

# UNEMPLOYMENT INSURANCE REFORM IN ATLANTIC CANADA

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Laws are rules, regulations or principles which apply to a community and which are enforced by the authority of the community. In a community that embraces liberal democratic traditions, one might expect that these rules would be generally consistent with the values of the majority of the citizens of that community.

In Atlantic Canada, the lives of several hundred thousand people are affected directly by the laws and regulations of the *Unemployment Insurance Act*.<sup>1</sup> Unemployment insurance benefits are a major, and often primary, source of income for many families, especially those living in rural areas. The relative importance of the unemployment insurance program has been such as to transform the very nature of economic activity in Atlantic Canada, and the culture of the region. In spite of the apparent economic benefits accorded to those receiving unemployment insurance, the program has come under strong criticism. One such criticism, perhaps the strongest to date, came in the *Final Report* of the Newfoundland Royal Commission on Employment and Unemployment (the House Commission). The basis of the House Commission's criticism was that the rules and regulations of the *Unemployment Insurance Act*, in their application, were such as to undermine fundamental values and principles of the community. The *Final Report* states: "a fundamental revision of the income security system in Newfoundland must be undertaken ... as a prerequisite to new initiatives for long-term economic development and employment."<sup>2</sup>

The purpose of this essay is to examine the process of institutional reform and to query whether or not laws act as a barrier or a catalyst to institutional change. The approach of the essay is to use the *Unemployment Insurance Act* and its administrative regulations as a case study. Specifically, the essay will seek to answer the question of why the process of reforming the *Unemployment Insurance Act* has been so difficult, even though the application of the Act appears to violate principles and encourage behaviour that Atlantic Canadian society, in general, does not accept. In order to understand the process of regulatory change, the essay will use some of the analytical framework from microeconomics as it relates to institutions and optimal resource usage.

Nowhere has the influence of the *Unemployment Insurance Act* been more

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<sup>1</sup>R.S.C. 1985, c. U-1.

<sup>2</sup>Royal Commission on Employment and Unemployment, *Final Report: Building on Our Strengths* (St. John's, 1986) at 410.

strongly felt than in Atlantic Canada. In the rural areas of Newfoundland, unemployment insurance benefits account for more than 40% of average personal incomes. The community structure and the activities of individuals are centred around obtaining UI payments. Seasonal occupations are viable because of the unemployment insurance system. Unlike their urban counterparts, many rural UI recipients "work" while receiving UI benefits, that is, they engage in productive activities rather than leisure. These unpaid activities would include such things as house-building, boat and equipment repair, or child care.

The UI program influences not only the individual, but also the region. For example, the population of the region would be smaller if, in the absence of UI, families were forced to migrate in order to achieve the same standard of living. The unemployment insurance program has been institutionalized; it has modified the behaviour of the citizens in many parts of our region to such an extent as to change the economic patterns of behaviour, culture, and even ethical standards.

For the Newfoundland provincial government, UI is an indirect and important source of revenue. In 1991, the UI program brought net transfers into the Newfoundland economy of some \$850 million. From 1980 to 1991, UI payments represented the single most important source of growing real income for the province. While the real output of the province has virtually remained stagnant during the past 12 years, unemployment insurance benefits have prevented the standard of living of the populace from falling.<sup>3</sup>

By the end of the 19th century, it was generally accepted that market-driven industrialized economies could produce relatively high standards of living for a large portion of the citizenry. It was also observed that economic growth in these economies was not a smooth path, but one that was subject to fluctuations. During downturns in the level of economic activity, many people found themselves unemployed. Without employment income, the hardship suffered by families was often severe. In response to these circumstances Chancellor Bismark of Germany, in 1898, suggested that unemployment insurance be provided to workers, with the intent of helping to maintain income levels during recessions or depressions.

In Canada, a program of social insurance for unemployed workers was initially proposed by the Royal Commission on Industrial Relations in 1919. However, the need for such a program was not generally accepted until the Great Depression. Laws were needed to make the program compulsory, since the unemployed could apply for welfare, thus imposing a cost on others. Private insurance markets

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<sup>3</sup>During the period from 1981 to 1991 the population of Newfoundland and Labrador virtually remained unchanged.

would likely fail due to "moral hazard" and "adverse selection."<sup>4</sup>

In 1935 the *Employment and Social Insurance Act*<sup>5</sup> was passed, introducing compulsory unemployment insurance. However, this Act was struck down by the Privy Council as *ultra vires* the federal government.<sup>6</sup> A subsequent constitutional amendment permitted the federal government authority in these matters,<sup>7</sup> and in 1940 the *Unemployment Insurance Act* was passed. The program was one of compulsory insurance designed to provide income maintenance to full-time, full-year workers in the private sector who, although willing to work, found themselves unemployed due to circumstances entirely beyond their control.

The passing of the Act was accompanied by the formation of the Unemployment Insurance Commission (UIC) and the National Employment Service (NES). While the UIC dealt more with legal and administrative matters under the Act, the NES attempted to reduce the reliance on UI by providing information on job availability and monitoring the individual circumstances of those drawing insurance benefits.

As Green and Riddell note,<sup>8</sup> the design parameters of the UI program play a major role in determining the impacts of the program on individual behaviour and hence on labour markets. For example, self-employed workers in the fishery were excluded from the initial program. In other words, it is the design parameters that will ultimately determine how faithful the regulations are to the underlying values and principles of society. Some of the other design parameters of the UI program are maximum insurable earnings, replacement rate, minimum number of weeks to qualify, and maximum number of weeks a claimant can receive benefits.

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<sup>4</sup>Under conditions of moral hazard, the insured individual can affect the probability of occurrence of the event against which he or she is insured. Under conditions of adverse selection, those who are more aware that they are likely to need insurance will tend to seek it. In this case there may be no way that private insurers can discern who is at greater risk.

<sup>5</sup>S.C. 1935 c. 38.

<sup>6</sup>*A.-G. Canada v. A.-G. Ont. (Unemployment Insurance)*, [1937] A.C. 355 (P.C.) (*Unemployment Insurance Reference*).

<sup>7</sup>3 & 4 Geo. 6 c. 36, "An Act to include unemployment insurance among the classes of subjects enumerated in section ninety-one of the *British North America Act, 1867*." Although communities and provincial governments were responsible for general welfare, it was clear that the ability to provide assistance to the unemployed during the 1930s varied greatly from community to community and across provinces. Thus there was provincial acceptance that these laws should fall under the regime of the federal government.

<sup>8</sup>D.A. Green and W.C. Riddell, *The Economic Effects of Unemployment Insurance in Canada: An Empirical Analysis of UI Disentitlement*, Discussion Paper 92-15 (Vancouver: University of British Columbia, 1992).

After 1940, there were a number of gradual changes in the UI program. These changes were generally such as to increase the generosity and coverage of the program. For Atlantic Canadians, the most important change during this period was the inclusion of seasonal workers and self-employed fishers in 1957. This process of liberalization began to alter the principles under which the UI program was founded. The program scheme began to move away from insurance-based principles to equity principles, and from providing income maintenance to providing income supplementation.

As writers such as Cousineau noted,<sup>9</sup> the notion of equity was primarily "horizontal" rather than "vertical." Horizontal equity would require equal treatment of those facing equally adverse circumstances, whereas vertical equity would require differing treatment depending on differing economic needs. In the case of UI, vertical equity would target payments to those most in need at the lower ends of income distribution.

The most dramatic changes in the regulations under the *Unemployment Insurance Act* occurred in 1971. Under these changes, almost all employed workers below the age of 70 were covered by the Act. The benefit rate was increased so that some unemployed individuals could receive as much as 75% of their previous earnings. The maximum insurable earnings were increased from \$53 to \$100 per week, and future maximums were to be indexed to changes in average wages. The qualifying period for benefits was reduced from 30 weeks during the previous 2 years, to 8 weeks during the previous year. The maximum benefit period depended on previous work experience, the national unemployment rate and the differential between the national rate and regional rates. Finally, the UI program was also applied to earnings disruptions due to retirement, sickness, and maternity. The dramatic increases in the generosity of the program were partially offset by a change in the *Income Tax Act*<sup>10</sup> which now made UI benefits taxable.

These changes occurred at a time of rapidly increasing government services and expenditures. While post-war economic growth in Canada had been dramatic, Canada was experiencing a mild recession during 1970-71. In addition, inter-regional equity considerations were beginning to play a dominant role in the Canadian political mosaic. The regional income disparities between Atlantic Canada and the rest of the country had been noted by Prime Minister Trudeau and had resulted in new regional development strategies.

As a result of cost increases in the UI program, the federal government

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<sup>9</sup>J.-M. Cousineau, "Unemployment Insurance and Labour Market Adjustments" in F. Vaillancourt, ed., *Income Distribution and Income Security in Canada* (Toronto: University of Toronto Press, 1985).

<sup>10</sup>R.S.C. 1952, c. 148.

introduced measures in 1976 which reversed the liberalization process of the 1940-71 period. In that year UI coverage was reduced to those 65 and younger, the maximum benefit rate was reduced to 67% from 75%, and the disqualification period for voluntary job quitters was increased from 3 to 6 weeks.

Further changes were introduced in the 1977-79 period which tended to further "regionalize" the program, presumably to be consistent with some notion of horizontal equity. Benefit rates were lowered to 60% and high income earners were subject to a tax clawback. In 1979, the UI regulations were tightened to exclude part-time workers who worked less than 20 hours per week. In addition new entrants and re-entrants needed 20 weeks of employment in order to qualify for UI.

Seen in perspective, the introduction of the *Unemployment Insurance Act* and subsequent changes to it seem to be entirely consistent with changing values, needs and priorities of Canadian society. It can be argued that the law was a *catalyst* for change. The scope of the UI program was so large, and the alterations in the behaviour of individuals were so dramatic, that the program transformed the cultural and economic structure of the country, particularly of the Atlantic region, where the impacts were the greatest.

Many of the changes would have been qualitatively predicted by economic theory. What was not predicted, however, was the magnitude or the importance of these changes on rural lifestyles, or their timing. This inability to predict was hardly surprising. Economic models of labour market behaviour concentrated on an urban industrial setting.<sup>11</sup> Econometrics and the use of computers to estimate impacts were just beginning to occur, and data about the impacts did not exist.

To the economist, it would appear that policy-makers may have forgotten that people will alter their behaviour in response to changing parameters in their economic environment. Modelling such behavioral changes is the stuff of modern microeconomic theory. The other aspect which seems to have been ignored is, as Pigou put it:

... that the economic aspects of the economic life of any modern country are bound together in an intimate unity. The consequence is that attempts to deal with any particular evil, as it appears at one point, may be followed by important and not at all obvious effects, breaking out elsewhere and capable of more than neutralizing whatever immediate good may have been done.<sup>12</sup>

What are the values and principles that are being compromised? The House

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<sup>11</sup>For example, the framework concentrated on the workers' choice between employment income and leisure. As I have noted, in rural areas unemployed individuals might well be "working."

<sup>12</sup>A.C. Pigou, *Unemployment* (London: Williams and Norgate, 1913) at 10.

Commission outlined a number of goals that the current UI and make-work system violates or fails to achieve. The Commission's *Final Report* contains the following list:<sup>13</sup>

- (a) The system undermines the intrinsic value of work.
- (b) The system undermines good working habits and discipline.
- (c) The system undermines the importance of education.
- (d) UI is a disincentive to work.
- (e) UI undermines personal and community initiatives.
- (f) UI discourages self employment and small scale enterprise.
- (g) The UI make-work system encourages political patronage.
- (h) UI make-work distorts the efforts of local development groups.
- (i) The system has become a bureaucratic nightmare.
- (j) The system distorts the role of state officials.
- (k) The system is vulnerable to manipulation.

In the Commission's opinion, the implication of these deficiencies were such as to prevent long-term economic development and employment within the province.

The House Commission was not the only group calling for a major reform of UI and Canada's income security system. The Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission) in its Report<sup>14</sup> called for reform of Canada's income security system. Its solution is almost identical to the one called for by the House Commission: the UI program should revert to its insurance principles while the income security system should be more vertically equitable, targeted to those most in need. Both reports noted the need to supplement earned incomes at the lower end, in order to provide an incentive to work rather than promoting total dependency.<sup>15</sup> Both groups did not see reform as involving a reduction in transfers to the provinces, but rather a redirection of those resources. Finally, the federal Commission of Inquiry on Unemployment Insurance (the Forget Commission<sup>16</sup>) noted the vertical and horizontal inequity of the program and suggested reforms similar in principle to the other two Commissions.

Although the basic principles of, and programs for, reform were essentially the same from all three commissions, the reaction was different. The public viewed

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<sup>13</sup>See pages 406-09.

<sup>14</sup>See the *Report of the Royal Commission on the Economic Union and Development Prospects for Canada* (Ottawa: Supply and Services, 1985).

<sup>15</sup>In Atlantic Canada, the current unemployment insurance system also encourages "work" in the formal labour force if only for ten weeks annually.

<sup>16</sup>Ottawa: Minister of Supply and Services, November 1986 (Chair: C.E. Forget).

the Macdonald Commission's Report as giving much more emphasis to free trade, and therefore its proposals on income security reform were almost ignored. The House Report received widespread public approval and academic adoration for being so bluntly honest in discussing the problems. The Forget Commission met a tidal wave of public rebuff. The rebuff was severe enough so that in 1986-87, members of all three federal political parties refused to acknowledge that the tax reform discussions which were then taking place had anything to do with income security reform. Since then, income security reform has been quietly left to the evolutionary approach of mandarins in the Department of Finance. The recently introduced Child Tax Benefit has the same program characteristics as advocated by the three commissions, but the changes are viewed by many as marginal rather than fundamental.

Further reform of the *Unemployment Insurance Act* was proposed in 1989, but was not ratified by Senate until October of 1990. The changes tried to move the UI program back to its insurance roots. The new legislation promoted pro-active labour market policies focusing on training, skills enhancement and community development. The program was to be "self-financing," and would not have to rely over the medium term on funds from the federal government. Benefits were reduced and changes were made to be consistent with the *Canadian Charter of Rights and Freedoms*.<sup>17</sup> Once again, one can argue the law was a catalyst for change.

While one might argue that the amendments over the past five years in the *Income Tax Act* and the *Unemployment Insurance Act* have gone in the right direction, one could argue that their effect has been marginal. The fundamental deficiencies of our system identified so dramatically by the House Commission still exist.

For Atlantic Canadians, the deficiencies of the current unemployment insurance program can best be viewed by examining the administrative regulations as they apply to self-employed fishers. As was previously noted, this group was not originally included under the Act, since the program was designed to provide income security to employees who might experience a loss in employment during a recession. Other groups of self-employed workers in primary industries, such as farmers, are not covered. The comparison is an important one, since both groups earn their living by exploiting a resource, and fluctuations in resource availability and/or the production process are subject to exogenous variations. For the farmer, cold weather could mean crop damage or destruction; for the fisher, abnormally cold weather could affect the movement of fish stocks and the ability of the resource to regenerate itself.

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<sup>17</sup>Part I of the *Constitution Act, 1982*, being Schedule B of the *Canada Act, 1982* (U.K.), 1982, c. 11.

Surely the application of unemployment insurance benefits to one of the groups and not the other is due to historical factors. In 1957, when fishers first began to receive unemployment insurance, the Newfoundland fishery was undergoing a dramatic period of adjustment. Traditional European markets had been disappearing and American markets were being developed. The salt fish trade was being replaced by frozen cod blocks. Incomes in the fishery in Newfoundland had never been high; most would probably have been placed at or below the poverty line. Who at the time could have strenuously objected to this group receiving financial assistance from the federal government? Who would have forecast that unemployment insurance benefits would become so interwoven into the fabric of the fishery that they would represent the primary source of income for many families, or that fishing patterns themselves would adopt to the system and the institution? The benefits conferred by the institution encouraged many young people to abandon their education and adopt a non-traditional way of life. Habits of dependency were formed which are virtually impossible to break. Eventually, this system would encourage too many to remain in the fishery and result in too much effort relative to the resource stocks available. The result of this process, coupled with other factors, was the depletion of the resource and the destruction of the livelihood. Unemployment insurance benefits were a socio-economic Trojan Horse.

The above description of the adaption of the fisheries in rural areas of Atlantic Canada to UI regulations suggests that several principles are being violated. The first of these is the principle of economic efficiency. The UI regulations compound the "tragedy of the commons." Private markets, if left to their own devices, would result in over-exploitation of the resource. There is, therefore, a need for licensing laws to restrict access. In this case, the UI regulations subsidize fishers to stay in the industry when market forces might drive them out. There were more active fishers in Newfoundland in 1991 than in 1951.

Second, the system does not encourage individual responsibility or self-reliance; it encourages dependency. In this respect, the UI system rips at the cultural heart of Atlantic Canadians who pride themselves on being "survivors." Third, the system is open to manipulation. Anecdotal evidence abounds of the ability to buy stamps. This should not surprise us, since the UI system was designed with employed workers in mind. To adapt the system to the fishing industry, "stamps" are based on the value of the landed catch averaged over some period of time. "Ten weeks of stamps" does not ordinarily imply a constant work effort over that period of time but rather a certain net value of landed catch during that period.

Fourth, the system does not contribute to vertical equity, since lower income fishers receive less absolute dollar amounts of UI benefits than those whose incomes are well above the poverty line. This failure is due to the insurance principles of the program. Fifth, as an insurance program designed for income



maintenance, the UI program is ill-suited for self-employed fishers. When prices are high and catches are abundant, UI payments to fishers increase. A poor fishery results in a reduction of UI benefits. The system does not smooth out the fluctuations in income; it accentuates them.

In failing to encompass fundamental reform of the *Unemployment Insurance Act* and the *Income Tax Act* as called for by the House Commission, the Macdonald Commission and the Forget Commission, the law is acting as a barrier to change in a direction which society would generally deem as desirable. In fact, the existing laws, by encouraging behavioral changes, aggravate the problem and increase the magnitude of adjustment that will eventually have to be made. Why do we observe an institution which, having been established, appears open to rapid change and then appears to resist change in a direction which society sees as being consistent with its underlying values?

The answer to the above question may be found in the nature of bureaucracies and, in part, in the nature of the "market" for government services (in this case UI) in which the institution participates. While not all institutions are similar to Employment and Immigration Canada, which manages the unemployment insurance system, there are a number of government institutions which have similar characteristics.

Once established in 1940, change came rapidly to the unemployment insurance system until 1971. For the associated government bureaucracies, changes to the *Unemployment Insurance Act* represented an increase in responsibilities, influence and power. During this period there seemed to be a coincidence of interests of the increasing number of "clients" (UI recipients), the agency (EIC), and the "principals" (the general voting and taxpaying public).

During the period from 1978-93, changes have reduced liberalization and steered the program towards more insurance-based principles. The recent pro-active labour market policies of the past five years have increased the activities and responsibilities of the agency. While some clients have lost (marginal workers or the unemployed), others have gained (those receiving training). The principals have generally supported the direction of change. What has not occurred during the past decade is *fundamental* reform, even though there is a general acknowledgement that such reform should occur. Resistance to such fundamental reform has probably come from all three of the groups noted above.

As unemployment insurance regimes continued, the behaviour of the system's clients altered. In many cases UI recipients had changed their work, occupation or location patterns. The process of addiction to the system was "putty-clay." It was easy to accept and adapt to the prior changes which, in general, improved recipients' immediate circumstances; behaviour was therefore "putty." However,

accepting changes after liberalization of the benefits meant adjustment and sacrifice for recipients. Change is now very difficult to achieve. Many self-employed fishers live in isolated areas in homes with no mortgages. Many have skills primarily related to the fishery and very little formal education. How could people who have less than a Grade 9 education and whose main source of income is unemployment insurance benefits now go back to school? How could they change occupations? To whom in their communities could they sell their homes if they had move? Having adapted to UI, investments have been made and changes would be costly. Changes would mean sacrifices, and it is not in people's interests to accept self-sacrifice.

The client groups which might be negatively affected often organize and assail politicians for their "attacks" on the poor and the disadvantaged. With their own unions, the fishers of Atlantic Canada could put pressure on politicians to resist amendments in the law which might disadvantage them. Richard Cashin, head of one of the two fishers' unions and an NDP supporter, was asked by a Conservative Minister, John Crosbie, to chair the Task Force on Incomes and Adjustment in the Atlantic Fishery. This is an example of the client having a great deal of influence on the evolution of the system. The system may evolve; it is predictable that the recommended policies will not involve short-term sacrifice for members of the union.

This hides another factor which causes the clients to resist change: information or the lack of it. Information, which might be used to promote change, has only been produced by independent commissions. For the government department responsible, to produce evidence in support of change is to invite a direct political challenge. With a lessening of executive federalism in Canada in favour of growing citizen empowerment, politicians look to citizens for leadership to advocate change. Met with powerful interest groups, change understandably comes slowly.

The Forget Commission provides a striking example of a political disaster when an independent commission advocates change. The Forget Report identified the losers and talked about a process to produce winners. Given the certainty of who were to be the winners and losers, the political fiasco was not surprising.

The Employment and Immigration Agency has thus far been a winner in the unemployment insurance system. It manages the largest single expenditure program of the federal government, worth about \$20 billion annually. UI premiums are an important source of revenue, and a certain portion of this revenue is designated for innovative programs. In its discretionary expenditures, the Agency has formed liaisons with its clients and with those who deliver services to clients on its behalf.

It is understandable that the Agency does not openly support reform, since this

would necessarily involve a decrease in its power. Further, the Agency's labour market policies are seen as complementary to its role with the unemployment insurance program, and, therefore, any decrease in the latter might also be expected to cause a decrease in the former.

Finally, the institution has evolved to reflect place equity and, therefore, regional differences in unemployment. The system has destroyed horizontal equity for the individual citizen: a citizen in Toronto facing the same personal circumstances is treated identically to his or her counterpart in rural Newfoundland. Because changes to the system since 1971 have had differential regional impacts, provincial politicians in the disadvantaged region have fiercely resisted any change that would affect the flow of funds into the region.

What is the average voter/taxpayer's attitude towards fundamental reform? For the moment the mood is not very positive in much of the country. Guaranteed annual incomes and negative income tax programs, while supported in principle, are thought to be costly. The child tax benefit is amazingly generous to middle class taxpayers and could have been targeted much more towards the poor.

In addition, one could argue that the principals have begun to identify with the clients on a geographic basis. The citizens of Atlantic Canada will only support fundamental reform if such reform does not decrease the flow of federal funds into their provinces. Proposals for reform emanating from the provinces may be financially feasible for the provinces but not for the country. Fundamental reforms which are more nationally equitable or which promote longer term economic growth will probably be resisted by principals at the provincial level if such reform involves immediate sacrifices. Principals from the "have" regions of Canada have tended not to force through reforms which might negatively impact the "have-not" regions in the short term, even though they would benefit in the long run. While the average benefit per capita in the "have-not" regions is relatively high, the cost in the "have" regions is relatively low; the population of Atlantic Canada is only 8% of the Canadian total.

In summary, although there has been a recognized need for fundamental reforms to the income security system in general and the *Unemployment Insurance Act* in particular, there are many reasons why those agents most directly involved in the unemployment insurance regime might resist change. This case study of the *Unemployment Insurance Act* in its application to Atlantic Canada demonstrates a general principle about the law and institutional reform. The law acts as a catalyst to reform when the changes are consistent with societal values and principles and when the changes are viewed as providing benefits to some but widely spreading the costs. However, when the costs are more immediate and the benefits are more widely spread, the law acts as a barrier to institutional reform.

Failure to engage in law reform only aggravates the situation, postpones the inevitable, and forces an ever increasing adjustment. It will be a hard lesson for Atlantic Canada to learn. In the case of the unemployment insurance system in Atlantic Canada, change in the law and its institutions cannot come soon enough if our economies are to develop, and our people are to become self-reliant.