Insuring AGAINST Recession

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Although the economy may yet skirt a recession, there is no question that the labor market has turned down. And if this downturn is like recent ones, it will take a while for the job market to recover. A short-term economic stimulus package could speed the recovery and help reduce poverty. Unfortunately, the stimulus bill that the president proposed and Congress passed had different goals. But it is not too late for them to return to the drawing board for a second try.

A short-term economic stimulus program should have three goals. First, and most obviously, it should stimulate the economy. Second, it should provide relief to individuals whose economic situation was severely and unexpectedly hurt by the downturn—not just because these individuals need the most help but also because such targeting assists with stimulus. Third, the program should not weaken the government's long-term budget position. The bipartisan stimulus plan that quickly passed Congress this spring was notably weak on the second criterion in that unemployed job seekers receive little relief from the enacted stimulus package.

We can build a better stimulus plan by retooling the unemployment insurance (UI) program. Before laying out this argument, some background information may be useful.

According to the Bureau of Labor Statistics (BLS), "Persons are classified as unemployed if they do not have a job, have actively looked for work in the prior 4 weeks, and are currently available for work." The unemployment rate has been creeping up in recent months, rising from 4.5 percent in April 2007 to 5.0 percent in April 2008 (both seasonally adjusted). It is also worrisome that the average duration of ongoing unemployment spells has been rising for some time. In January 2001, the average duration of unemployment for an unemployed worker was 12.7 weeks; in January 2008 it was 17.5 weeks. Nearly one in five of those currently unemployed have been unemployed for more than six months. Data from recent Gallup Polls indicate that Americans, especially those in middle and higher income groups, are increasingly concerned that it has become more difficult to find a quality job. Workers are anxious about the job market, and they are reining in consumption.

Unemployment has serious economic consequences for the unemployed and the broader population. Jonathan Gruber of the Massachusetts Institute of Technology, for example, has found that consumption of food, clearly a basic necessity, falls for the unemployed. He further finds that receiving UI benefits reduces the drop in food consumption of the unemployed. And the very existence of unemployment implies that we are not getting the most out of our resources, which costs the economy output and tax revenue. In a very real sense, providing adequate UI and providing economic stimulus go hand in hand.

The unemployment insurance program provides automatic economic stimulus because benefits ramp up temporarily in a downturn and reach those most in need. For example, outlays for unemployment insurance soared from $14 billion in 1989 to $37 billion in 1992, when the jobless rate peaked, and fell to $21 billion in 1995, when the labor market improved. By building up reserves in prosperous times and spending them in weaker times, the program helps stabilize the economy. And unemployment insurance provides a measure of security for those who do not directly receive benefits. Just knowing that benefits are available in case of job loss inspires confidence. A strong safety net also makes it unnecessary to have industry-by-industry bailouts in response to adverse shocks.

The last two recoveries from recessions could be described as "jobless recoveries." Unemployment lingered and job growth was painfully slow for months after the recessions officially ended. Although no one has a crystal ball—and it is unclear how long the current slowdown will last, or whether it will be declared a recession by the National Bureau of Economic Research's Business Cycle Dating Committee—there are reasons to expect unemployment to linger after the current slowdown ends. In this environment, it is particularly appropriate to consider reforms to the UI program, both temporary and permanent. Undertaking these reforms would help both unemployed workers and the economy as a whole bounce back.

As with all insurance programs, UI involves several trade-offs. Paying benefits to the unemployed could induce some people to stay unemployed longer than they otherwise would. Economists have long noted that reducing the burden of unemployment increases the opportunity cost of work, leading some unemployed workers to delay a return to work. Such an incentive effect, however, is not a sign of the program's failure. It simply means that the unintended consequences must be weighed against the desired effects of the program, and an appropriate balance struck. In addition, recent research by Raj Chetty of UC-Berkeley suggests that it may be desirable from society's perspective to provide job seekers who have inadequate savings sufficiently generous UI benefits to enable them to stay out of work longer and search for an appropriate job. Longer spells of unemployment, to the extent they occur, are not necessarily undesirable if they enable workers to find jobs that use their skills fully. Thus, longer unemployment spells are not always an unintended consequence of UI. In a downturn, when good jobs are harder to find and spells of unemployment are longer, the balance of UI's intended and unintended consequences shifts, and we should worry more during those times about cushioning the blow of unemployment.

Through a series of sensible reforms, UI could be a much more efficient and effective program. Four reforms in particular should be considered.

Automatic triggers: The automatic triggers that temporarily turn on extended benefits without Congressional action are no

longer set at realistic levels. The state triggers are connected to the insured unemployment rate, which is the fraction of covered workers who receive benefits. The insured unemployment rate must exceed 5 percent for extended benefits to be provided and must be 120 percent above the rate in the corresponding period in each of the prior two calendar years. Because insured unemployment has drifted down relative to the BLS's unemployment rate (which includes all unemployed workers, insured and ineligible), and because the natural rate of unemployment has declined, it is now very unlikely that a state will automatically trigger extended benefits. In practice, the automatic triggers have become irrelevant. These automatic triggers have not been modernized, and modernizing them would significantly improve the current system. If more reasonable automatic triggers are not put in place, a short-term fix would be to extend the maximum duration of benefits in the current economic slowdown, especially in those areas with high unemployment. Extended benefits are well targeted to a population that is very much in need of assistance, and that population is growing.

Making layoffs more costly: The financing of UI could do more to stabilize the economy and discourage layoffs. The federal government sets minimum standards for state unemployment insurance programs and has a history of encouraging "experience rating." The practice of experience rating discourages employers from laying off workers because it assesses a higher UI contribution rate for employers with a worse history of layoffs. This unique feature of the American UI system may in part help to account for the relatively low unemployment in the United States compared with other economically advanced countries.

Unfortunately, the degree of experience rating has severely lapsed. Better experience rating could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers, and by requiring the states to have at least five different rates and to spread employers among the rates. Some states have only two rates. In addition, the per employee taxable earnings cap—which ranges from $7,000 to $10,000 in half of the states—should be raised, which would allow better experience rating at lower tax rates and make the financing of the program less regressive. Raising the caps and lowering the rates would also increase demand for less skilled workers. Improved experience rating would discourage employers from laying off workers, and help internalize the externalities layoffs impose on society. A study by David Card of UC-Berkeley and Phillip B. Levine of Wellesley estimates that the unemployment rate would decline by six-tenths of a percentage point if industries were fully experience rated—that is, if employers in an industry were required to pay the full additional costs of unemployment benefits for layoffs in that industry. These changes could be made in a way that is revenue neutral, so the tax on employers as a group would not change.

Eligibility for part-time workers: Third, unemployed workers who are otherwise eligible for UI but are searching for a part-time job (because of family obligations, for example) are ineligible for benefits in many states, a restriction in coverage that should be changed. These workers pay into the system, but are prevented from receiving benefits when they and their

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Alan Krueger chats with Senator Ted Kennedy (D, Massachusetts) after testifying before Congress on Unemployment Insurance reform in March, 2008.

families need them. States could be required to expand eligibility. Workers who would be made eligible for UI benefits as a result of this reform would be primarily single-parent, female, and low-income earners, all of whom are likely to be particularly hard hit by an economic downturn.

Addressing the credit crunch: Last, but not least, the credit crunch that the economy is experiencing presents a unique situation in which a temporary increase in the level of UI benefits may be particularly timely. Unemployment benefits help unemployed workers maintain a minimum level of consumption when their income drops. Benefits replace around 50 percent of lost earnings, but the replacement rate is typically less than that because benefits are capped, often at less than $400 a week. The average weekly UI benefit as a percent of the average weekly wage of covered workers was only 34.5 percent in the third quarter of 2007 according to Labor Department data. Even with UI benefits, many of the unemployed are forced to borrow to pay their bills. But borrowing is difficult in the current credit crisis. In addition, many adjustable rate mortgages are resetting, requiring higher monthly payments. Even the short-term unemployed may face pressure meeting mortgage payments. A temporary increase in UI benefits can thus help forestall mortgage foreclosures for a vulnerable population.

This is not of course to suggest that UI reform alone is enough. A meaningful stimulus package should also assist workers who are not eligible for UI—for example, by improving food stamp eligibility and delivery. But UI reform should be a central part of any sensible stimulus package. In this most recent economic slowdown, the set of policy choices we've made does little to buffer harsh consequences for low-income workers. By helping those workers, we not only assist where need is greatest, but we promote economic stimulus by smoothing consumption and bolstering demand. The simple conclusion: A reformed UI would help not only those who find themselves out of a job but the rest of us as well.

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