

How Increases in EI Premiums Speed Up Deficit Reduction

The government's September "Update of Economic and Fiscal Projections" (Update) showed the deficit falling from this year's \$56 billion to only about \$5 billion in 2014/15. The government emphasized that it "will not raise taxes," and that it would "protect the growth track" of major transfers to persons and to other levels of government. However, what the government did not mention was that this pace of deficit reduction relies heavily on large increases in Employment Insurance (EI) revenues over the 2011-2014 period and these increases in EI revenues in turn rely heavily on increases in the rates charged to employees and employers for Employment Insurance. My September Special Issues paper pointed out the existence of these EI revenue increases, embedded in the Update, but receiving no profile whatsoever, either in the Update or the Finance Minister's presentation. The purpose of this present paper is to provide more quantitative detail on the size of these increases in EI revenues, the magnitude of the increases in EI rate premiums, the contribution of the premium increases to the EI surpluses and ultimately the role of these EI revenue increases in contributing to the path of deficit reduction reported in the Update. The paper closes with the strong policy recommendation that the EI premium rate not be increased over the current level.

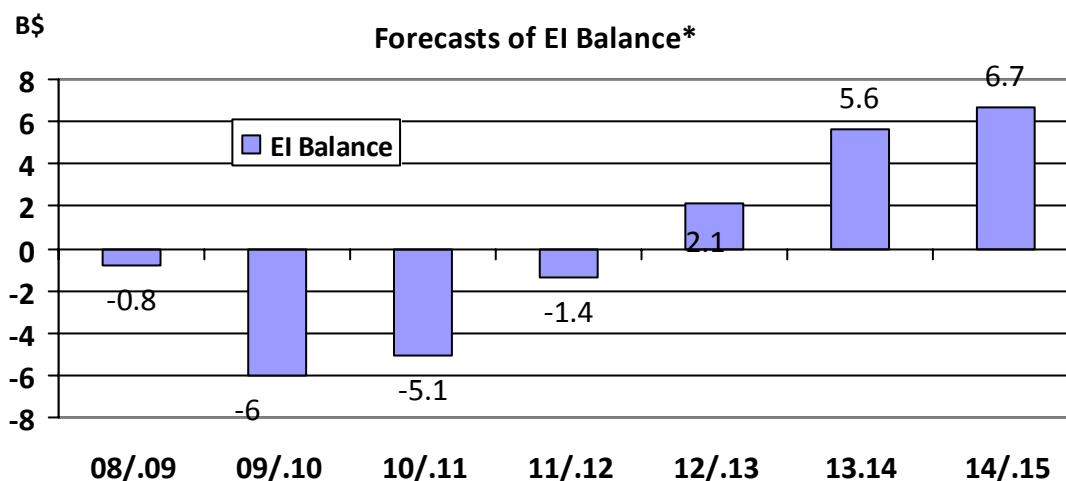
Both the government, as well as the Liberal opposition, say they place a high priority on eliminating the fiscal deficit and fundamentally will opt to "grow out" of the deficits, not relying heavily on tax increases or spending cuts to accelerate the date of deficit elimination. The differences in approach to deficit elimination between the major political parties, therefore, seem to be relegated to fine tuning. The Liberals have not provided much quantitative detail on their approach to deficit elimination, but Mr. Ignatieff's speech of September 21 did say "we need to have an actual discussion about EI premiums..." It is distinctly possible the issue EI premiums and their contribution to the pace of deficit reduction will be a high profile and contentious issue in the coming months.

How Large Does the EI Surplus Get?

The government's Update reports the EI revenues (Table 5) as a component of federal revenues and EI Benefits (Table 6) as a component of Program Spending. From the data in the Update it is obvious that EI revenues will fall significantly short of EI Benefits during the recession of 2009 and 2010, but the balance turns positive and grows sharply from 2011/12 thru 2014/15.

The Canada Insurance Financing Board (EI Board) is responsible for setting EI rates that “ensure that revenues and expenditures break even over time.” The definitions that the EI Board uses to define “balance” in the EI account require several important adjustment's from the data in the Update. For example, the EI Board operates on a calendar year, unlike the federal budget's fiscal year. The EI Board includes some imputed revenues not in the Update and some administrative expenses not included in the Update. As well, the enhancements to EI benefits that were part of the Budget 2009 stimulus package are not to be recovered. However, with some work at a detailed level, the EI balance, roughly consistent with the data in the Update, can be estimated.

Chart 1



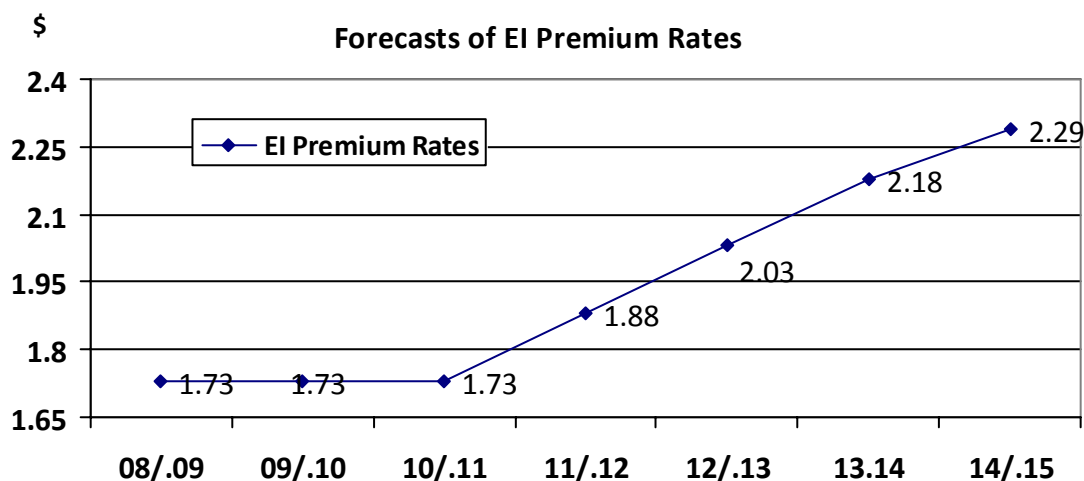
**To make a rough adjustment from the EI rates set on a calendar year basis to the data in the Update on a fiscal year basis, I assume the EI deficit for 2008/09 is entirely due to 2009 Q1.*

When we adjust the EI revenues and benefits to define the EI balance as the EI Board defines it, it appears an EI deficit of just over \$13 billion (on an annual basis) is incurred over the recession (slightly more if calculated on a quarterly basis). Note the weakness in the labor market began in the fourth quarter of 2008 and will not abate until early 2011. Over the 2012/13 through 2014/15 recovery period EI revenues (as defined by the EI Board) will be positive and growing strongly from the \$20 billion level to the \$26 billion level. Over this period EI benefits will be fairly stable in the \$20 billion level. Over the 2012/13 through 2014/15 period an EI surplus of just over \$14 billion will be accumulated. Therefore it appears the EI account will be approximately in balance cumulatively over the 2008/09 through 2014/15 period. This is consistent with current EI policy to have the EI account “break even over time.” Therefore the assumptions underlying the estimates of EI revenues in the Update appear to be reasonable assumptions for the Finance Department to make.

What Increases in EI Premiums are Assumed in the Update?

In Budget 2009 the government froze EI premiums at \$1.73 through 2010. It is consistent with the policy of the EI Board to increase rates up to a cap of 15 cents per year to recover the deficit in the EI balance incurred over the 2009 and 2010 recession years. From the data in the Update it appears this is the assumption which has been made to generate the reported EI revenues.

Chart 2



**To make a rough adjustment from the EI rates set on a calendar year basis to the data in the Update on a fiscal year basis, I assume the EI rate is set at \$2.33 for 2014 but lowered to \$2.18 for 2015, yielding an average rate for 2014/15 of \$2.29.*

That is, in 2014 EI premium rates will be \$2.33 compared to the \$1.73 currently. I assume rates will be dropped as much as the cap allows, to \$2.18 for 2015, yielding an average rate of \$2.29 for 2014/15. This rate of increase would also apply to employer's premiums.

How Important are Rate Increases Relative to Employment Growth and Other Reasons in Explaining EI Revenue Growth?

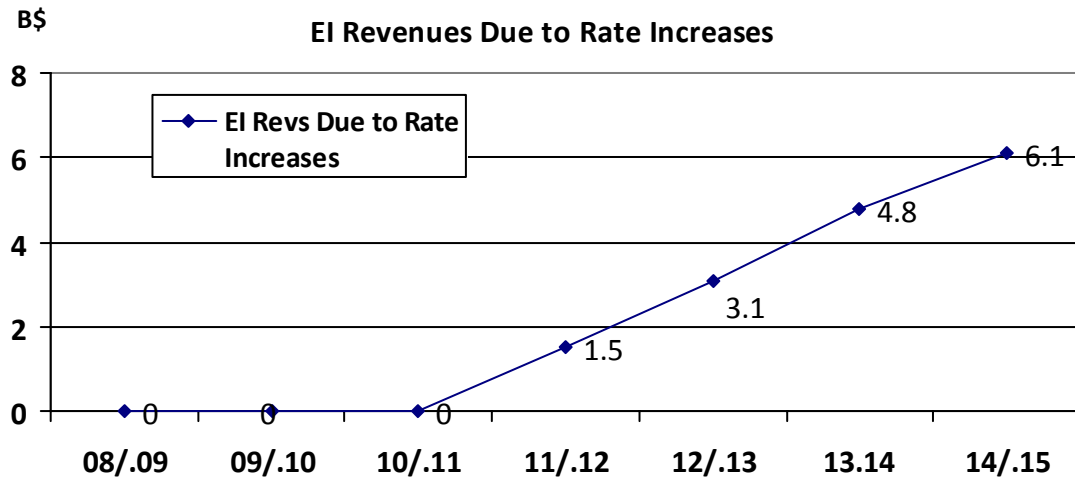
I next forecast the amount of EI premium revenue collected due to the increases in EI premiums over the current \$1.73 level. The \$1.73 EI premium rate is the rate per \$100 of earnings levied on worker's paychecks up to an earnings threshold (\$42.3 k. per year in 2009). This level is subject to increase as average earnings of workers increase over time. The amount levied on employers is 1.4 times the rate levied on workers. (No theory here, this is just the policy).

EI premium revenue would increase over this 2012 – 2015 period, even at constant EI premium rates, due to the growing level of employment over this recovery period as well as increases in the threshold level of income upon which EI premiums are collected.

I estimate that the increases in EI premiums over the current level will generate increasing amounts of revenue after 2010, beginning with about \$1.5 billion in 2011/12, and growing to over \$6 billion in 2014/15. These annual amounts accumulate to over \$15 billion ($1.5+3.1+4.8+6.1=15.5$) over this period. Note that the cumulative annual growth of EI revenues for all reasons combined over the 2011/12 through 2014/15 period is about \$24 billion. Therefore, of the cumulative growth in EI revenues over this recovery period, \$15.5 billion of the \$24 (or about 64%) can be attributed to the increases in EI premiums over the current level.

The increases in EI revenues due to employment growth are small, but growing over this same period. They are under \$1 billion in 2011/12 and reach about \$1.5 billion by 2014/15. They accumulate to less than \$4 billion over the 2011/12 – 2014/15 period, compared to the \$15.5 billion attributed above to increases in EI premiums.

Chart 3



The level of employment is forecast to increase from about 17 million in 2010 to just over 18 million in 2014, an increase of only about 7%. In the Update EI premium revenues are forecast to increase more than 50% from \$17.2 billion in 2010/11 to \$26.1 billion in 2014/15. Obviously, increases in employment growth of 7% are not a major contributor to the 50% increase in EI revenues planned for in the Update. They account for about 14% of the increase in EI revenues over the 2011/12 through 2014/15 period.

About \$5 billion cumulatively is attributed to factors other than the EI premium increases and increases in employment growth. Within this “other” category would be the incremental EI revenues from the annual increases in the threshold income level over which EI premiums are collected, as well as changes in the composition of the labor market.

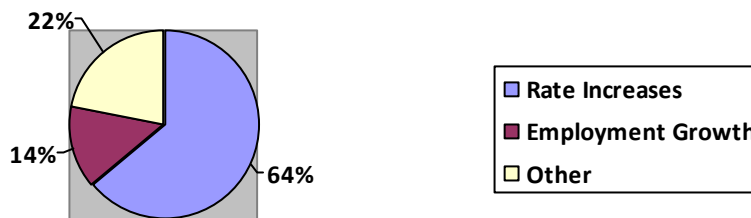
The increases in the amount of income earned annually upon which EI premiums are collected is indexed to the average weekly earnings and can generally be expected to increase about 3% per year. This threshold increased 2.9% in 2009 and required most workers to pay about \$20 more in EI premiums in 2009 than in 2008. Some would also consider this increase in EI premiums deducted from their paycheck to be a tax increase.

I estimate this annual increase in the threshold to increase the government’s collection of EI revenues by about \$0.5 billion per year. If the threshold were frozen at the 2009 level, rather than increasing by an additional 3%

every year over the 2011/12 – 2014/15 period, the government would collect about \$2 billion less in EI revenues. Therefore this (some would say) other form of tax increase currently embedded within EI policy could account for about \$ 2 billion of this \$5 billion in “other” reasons for the increase in EI revenue collections.

Chart 4

Reasons for Growth in EI Revenues Over Recovery Period



Therefore, of the about \$24 billion cumulatively which total EI revenues grow over the 2011/12 – 2014/15 period inclusive, about \$15.5 billion (or 64%) are due to increases in EI premium rates over the current level, about \$4 billion (or 14%) to employment growth and about \$5 billion (22%) to other factors.

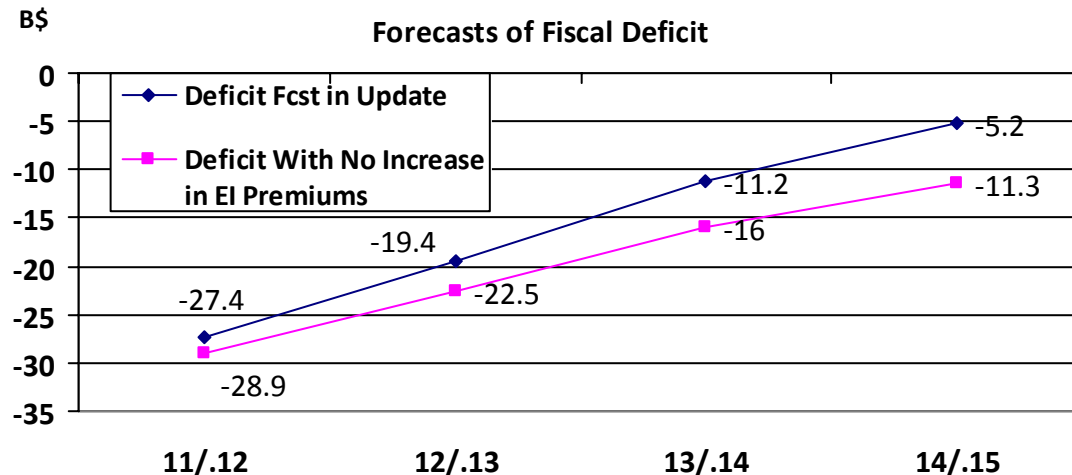
Role of the Increases in EI Premium Rates in Fiscal Deficit Reduction

In their September 10 Update the government forecast a fiscal deficit of \$27.4 billion in 2011/12, with that deficit falling to about \$5 billion in 2014/15. If EI premiums were kept at their current level of \$1.73, as opposed to increasing from \$1.73 to \$2.29 over the 2011/12 – 2014/15 period, we can estimate the impact of this potential loss in EI premium revenue on total government revenues and the resultant fiscal deficit.

Over the longer term, increases in EI premiums provide a disincentive to work. So over the longer term, a slight downward adjustment in the forecast level of employment may be in order. Since we are dealing with short term impacts here, and to keep things simple, we assume that the relationship between a loss of EI revenue and the fiscal deficit is dollar for dollar. These assumptions and this analysis is similar to that of the government’s Update

which shows the impact of the declining EI revenues and increasing EI benefits of 2009 on the forecast fiscal deficit for this year.

Chart 5



Above we estimated that the increase in EI premiums from \$1.73 to \$1.88 in 2011/12 would bring in about \$1.5 billion in extra revenue to the government. Therefore, if EI premiums were instead kept at \$1.73, the loss of about \$1.5 billion in revenue would cause that year's fiscal deficit to be about \$1.5 billion higher, at about \$28.9 billion, as opposed to the forecast of \$27.4 billion in the Update. Likewise in 2014/15, we estimated that the increase in EI premiums from \$1.73 to \$2.29 in 2014/15 would bring in about \$6.1 billion in extra revenue to the government. Therefore, if EI premiums were instead kept at \$1.73, the loss of about \$6 billion in revenue would cause that year's fiscal deficit to be about \$6 billion higher, at about \$11.3 billion, as opposed to the forecast of \$5.2 billion in the Update.

The government left us with an estimate of a fiscal deficit falling at a pace of about \$6 billion per year, down to the \$5 billion level by 2014/15. They did not however, show a date for deficit elimination. They emphasized their commitment to return to balanced budgets "in due course" and "over the medium term." Reasonable assumptions for revenues and a continuation of the 3% pace of program spending leads to an estimated surplus of \$1 billion in 2015/16. That is, deficit elimination could come in 2015/16, extending the assumptions of the Update into that year.

On the basis of the analysis in this paper, if EI rates were frozen at the \$1.73 level over the 2011 – 2015 period, as opposed to increasing as assumed in the Update, the deficit would be about \$11 billion rather than only about \$5 billion in 2014/15. With the deficit declining by about \$5 billion per year, it appears that if the government froze EI premium rates at the current \$1.73 level, the date for deficit elimination would be pushed out about another 2 years, that is, to 2017/18.

Policy Recommendations

The increases in EI premiums from the current \$1.73 level to a peak of \$2.33 in 2014, which underly the forecasts for EI Revenues in the government's Update, are consistent with the current policy for EI. Increasing premiums on this schedule does ensure that revenues and expenditures break even over time, consistent with the mandate of the EI Board. If the government were to extend the freeze of EI premiums through 2015 the fiscal deficit would not be eliminated until about 2 years later. The government clearly and wisely places a high priority on deficit elimination. However, a policy choice must be made with respect to whether this planned increase in EI premiums is a wise trade-off for the 2 year acceleration in the date of deficit elimination which it finances.

While the EI Board is responsible for “implementing an improved EI rate setting mechanism” the government can usurp that responsibility and determine EI premium rates. That is precisely what the government did in Budget 2009, freezing EI premium rates for 2009 and 2010. It therefore is reasonable to conclude that, if there is a political will to extend the freeze on EI premiums through 2015, that is within the government's discretion. In Budget 2009 the government also instructed the EI Board not to recover the enhanced EI benefits included in the stimulus plan. Therefore, apparently, the government can also modify the character and pace of the EI Board's mandate to balance EI “over time.”

There are several arguments why the government should extend the freeze on EI premiums through 2015. Most important, while economic output is expected to have completed the recovery phase by 2015, labor markets will be lagging behind. I, along with most other economists, forecast that the unemployment rate will not fall back down to the pre-recession level much before 2015.

Second, the government has stated that they would not move up the pace of deficit elimination through tax increases. However, substantively, an increase in EI premiums is a tax increase. From the economic performance perspective EI premiums are a tax. From the economic performance perspective, it is not relevant that this “tax” may be implemented by the EI Board rather than directly by the Finance Minister, nor that this “tax” increase is consistent with the mandate of this Board. An increase in EI premiums, from the employees’ perspective, is a tax on working. From the employer’s perspective, EI premiums are a tax on hiring. Over the longer term, higher EI premiums lead to a level of employment lower than otherwise. An increase in EI premiums is not only one of the most economically harmful taxes, it is also one of the most perverse. It affects lower income workers relatively more heavily than higher paid workers since EI premiums are not collected on earnings over a threshold.

Third, I agree with the principle of balancing the EI revenues and benefits “over time.” There can, and there should be, a serious debate about what the optimum time frame, under these conditions ought to be. I do not believe the time frame should be defined so short that it requires a significant increase in EI premiums.

Speedy deficit elimination must be given a high priority. Eschewing both tax increases and significant program spending reductions, relying instead almost entirely on economic growth to “grow out” of deficit, is a risky option. A spike in interest rates, a dip in economic growth and/or pressure on program spending can knock us off schedule while we are waiting for economic growth to grow us out of deficit. From the Update it is clear the government does not plan to eliminate the deficit before 2015/16. However, if the government decides that the deficit must be eliminated by 2015/16, then, I recommend they temporarily increase the GST rather than raising EI premiums.

If the GST were increased from the current 5% rate to 6% in 2014/15, that would bring in almost another \$7 billion. With the GST increase and EI rates held at \$1.73, then the deficit in 2014/15 would be about \$4 billion rather than \$11 billion without the GST increase. From this deficit of \$4 billion in 2014/15, with the GST increase bringing in an additional \$7 billion per year, we could expect deficit elimination the next year, in 2015/16. Going forward beyond 2016, we could then eliminate the temporary GST increase, moving it back down to 5% in 2017. This temporary (2 year) increase in the GST

would be much less harmful to economic growth than the increase in EI premiums. However, an increase in the GST has its own indirect disincentives to work as well as to invest.

If the government is going to accelerate deficit elimination by a tax increase, better to impose a temporary increase in the GST than an increase in EI premiums, as is now implicit in their Update. There is no painless way out of this fiscal dilemma.