Unemployment Insurance and Fiscal Stimulus

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Sticking to the Principles

In previous papers, we have delineated principles for judging the stimulative impact of tax proposals and then applied those principles to recent tax proposals.[2] According to these principles, any tax cut should be temporary, have a significant stimulative bang for the buck, and avoid long-term damage to the nation's fiscal position.

These same tests should be applied to spending proposals included in any stimulus package. Indeed, if anything, recent economic releases have underscored the importance of the principles. To be sure, output fell during the third quarter of 2001 and employment declined substantially in October, highlighting the benefits of a timely stimulus package. But according to professional forecasters, the slowdown is expected to be temporary – with the economy recovering sometime next year.[3] The expectations of professional forecasters, of course, can be wrong, but they are the best we have at this point. They strongly suggest that any stimulus should be focused on the next six to nine months, when the economy most needs the assistance.

Recent budget updates also highlight the importance of maximizing the bang for the buck and ensuring minimal costs to long-term fiscal discipline. A recent analysis released by the bipartisan leadership of the House and Senate Budget Committees showed that with the costs of the recently passed tax cuts, measures to combat terrorism, and the weaker economy, the United States will be unable to have a balanced budget without the use of Social Security surpluses until 2007.[4] The situation is far worse once the expected costs of fixing the individual alternative minimum tax and other expected costs are incorporated into the analysis: A recent paper that we co-authored with Bill Gale of Brookings suggests that the deficit outside Social Security may amount to about $1.5 trillion over the next 10 years under reasonable assumptions that incorporate these other costs.[5] Within this new budgetary context, tax or spending measures that

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[2] This work was undertaken in conjunction with William Gale of the Brookings Institution. See William Gale, Peter Orszag, and Gene Sperling, "Stimulating the Economy Through Tax Policy: Principles and Applications," The Brookings Institution, October 5, 2001; William Gale, Peter Orszag, and Gene Sperling, "Tax Stimulus Options in the Aftermath of the Terrorist Attack," *Tax Notes*, October 8, 2001; William Gale and Peter Orszag, "Evaluating President Bush's Tax Stimulus Package," The Brookings Institution, October 9, 2001; Peter Orszag, "Evaluating Economic Stimulus Proposals," Committee on the Budget, U.S. Senate, October 25, 2001; and William Gale, "Perspectives on the Tax Stimulus Debate," Committee on the Budget, U.S. Senate, October 25, 2001.

[3] For example, the Blue Chip consensus of leading economic forecasters now projects negative growth in the fourth quarter of 2001 (which, given the negative growth in the third quarter, would produce a recession under the informal definition of that term). But these same forecasters also project robust growth by the end of next year, with growth of over 3 percent in the third quarter of 2002 and 4 percent in the fourth quarter of 2002.

[4] "Revised Budgetary Outlook and Principles for Economic Stimulus," Senate Budget Committee (Senator Kent Conrad, Chairman; Senator Pete V. Domenici, Ranking Member) and House Budget Committee (Rep. Jim Nussle, Chairman; Rep. John M. Spratt, Jr., Ranking Member), October 4, 2001.

[5] William Gale, Peter Orszag, and Gene Sperling, "The Changing Budget Outlook: Causes and Implications," Brookings Institution, October 11, 2001. Richard Kogan of the Center on Budget and Policy Priorities has reached a

have long-term costs and are not tightly tied to stimulating demand during the next nine months may not only miss the mark, but could actually do harm.

The appropriateness and effectiveness of all stimulus options should thus be judged on the degree to which they bolster demand during the current short-term economic downturn without damaging the long-term fiscal picture. This analysis evaluates proposals to expand or extend unemployment insurance within that context.

The Basics of Unemployment Insurance

The Unemployment Insurance (UI) program was created during the Great Depression as part of the Social Security Act of 1935. It was designed to attenuate the hardships of involuntary job loss and stabilize the economy by supporting the consumption patterns of the unemployed. Benefits and eligibility are determined at the state level under Federal guidelines, with a majority of the program's funding effectively coming from state-level employer taxes. In addition to these state-level employer taxes, the Federal government imposes an unemployment insurance tax of 0.8 percent of covered wages.[6]

Eligibility is open to workers whose employers contribute to state unemployment insurance funds, federal civilian employees, and former military service members, as long as the workers are unemployed and are able, available, and looking for work. Under all state laws, the weekly benefit amount varies within certain minimum and maximum limits and is calculated as a function of the wages earned in one or more quarters of some base period (which is typically the first four quarters of the last five completed calendar quarters preceding the claim for unemployment benefits). During sound economic times, most states replace 40 to 50 percent of previous wages for up to 26 weeks of unemployment.

Unemployment Insurance as an Economic Stabilizer

Not surprisingly, job loss is often associated with a decline in consumption, which then reduces demand for other goods and services as part of a negative cycle of increasing unemployment and declining economic activity. The unemployment insurance program helps to break this negative cycle: By partially compensating for lost income, it attenuates the reduction in spending and demand that unemployment can cause. For example, according to research undertaken by MIT Professor Jonathan Gruber, the amount a family spends on food falls by 7 percent, on average, when the head of a household becomes unemployed -- but would decline by 22 percent in the absence of unemployment benefits.[7]

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similar conclusion. See Richard Kogan, "Where Has All the Surplus Gone?" Center on Budget and Policy Priorities, November 1, 2001.

[6] Technically, the Federal government imposes a 6.2 percent gross tax rate on the first $7,000 of earnings, but then provides a credit to the employer for 5.4 percent of those earnings – so that the effective Federal rate is 0.8 percent. The state employer taxes vary by type of employer, and the state taxes have different wage bases. For example, the tax in Arizona is imposed on the first $7,000 of earnings, but the tax in Alaska is imposed on the first $25,500 of earnings.

[7] Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87, March 1997, pages 192-205.

Reflecting its effectiveness as a counter-cyclical stabilizer, the UI program provides the most aid to those geographic areas with the greatest concentration of unemployment and economic distress. Communities that experience high rates of unemployment receive more stimulus in the form of unemployment insurance, thus mitigating the effects of lost wages on the local economy. Indeed, Jonathan Gruber also confirms that a newly unemployed person is more likely to live in a county or state with higher unemployment than a person keeping her job. The paper estimates that those who become unemployed reside in counties and states with unemployment rates that average 10.3 percent and 8.2 percent higher respectively than those who remain employed.[8]

The counter-cyclical benefits of the UI system have been corroborated in recent studies. One recent study commissioned by the Department of Labor concluded that UI has had a significant impact in dampening recessions.[9] Another recent study found that, for its size, the unemployment insurance system is remarkably effective as an automatic stabilizer.[10]

In summary, unemployment insurance benefits respond quickly to an economic downturn, and then help to mitigate the severity of that downturn by providing crucial assistance to those recently unemployed.

Analyzing New Proposals

Households with an unemployed worker are often in some form of economic distress, and therefore tend to spend a high percentage of received unemployed benefits.[11] Unemployment insurance benefits are thus a particularly effective stimulus: They are concentrated on those with relatively high propensities to consume, and translate quickly into higher spending and additional demand. But despite the potential for unemployment insurance to play a significant role as a stabilizing force in the current economic downturn, its effectiveness is limited for three reasons: The triggers for additional weeks of benefits beyond 26 weeks are excessively tight; eligibility rules are outdated; and benefit levels are relatively low.[12]

1. Extending the duration of unemployment benefits

Extending the duration of UI benefits beyond 26 weeks may be counter-productive in sound economic times. For example, Lawrence Katz and Bruce Meyer estimate that extending the duration of benefits from six months to one year would increase unemployment spells by 4 to

[8] Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," National Bureau of Economic Research, Working Paper 4750, May 1994.

[9] Lawrence Chimerine, Theodore Black, and Lester Coffey, "Unemployment Insurance as an Automatic Stabilizer: Evidence of Effectiveness over Three Decades," Unemployment Insurance Occasional Paper 99-8, U.S. Department of Labor, July 1999.

[10] Alan Auerbach and Daniel Feenberg, "The Significance of Federal Taxes as Automatic Stabilizers," *Journal of Economic Perspectives*, Vol. 14, Number 3, Summer 2000, pages 37-56. Auerbach and Feenberg found that the unemployment insurance system provides roughly 25 percent of the automatic stabilizer impact as the entire tax system, despite the fact that UI benefits are only about 1.5 percent to 3 percent of the size of total Federal revenue.

[11] Alan Krueger, "Economic Outlook and Policies in Light of Recent Events," Committee on the Budget, U.S. Senate, October 2, 2001.

[12] See, for example, National Employment Law Project, "Unemployment Insurance: Key Elements for an Economic Stimulus Package," September 2001.

5 weeks.[13] In sound economic times, increasing the duration of eligibility could increase unemployment and create incentive problems in the job search process. Indeed, many economists believe that Europe's high unemployment rates partially reflect the duration of benefits available there (in addition to the generosity of the unemployment insurance benefits).

The situation is somewhat different in a deteriorating job market. As the economy slows, longer spells of unemployment more likely reflect scarce job opportunities rather than a lack of effort in finding a new job. In a deteriorating labor market, those already unemployed will find it difficult to obtain a new job no matter how earnestly they search for one. This helps explain why during spells of high unemployment, current law provides for an extension of benefits from the standard 26 weeks by an additional 13 to 20 weeks. Indeed, a system of automatic triggers was adopted in 1970 to extend benefits when insured unemployment rates -- that is, unemployed workers receiving benefits as a percentage of the covered labor force -- hit predetermined levels, avoiding the delays and disputes inherent in creating temporary benefit extensions. Unfortunately, the triggers were tightened so significantly in the early 1980s that they are no longer relevant in anything but the most severe economic depression.[14]

Three automatic triggers exist for the extension of benefits. States are required to provide extended benefits when the state's insured unemployment rate averages 5 percent or more over a 13-week period and 120 percent of the state's average in the same period in the last two years. All but 12 states have adopted a second trigger that extends benefits if the insured unemployment rate raises above 6 percent, regardless of whether it has increased in the past two years. A third trigger, afforded to states in 1992 legislation and adopted by only eight states, extends the period of eligibility if the *total* unemployment rate averages 6.5 percent or higher for the three most recent months and 110 percent of the average over the same period in the past two years**.** The first two triggers are based on the "insured" rate -- which covers only those unemployed workers receiving benefits under the state's unemployment insurance program. This number is 2 to 3 full percentage points below the household unemployment rate from the Current Population Survey, which is the more widely quoted and understood number. Thus a trigger defined as 6 percent for the insured rate translates into a household unemployment rate that is much higher – perhaps 9 percent or so.

Given the declines in unemployment rates and the percentage of those unemployed receiving benefits, triggers based on the insured unemployment rate are now excessively restrictive. As of the second quarter of 2001, Department of Labor data show that only 12 states had an insured unemployment rate (IUR) above 2.5 percent and only 5 states (Alaska, Oregon, Pennsylvania, Puerto Rico, and Washington) had an IUR above 3.0 percent, while the average IUR across states was 2.1 percent. That means 38 states would require a doubling of their IUR and five states would require at least a two-thirds increase in the insured unemployment rate to set off the automatic triggers for extended benefits. In the 1990-91 recession, a separate temporary extension program (the Emergency Unemployment Compensation program) was created because the triggers were reached in only 10 states. As recent proposals have

[13] Lawrence Katz and Bruce Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment," *Journal of Public Economics*, Volume 41, Issue 1, February 1990, pages 45-72.
[14] See, for example, Wendell Primus, "Economic Security: Helping Working Americans and Those Out of Work," prepared testimony for the Health, Education, Labor & Pensions Committee, United States Senate, October 2001.

underscored, the current situation requires a similar program: The automatic triggers are not sufficient to address the underlying problem.

President Bush's 'Back to Work Relief Package' would extend benefits for the unemployed given that they meet certain requirements. The administration would provide an extra thirteen weeks of benefits to the unemployed if they became unemployed after September 11th, 2001, live in states where the total unemployment rate rises 30 percent above the pre-September 11th rate, or live in one of the three states (Virginia, New York, and Pennsylvania) that President Bush declared major disaster areas after the terrorist attacks.

As a stimulus measure, the Administration approach has several drawbacks. First, because the extension of benefits from 26 to 39 weeks only goes to those who became unemployed after September 11, the extended benefits would not kick in – and therefore no additional stimulus would be provided -- until March 12, 2002 at the earliest, even though forecasters project that the most vulnerable economic period will occur over the next several months. In October 2001, 26 percent of the unemployed had been out of work for 15 weeks or more. That means that roughly hundreds of thousands of unemployed Americans could be close to exhausting their benefits. Since these unemployed workers lost their jobs before September 11, they would never receive extended benefits under the President's Back to Work plan. Nor would their communities receive the stimulus from their extended benefits. The Labor Department estimated that if the recession is comparable to the recession of the early 1990s, the extra weeks of jobless benefits provided by the Administration's proposal would cost $5 billion. In the 1990-1991 recession, by contrast, $35 billion (in 2002 dollars) of additional weeks of benefits were provided through the mechanism that Congress created at that time.[15]

Secondly, the President's plan would only provide benefits to newly unemployed workers in states in which the unemployment rate had increased by 30 percent above its June-July-August 2001 average. This standard undermines the important role of UI as a cushion to the most distressed areas. For example, a state with 3.0 percent unemployment over the summer of 2001 would be eligible for extended benefits if its unemployment rate climbed to 4 percent (a 33 percent increase). Yet, a far more distressed state with, say, 7 percent unemployment over the summer would be ineligible even if its unemployment rate rose to 8 percent (a 14 percent increase), even though it has an unemployment rate twice the level of the first state.

The unemployment insurance proposal passed by the House of Representatives would be even less effective in providing an effective stimulus to the economy. The House bill simply accelerates the transfer of $9.2 billion to state unemployment accounts from the federal UI Trust Fund. The additional funds are supposed to provide states the option of extending benefits, but it is left as a state option and would require legislative changes in most states. Furthermore, as the Center on Budget and Policy Priorities has emphasized, "the $9 billion in funds that would be transferred to state unemployment accounts would be allocated among the states *not* on the basis of current need or unemployment levels but in accordance with where the revenues in the federal unemployment trust fund were collected. As a result, the level of funds allocated to many states would bear little relationship to the need for additional unemployment benefits for laid-off

[15] Robert Greenstein, "The Administration's Stimulus Proposal: Is it a Sound and Balanced Package?" Center on Budget and Policy Priorities, October 9, 2001.

workers in those states."[16] Since many states would be reluctant to spend the transfer quickly on extended benefits, and since the transferred funds would not be well-targeted to those states that most need them, the Congressional Budget Office estimates that only $2.3 billion would be spent in FY2002.

The Baucus legislation in the Senate would be more effective in providing an effective economic stimulus.[17] It would immediately extend benefits by thirteen weeks to the long-term unemployed, defined as those who have been receiving benefits for 26 weeks. (As of October 2001, 888,000 individuals, or 11.4 percent of the unemployed, had been unemployed 27 weeks or longer.) The proposals would provide federal financing for the extended benefits, ensuring that the extensions did not impose any additional burden on state budgets or unemployment insurance programs.

2. Expanding eligibility

For various reasons, the majority of unemployed workers do not qualify for unemployment insurance benefits. Indeed, only about 40 percent of the unemployed currently receive benefits. To be sure, a substantial percentage of the unemployed are either new entrants to the labor market or are recent re-entrants – and therefore should not be expected to receive unemployment benefits. But even unemployed workers with a recent attachment to the workforce will sometimes be excluded from unemployment insurance benefits for reasons described below.

One eligibility restriction involves the definition of "available for work." In 31 states, part-time workers are excluded from unemployment insurance benefits because the states require workers be available for full-time work as a condition for eligibility.[18] In such states, an individual who has been working even 30 hours a week and cannot commit to more hours -- perhaps because of child care needs -- is not eligible for unemployment insurance benefits, even though UI taxes had been collected on the worker's previous earnings and the person is seeking work..

Another reason many unemployed workers fall through the cracks is that they have not worked enough quarters to be eligible for UI benefits. In many states, the current quarter and the previous quarter of work are not counted in determining eligibility. Therefore workers who have recently joined the labor force are often ineligible.

These two limitations fall particularly hard on single working mothers who have just left welfare to join the workforce. Such former welfare recipients may be the first let go in an economic downturn because of their lack of seniority; the inability to count the last two quarters they work can be critical for their eligibility. Furthermore, because many are single mothers, they

[16] Joel Friedman and Robert Greenstein, "Ways And Means Package Departs From Bipartisan Principles For Effective Stimulus and Offers Little Help to the Unemployed," Center on Budget and Policy Priorities, November 5, 2001.
[17] For a description of the legislation, see Senate Finance Committee, "Economic Recovery and Assistance for American Workers Act of 2001," November 6, 2001.
[18] Wendell Primus, "Economic Security: Helping Working Americans and Those Out of Work," prepared testimony for the Health, Education, Labor & Pensions Committee, United States Senate, October 2001.

may have difficulty meeting the full-time work requirements discussed above. The unemployment rate for women who maintain families has risen from 5.1 percent at the end of 2000 to 7.0 percent in September 2001.[19]

Temporarily expanding unemployment insurance benefits to these types of unemployed workers would likely have a very high bang for the buck: Since the benefits are relatively well-targeted toward those with low incomes and without substantial assets, the additional benefits would be spent quickly. Yet the Administration's proposal and the House bill do nothing to extend unemployment insurance along these dimensions. The Baucus legislation would provide Federally funded benefits for workers who would qualify for benefits if their most recent quarters of work were included in their wage record, and workers seeking part-time work. The cost of this temporary change is relatively modest, but may be among the highest bang-for-the-buck components of any stimulus package.

3. Raising benefit levels

Unemployment insurance benefits are relatively low: In many cases, they fall significantly below poverty levels. The *average* unemployment benefit is just over $200 per week – which is below the poverty threshold for families with two or more people. UI benefits, furthermore, vary substantially from state to state. In Mississippi, for example, the average state benefit is roughly $150 a week – relative to roughly $300 in Massachusetts. Since benefits are only received by those who have experienced a reduction in income from the loss of their jobs and whose consumption expectations may therefore exceed their current income, an increase in benefit levels (especially in relatively low-benefit states) would spur spending and stimulate the economy.

As with the extension of benefits beyond 26 weeks, policy-makers should be careful in raising UI benefits during sound economic times. Economic research suggests that more generous benefits may reduce the effort that the unemployed devote to finding a job and therefore cause workers to remain unemployed longer.[20] But as with the duration of benefits, this concern is less relevant in the context of an economic downturn: Given a weakening labor market, the search effort of unemployed workers will likely be a relatively less important determinant of whether they find a job than in strong economic times. Any incentive problems associated with increased UI benefits – especially if the increases are temporary -- may therefore be less important during an economic downturn than at other times.

Raising UI benefits on a temporary basis would have a relatively high bang for the buck. The Baucus legislation would raise unemployment insurance benefits by 15 percent of the worker's benefit, or $25 per week, which is greater. But the Administration proposal and the House legislation include no explicit provisions for increased UI benefits.

[19] Wendell Primus, "Economic Security: Helping Working Americans and Those Out of Work," prepared testimony for the Health, Education, Labor & Pensions Committee, United States Senate, October 2001, page 6.
[20] See Anthony B. Atkinson, John Micklewright, "Unemployment Compensation and Labor Market Transitions: A Critical Review," *Journal of Economic Literature*, Vol. 29, December 1991, pages 1679-1727.

Conclusions

Expanding unemployment insurance benefits would provide economic stimulus when it is needed without damaging the long-term budget outlook. The UI program is able to target the pockets of the economy that need the most stimulus, effectively limit the decline in consumption for those who become unemployed, prevent the loss of more jobs, and dampen the severity of the recession. Temporary expansions in unemployment insurance to cover part-time workers, extend benefits beyond 26 weeks, and raise benefit levels would have a high "bang for the buck" in stimulating the economy over the next few quarters.