment are lower-income workers. While it provides some insurance against job loss to all eligible workers, it does so inefficiently by favouring industries with higher-than-average and perfectly predictable layoff rates. The relatively high number of hours of work required for eligibility makes some contributors ineligible, and the limited duration reduces insurance for workers with longer than expected spells of unemployment. At the same time, the program guarantees portability among employers and provinces.

To enhance the redistributive role, EI would have to be better targeted to those who need it most, i.e., the lowest-income workers. This could be achieved by reforms of both contributions and benefits. On the contribution side, financing of EI could rely more on general revenues and less on earmarked payroll taxes. Relying entirely on general revenues (as in Australia) would enhance considerably the redistributive properties while not detracting from efficiency or insurance. Given that contributions currently bear little relation to expected benefits, little of insurance value would be lost by moving to general-revenue financing. Moreover, current eligibility criteria could still be applied since hours of work could still be used.

General-revenue financing would notionally change the system from a social insurance system to a transfer system, and it might be argued that the constitutional assignment to the federal government for 'unemployment insurance' might somehow be jeopardized. That argument has little substance from an economic point of view. Contributions now are effectively a tax since they are mandatory and bear little relation to expected benefits. Changing the financing to progressive taxation from the current regressive one, such as through general-revenue financing,

can be done independently of the choice of the benefit structure, and there seems little reason not to do so. We are not in a position to judge the constitutionality of the issue.

General-revenue financing would have a further benefit. It would disentangle contributions from benefits and eliminate the requirement to keep the fund in balance. To the extent that fund balance is imposed on a yearly basis, EI is precluded from being an effective automatic stabilizer to help counter the economic cycle.

Redistribution could also be enhanced by reforms on the benefit side. The current system restricts benefits by a ceiling on insurable earnings combined with limits on duration. This limits earnings insurance for higher-income workers, but largely insures them on the same terms as low-income workers. The taxability of EI benefits adds an element of progressivity, as does the tax-back of benefits for those earning more than \$54,000 of income in the year, but these are relatively limited. As well, the EI Family Supplement targets very low-income families with children, but this too is relatively limited, as is the paltry amount of part-time earnings allowed while on EI. The restriction on the duration of benefits might constrain low-income workers more to the extent that re-employment is more difficult for them, given that they have lower skills. Reduction of the two-week waiting period would also particularly benefit low-income workers.

An alternative approach, and one that has been proposed by Battle, Mendelson and Torjman (2006), is to create a second-tier of benefits based on duration, as in Spain and Germany. A uniform EI benefit could apply for a given period, presumably somewhat shorter than the current system. Those who exhaust this first tier would move on to a second tier that is means-tested, thereby targeting benefits better. The means-testing could take account of family income or assets, number of dependents, and perhaps even allow for more part-time work with a less punitive tax-back rate than the current 100 per cent one. Making second-tier benefits conditional on family income would address the anomaly whereby laid off secondary workers with high-income spouses can claim full EI despite their superior ability to self-insure.

The duration of the two tiers could be longer than that of the current single-tier system, entailing a longer period of federal EI, at least for those in need. It would be administered as part of the EI system. Once the two tiers of benefits have elapsed, those still unemployed could move to provincial welfare. Such a system smoothes the transition to welfare, reducing administrative and waiting time, and perhaps more important increasing take-up by reducing stigmatization and application costs. It would also serve to reduce the differential treatment that long-term unemployed workers obtain from different provincial systems as a result of fiscal competition. Of course, there may still be a drop in income to the extent that provincial welfare systems are less generous than EI. And, the unemployed may be deterred from applying for welfare because of asset restrictions in provincial welfare systems. Those problems would obviously be up to the provinces to address.

This implicit reallocation of some costs of supporting the long-term unemployed from the provinces to the federal government could entail some minor adjustments in the system of social transfers. It would also free up provincial social assistance funds for other needy groups, including the disabled and single parents with small children. More generally, the whole system of transfers to the poor could be rationalized. In particular, all income tax credits could be

refundable, thereby turning the income tax system into a proper negative income tax system.<sup>16</sup> This would reduce some of the need for transfers under the proposed second tier of EI as well as provincial welfare systems.

The advantage of a two-tier system is that it would improve the targeting of EI to those who need it most. There are alternative measures that could be taken. Regular EI benefits could be conditioned on family income and circumstances. The earnings replacement rate, currently low by international standards, could be increased and perhaps made contingent on earnings. Even reducing the waiting period below two weeks, which is higher than the international norm, would help lower income workers for whom self-insurance is costly, particularly adjusting their consumption patterns.

At same time, insurance could be enhanced without compromising redistribution unduly by deploying some experience rating in the case of repeat users. Repeat use is already discouraged to some extent by the reasonably stringent eligibility rules during the qualifying period (the most recent 52 weeks), although this is compromised by the regional differentiation of eligibility, discussed further below. Repeat use is a particular concern in two contexts. One is in seasonal industries where layoffs are predictable, so there is no real insurance rationale for EI. In this case, EI ultimately serves to subsidize employment in these industries. The other is the use of EI to finance temporary layoffs in sectors facing a downturn in demand. There is less predictability of unemployment than in the case of seasonal industries, but the probability of layoffs is higher than in more stable industries. The absence of experience rating combined with the fact that to draw EI requires being laid off implies that the EI system subsidizes temporary layoffs when it might be more efficient for a firm to reduce hours of work per employee of build inventories. This could be mitigated by some combination of experience rating, whereby either contributions or benefits are related to past claims, allowing EI to be claimed for reduced hours, and allowing workers to claim EI while continuing to work part-time. Exploring details of such schemes are beyond the scope of this paper.

## **The EI-Welfare Nexus**

The fact that EI is delivered by the federal government, while welfare is provincial leads to inevitable concerns about coordination, gaps in coverage and complexity. The clientele served by EI and welfare overlap. EI beneficiaries are mainly the short-term unemployed, whether involuntarily or for maternity, compassionate or sickness reasons. Some EI recipients are temporarily laid off and will be rehired by the same firm; others will have left employment in one firm and will be searching for comparable employment elsewhere (frictional unemployment); and others have been permanently displaced and are seeking employment that may require different skills than the one they left (structural unemployment). In all cases, EI is intended to provide support until they return to their original job or find a new one. Welfare applies to the longer-term involuntary unemployed, both those who have not succeeded in getting a new job after having been laid off and those who have yet to secure employment. Welfare also applies to the disabled and non-working parents with children, but our main focus here is on those able to work.



The main structural differences between EI and welfare concern the sequence and duration of need, the eligibility requirements, and the level of benefit. While EI is a contributory program whose eligibility and duration depend on recent employment history, welfare is not related to previous employment, given that recipients include those who have not yet been employed. Instead, it is needs-based and financed from provincial general revenues (with some indirect federal assistance via the Canada Social Transfer). Of particular importance are the stringent asset limitations that restrict welfare eligibility, and that undoubtedly constrain the ability to move to welfare when EI eligibility ends. Duration of welfare benefits are indefinite as long as need is verified. Both EI and welfare recipients are allowed to earn some income, but the amounts are relatively low. EI and welfare programs have as an objective finding employment for recipients, and they deploy employment services and training to that end.

Full EI rates are substantially more than those of welfare, although the differences vary across provinces. For example, maximum insurable earnings under EI are \$43,100 per year. Given a benefit rate of 55 per cent, the maximum EI benefit is \$23,760 per annum, or \$457 per week (Service Canada, 2010). In Ontario, the welfare rate for single employable persons is \$6,877 per annum or \$132 per week, which is less than one-third of maximum EI eligibility and well below the poverty line (National Council of Welfare, 2010). To put the comparison differently, the Ontario welfare rate would be equivalent to the EI weekly benefit for a worker who has average insurable earnings of only \$12,504. This would be below the minimum wage income for a full-time worker. If instead, the comparison is with the median welfare rate for single employable persons, it is slightly more favorable for welfare. The median welfare rate is \$140, which is still less than one-third of maximum EI benefits. EI benefits would be \$140 per week if average insurable earnings were \$13,230.

Part of the problem lies with the relatively low welfare incomes paid to single employable persons compared with either the disabled or welfare recipients with children. But, the bigger problem concerns the stagnation of provincial welfare rates since the early 1990s, coinciding with a dramatic reduction in federal transfers to the provinces. Provincial social assistance rates have declined in real terms since then, as documented in National Council of Welfare (2010). Among other things, welfare rates are not indexed to inflation, so changes must be legislated. Given the competing demands for funding health and education, provinces find this difficult to do. There may as well be fiscal competition factors that discourage provinces from unilaterally raising welfare rates.

The administrative requirements of the two systems are similar. In both cases, monitoring must be done for initial and continuing eligibility. In the case of EI, monitoring is particularly focused on the labour market behaviour of beneficiaries: involuntary layoffs, job search and job acceptance. Welfare is less concerned with verifying the fact of involuntary unemployment, though job search activities remain relevant. In addition, welfare eligibility entails verification of assets, part-time earnings and family circumstances.

Given that they both address the needs of the involuntary unemployed, there are apparent advantages to harmonizing EI and welfare. Harmonization could be of various sorts. The formal provisions could be harmonized so that the rules determining eligibility are similar, although it is not clear that much can be gained here. The EI system focuses much more on temporary and involuntary unemployment, while welfare is more concerned with determining needs and



includes persons who have not yet been employed. It is not clear that the rules specifying what constitutes involuntary layoff, or rules governing when job offers must be accepted, should be the same under EI and welfare. Any harmonization of rules would be difficult since it would involve all provinces and territories, whose rules are not harmonized.

Harmonization could instead entail a common administration, analogous to the administration of taxes through the Canada Revenue Agency. This might make it easier for clients who move from one system to another. They would have only one agency to deal with, and their records would be available in a single place. The principle of subsidiarity might suggest that the administration of EI and welfare would best be located at the provincial level. The provinces are closer to those being served; they are likely to be more accountable; they are better able to innovate to improve delivery; and, the number of layers of management would be reduced. However, given that the administrative focus of case-workers is likely to be very different in EI than in welfare, it is not apparent that real gains of administration are possible given the difference in clients being served. The only real advantage of joint administration of EI eligibility and benefits, and welfare eligibility and benefits involves the movement of the long-term unemployed from EI to welfare. As mentioned, this only includes a subset of welfare recipients, since many have not been EI recipients. There are better ways of smoothing that transition than by unifying the administration, which we return to below.

Where more scope for harmonization exists is in the provision of employment services and training. Both EI and welfare have as objectives the re-employment of those who are able to work but are involuntarily unemployed. Employment services are particularly important for those who suffer permanent layoffs, and similar services apply as long as the worker is involuntarily unemployed, whether on EI or welfare. It would seem to be efficient to have one-stop employment services that can be used by both types of recipients. Two main problems exist. One is that, on average, EI recipients might be expected to have better job skills and more experience than welfare recipients, and would be suited for different types of jobs. A common employment service might not serve well the interest of welfare recipients, for whom placement is more difficult and takes more time. More important, it is not obvious how employment services could be harmonized given that the fact that EI is federal and welfare is provincial. One possibility is for bilateral federal-provincial agreements to be signed whereby the provinces provide employment services for both EI and welfare recipients. This seems to have worked well in the case of training.

Like employment services, training is an instrument for improving the prospects for the unemployed to obtain a job. This is obviously relevant whether a worker is on EI or welfare. The provincial interest in training, even to those on EI, is obvious on various dimensions. The sooner training takes place, the smaller is the chance that EI recipients will eventually end up on welfare. When the duration of one's unemployment spell is expected to be long, it will be in the joint interest of the unemployed and the government to initiate retraining. This is especially true for the structurally unemployed who cannot expect to be re-hired in their previous sector, and whose human capital is specific. Although training is currently part of the EI program, and as such is directed to those eligible for EI, there is no compelling reason in principle to differentiate training for EI recipients from that to others, including welfare recipients, many of whom have never had a job. The fact that the federal government is exclusively responsible for EI may have resulted in the training component of EI being restricted to EI recipients, but that

is an artifice of that particular division of responsibilities. Constitutional limitations aside, it would make more sense on economic efficiency grounds for federal-provincial training agreements to apply to all able but unemployed persons. EI benefits are of fixed duration, whereas welfare lasts much longer and can be the last resort for the long-term unemployed. Moreover, because of the stigmatization and costs of applying for welfare, some needy unemployed may be reluctant to apply. Ensuring that the unemployed have the skills to facilitate their re-employment is important, and this requires identifying potential unemployed workers who could benefit from skill improvement as soon as possible, whether or not they are EI recipients.

Given their responsibility for education and training, the provinces seem to be better placed to provide training. However, it is in the joint interest of both orders of government to fund these services. Training agreements exist between all provinces and the federal government. They are of two sorts (Human Resources and Skills Development Canada, 2011). Labour Market Development Agreements provide federal funding for provincially delivered training programs for those eligible for EI. In addition, there are separate bilateral Labour Market Agreements in support of provincial training programs targeted at workers who are not eligible for training under EI. The case for coordination is even stronger when eligibility for EI and welfare benefits are both conditional, to some extent, on one's involvement in a training program. The principle of equal opportunity, along with standard efficiency arguments, would support some national harmonization of training standards across provinces so workers have comparable job market opportunities.

A more ambitious approach to coordinating EI and welfare, as mentioned, is to change the EI system into a two-tier one along the lines of some European countries, while retaining welfare as a last-resort income support system for the long-term unemployed. Under a two-tiered system, workers who lose their jobs would initially be eligible for EI based on their past contributions. Those who exhaust their benefits or who did not meet the eligibility criteria would be eligible for the second tier of benefits which would be based on need rather than contributions. This would exist alongside welfare, which would cater to the long-term unemployed and those who had not yet had a job. This three-stage support program for the involuntary unemployed would recognize the fact that there are three fairly distinct classes of involuntary unemployed workers: those whose unemployment is temporary, the long-term unemployed for whom re-employment is difficult because of loss of skills, and the unemployment who have yet to acquire an attachment to the labour force.

The requirements for these three categories are somewhat different. For the temporary unemployed, EI plays an important insurance or consumption-smoothing role, especially for low-income workers. For these workers, training is of limited importance, though employment services may be important unless they expect to be re-hired by their original employer. The requirement that job loss be involuntary and that job seeking be undertaken are important eligibility considerations. The duration of benefits in this first, contributory, tier could be less than in the current EI program.

For workers whose job loss is longer term, the role of insurance wanes, while redistribution becomes more relevant. Basing benefits on need rather than past earnings, including especially family income, emphasizes this redistribution role. These workers also benefit from training. Given that they have had work experience and have presumably built up some skills, training

can build on these skills. Those who remain unemployed for an extended period could then transfer to welfare, and the transition would be made easier if they are already receiving needs-based transfers.

Those who are not yet attached to the labor force would constitute the bulk of the welfare recipients. Seeking to facilitate the entry of welfare recipients into the workforce is both important and difficult, probably more so than for those who have previously lost jobs. New entrants will have had limited experience, and their innate education and skills are likely relatively low. The sort of training for which they are suitable will differ from that suitable for those with work experience. Determining the level of income support for these persons is contentious. Basic equity principles might suggest that welfare incomes should be sufficient to exceed basic poverty levels, such as Statistics Canada's Low Income Cut-off, which would be significantly higher than existing welfare incomes for single employable persons (National Council of Welfare, 2010). As with EI, conditions are attached to welfare that require recipients to search for work and accept suitable jobs. However, this may be difficult to enforce because welfare is the last-resort source of income. Low welfare rates may be seen as means of inducing recipients to find work, albeit a fairly drastic means.

The issue of adequacy of welfare incomes is beyond the scope of EI reform measures. At the same time, the fact that welfare rates are relatively low compared with EI has some implications for the design of EI. It adds impetus to the case for a two-tiered system of EI with relatively lengthy duration of the second tier, given the sizeable income drop in going from EI to welfare. Enforcing job search requirements is likely to be easier in the second tier of an EI system than it is in welfare where there is no further fall-back source of income. The fact of low provincial welfare rates also adds urgency to reforms of the tax system so that those at the bottom end of the income distribution do not rely primarily on welfare for support.

### **Regional Differentiation of Eligibility and Benefits**

For the most part, the EI system does not use insurance principles to determine contribution rates, eligibility, or the level and duration of benefits. Contribution rates are uniform despite the fact that the risks of layoff and the expected duration of unemployment vary across industries. As a result, EI redistributes systematically from sectors with low probabilities of layoff, such as the public sector and stable industries like financial and other services, to those with high probabilities, including seasonal industries and industries subject to cyclical demand. Employment is implicitly subsidized in the latter industries relative to the former, and regions that rely on seasonal or fluctuating industries benefit relative to other regions.

There are some exceptions to this absence of insurance principles. One is that the ability to qualify for EI is slightly more onerous for recent EI recipients. Another is the longer qualifying period required for new entrants and those who have been out of the labour force for two years (the so-called 910 rule). The more important one for our purposes is the differentiation in eligibility requirements and duration of benefits among the 58 regions of the country. The number of hours of insurable employment in the past 52 weeks required to qualify for EI varies from 700 in regions with a 6 per cent unemployment rate to 420 in regions with a 13.1 per cent unemployment rate. The number of weeks of benefits for those who meet the minimum

eligibility requirement vary from 14 in low-unemployment regions to 32 in high-unemployment regions, and the differences remain significant for those who have accumulated more than the minimum eligible hours.

The rationale for these regional differences in eligibility and duration is to recognize the greater chance of being laid off and the longer time it takes on average to find a new job in high-unemployment regions. At the same time, there are a number of anomalous features of these provisions.

- Some regions that have higher unemployment rates might also be those that already benefit from an absence of insurance-based contribution rates. Thus, if a region has a concentration of seasonal industries or industries susceptible to fluctuating demand, it may also have a higher than average unemployment rate.
- If some regions have persistently higher unemployment rates, regionally differentiated benefits might discourage the reallocation of labour to other regions where it might be more efficiently employed.
- The probability of being laid off may not be well approximated by the regional unemployment rate. For example, in economic downturns, layoffs often target short-tenure workers who are not eligible for EI (even though they may have contributed) rather than those who are eligible. Differential eligibility requirements effectively discriminate against short-tenure workers in low-unemployment regions.
- More generally, the unemployment rate is not a very precise indicator of the difficulty of getting a job. Better candidates might be the employment rate or the average duration of an unemployment spell in a region. Alternatively, since these measures reflect to some extent past conditions, changes in the rate of unemployment might be better. But, no measure will be perfect.
- The definition of regions is to some extent arbitrary. The presumption is that a region should reflect a relatively well-defined labour market with distinct employment prospects within the region. In practice, this is difficult to apply. There is bound to be some heterogeneity within regions, so that different rates of unemployment exist in different industries within the same region. In principle, it might make more sense to differentiate by industries rather than regions, but that would also be difficult to implement. The possibility that workers can migrate from one region to the next also makes regional differentiation arbitrary.
- These problems imply that regional differentiation will always give rise to workers in comparable situations facing different EI rules simply because they reside in different unemployment regions.

These considerations lead to the conclusion that regional differentiation is too problematic to be warranted, and it is not surprising that it is little used in other federations that have federal-level EI schemes. Although regional differentiation is observed in the United States, it seems

to be mainly explained by constitutional and political constraints rather than by efficiency concerns.

In the absence of regional differentiation, what alternatives might be used to deal with the fact that different workers might have systematically different chances of layoff and re-employment? One answer to that is to deploy a uniform set of rules throughout Canada and rely on the administration of EI to ensure the integrity of the system. The rules state that eligibility for EI requires that workers have lost their job through no fault of their own, that they are willing to work, and that they are actively looking for work. As long as these criteria are being diligently enforced, it is not clear why differential eligibility and duration rules should apply.

If regional differentiation must apply, the current system could be improved. Differences could be restricted to duration and not eligibility, as suggested by Bishop and Burleton (2009). More accurate measures of local conditions could be applied. As mentioned, candidates include the local employment rate or the average duration of an unemployment spell, although neither of these is perfect. More generally, if there is a desire to institute some insurance principles into the system, experience-rating of frequent users would be a better place to start.

One other provision that is discriminatory and has regional implications is the eligibility of self-employed fishers for EI. While it is true that many of them have a regular pattern of employment because of regulated fishing seasons, it is nonetheless anomalous that this category of the self-employed are eligible to the exclusion of all others.

### **Part-Time workers**

Part-time workers are to some extent covered given that eligibility is based on cumulated hours of work rather than full-time work weeks. However, the hours required are quite high, and apparently rule ineligible many workers, especially those with limited seniority for whom the need for insurance is great. This could be addressed by reducing the minimum hours required for eligibility, assuming that those laid off after such a short period can be verified to be truly involuntarily unemployed. Bishop and Burleton suggest 350 hours as a minimum (2009).

There are some concerns with shortening the eligibility period. One is that it is more tempting to game the system by arranging to take short-term employment with the prospect of a spell of EI benefits afterward. This sort of temptation has been a concern in high-unemployment provinces. It may be particularly a problem for secondary workers with limited attachment to the labour force, who may have primary workers as partners so self-insurance is not an issue. As well, the shorter the period of earnings, the less is the rationale for income smoothing, because the less income there is to smooth.

Workers who suffer significant reductions in hours worked without being laid off are typically not eligible despite the fact that the reductions may be involuntary and the need for income insurance great. Some countries offer insurance to workers whose work schedule is involuntarily and significantly reduced without being laid off (e.g., Belgium). It has been allowed on a discretionary basis for work-sharing agreements in Canada. Extending the EI system to include those whose employment has been significantly reduced would insure against unexpected fluctuations in income, especially during a recession. It would also mitigate the incentive for

firms to use temporary layoffs to take advantage of EI for their workers. However, successful insuring of part-time workers would require good administrative oversight to verify that reductions in work schedules were involuntary and substantial. An eligibility aid would be to require minimum weekly hours of work along with minimum cumulated hours. The ability to condition benefits on family income, as in the second tier of the proposed two-tier system, would also help.

### **The Role of the Income Tax-Transfer System**

The income tax-transfer system, which serves primarily as a revenue-raising device, also redistributes income and provides some implicit insurance against fluctuating earnings. It is worth considering the role of income taxes and transfers as a complement to the EI system. There are three cases in which the income tax system, rather than EI, assumes the primary role as a social insurance device: the self-employed, displaced workers and the long-term unemployed.

Self-employed workers are those who operate their own businesses as professionals, contractors or consultants, as well as farmers and fishermen. In 2009, around 2.7 million Canadians earned at least a part of their income from self-employment, two-third of them being men. The number of self-employed is constantly growing, especially in times of recession (Statistics Canada, 2008).

### **The self-employed**

It would seem natural to include self-employed workers in EI. They are subject to the same labor market risks as regular employees, particularly during economic downturns. Moreover, self-insurance may be costly, given their modest average income, which was \$22,866 in 2005 when 79 per cent of them reported incomes less than \$20,000, while only 3 per cent reported incomes higher than \$100,000. On the other hand, many self-employed have other sources of income, some of them being potentially insurable through the regular EI scheme. In 2005, 46 per cent of the self-employed had employment earnings. Another difficulty is that becoming self-employed can itself be a self-insurance device, especially in times of recessions (La-Rochelle-Coté, 2010). This makes it difficult to determine their ability to self-insure.

Agreeing on proper definition of what being unemployed means for the self-employed is a substantial problem. Independent work is more prone to volatility and does not involve stable work schedules. If the self-insured were insurable, it is not clear how the EI program could provide them with timely help in case of unemployment, and what timely would mean.

Eligibility to the program depends on the number of hours worked, which for regular employees is obtained from employers. For the self-employed, eligibility would rely on voluntary reports from the potential claimants, which is liable to be unreliable. Determining the amount of the contributions would also be difficult. Self-employed individuals declare their incomes at most on a quarterly basis. Contributions would have to be determined as a function of quarterly income, when they have to pay provisional accounts.



It is important to recognize that the self-employed are already partially insured through the tax system. They derive their income from the profits and face the risk of a loss in any given year. In a loss year, they nonetheless incur current and capital costs. To some extent, these costs are insured by the tax system since they can be carried forward to fiscal years. However, this insurance against losses is imperfect. Not only are negative tax liabilities not immediately refundable, they will never be credited if future profits do not materialize due to bankruptcy or a longer-term economic downturn. Allowing for full refundability of losses would provide them with an effective form of insurance. It would also incidentally encourage risk-taking and entrepreneurship and assist with the cash flow of risky firms. Governments seem reluctant to offer full loss refundability, perhaps because of the potential for abuse.

Some countries include the self-employed in EI, though there are difficult problems of implementation. Sweden is a case in point. To receive benefits, they must cease all their business activities for some period of time, disposing of all business assets and deregister the business (Swedish Unemployment Insurance Board, 2007:6). Belgium also insures the self-employed by EI, but a complicated administrative process determines contributions. Initially, a provisional account is set up and can last up to 15 quarters until a proper amount can be established. In addition to being administratively costly, timeliness of help is compromised and self-employment discouraged. Relying on the tax system to insure the self-employed seems preferable.

Finally, note that the treatment of the self-employed may be affected by human rights requirements. The 2010 decision of the federal government allowing self-employed workers to opt into extended EI benefits complied with the judgment of the Canadian Human Rights Commission that excluding such workers constituted a potential violation of the principle of equality.

### **Permanently displaced workers**

Displaced workers include those who suffer structural unemployment when their industry of employment suffers a major shock. They represent a special case of the unemployed both because of the long-run nature of their unemployment and because of the loss of the value of their skills when they are laid off. While EI can mitigate the immediate consequences of their job loss, and training can help them find a new job, in the long run, because their skills have depreciated, they typically face a permanent reduction on their earning power.

The EI system is ill-suited to deal with permanent reductions in earning capability. The income-transfer system has as one of its objectives the redistribution of income from those with higher earnings to those with lower earnings. Typically, these differences in earnings potential are life-long: some persons are born with greater earnings ability than others, and one task of the income tax system is to address those inequalities. Inequalities that arise partway through the lifetime pose similar challenges that the income tax system is designed to address. The income tax is not expected to fully insure permanent earnings inequalities, whether they arise at birth or partway through the life cycle. One improvement in the income tax system that would be particularly helpful would be to reinstitute general income averaging so that workers who suffer a permanent reduction in earnings can average their tax liabilities across periods in their working life when they face different tax rates.



## **The long-term unemployed**

The long-term unemployed, including those who have never been eligible for EI, rely mostly on provincial welfare systems for income support. They do get limited help from the income tax system through refundable tax credits, such as the Goods and Services Tax Credit and the Canada Child Tax Benefit. These are relatively small in size, especially for single unemployed persons. As we have mentioned, welfare incomes are very modest relative to standard poverty levels, and there is no apparent prospect for the provinces to improve their generosity.

Here, too, the income tax-transfer system could play a complementary role to provincial welfare systems in meeting the needs of the long-term unemployed. Simply making all income tax credits refundable would be a start. Their generosity for the lowest-income persons could be enhanced in a revenue-neutral way by conditioning them on income as is done with existing refundable tax credits. Employment services and training, such as those available for EI recipients, are also important for the long-term unemployed.

## **5. Recommendations**

To conclude, based on our consideration of the rationale for EI and the special issues that arise in a federal setting, we propose the following policy recommendations.

Change the financing of the system as much as possible from payroll-based contributions to general revenue financing. This recognizes that the contributions are a form of taxation that serve no real insurance function and are regressive. General-revenue financing would make the system more progressive, would eliminate the requirement for an EI fund that is self-financing on an annual basis, and would not detract from the setting of eligibility and benefits based on insurable earnings.

- Complement the financing system by charges on firms that are repeat users as a means of experience rating.
- Make benefits more progressive. For one, benefits could be conditioned on family income and family responsibilities. More ambitiously, a two-tier EI system could be established. The first tier would be earnings-based, and could be of relatively short duration. The second tier would be need-based, including by family income and responsibility. Overall, duration of the two tiers would be longer than the current system. A two-tier system would explicitly recognize the three distinct categories of unemployed — short-term unemployed, long-term employed and those never employed). Ideally both tiers could be financed from general revenues as proposed above, but if contributions are deemed necessary, they should apply only to the first tier.
- Eliminate regionally differentiated benefits and the selective eligibility of fishers. This would eliminate a source of arbitrary difference in rules for particular claimants that results in unfairness to workers in like circumstances.

- Separate training from EI so that distinct training programs do not apply that are restricted to those eligible for EI and those that are not.
- Improve the income tax system to deal with variability of earnings of the self-employed, displaced workers, and welfare recipients. This includes improved measures of loss refundability for the self-employed, general income averaging, and converting all nonrefundable tax credits to refundable ones while increasing their generosity and conditioning them on income.
- Stress the importance of administration of EI as necessary for maintaining the integrity and generosity of the system.
- Reform provincial welfare systems so that payments to the long-term unemployed closer to poverty levels are indexed.

# Endnotes

1. Unemployment insurance became a federal responsibility as a result of a constitutional amendment in 1940. The federal government had passed an unemployment insurance bill in 1935 the midst of the Great Depression, but it was declared unconstitutional, being an exclusive provincial responsibility.
2. For a recent comprehensive discussion of administration of tax systems, see Shaw, Slemrod and Whiting (2010).
3. The role of monitoring and administration in transfer programs is outlined in Boadway, Cuff and Marceau (2008). Theoretical treatments may be found in Boadway and Cuff (1999) and Boone, Fredriksson, Holmlund, and van Ours (2007).
4. The redistributive role of social insurance is discussed in Chetty and Looney (2006) and Chetty and Saez (2010).
5. This was emphasized as one of the key incentive effects of unemployment insurance in the 1970s by Baily (1978) and Feldstein (1978).
6. However, the current EI program allows firms to sign work-sharing agreements to mitigate the incentive for temporary layoffs, although at some cost for the EI fund.
7. Section 36(1) states: Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to:
  - (a) promoting equal opportunities for the well-being of Canadians;
  - (b) furthering economic development to reduce disparity in opportunities; and
  - (c) providing essential public services of reasonable quality to all Canadians.
8. The implications of regionally extended benefits for Ontario are discussed in Jacobs (2010) and Bishop and Burleton (2009).
9. We follow the common practice elsewhere in the world of referring to programs to insure the involuntary unemployed as “unemployment insurance.”
10. The administrative rules in the United Kingdom define an unemployed worker as an individual who is at least 18 years old and below public pension age, who works no more than 16 hours per week on average, and who satisfies the other conditions for regular unemployment, such as being actively searching for a new job. In extreme circumstances, i.e. being a single parent, this extends to 16- and 17-years-old.
11. The UK government has announced that they will replace the existing means-tested benefits and tax credit programs, including the JSA, with a unified Universal Credit. Nonetheless the features of the JSA are worth recounting since they reflect the kind of UI programs that have been used in the past.
12. It is interesting to note that the Swiss federal government emphasizes the fact that the self-employed have a special responsibility so as to guarantee their financial security and that of their family in case of unemployment (<http://www.ch.ch/private/00054/00058/00585/00590/index.html?lang=fr>).
13. Because the duration of benefits depends on the duration of contributions but not their size, one suspects that the dependence on past contributions is more designed to avoid adverse selection than to be based on insurance principles.
14. The TANF program was called “Aid to Dependent Children” between 1936 and 1962, to become the “Aid to Families with Dependent Children” until 1996. Under the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 it became the “TANF Emergency Fund,” which also reimburses the States 80 per cent of their expenditure increases due to subsidized employment to low-income parents and youth, and some short-term non-recurrent benefits.
15. The federal government determines which states qualify for that so called “tier-III” part of UI. As of March 26, 2010, eligible states had a 3-month average unemployment rate of at least 6 per cent.
16. A recent proponent of a guaranteed annual income is Senator Hugh Segal in an article in the National Post on Dec 15, 2009 entitled “A Real Fix for Poverty.” The concept has frequently been recommended by advocacy reports, including the Royal Commission on the Economic Union and Development Prospects for Canada (1985).

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## About the EI Task Force

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The Mowat Centre has convened a research-driven Employment Insurance Task Force to examine Canada's support system for the unemployed. The Task Force will develop an Ontario proposal for modernizing the EI system—conscious of the national context—that works for individuals and businesses.

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