

Policy Application: The “Cash Cow” of Imperfect Experience Rating

The U.S. is actually relatively unique among industrialized nations in having any experience rating of its UI system, however imperfect. Most nations finance their UI systems through a flat payroll tax that is unrelated to the firm's actual layoff experience. Such a system can turn the UI system into a “cash cow” that subsidizes the existence of highly inefficient firms.

Consider the case of Canada's UI system, where workers had to work only 10 weeks to qualify for 42 weeks of UI with a replacement rate of 60%, at no extra cost to their firm. In this system you and four friends are considering buying a fishing boat. You know that this fishing boat can only produce \$40,000 worth of fish catch during the entire year. That is only \$8000 for each of you, and this is not enough to support each of you for an entire year. So, in the absence of UI, you would not purchase this fishing boat.

Given that structure of the Canadian UI system, however, this purchase will be more attractive. In this system, you and your friends could each just work 10 weeks, for a total of 50 work weeks. Each of you would report earning \$800 per week for those 10 weeks, and then report being laid off. Then you would each receive \$19,200 of UI during the rest of the year (60% of the \$800 per week reported earnings, for forty weeks). So the total UI benefits income across all five recipients is $\$19,200 \times 5 = 96,000$. Adding the \$40,000 of fish produced, that is a total income to the firm of \$136,000, or \$27,200 per worker per year – for only 10 weeks of work! This makes the purchase of the fishing boat much more attractive.

This example illustrates the fundamental problem with imperfect experience

rating: it subsidizes the existence of inefficient firms. This firm is not an economically viable employer of five employees; it could only pay each employee \$8000 per year if there was no UI system. But by exploiting imperfect experience rating, it can remain viable. Thus, UI is not simply a system of insurance against true unemployment risk in Canada, but also a large government transfer to firms and their laid off workers.]