CALEDON INSTITUTE OF SOCIAL POLICY

caledon commentary

September 2010 ISBN #1-55382-486-5

EI Financing: Reset Required

In mid-November 2010, the Canada Employment Insurance Financing Board will likely recommend a 15-cent increase in Employment Insurance employee premiums from $1.73 to $1.88 per $100 of insurable earnings for 2011. The current maximum annual premium is $747.36 since insurable earnings are limited to $43,200. If the Board's recommendation is accepted, the new maximum annual premium for employees will rise to $812.16 – a hike of $64.80. The contribution for employers is 1.4 times the employee premium, so the employer's maximum annual contribution will increase by $90.72 to $1,137.02. The total EI payroll contribution per employee will therefore amount to $1,949.18, which is $155.52 higher for a sizeable 8.7 percent increase.

If the Financing Board's recommendation is accepted, the new premium schedule will go into effect on January 1, 2011. However, the Cabinet has until November 30 to reject the Board's recommendation. Instead, the Cabinet could continue the current EI premium freeze for another year.

The seemingly small 15-cent increase in premiums would still raise $1.5 billion in 2011, at a rough estimate. But the real fiscal impact of a premium increase is not the amount it brings in the first year. Each premium hike is on top of the last, so three consecutive years of increases will raise about $1.5 billion in 2011, $3.0 billion in 2012 and $4.5 billion in 2013 (depending on the state of the economy and several other factors). Assuming the federal government goes ahead with premium increases in the subsequent two years, freezing the rate in 2011 means that Ottawa will collect half as much in added premiums over the next three years. Losing $4.5 billion will punch a substantial hole in Ottawa's fiscal plan.

The federal government faces a dilemma. On the one hand, if it fails to raise the premium rate it will diminish both its fiscal credibility and the pace at which it reduces the deficit. On the other hand, the Canadian economy is at best shaky and unemployment remains high. If there is one consensus in economics, it is that raising payroll taxes in the midst of an economic downturn is a bad idea. An added tax on employment will result in a tangible loss of jobs and extra financial pressure on business.

This dilemma is largely the Harper's government own making. During the boom years leading up to the financial crisis, the federal government's spending increases and tax cuts ate up all the fiscal room accumulated in the previous decade, plus a little more. So much so that many observers, including the Parliamentary Budget Office, have calculated that Canada now has a structural deficit, meaning that even if the economy were doing well we would still be adding on debt.

Regardless of how we got here, there is no straightforward 'right' answer today. Either route has both pros and cons, but given the choices available now, the better option is to maintain the premium freeze in 2011. Canada still has among the lowest debt burdens of developed countries. We have the fiscal capacity to forego this tax increase. While credibility is a good thing, we have some room to spare – as evidenced by the extremely low interest rates we pay on long-term government borrowing. Against the somewhat ephemeral risks of loss of credibility, we must weigh the cost of higher unemployment and potential business failures. This is a devastating burden for those who become the collateral damage of economic policy. Moreover, if Ottawa is seriously concerned about the longer-term fiscal situation, it could forego some of the questionable expenditures it currently has planned such as spending untold billions on new prisons when expert advice is unanimous that this expenditure will do nothing to reduce crime (and may even worsen it by expanding 'crime universities').

But beyond the immediate dilemma of whether to increase or freeze premiums in 2011, Ottawa faces a longer-term problem: What to do about Employment Insurance financing?

In 2005, Ottawa passed a new *Employment Insurance Act* which included financing provisions. The essence of the new financing arrangement was that premiums should be set so as to pay for all EI benefits in each year. As we said at the time in our response to the 2005 Budget:

> …our most important concern is that this proposed financing change will remove altogether any potential countercyclical element of EI. When unemployment rises, EI premiums will go up, not down. Similarly, when unemployment goes down, EI premiums will follow them and decrease. Instead of maintaining consumer demand in a declining economy, EI will accentuate the decline. Rather than dampening demand in a rising economy, EI premium cuts will add to demand.
>
> The government proposes – in the words of the Budget – to "limit" this pro-cyclical effect by restricting the change in premiums in any one year to 15 cents. But 15 cents is not insignificant and, in any case, still goes in the wrong direction [Battle, Torjman, Mendelson and Pomeroy 2005: 24].

It was readily foreseeable that the present premium setting train-wreck was racing down the track. We called attention to this fact in several publications over the past five years, to no avail.[1] If Ottawa retains the 2005 financing rule for EI, it will have the opposite problem in the future – assuming that one day Canada returns to robust growth. EI premiums will need to be cut in the midst of economic growth, thus contributing inflationary momentum and adding to upward pressure on interest rates as monetary policy is called upon to offset pro-cyclical fiscal policy.

Canada needs a counter-cyclical financing regime for EI – a regime that can be established in law and maintained with some semblance of reliability through the ups and downs of the economic roller-coaster. Such a financing regime would not only add to our economic stability, it would also bolster our economic credibility. There are many options for such a regime, from a multi-year stabilization fund externally invested to an internal earmarked nominal account within government, and other options besides. As we recommended in our last Budget commentary: "The government needs to initiate a serious and careful review of EI financing involving both labour and business, so we can have clear, stated rules and accounting for EI financing that is both operable and sensible" [Battle, Torjman and Mendelson 2010: 3].

Michael Mendelson, Ken Battle and Sherri Torjman

Endnote

1. "Employment Insurance legislation passed as part of the 2005 Budget requires that premiums be set to equal next year's forecast costs. During the next recession, premiums will ratchet up while employers are shedding more workers. The federal Cabinet can override this legislated increase, but it will take some courage to do so. We could face the paradoxical and self-defeating prospect of increasing Employment Insurance payroll taxes at the same time as employers are laying off employees to reduce costs" [Mendelson 2005: 2].

   "The rate setting rules for Employment Insurance were apparently devised under the startling assumption that Canada would never again experience a surge in unemployment, and that it was perfectly sensible for premiums to go up when more people were unemployed and down when the economy was booming! ... We would urge that a truly new financing mechanism be established that can actually function in the real world. This is not a policy where the premiums are set to 'break even' every year; rather, it is a mechanism where premiums go up when unemployment goes down, and go down when unemployment goes up" [Battle, Torjman and Mendelson 2009: 20].

   "The 2005 legislated rate-setting mechanism is still on the books, but has proven to be unworkable and will remain so into the foreseeable future. Until there is a viable rate-setting policy, we remain in the world of Ottawa making ad hoc decisions every year about premium levels, inevitably politicizing the rate decision" [Mendelson, Battle and Torjman 2009: 4].

   "The current EI financing rules are, in reality, unenforceable because they are pro-cyclical when they should be counter-cyclical. Were the rules applied, premiums would go up when unemployment increases and down when it declines. ... So we can anticipate a spate of [premium] increases whenever Cabinet takes the lid off, regardless of economic conditions. Nonetheless, it is clear that the EI financing rules in place are non-functional and – dare we say it so bluntly – dumb" [Battle, Torjman and Mendelson 2010: 3].

References

Battle, K., S. Torjman and M. Mendelson. (2010). *The Déjà Vu All Over Again Budget*. Ottawa: Caledon Institute of Social Policy, March.

Battle, K., S. Torjman and M. Mendelson. (2009). *The Red-Ink Budget*. Ottawa: Caledon Institute of Social Policy, February.

Battle, K., S. Torjman, M. Mendelson and S. Pomeroy. (2005). *The Vote or Veto Budget: An analysis of the 2005 federal Budget*. Ottawa: Caledon Institute of Social Policy, March.

Mendelson, M., K. Battle and S. Torjman. (2009). *Canada's Shrunken Safety Net: Employment Insurance in the Great Recession*. Ottawa: Caledon Institute of Social Policy, April.

Mendelson, M. (2005). *Anyone Got a Plan?* Ottawa: Caledon Institute of Social Policy, November.

401-1390 Prince of Wales Drive
Ottawa, ON K2C 3N6
CANADA

Tel/Fax: (613) 729-3340

E-mail: caledon@caledoninst.org
Website: *www.caledoninst.org*