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A Literature Review of Experience-Rating Employment Insurance in Canada

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Introduction

As one of Canada's most important income security programs, the Employment Insurance (EI) program receives a considerable amount of scrutiny regarding its fiscal prudence. Introduced in the 1940s on fairly strict insurance-based principles (excluding, for instance, workers who were at high risk of unemployment), the program has undergone considerable change over the years in a way that some would claim has left those principles behind. As a result, there have been repeated calls throughout EI's history to return the program to what its framers had originally intended. Numerous critics have argued that introducing experience rating in the way the EI program determines premium levels for firms could make the program more insurance-based. Many analysts wonder why such a premium-setting regime has never been adopted by Canada despite the fact that it is a key feature of American unemployment insurance (UI) programs and of Canadian Workers' Compensation (WC) programs.

The debate on experience rating is rooted in the observed change in behaviour by firms and employees induced by the existence of unemployment insurance. Like other social programs, EI creates incentives or disincentives that may not lead to desirable social or economic outcomes. It is often argued that more generous benefits can result in longer and more frequent unemployment spells. The program also has an impact on firms' layoff decisions: When facing a decline in the demand for their product, firms will more likely lay off workers if they are eligible to receive unemployment benefits rather than engage in other workplace practices such as adjusting their employees' working schedules. Many argue that the introduction of experience rating would correct the adverse effects of EI, as it would more accurately reflect the cost of layoffs and unemployment.

Experience rating in the context of unemployment insurance can take a variety of forms. The most common method is to adjust employers' premiums according to their ex-employees' reliance on benefits, a method that is most commonly found in systems where all premiums are assessed to employers. As the most common form of experience rating, it therefore receives the most attention in the literature.

A less prevalent method is to experience-rate benefits, a method that has been a part of the Canadian EI program at different points in time over the past 25 years. It has also been an approach utilized by other countries such as Italy and Norway (see Organisation for Economic Co-operation and Development, 2002). Another option is to adjust employers' premium levels according to their human resource practices as opposed to their employees' receipt of benefits. This type of experience rating can already be found within the EI program, whereby firms can receive premium reductions if they provide a short-term disability insurance program for their employees.

In this paper, we survey the literature on experience-rating unemployment insurance programs. We review the theoretical and empirical research on the topic, summarizing the rationale for and against experience rating at both the claimant and firm level. Throughout, we will identify lessons learned and key considerations for implementing experience rating within the EI program. We conclude by identifying avenues for further research in order to inform analysts and policy-makers on possible future directions for the EI program.

Rationale for Experience Rating

The American experience with experience rating has often been touted as a rationale for implementing a similar rate-setting regime within the Canadian program. While the Canadian Employment Insurance (EI) program has never had employer-side experience rating, the US has extensive experience with this system of financing unemployment insurance (UI) premiums. Since UI is administered at the state level, the way in which experience rating is applied varies from state to state. Most states use what is termed a *reserve ratio*, where premiums to be paid are calculated on the difference between contributions paid by the firm and benefits received by its employees, divided by the firm's payroll. Other states use a *benefit ratio*, where average benefits paid to a firm's employees are compared with their average taxable wages. Under either system, UI premiums fluctuate according to the rise and fall of the ratio. Since the ratios are not based on the past year but on longer time periods, firms' contributions to the UI fund do not immediately reflect a change in the level of benefits paid to a firm's employees. For this reason, and because each system incorporates premium maxima and minima, the US regime is considered to be partially, as opposed to fully, experience-rated.

There are other key differences between the Canadian and American unemployment insurance regimes, apart from the fact that the EI program does not experience-rate EI premiums. For instance, UI in the US is administered at the state level, and benefits are considerably less generous both in terms of maximum benefits paid and the number of benefit weeks available (in most states, benefits can be paid for a maximum of 26 weeks). As well, only employers pay UI premiums.[1] These differences, in addition to differing social and economic policy environments within the two countries, complicate direct comparisons between the two regimes.

The US experience is the basis for most of the empirical evidence of the impact of experience rating on labour market behaviour. The arguments for experience rating in the economic literature — both empirical and theoretical—are often predicated on the assumption that UI induces firms to respond to fluctuations in their business environment by engaging in temporary layoffs, rather than other business practices such as making adjustments to employees' wages or hours of work. Economists argue that without experience rating, UI induces cross-subsidization between firms, with some firms consistently paying more premiums than their workers receive in benefits while other firms' workers receive more in benefits than the amount of premiums that they pay each year.

In addition to acting as a disincentive for firms to engage in temporary layoffs, experience rating is perceived to allow product prices to reflect better the actual costs of production by directly charging the cost of temporary layoffs to firms who engage in them. Early analyses such as those of Becker (1972, 1981) suggest that a non-experience-rated system leads to artificially low product prices, high real wages, and overproduction in industries that are subsidized by the unemployment insurance system. At the macroeconomic

[1]Three states require minimal employee contributions.

level, experience rating is perceived to engender greater economic stabilization by encouraging firms to stabilize their employment levels, which complements the stabilizing impact that UI benefits have during times of economic contraction.

Among the first major contributions to the literature on experience rating in the context of UI, Feldstein (1976) offers a framework to analyze temporary layoffs (as opposed to permanent separations) that had been previously disregarded in the literature. Prior to this study, unemployment spells had been typically assumed to be the result of involuntary job separations. Feldstein instead considers the scenario where workers are attached to the firm and do not find employment elsewhere when laid off as they expect to be recalled by the same employer. Under this model, layoffs are "the result of explicit or implicit voluntary agreements" (p. 938) between firms and their employees. Unemployment insurance subsidizes layoffs by reducing their cost and thus, increases the number of layoffs that occur. Experience rating of premiums would eliminate subsidies and therefore eliminate distortions within the UI program.

One weakness of the model used by Feldstein is that it assumes that workers are permanently attached to a firm and that unemployment is caused only by temporary layoffs. However, there are other forms of unemployment and it would be very difficult, if not infeasible, to design a scheme that would separate the workers who are temporarily laid off from the rest of the unemployed. Hence experience rating may not be desirable in a real-world setting.

Although Feldstein's analysis provides support for the introduction of experience rating, it also suggests that experience rating would counterbalance UI disincentives only if it was fully, rather than partially, implemented. Under a fully experience-rated system, firms are required to incur the cost of benefits paid to a laid-off worker through higher premiums. Under a partially or incompletely experience-rated system, such as American UI programs, firms pay a tax in proportion to the UI benefits their unemployed workers receive but the tax rate fluctuates between a minimum and a maximum threshold. Under this system, the full impact of experience rating is limited in the following way: firms that often lay off workers hit the maximum rate and do not pay more for additional layoffs while firms that never lay off workers will continue to contribute to the UI fund at the minimum rate, even if none of their workers ever claim UI. Hence the intended effects of experience rating are potentially lost for firms at either end of the rate spectrum.

Empirical research since Feldstein has supported his theoretical claims to some extent. For instance, Kesselman (1983) finds that American states with the smallest degree of experience rating of UI premiums exhibit the most unstable, seasonal employment and that the capping of experience rating in some state programs is found to increase unemployment by a small yet significant amount. Topel (1983, 1984) shows that implicit subsidies that result from imperfectly experience-rated programs tend to increase temporary layoffs. However, the same is not true for the benefit level's impact on layoffs. When the analysis is extended to permanent layoffs, experience rating is found to have little impact. More recently, Anderson and Meyer (1993) also posit that the impact of less-than-complete experience rating on temporary layoffs is not clear. Their survey of UI programs in the US shows that most unemployment insurance receipt can be attributed to firms who pay only a part of their employees' UI receipt. Due to weak experience rating, industries such as construction, manufacturing, and mining consistently receive subsidies through UI. Given the states' methods for calculating premiums, a large fraction of UI benefits do not get charged back to firms responsible for the layoffs.

No matter how perfect the rating may be, research has shown that the way experience rating is applied can also impact on its success in engendering greater economic efficiency. In their examination of US data, Cremieux and Van Audenrode (1996) show both theoretically and empirically that a system where *future* UI premiums are based on *past* UI reliance may lead to higher layoffs than systems with no experience rating at all. They obtain this counterintuitive result "due to the implementation of experience rating as a tax on the remaining workforce rather than a tax on layoffs as it has been modeled in previous research and to the imperfect nature of that experience rating system" (p. 15). In other words, any increase in premium levels can limit the firm's ability to maintain its workforce, thus leading to even further layoffs. This research cautions that the introduction of experience rating might have the unintended consequence of higher unemployment.

Another unintended outcome from experience-rating employers' premiums is that it can impact workers both in terms of their earnings and their access to UI benefits. Facing higher premium rates, employers tend to pay their workers less and to challenge their claims for benefits under an experience-rated system. In 1984 Washington State was required by US federal law to switch from a payroll tax system to an experience-rated system, providing researchers with a natural experiment to gauge the impact of experience rating on workers and firms' behaviour.[2] Anderson and Meyer (2000) compare the experience of Washington State before and after the 1985 change with that of other states and find that, overall, experience rating does in fact reduce turnover and UI claims. However, consistent with economic theory, higher premiums are largely (yet not completely) passed on to workers in the form of reduced earnings. As well, experience rating is found to limit workers' access to benefits since the number of UI claim denials increased between 51 to 66 per cent, depending on the year.

More recent theoretical research has been inconsistent with respect to its conclusions on experience rating. On the one hand, Albrecht and Vroman (1999) find that experience rating is favourable to employment, wages, and production for any level of unemployment benefits.[3] In a system without experience rating, the more generous the UI benefits the less incentive workers have to seek re-employment, thus leading to higher unemployment and longer unemployment spells. By increasing separation costs, experience rating can induce firms to pay higher wages in order to make employment more attractive than becoming unemployed and receiving UI benefits. Similarly, Cahuc and Malherbet (2004) find that experience rating is likely to reduce unemployment and to improve labour market efficiency among low-skilled workers in France and Continental European labour markets based on an equilibrium search and matching model that incorporates firing costs, temporary jobs, and a minimum wage.

On the other hand, the series of papers by Mortensen and Pissarides (1994), Millard and Mortensen (1997), and Mortensen and Pissarides (1999a, 1999b) show that while the

[2]Between 1972 and 1984, UI was not experience-rated in Washington State. Anderson and Meyer explain, "state legislation would have brought back experience rating if the state UI fund balance reached a high level, this event was not expected to occur in the foreseeable future" (p. 84).

[3]Albrecht and Vroman's analysis compares two self-financing unemployment compensation systems, one that finances benefits through a proportional payroll tax and another that taxes firms in proportion to their layoffs.

decrease in the payroll tax is usually beneficial to employment, the increase in firing costs implied by an experience-rated system has an ambiguous impact on unemployment as it reduces layoffs but also job creation. Millard and Mortensen (1997) use a matching model and find that an increase in experience rating has exactly the same effect on unemployment as a rise in firing costs.[4] Mongrain and Roberts (2003) model an environment with publicly provided unemployment insurance and privately supplied severance payments. They find that incomplete information mitigates the positive impacts of experience rating as it leads to a labour market with higher unemployment and incomplete private insurance against unemployment. One concern about experience rating is that higher premiums may lead to a higher bankruptcy rate. To examine this issue, Fuest and Huber (2003) compare the impact of experience rating in a centralized system or a regionally differentiated system. They find that experience rating may lead to additional bankruptcies in a centralized system, which in turn contributes to higher unemployment.[5]

[4]It should be noted that the authors do not explicitly introduce a balanced budget for the unemployment benefit system, and that doing so would magnify the decrease in unemployment due to experience rating, since the payroll tax should be reduced by the increase in the experience rating.

[5]This finding is relevant to the Canadian EI regime since it is a centralized system that differentiates benefits according to regional unemployment rates.

Experience Rating in Workers' Compensation

An oft-cited justification for introducing experience rating is its successful implementation within the context of Workers' Compensation (WC), one Canadian program that has an extensive history with experience rating. Unlike Employment Insurance (EI), WC is administered at the provincial level with separate rules for each province. In the context of WC, firms and industries that have more accidents or higher accident costs are required to pay higher premium rates.

The extent to which firms pay different WC premiums varies from province to province. In some cases, firms pay a higher, personalized premium rate based on their experience over the preceding rate period. In other cases, firms pay the same premiums up front but then receive refunds or surcharges depending on the claims that accumulate over the subsequent premium-rating period. Within each of these types of programs, the method for determining premiums also varies: rates can be based on the monetary costs of workplace accidents, the frequency or number of claims, or both.[6]

Of interest to researchers is that the number of workers' compensation claims has steadily decreased in many WC programs on both sides of the Canada–United States border over the past two decades, which has in large part been attributed to the implementation of experience rating. Experience rating in the context of WC is designed to encourage firms to adopt practices that will reduce their accident record, insofar as their accident record influences their premium rates. Under this system, firms can avoid a penalty by preventing accidents as well as minimizing accident costs when they occur, such as increasing worker protection, retraining, and job reorganization following an accident.

Early research by Ruser (1985) finds that experience-rating WC premiums is an important incentive for firms to invest in safety measures. In their review of the literature on experience-rating WC, Hyatt and Kralj (1995) observe that despite this effect, there is a lack of empirical support for the impact of experience rating on reducing the number of workplace accidents. By way of explanation, they point to studies that show that the indirect costs of accidents, such as lost productivity, are much greater incentives to firms than the marginal cost to their premium rates. They conclude, however, that the financial incentives of experience rating "may still be sufficient to cause employers on the margin to invest in safety to reduce workers' compensation costs" (p. 99).

One of the ways that firms can respond to higher premium rates is to challenge claims made by their employees. This is one area of research that has received little attention in the literature, as most studies have focused on the impact of experience rating on workplace injuries. While some may argue that challenging claims is a negative secondary effect of experience rating since it may result in legitimate claims being denied, it may improve the accuracy of claims since employers have an incentive to oppose any illegitimate claims. Using data from Ontario, Hyatt and Kralj (1995) model the decision to appeal a claim in order to estimate the impact of experience rating on that decision. They find that experience-

[6]That is, not to mention the myriad other minor premium adjustment allowances that each program can include.

rated employers are more likely to appeal injury claims and that the effect is greater for larger rather than smaller firms. They do not address, however, whether the appeal activity is at an optimal level in terms of firms challenging legitimate as opposed to illegitimate claims.

The literature examining experience rating in the context of WC programs is relevant for any discussion on the relative merits of introducing a similar rate-setting regime within the EI program, particularly since the WC experience is often held up as evidence for the success of experience rating at altering employer behaviour. While it would appear that experience rating does have an impact on the behaviour of firms, namely on the extent to which they implement safety measures and appeal claims, the literature is not conclusive on the role of experience rating in the observed reduction of WC claims in recent years. For instance, employers can have greater incentive to change their practices due to the other financial costs of losing an employee to injury, such as the loss in productivity, rather than to any increases to their premium rates due to workplace accidents. Applying this lesson to the EI program begs the question as to whether the impact of experience rating on EI premiums, which can represent a small share of all payroll taxes, will represent a strong enough incentive for firms to change their human resource practices.

A Historical Perspective on the Canadian Experience

The funding of the original Unemployment Insurance (UI) program was designed to have employers and employees financing the program equally, with lower-paid workers contributing a smaller share and higher-paid workers contributing a greater share than their employers in a way that made both parties' aggregate contributions equal. However, this financing scheme changed along with other amendments to the program over time. For instance, employers began to bear a larger share of all premiums in 1971, and in the early 1990s the federal government withdrew its contribution. Currently employers contribute 7/12 of all premiums paid, with employees contributing the remaining share.[7] As of January 2004 employees pay $1.98 for every $100 of insurable earnings while employers pay $2.77 per $100 of insurable earnings (i.e. 1.4 times the employee's rate). Premiums are paid on earnings up to $39,000, and workers (but not their employers) receive a reimbursement of their premiums if their annual paid earnings fall below $2,000.

One of the most controversial aspects of the Employment Insurance (EI) program is the relationship that particular workers, firms, and industries have with it. While at different points in time the program has limited access to benefits among workers who had claimed benefits previously, the premiums paid by workers or their employers have never taken into account either party's history with the program. This lack of experience rating has been the source of much debate throughout the program's history, with proponents arguing that its inclusion would return the program to its original insurance principles.

Although premiums have never been experience-rated, the program has experimented with different methods to limit frequent and systematic recourse to benefits on the benefits' side. Just prior to the program's major expansion in 1971, the 1970 *White Paper on Unemployment Insurance* discussed the possibility of including experience rating within the context of a new financing scheme for the program (Human Resources and Skills Development Canada, 2004c). The paper argues that the successful implementation of experience rating in the United States was justification for introducing a similar system in Canada, and the relative merits and disadvantages are discussed as well as the opposition to such a scheme from employee- and employer-representative groups. The report notes that one challenge for implementing experience rating in Canada is the fact that it was funded not only by employers, but also their employees and the federal government at that time.

While experience rating was not included in the 1971 reforms, the *Comprehensive Review of the Unemployment Insurance Program in Canada*, published in 1977, gives further consideration to the White Paper's recommendations (Human Resources and Skills Development Canada, 2004a). This study, the first major empirical assessment of the impact of UI on the labour market, claimant behaviour, and the economy in the post-1971 reform era, notes that introducing experience rating would require costly administrative arrangements beyond any advantages it would afford. Instead, the review recommends that

[7]As explained in *Beyond Bill C-2: A Review of Other Proposals to Reform Employment Insurance*, it has been argued that "the reason for this higher rate is that employers have greater control over layoffs and, in this event, should bear a higher overall share of program costs" (House of Commons, 2001).

attention should be focused on benefit restructuring. These recommendations led to the introduction of amendments in 1978 that included a special entrance requirement for frequent claimants. Under Bill C-14, any claimants who were not living in high unemployment regions and who were receiving benefits over an extended period were required to work up to six weeks longer than other claimants before regaining eligibility for more benefits. This short-lived implementation of adjusting entrance requirements according to claimants' experience with the program reflects the Canadian inclination towards experience-rating benefits instead of premiums, an approach that would be revisited in later years.

The early and mid-1980s saw a number of reviews examining the UI program that discussed the relative merits of experience-rating premiums. The Royal Commission on the Economic Union and Development Prospects for Canada, chaired by Donald Macdonald, argued that while the UI program had been helpful to Canadians during the economic hardships of the early 1980s, it was contributing to a greater number of layoffs, longer unemployment spells, and increased instability in the job market, particularly in high unemployment regions (Human Resources and Development Canada, 2004b). Among its recommendations for rectifying the work disincentives within the program, the commission recommended that the program experience-rate employer premiums. Soon after, the newly elected Conservative government established the Commission of Inquiry on Unemployment Insurance (the Forget Commission). While it agreed with the Macdonald Report that the UI program system of benefits discouraged stable work patterns, it rejected the recommendation that these objectives be achieved through the introduction of experience rating.

In another comprehensive review of the UI program, the 1994 *Improving Social Security in Canada* (Government of Canada) criticizes the program for its high premiums, caseloads, and expenditures. The paper notes that 40 per cent of the caseload could be classified as frequent claimants, a figure that was double that from 10 years before. Its supplementary paper, *From Unemployment Insurance to Employment Insurance* (Government of Canada, 1994), reviews the evidence and arguments for and against experience rating (or what it referred to as "risk-based premium rates"). Noting research that shows that there existed a great deal of firm- and industry-level subsidization in Canada, the report, nevertheless, argues against premiums-based experience rating and instead emphasizes that the method for distributing benefits should be changed. The paper summarizes the arguments against experience rating, noting that it would likely increase administrative costs and complexity, limit the control employers have over their human resource needs, provide an ineffective behavioural disincentive due to the relatively small size of premiums compared with wages, and encourage employers to hire workers not covered by the program (for instance, part-time workers). As well, the paper expresses a concern that experience rating could have a negative impact on the profitability of Canadian businesses, particularly small businesses, as well as the Canadian economy as a whole.

Instead of experience-rating employers' premium rates, the paper recommends that experience rating be introduced on the benefits side, with frequent claimants receiving a reduced level of income support so that an expanded set of employment services could then be funded. Under this type of system, "experience rating would more directly address the real labour market adjustment needs of the individual" (Government of Canada, 1994, p. 85). On the employer side, the paper recommends the implementation of a program that would reduce premiums for employers who provide training to their employees — a system that is based on similar principles as experience rating. The targeted premium reductions “would help promote the development of a more skilled and, therefore, more adaptable workforce which would place less demands on the UI system” (p. 92).

In response to *Improving Social Security in Canada* (House, 1995), some critics argue that changing the benefit structure and instituting training incentives through reduced premiums should be complemented by the introduction of experience rating. For instance, Riddell (1995) argues that a non-experience-rated system “is equivalent to taxing firms that provide stable employment and subsidizing those that provide unstable employment” (p. 75). Based on prior research, Riddell posits that experience rating would yield major benefits to the Canadian economy and therefore was fundamental to the proposed changes to UI. However, others argue that the instability of employment patterns within some occupations and industries is often beyond the control of workers or their employers, and that those with stable employment patterns “should be willing to contribute to the support of those in less stable occupations” (House, 2003, p. 27). While there may be agreement that experience rating can lead to particular firms and industries paying a greater share of the costs of their layoff patterns, this debate reflects the lack of consensus regarding the fairness of making them do so.

The 1994 (Government of Canada) paper laid the groundwork for the extensive reforms of the UI program that culminated with the introduction of the Employment Insurance (EI) program in 1996. Included with the 1996 reforms was a form of experience rating, where claimants who had claimed EI frequently in the past five years would face a lower replacement rate under the “intensity rule” and face a more severe clawback schedule if their accumulated earnings and benefits exceeded a certain threshold in a given year — a threshold that was lower than that of regular claimants. However, these provisions were repealed in 2001, as they were believed to be ineffectual at reducing the share of frequent claims among all EI claims (Human Resources Development Canada, 2002, p. 13).

The Fortin and Van Audenrode (2000) paper appears to be the only empirical study focusing on the impact of experience rating on EI benefits following the reforms of 1996. Their study shows that, although not completely phased in, experience rating of benefits had some impact on the behaviour of claimants. Specifically, the intensity rule seemed to have shortened the duration of claims as claimants were found to terminate their claims just prior to the rule’s threshold. While the authors note that the reduction in claims’ durations was significant, the overall economic impact of the intensity rule was minimal. It also did not appear to reduce the number of claims made by frequent claimants. More recently, Nakamura and Diewert (2004) question the repeal of these measures that experience-rated frequent claimants’ benefits, arguing that they were in large part responsible for the EI fund surplus that grew substantially in the wake of the reforms.

Some Empirical Estimates for Canada

Given the theoretical arguments and the apparently positive experience of American unemployment insurance (UI) programs with experience rating, Canadian researchers have attempted to determine whether the Canadian Employment Insurance (EI) program would be well served by implementing a similar premium-setting regime. In an early study, Karagiannis (1986) investigates the impact of experience rating on the Canadian economy and estimates that, assuming experience-rating calculations would be based on industry averages, it would have a negative impact on real GNP and employment. It is important to stress that his analysis is based on short-term outcomes of the introduction of experience rating and does not offer a long-term view of how industries would adjust to experience rating.

Karagiannis (1986) argues that the fact that the Canadian industry composition differs from its southern neighbour would mitigate the positive impact of experience rating. The author explains that since the manufacturing and construction industries are key elements of growth in the Canadian economy but are also the main industries to be subsidized via the unemployment insurance program, imposing experience rating would have an adverse effect on these industries and consequently on the Canadian economy as a whole. While the service industry (which is a net contributor to the program) would benefit from experience rating by paying lower premiums, Karagiannis' results suggest that the growth in this industry would not be important enough to compensate for the loss in the industries of construction and manufacturing. Also, small firms would be greatly affected by experience rating, as they are net beneficiaries of the system.

In his argumentation, Karagiannis (1986) points out the potential weaknesses of partial experience rating. As mentioned earlier, firms that have already reached the maximum rate have no further disincentive to lay off more employees, as there will be no further impact on their rate. Under the assumption that small businesses account for an important share of UI benefits in Canada and that their survival rate may be lower than in the US, Karagiannis concludes that the share of benefits to be experience-rated will be smaller than that in the US.

It is often conjectured that the traditionally higher Canadian unemployment rate may partly be due to the fact that the UI program is not experience-rated in Canada and consequently Canadian firms lay off workers more easily than in the US. In the mid-90s, Beauséjour, Sheikh, and WIlliams (1995, 1998) investigated experience rating in the context of explaining unemployment rate differentials between the US and Canada. Using a general equilibrium model to quantify the economic effects of experience rating, the authors estimate that the non-experience rating of the UI program may indeed explain part of the differential between Canadian and American unemployment rates. According to their model, adopting experience rating would have a positive impact on economic growth and lead to reductions in unemployment. It should be noted, however, that the authors identify limitations in their model. For instance, it does not take into account the administrative cost and complexities of adopting experience rating and it ignores equity issues.

In their study, Betcherman and Leckie (1995) use employer survey data to model the impact of experience rating on the behaviour of Canadian firms. More specifically they investigate if experience rating has an impact on layoffs and training. The motivation for testing the impact of experience rating on training is based on the following argument: If experience rating induces a reduction in firms' labour turnover, it can be assumed that firms will be more likely to provide training to their workforce given its greater stability.

To conduct their analysis, Betcherman and Leckie (1995) survey a sample of firms located in Ontario in two industrial sectors (machinery manufacturing and metal product manufacturing). As there is not much variability in the Canadian UI program coverage due its lack of experience rating, the authors also survey firms located in some American states with different degrees of experience rating. Based on this rather restricted sample, they find that firms in Ontario have higher layoff rates compared with American firms. However, the results from the estimated models show that experience rating does not significantly deter firms to use layoffs when facing a decline in demand. As experience rating does not seem to have an impact on layoffs, it is not surprising to find that a more experience-rated UI regime does not lead to firms providing more training to their employees.[8]

[8]The survey also provides qualitative evidence of the impact of experience rating on firms' behaviour. Perhaps a little surprisingly, the authors find that, on the one hand, American firms do not consider the impact of experience rating on their premiums in their layoff decisions. On the other hand, "Ontario employers, faced with the theoretical notion of experience rating, evaluated it as a potentially much more important factor" (Betcherman & Leckie, 1995, p. 6).

Conclusion

> *A major obstacle to the adoption of ER [experience rating], though, has been the numerous misconceptions which surround the topic.* (Kesselman, 1983, p. xii)

When considering the relative merits of experience-rating the Employment Insurance (EI) program, it is important to consider the objectives of the program, particularly with respect to the provision of regular benefits to unemployed Canadians. First and foremost, EI's goal is to provide a partial replacement of earnings to Canadians who have lost their jobs through no fault of their own. Secondary objectives, whether intentional or unintentional, include helping claimants improve their employability through training and job-search assistance, stabilizing shocks to the economy during downturns in the labour market, and facilitating the distribution of income between regions and individuals.

Many have argued throughout the program's history that EI should meet its primary objective according to insurance principles: Higher premiums should be charged for those known to be at a systematically higher risk of unemployment. However, the extent to which EI conforms to insurance principles is confounded by its secondary objectives. As noted by the Organisation for Economic Co-operation and Development (OECD) (2003), "EI has moved well beyond providing income support during unexpected spells of unemployment and has become a major vehicle for delivering family, social and regional assistance" (p. 11). Therefore, the extent to which EI conforms to insurance principles needs to be balanced with the other objectives it is intended to achieve. While some may question their legitimacy, the secondary objectives of the EI program will influence the type of and extent to which experience rating will be implemented.

Despite the lack of compelling evidence for justifying experience rating in the context of the EI program, it is clear that there are both firms and individuals who continue to receive subsidies through the EI program. On the claimants' side, the EI program briefly flirted with benefits-side experience rating, whereby frequent claimants received fewer benefits or, if their income was high enough, faced a higher clawback rate at a lower threshold, depending on the number of years they received benefits. According to Nakamura and Diewert (2004), the unprecedented growth in the EI surplus following the introduction of these reforms "could be an indication that the benefit-side experience rating changes were effective in helping to correct, or reduce the costliness of, the repeat use problem" (p. 11). For this reason, the authors recommend reinstating a similar program in order to protect the long-term health of the EI program. This recommendation is echoed by the OECD (2003), which notes that:

> *Other aspects of the system also need to be improved. The qualification period is short by international standards, while variations in eligibility rules between high- and low-unemployment regions discourage internal labour mobility, leading to persistent differences in joblessness across the country and thus higher structural unemployment.* (p. 11)

On the firms' side, Corak and Chen (2003) show that a considerable number of firms persistently receive subsidies through the EI program. Examining the receipt of benefits by firms' employees compared with the premiums they paid into the program over the 1986 to 1996 period, they find that there are patterns in the subsidies received by certain firms. Their analysis shows that the major flow of funds is from the service industries toward the primary sector and construction and from Ontario towards Quebec and the Atlantic provinces.

These cross-subsidization patterns have often been interpreted as the result of regional labour market differences or some regions' disproportionate share of seasonal employment. However, the authors find that geography and industry are not as important in determining cross-subsidization as firm-specific factors. While it is not clear at this time what practices or characteristics are most important in determining whether a firm is a net contributor to or net beneficiary of the EI program, these results point to the need for greater research into understanding better the relationship between firms and the EI program. The results also suggest that if experience rating were to be adopted in Canada, it would need to account for the fact that there are substantial variations in firm behaviours within industries and regions, and that the common practice of setting premium rates according to industry averages will not account for the heterogeneity of firms within industries. In his advocacy for introducing experience rating in the EI program, Kesselman (2004) notes that an industry-based experience-rating system would be an interim measure at best, as it would not "achieve the additional gains of inducing individual employers to stabilize their employment" (p. 25).

There remains a third, and relatively unexplored, option for experience rating: giving firms' a financial incentive to change their human resource practices in the form of reduced premiums. This method has been a part of the EI program in a number of ways, most notably the EI Premium Reduction Program, which discounts firms' rates if they provide private disability insurance to their employees. While not tied to particular unemployment insurance outcomes, this type of experience rating could encourage best practices among firms to manage their human resources in a way that would lead to fewer layoffs and consequently less reliance on EI benefits by their employees. The exact practices that would be encouraged could be the subject of future research that could exploit newly available data sources on firm behaviour, such as Statistics Canada's Workplace and Employee Survey.

In reviewing the literature on experience rating, it would appear that there is a lack of clear evidence to show that such a system, if implemented in Canada, would address the persistent subsidies received by particular firms and workers through the EI program while reducing seasonality of employment and frequent claims for EI benefits. Despite this state of affairs, there are still calls for EI premiums to be experience-rated. However, given the number of challenges facing the EI program, experience rating needs to be evaluated relative to other policy options that may have a greater impact on boosting employment and lowering structural unemployment within the Canadian labour market.

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