The federal government is finalizing its long-promised reform of the Employment Insurance system. In this special three-part series, Miles Corak argues that the financing of the program should be part of the reform process, and offers practical changes to EI contributions based on insurance principles.

From: Miles Corak

To: Employment Minister Carla Qualtrough

Date: October 11, 2022

Re: **Insurance Principles Make the Case for Stable Contribution Rates as a Part of Employment Insurance Modernization**

Insurance principles suggest that employer and employee contributions to Employment Insurance (EI) should be relatively constant, covering unemployment from ongoing labour market dynamics. They also suggest the federal government should become a partner in EI financing, covering program expenditures during big collective shocks, providing rate stability for employers and employees.

Unemployment is caused by three different mismatches. The first two, frictional unemployment and structural unemployment, are the types to which employer and employee EI contributions should be directed.

The third, involuntary unemployment, calls for federal government contributions.

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

Structural unemployment is a mismatch between individuals and the requirements of the jobs that are available. A vacancy exists, but it takes time to develop the skills or move to the right location. Unemployment reflects the time to make these changes. There is uncertainty about the skills that will be required, and individuals need insurance to cover the gaps between jobs that are always changing in their requirements.

This all reflects the workings of dynamic labour markets, where thousands upon thousands of employers expand, contract, disappear or are newly born every month; where new people come of age looking for work for the first time, others suffer layoffs from jobs they've long held, others making transitions between family responsibilities and work, while others move to retirement.

Since this involves individual firms and workers making decisions in the face of product market and family uncertainties, it is to these two types of unemployment that individual employers and employee contributions should be directed.

Frictional and structural unemployment evolve slowly. This reinforces the case for relatively stable EI contributions, their level being associated with the insurance needed to cover that underlying trend unemployment.

Using the average unemployment rate over a moving window of a number of years might help approximate premium levels. EI funding rules determine contributions annually to balance the account over a seven-year window. If a window this long was adopted, it would suggest setting current contribution rates to finance program expenditures consistent with a 7-percent unemployment rate. Using a shorter window of five years, a horizon consistent with the usual mandate of new elected government, would imply the same thing.

This is only slightly higher than the 6.5 percent that both rules would have implied in January 2020, before the onset of the pandemic. The implication is that contribution rates would have been held relatively constant, even in the aftermath of a shock as big as the pandemic when the unemployment rate jumped from less than 6 percent to above 13 percent.

Which brings us to involuntary unemployment, the third type. It reflects a more dramatic mismatch associated with the lack of jobs. Sometimes workers are willing to work, are in the right place, and have the required skills, but the jobs are just not available.

This reflects collective risks associated with business cycle downturns, financial or commodity market shocks, and social priorities such as the decision to pursue free trade or to fight inflation notwithstanding the broad-based job destruction or slower job growth that results for a period.

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

Whatever the contribution level, employers and employees prefer stable rates. It is a misguided application of insurance principles to finance all of EI's risk exposure through individual contributions.

Miles Corak is Professor of Economics with the Graduate Center of the City University of New York, and was an Economist in Residence in 2017 at Employment and Social Development Canada. @MilesCorak.

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