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Safeguards for Workers' Entitlements

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While the employment impacts of business insolvencies in Australia are relatively modest, employees are seen as a particularly vulnerable group that often loses a significant share of its claims on the insolvent business. A number of high profile cases involving lost employee entitlements in the event of business insolvency has arisen in recent years. Examples include National Textiles at Rutherford (in 2000), Oakdale Colliery at Camden (in 1999), CSA Copper Mine at Cobar (in 1998) and Gilberton Abattoir in Grafton (in 1997).

Governments around the world use a variety of mechanisms to protect employee entitlements. In February 2000, the Commonwealth Government responded to community concerns by introducing a national insurance scheme to protect employees' entitlements. However, there has been significant debate over its merits. All state and territory governments — with the exception of the Northern Territory — have so far declined to participate in the scheme. In addition, employee organisations such as the ACTU have been critical of some of its characteristics.

In theory, there is a variety of possible employee protection schemes, involving different combinations of who pays (employers, governments, employees) and on what basis (flat rate, variable rate, risk rated, non-risk rated). This article outlines and analyses four of the principal approaches that might be adopted to protect employee entitlements, including the current Australian policy approach. It also discusses the merits of imposing limits on the amount of insurance payments made to employees — a common feature of employee protection schemes around the world.

Allocation of Liquidated Assets in the Event of Insolvency

A critical issue in the liquidation process is the allocation of available funds to the various stakeholders in the insolvent business. Because there are usually insufficient funds from the liquidation of assets to satisfy all stakeholders, a system has developed in Australia — under the Bankruptcy Act and the Corporations Law — to assign priorities to stakeholders' entitlements when funds are distributed.

Although employees are ranked relatively highly (near the top of the unsecured creditors), their position is subservient relative to most secured

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creditors[1]. This can be very costly as employees often have substantial financial stakes tied up in insolvent businesses.

Many governments around the world have introduced arrangements to protect employee entitlements. Most of these arrangements appear to have been introduced on equity grounds to provide a ‘safety net’ for affected employees. However, efficiency rationale may also have been a factor — for example, due to an inability of workers to observe risk differences between firms (high search costs, inability to assess information).[2] Such employee entitlement protection mechanisms accept the current order of priority in legal terms, but recognise that employees are rarely able to access the proceeds of any liquidated assets in the event of insolvency. They represent an alternative policy option that places employees in a more secure position, without weakening the position of secured creditors.

What is at Stake in Australia

The employment impacts of business insolvencies in Australia are relatively modest. Direct job losses resulting from bankruptcies and liquidations in Australia in 1999-00 (see Table 1) are estimated at around 19,000 persons (or only around 1 per cent of total job losses in that year). Furthermore, these data include working proprietors. The employee component of this number is likely to be in the order of 12,000–13,000 persons.

While the number of employees affected by business insolvencies in recent years is low, it may be significantly higher during economic downturns — as it was in 1991-92, when the employment loss was around three times greater than in 1999-00.

Entitlements that may be due to employees of insolvent businesses include those accrued during service — annual leave, long service leave, unpaid wages and pay in lieu of notice — as well as any redundancy pay.

In researching its Employee Entitlements Support Scheme (see below), the Commonwealth Government (Reith, 2000) estimated that, on a long-term trend basis, around 19,000 employees annually might lose about $110 million in entitlements from insolvency (based on an average amount lost per employee of around $5,700). However, on the basis of actual data collected under the Employee Entitlements Support Scheme, this estimate of annual aggregate losses appears excessive. While the average amount lost per employee is currently higher than previously estimated ($7,200), the number of affected employees has been significantly lower than expected. Accordingly, the Commonwealth Government recently estimated that the total employee entitlements lost in 2000-2001 might be in the order of only $50–$60 million (DEWRSB, 2001).

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[1] For a discussion of the current order of priority and possible alternatives, see Bickerdyke, Lattimore and Madge (2000).

[2] A discussion of the economic and social justifications for government intervention to protect employee entitlements in the event of employer insolvency is beyond the scope of this paper.

Table 1: Employment Impacts of Enterprise Failures, 1991-92 to 1999-00

	Employment Loss (Number of persons)		
	Incorporated Enterprises[a]	Unincorporated Enterprises[b]	Total
1991-92	50 326	6 857	57 183
1992-93	40 231	6 105	46 336
1993-94	23 223	5 517	28 740
1994-95	19 584	5 088	24 672
1995-96	15 795	6 075	21 870
1996-97	11 242	6 607	17 848
1997-98	14 524	6 178	20 702
1998-99	14 524	7 516	22 040
1999-00	14 333	4 962	19 295

Notes: a. Comprises all employees plus working proprietors for small incorporated enterprises (less than 20 employees).

b. Comprises all employees and working proprietors.

Sources: ABS (Labour Force, Australia, Cat. No. 6203, various issues); ABS (Small Business in Australia, Cat. No. 1321.0, various issues; unpublished data); Annual reports of the Inspector-General in Bankruptcy; Australian Securities and Investments Commission (annual reports and unpublished data); Study estimates.

Current Australian Policy Approach

A ministerial discussion paper issued in August 1999 (Reith, 1999) canvassed two main options for the protection of employee entitlements in Australia — an employee protection fund and a compulsory insurance scheme. In February 2000, the Commonwealth Government established the Employee Entitlements Support Scheme (EESS) to provide a national safety net for the basic protection of employees' entitlements in the event of an employer's insolvency (Box 1). The model announced by the Commonwealth is a form of non-risk rated employee protection fund and is entirely government funded.

The Commonwealth originally committed $55 million of its own funds to the EESS for the 2000-01 financial year (DEWRSB, 2001). It proposed that the remaining $55 million of the expected $110 million annual cost be funded by the State/Territory Governments.[3] However, to date, only the Northern Territory Government has agreed to contribute. The main ramification of this lack of participation on the part of State/Territory Governments is that the vast majority of employees claiming EESS payments has only received compensation from the

[3] In fact, even if the outstanding entitlements lost by employees equalled $110 million per annum, the amount paid out under the EESS would be less than this figure — due to the capping arrangements that exist under the scheme. See the section on capping payments below.

Commonwealth. Had their relevant State/Territory Government been participating in the scheme, the employees would have been paid twice as much.

Box 1: The Employee Entitlements Support Scheme

The Commonwealth Government has established the Employee Entitlements Support Scheme (EESS), in order to provide a national safety net for the basic protection of employees' entitlements in the event of an employer's insolvency.

If workers had their employment terminated on, or after, 1 January 2000 because their employer has become insolvent or bankrupt, the EESS may advance them some money for the entitlements that they are owed. Depending on their employment conditions, former employees may be entitled to receive:

- up to 4 weeks unpaid wages;
- up to 4 weeks annual leave accrued in the last year;
- up to 5 weeks pay in lieu of notice;
- up to 4 weeks redundancy pay; and
- up to 12 weeks long service leave.

This assistance will be paid at ordinary time rates. The maximum rate of payment for each week's entitlements will be the rate corresponding to an annual wage of $40,000. There will be a $20,000 cap (based on combined funding) on the amount any individual may receive from the fund.

The EESS will seek to get back some or all of this money later, if funds become available (for example, from a distribution of the insolvent employer's assets).

Source*:* DEWRSB (2000).

At a cost initially expected to be $110 million per annum, the Australian employees' protection scheme would be the equivalent of around 0.06 per cent of total private sector employees' earnings. Under the revised estimates (DEWRSB, 2001), the cost of the scheme falls to around 0.03 per cent of earnings. Using either the original or revised estimate would make the EESS among the least costly of such schemes around the world (although the cost will increase during downturns in the business cycle). The following provide an indication of the cost of some overseas schemes:

- Benfield Greig (1999) found that comparable schemes cost between 0.1 and 0.3 per cent of wages, but reported that they have been as high as 1 per cent of wages in Spain during an economic recession.
- The Ministerial Discussion Paper (Reith, 1999) found that the basic contribution rates as a share of employee compensation were 0.43 per cent in Belgium, 0.05 per cent in Finland, 0.15 per cent in Greece and 0.2 per cent in Italy. Variations reflect the different scope of the insurance schemes.
- Contribution rates vary significantly over time. For example, in Austria, the scheme cost 0.1 per cent of wages in 1981, 0.8 per cent in 1983-84, 0.5 per

cent in 1985 and 0.2 per cent in 1986 — so that the annual cost has varied over the cycle by a factor of 8 times (ILO, 1991). Over a few years, the cost of similar schemes have varied by factors of over 2 in Belgium, 1.4 in Denmark, 5.5 in Spain, 2.3 in France and 2 in the UK (ILO, 1991; DTI, 2000).

The employee protection fund model adopted by the Commonwealth — along with other possible options for protecting employee entitlements — is described and analysed in the following section.

Mechanisms for Protection of Employee Entitlements

In the event of employer insolvency, governments have a variety of employee protection mechanisms at their disposal, including:

- *A non-risk rated employee protection fund*: A scheme to collectively insure employees (on a non-risk rated basis) for any lost entitlements. The existing employee protection fund in Australia is entirely government-funded, but this need not be the case.
- *Compulsory risk-rated employer insurance*: A system of compulsory risk-rated insurance whereby employers take out policies to ensure the payment of their employees' collective entitlements.
- *Voluntary employee insurance*: Private insurance policies taken out by employees, or voluntary arrangements between employers and employees, to protect employee entitlements.
- *Trust fund*: Accrued employees' entitlements held in trust so that other creditors could have no claim against them in case of insolvency.

A discussion of these options follows.

Option 1 — A non-risk rated employee protection fund

The idea of *collectively* insuring employees was first raised as a possibility in the Australian context by the Australian Law Commission in its inquiry into insolvency (ALRC, 1988). It recommended the creation of a 'wage-earner protection fund' to protect employee entitlements on insolvency. Twelve years on, the Commonwealth introduced such arrangements through the Employee Entitlements Support Scheme.

Arrangements of this kind are quite common overseas, where they are often referred to as 'wage guarantee funds' or 'basic payment schemes'. According to the ILO (1991), they originated in Europe, with the first being established in Belgium in 1967. Subsequently, over the next 20 years, similar schemes were established in the Netherlands, Sweden, Denmark, Finland, Norway, France, Germany, the United Kingdom, Spain, Austria, Greece, Switzerland, Ireland and Portugal.

The types of entitlements covered by the overseas schemes vary, as do the amounts covered and the caps on payments. The responsibility for paying the contributions to the schemes also varies, with the financing often being undertaken by employers and not only by governments — as is the case in Australia — or some combination of employers and governments. There are even rare cases where employees contribute to the financing of an employee protection fund.[4]

The essence of employee protection funds is to collectively insure private sector employees engaged by businesses that are forced into liquidation. Affected employees are able to claim lost entitlements against the fund. In turn, the fund seeks to get back some or all of this money later, if finances become available (for example, from a distribution of the insolvent employer's assets).

To the extent that employees are unaware of the relative risks of losses of entitlements when choosing jobs, then a government funded insurance policy is like a compulsory insurance scheme for all employees, albeit with a much more efficient collection method.

Government-funded universal coverage schemes have some significant advantages:

- by providing coverage for all employees, they avoid the adverse selection problem of voluntary schemes;
- they avoid new mechanisms for funding; and
- they are relatively simple and have low administrative costs.

However, these schemes also have some limitations. The most important of these is that they are not risk-rated. An advantage of risk rating is that it signals the areas of the economy where risks are inherently higher and shifts resources out of them. Government funding of these schemes means that riskier businesses face no penalty through insurance premiums. This might increase risk-taking behaviour — the problem of moral hazard.

On the other hand, the gains from signalling high risk areas through risk rating are likely to be small because the probability of default is low and the degree to which insurers could differentiate relative risks is likely to be highly imperfect. Moreover, there are other ways of addressing excessive risk taking than risk rating (for example, by imposing excesses on claims).

Another possible weakness of employee protection funds is that budget funding exposes governments to unknown future liabilities. It would be expected that unpaid liabilities would increase significantly during downturns in the business cycle — when government budgets are already under severe pressure.

4 For a discussion of the operation of employee protection funds in other countries, see for example, Reith (1999), ILO (1991) and Bronstein (1987).

Option 2 — Compulsory risk-rated employer insurance

Prior to announcing the Employee Entitlements Support Scheme in 2000, the Commonwealth had also considered the relative merits of adopting compulsory employer insurance to protect employee entitlements (Reith, 1999).

Under such a scheme, employers would insure (pay a premium) to protect employee entitlements in case of their insolvency and there being insufficient funds to pay such entitlements. The existing commercial insurance market would be utilised (insurance companies already write policies for trade creditors in case of a customer's insolvency).

While premiums could potentially be either variable risk-rated or a flat percentage rate (both have been proposed), a flat rate policy is essentially identical to a government-funded scheme funded from labour taxes (option 1 above). Accordingly this is not discussed further here.

A variable risk-rated policy would take into account any factor that might increase the risk of insolvency (such as the size of the business, the extent to which assets are earmarked for employee entitlements, leverage, current profits to assets, and existing credit ratings). The premium would change periodically with the changing risk exposure of the business. However, the information underlying risk rating is costly. Accordingly, insurers would trade-off the gains from finer gradations of risk rating against the transaction costs of writing made-to-measure policies and information gathering. In practice, it is likely that a few simply monitored variables would be used as the basis for risk rating.

Risk-rated employer insurance implies that the risky part of the economy would contract somewhat in response to the higher premium rates. The use of price signals in the form of risk-rated premiums might have some impact on reducing the risk of insolvency — through employers putting greater effort into financial planning, risk management and other preventive measures to reduce the at-risk amount of outstanding employee entitlements. Under a flat rate insurance scheme (or other protection schemes where employers do not contribute), high-risk employers are no worse off financially than employers who take steps to reduce the risk of insolvency.

The additional cost of insurance to high-risk businesses could precipitate early insolvency. If the risk rating employed by the insurer was accurate, this may be a desirable outcome since it allows greater recovery for all creditors, including employees.

A potential difficulty with a risk-rated insurance scheme is its administrative complexity. To be effective, premiums would somehow have to be commensurate with the likelihood of failure — and that could be difficult for commercial insurers to assess. A significant amount of red tape and administrative hurdles would also imply significant costs. Benfield Greig (1999:paragraph 5.6) noted that variable premiums would require costly underwriting and administration by insurers:

> This additional expense would be incurred prior to the commencement of the scheme (in collating segmented historical data) and in managing

the ongoing scheme (in actuarial pricing adjustments and decision-making regarding the appropriate classification for each policyholder).

To date, a compulsory risk-rated insurance scheme for employee entitlements does not appear to have been introduced in any country.

Option 3 — Voluntary employee insurance

Given that employees are the potential losers, it may be thought appropriate to enable them to enter into insurance arrangements if they wish. This is analogous to a range of other voluntary insurance services. These include insurance for life, house and contents, travel, income protection and a range of other insurance services. Many of these have greater value than employee entitlements.

The prime advantages of voluntary personal insurance are that it can allow individuals to cover their risk according to their preferences and it would distinguish high from low risk businesses. In addition, employees with low leave entitlements (for example, new workers) would pay lower premiums than employees with large leave entitlements.

There are, however, a number of potential problems with *voluntary* arrangements as a solution to lost entitlements.

- Many employees may not seek cover because of ignorance about the risks.
- Participation could also be low because employees feel they have a right to expect their legal entitlements to be paid to them (and that they should not have to insure at their own expense).
- The cost associated with monitoring and administration of a large number of policies is likely to be significant, even if only a small proportion of employees seeks cover.
- There is likely to be adverse selection problems. Insurers may not know as much about an employer's risk of insolvency as an employee — especially in smaller enterprises. This means that premiums will be set for general risk categories that include a mixture of high and low risks. Employees in the low risk category will not generally want to pay the premium, while those who perceive themselves to be in the high-risk category will. If the low risks drop out, premiums rise, sparking others to give up insurance — resulting in a vicious circle that can lead to only the highest risks (or indeed no one) being insured. Some of these adverse selection problems could be dealt with by having different insurance products with different excesses. High-risk employees will prefer smaller excesses. But this reduces, rather than eliminates, adverse selection.

Option 4 — Trust fund

Instead of insurance schemes or government-financed funds, the same outcome — protecting employee entitlements — could potentially be achieved by the secured

pooling of entitlements. This would oblige employers to hold accrued employee entitlements in a trust fund, or another earmarked secure asset, to protect them in the event of insolvency.

Such a scheme has apparently been used in Venezuela and Japan for certain employee entitlements (ILO, 1991). The ACTU has previously supported the concept (ACTU, 1999) and the NSW Government also considered it as an option for guaranteeing wage payments (Carr, 2000).

Businesses might hold the assets themselves or deposit them with another body — but the employee would retain title to the assets and could assert title against the business, or the business's creditors, in case of insolvency. Such a scheme has been likened to lawyers holding clients' money in trust accounts, or indeed to the current superannuation system.

New trusts could be established or existing trusts (such as superannuation) could possibly be utilised. They could be employer-based, industry-based or economy-based. However, the administrative costs for employer-based funds could be high and there would be economies from industry or national trust funds. Further efficiencies could be obtained if the initiative could be tacked onto an existing scheme.

As well as covering accrued entitlements such as annual leave and long service leave, trust funds could potentially have a contingent liability element to cover potential expenses which may only eventuate in the event of insolvency (such as pay in lieu of notice, unpaid wages and redundancy payments). Although there would be difficulties in including such unspecified amounts in advance, some formula could probably be developed.

The major drawbacks of a trust fund scheme would be the administrative complexities and its impact on the working capital of businesses. On the administrative side, a few challenges might arise:

- One problem would be the provision of a mechanism to ensure payments by employers are actually paid to the trust fund at regular intervals. Random audits and substantial penalties may be an adequate method.
- Another administrative problem relates to the ability of employers to accurately provide for future entitlements, some of which may never eventuate. Pay in lieu and redundancy pay are contingent liabilities. If the maximum potential value of these liabilities were set aside, this would represent considerable excess provision across the economy as a whole — with implications for working capital. However, if incomplete provision is made, there may be insufficient funds to acquit employee entitlements for those businesses that actually become insolvent.
- Provisions for annual and long service leave, while ostensibly straightforward, involve administrative complications. For example employees' leave payments are based on current wage levels, but employers' contributions may have been made one or two years prior (and even longer in the case of long service leave). This inter-temporal problem applies to other similar mechanisms (such as superannuation) and, in part, relies on fund

earnings to assist the process. However, it could be particularly problematic for small trust funds if employer-based funds were the favoured option.

The impact of trust funds on working/operating capital could be significant. While prudent employers already make provision for leave entitlements, it is not clear how many businesses do, in fact, observe such practices. To the extent they do not, mandated trusts would significantly reduce liquidity.

The loss of working capital suggests that some businesses would be unable to pay trade creditors or bank loans. Ironically, a mechanism to protect employee entitlements in case of insolvency might actually be instrumental in triggering such an event (and costing employees their jobs).

As well, bringing forward future liabilities into a trust fund acts like a wage increase to the employer — because, in effect, more money has to be found now to pay for each employee. This would tend to discourage recruitment, increasing unemployment temporarily.

It is important to note that such problems would mainly affect existing businesses that had not already made adequate provisions and be of short-term duration. If a trust fund scheme were a preferred policy option, it would probably require a transition period for existing businesses to build up their full trust fund quotas and to allow wage adjustment. Otherwise, the measure would precipitate higher rates of business failure and unemployment in the short run.

Comparisons

The characteristics and impacts of the various options are set out in Table 2. There is clearly considerable uncertainty over the relative monetary costs of the alternative arrangements. A compulsory risk-rated insurance scheme is assumed to cost more than a non-risk rated fund because of its additional administrative complexity. Trust funds would also involve significant administrative complexities and have an additional cost to business arising from bringing forward future liabilities (which would act like a wage increase to employers).

The comparison of overall monetary costs in Table 2 is made on the basis there are no capping arrangements involved with the non-risk rated employee protection fund (option 1). In fact, payments are capped in Australia (see below). In practice, the existence of capping arrangements reduces even further the comparative monetary cost of the current Australian scheme. However, the existing arrangements also provide fewer benefits — assuming that the compulsory insurance and trust fund schemes would pay out employee entitlements in full.

More broadly, the comparisons suggest that voluntary insurance and trust funds have significant drawbacks. Voluntary schemes would be undermined by adverse selection. Trusts, which do not pool risks, would be relatively costly and require phasing in to avoid large transitional impacts on employment.

Table 2: Nature and Impacts of Measures for the Protection of Employee Entitlements in Australia

	Non Risk-rated Employee Protection Fund	Compulsory Risk-rated Employer Insurance	Voluntary Employee Insurance	Trusts
Overall monetary cost	Total entitlements lost annually currently estimated at between $50-60 million per annum	Unknown but likely to be higher than option 1	Cost per employee very high	Unknown but likely to be higher than options 1 and 2
Administrative costs	Low	High	High	High
Transitional requirements	None	None	None	Large
Adjustment costs	None	Moderate	None	High
Who pays?	Payroll tax and general revenue	Business	Employees	Business
Long run incidence	Probably employees (but depends on how revenue is raised)	Employees and consumers	Employees	Employees
Intermediaries	Government	Insurers	Insurers	Trusts
Who typically makes choice of coverage?	Government	Government	Employee	Government
Adverse selection	None	None	High	None
Deters risky businesses	No	Yes	Uncertain	Yes
Coverage of employees	Full	Full	Very partial	Full

The choice between the universal insurance mechanisms — a non-risk rated employee protection fund or a risk-rated employer scheme — depends on the trade-offs between administrative simplicity, government budget constraints and deterring higher risk business behaviour. Employee protection funds have some advantages — they are easy to implement, administratively simple, involve no adjustment costs and have relatively low ongoing costs (although liabilities may be significantly higher during economic downturns).

While taxpayers pay for the employee protection fund in Australia, employers would pay for a compulsory insurance scheme. However, this apparent difference in the source of funding is an illusion. It is likely that, in the long run, employees bear the burden under both financing methods.

The Commonwealth contribution to the Employee Entitlements Support Scheme is funded from general revenue, mainly taxes on labour. Indeed, the Commonwealth has explicitly signalled payroll tax as the funding source for any State contribution to the scheme. Payroll taxes are *paid* by businesses, but their true *incidence* and ultimate burden is on employees through lower wages (Stiglitz, 1988; Nickell and Bell, 1996).

In this regard, the relatively popular idea that a flat rate tax on employers is superior to taxpayers 'subsidising' failed businesses misses the point. A flat rate policy would be essentially identical to a government-funded scheme funded from labour taxes.

Moreover, regardless of where the money comes from, any insurance system that is not explicitly risk-rated implies that higher-risk businesses are subsidised.

Overall, a simple government-funded employee protection fund might be favoured over compulsory risk-rated insurance on the basis that:

- the overall default risk is very low; and
- the transaction costs of writing a large number of individual insurance contracts are high relative to the actuarially fair insurance premium.

Although preferable, employee protection funds also have some limitations. First, as the premiums are funded by government, riskier businesses face no penalty through insurance premiums. This might increase risk-taking behaviour — the problem of 'moral hazard'. Second, the future liabilities associated with a budget-funded scheme are unknown, but are likely to be significant during downturns.

However, their major weakness is not inherent. Rather it tends to be the effects of the capping practices that are commonly associated with such mechanisms.

Capping of Payments to Employees

A common feature of employee protection funds around the world is the imposition of a cap on the amount payable to an individual employee. The Australian Employee Entitlements Support Scheme caps entitlements as follows:

- a maximum of 29 weeks pay;
- a maximum payment for each week's entitlements corresponding to an annual wage of $40,000; and
- a maximum payment to any individual employee of $20,000.

The capping of payments under the Australian scheme has been criticised by Industrial Relations Ministers from the Labor States of NSW, Queensland, Victoria and Tasmania (AFR, 2000). Capping is also one of the major criticisms that the ACTU has of the Australian scheme (ACTU, 2000).

Capping may perhaps be regarded as acceptable if employee entitlement protection schemes are viewed as being part of a wider government 'safety net' to protect the less fortunate in society. In this context, the employee insurance system is not meant to provide 100 per cent coverage for all claims. Rather it is designed to provide the majority of workers caught up in insolvencies with the expectation of receiving a reasonable proportion of their accrued entitlements.

The most common justification used for capping payments though is to reduce the overall cost of employee protection schemes.[5] In the case of the Australian budget-funded model, it can be argued that it is a legitimate and responsible policy option for a government to impose caps as a means of limiting its budget exposure (particularly in the absence of comprehensive data on the extent of the problem).

A measure of the possible budget savings from capping under the Australian scheme is provided by the Commonwealth in its EESS Year One Activity Report (DEWRSB, 2001). In detailing the claims under the EESS between July-December 2000, the report notes that in some cases the scheme caps have been applied for the weekly wage and/or each of the five entitlements, namely, annual leave, long service leave, unpaid wages, pay in lieu of notice and redundancy pay. Thus, while the average amount outstanding for components covered by the EESS has been \$7,203 per eligible claimant, the average EESS payment per employee if the States had contributed would have been \$4,354 (in practice it has been only half of this amount ie \$2,177). In aggregate terms, DEWRSB estimates that the total employee entitlements lost annually for the components covered by the EESS will be around \$50–\$60 million. However, because of the capping arrangements, DEWRSB indicates that the likely cost of payments eligible to be made through the EESS will be considerably lower at \$30–40 million (of which the Commonwealth will pay half).

Although capping may reduce budget outlays, cost reduction is not, by itself, a good economic or social rationale for imposing limits on the amount of insurance payments made to employees:

- The capping of *individual* employee payments does not cap the *aggregate* budget outlay, the size of which is determined principally by the number of insolvent firms.
- As an instrument for constraining outlays, capping of individual entitlements places all the burden on a few individuals.
- Even when a government-funded scheme comes well under budget in a particular year, there may still be some individuals who do not receive their full entitlement.

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5 Another possible (but less significant) rationale for capping is that it might conceivably reduce moral hazard on the part of both employers and employees. For a discussion of the issues, see Bickerdyke, Lattimore and Madge (2000).

In fact, with respect to the last point, this appears likely in the EESS's first year of operation in Australia. As noted above, the Commonwealth has estimated (DEWRSB, 2001) that the annual aggregate loss of employee entitlements due to employer insolvency might be in the order of one-half of its original estimate. However, due to capping arrangements, the EESS would still pay affected employees, on average, only 60 per cent ($4,354 instead of $ 7,200) of the amount outstanding for the components covered by the scheme.

There are some other issues relevant to the desirable extent and nature of capping.

First, caps may provide less insurance than employees would wish to buy in a properly functioning insurance market. Insurance is most valued by people when it insulates them against rare adverse events that would have a significant impact. In effect, caps force some employees to take out only partial insurance.[6] If the primary intention of the government-funded insurance policy were to try to maximise the welfare gains for employees, taking into account their likely preferences for avoiding risk, no or little cap would be the most appropriate outcome.

Second, a cap may affect the distribution of claims among competing creditors that would have proceeded under insolvency law. Take, for example, a business in which the only creditors are two employees with $120,000 of claims — employee 1 is owed $100,000 and employee 2 is owed $20,000. However, the business assets can only realise $60,000. Under normal insolvency law, both employees would get 50 cents in the dollar, based on the principle of equal treatment of creditors. However, supposing there is a $20,000 cap, then under the insurance arrangements, both employees initially get $20,000 each. The government, in turn, claims this money back from the administrator, leaving $20,000 to be disbursed. Since employee 2 has had all of his or her claims met, only employee 1 can claim these assets. Accordingly, combining the effects of insurance and disbursement of the residual assets, one employee (employee 1) gets 40 cents in the dollar, while another gets 100 cents in the dollar. Capping has thus reduced the pay-off ratio by 10 cents in the dollar for one creditor and increased it by 50 cents in the dollar for another.

Conclusion

The employment impacts of business insolvencies are relatively modest. Direct job losses resulting from bankruptcies and liquidations in Australia in 1999-00 are estimated to have accounted for less than 1 per cent of total job losses in that year.

Nevertheless, in the event of business insolvency, employees are seen as a particularly vulnerable group that often loses a significant share of its claims on the insolvent business.

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6 In principle, employees could voluntarily take out their own insurance against loss over and above the capped amount. However, there may be a number of potential problems, as described under option 3 above.

Governments around the world use a variety of mechanisms to protect employee entitlements in the event of business insolvency. These mechanisms generally consist of an employee protection fund made up of contributions from governments, employers or employees. A government-funded national employee protection fund was introduced in Australia in early 2000.

Employee protection funds have some significant advantages. They are easy to implement, are administratively simple and have low costs (although liabilities may be significantly higher during economic downturns). However, employee protection funds also have some limitations.

As the funds are provided by government, riskier businesses face no penalty through insurance premiums. This might increase risk-taking behaviour — the problem of 'moral hazard'. The capping practices associated with employee protection funds mean that some employees can receive relatively low levels of insurance cover. In the case of the Australian employee protection fund, the effect of capping arrangements, combined with the failure of the States to contribute their half share, means that eligible claimants are, on average, only receiving around 30 per cent of their lost employee entitlements through the scheme.

Other forms of employee protection mechanisms that are potentially available include compulsory risk-rated employer insurance, voluntary employee insurance and accrued employee entitlements held in trust. While these have some benefits — particularly in addressing the relative risks of different businesses — they are likely to involve some transaction costs and implementation problems.

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