

Fix Unemployment Insurance First

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Unemployment Insurance (UI) started in the United States during the Great Depression. Despite its relatively small size – accounting for less than 2 percent of the federal budget in the 1990s – the program has become one of the government’s most important automatic stabilizers. When unemployment rises, benefit payouts automatically rise, stabilizing the economy. Likewise, when the economy is booming, UI benefits automatically decline. A 1999 study by the Labor Department estimated that UI mitigated about 15 percent of the decline in GDP that occurred in the last five recessions.

The UI program is the quintessential economic stimulus. The program also gives valuable help to those in need. According to standard economic analysis, the optimal level of UI benefits should be set by balancing the consumption-smoothing effect of benefits against the adverse effect of benefits on individuals’ incentives to search for a new job. During a recession, however, the adverse impact of reduced search intensity is likely to be reduced because jobs are less plentiful regardless of how hard someone looks for work. Moreover, the benefit of consumption smoothing is higher. Thus, making benefits longer lasting, more generous, and more widely available makes economic sense during a downturn. The UI program could be strengthened to offset the negative economic shocks that began in the middle of 2000 and accelerated after September 11th.

Unfortunately, the stimulus package before Congress is bogged down in a battle of partisan politics. In the meantime, the unemployed suffer. The following considerations lead me to recommend setting a goal of *fixing unemployment insurance first* – either as part of a stimulus package or as a stand-alone bill. Even if a broad stimulus package is never passed, a UI reform package will provide immediate benefits for unemployed workers and strengthen the U.S. economy.

- UI reform would be particularly valuable in the current downturn because most analysts agree that the main short-term threat to the economy is a collapse in consumer spending. The main goal of the stimulus package should be to reduce consumer jitters. If workers know there is a strong safety net beneath them, they will pursue more normal consumption plans despite uncertain times.
- UI benefits ramp up quickly in a downturn. Outlays soared from \$13.5 billion in 1989 to \$37 billion in 1992, when the unemployment rate rose from 5.3 to 7.5 percent, and fell to \$21 billion in 1995, when the unemployment rate returned to 5.6 percent.
- Progressive taxes also automatically stabilize the economy by taxing a larger share of income during good times. Because of reductions in the progressivity of income taxes, however, taxes currently provide less of an automatic stabilizing effect than they did in 1980.

- Unlike many elements being considered in the stimulus packages before Congress, UI will pay money out quickly to those who will spend it quickly. For example, income tax rebates will not be out until the Spring of next year, at the earliest. An acceleration of previously enacted tax rate reductions also will not have a quick impact on spending and will not be targeted to those with the highest marginal propensity to consume.
- UI benefits will quickly decline when the economy improves, so the long-term budget outlook will not be adversely affected. Moreover, there is a tradition of enacting temporary extensions of UI benefits during economic downturns. These extensions have not become permanent, so there is little risk to the long-term budget picture.
- By building up reserves in prosperous times and spending them in weaker times, the financing of the UI program helps stabilize the economy. Many states let their UI funds lapse in the booming 1990s. Reforms to ensure responsible state financing of UI should not be overlooked. To shore up the system, states could be required to improve experience rating and maintain adequate trust fund balances in the future. This could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers or requiring states to use a minimum of five different tax rates; employer lobby groups have opposed improved experience rating. In addition, the per employee taxable earnings cap – \$7,000 to \$10,000 in most states – should be raised, which would permit better experience rating at lower tax rates.
- In contrast to UI trust funds in many states, federal UI funds are currently flush. The federal funds contain close to \$40 billion. If the money is not spent on the unemployed now, then when?
- Just over 7 million workers are currently unemployed. If the unemployment rate rises to 6 percent, 8.5 million workers will be unemployed. If it rises to 7 percent, 10 million workers will be unemployed. Business tax cuts and income tax rate reductions will provide little benefit for these workers. Dick Armey, for example, generously predicts that the stimulus bill narrowly passed by the House will increase employment by only 170,000 jobs.
- Only 42 percent of the unemployed workers received unemployment benefits in September 2001. This is down from a high of 75 percent in 1975. (The take-up rate here is measured as the ratio of the insured unemployment to total unemployment.)
- Workers who seek part-time jobs are precluded from receiving UI benefits in most states, even though their earnings are taxed to finance the program.
- Increasing the generosity of UI benefits and providing benefits to part-time job seekers will give unemployed workers who are not currently eligible for benefits a stronger incentive to search for work. Finding employment for out-of-work individuals who are not currently eligible for UI becomes more attractive if they can qualify for UI benefits if they should lose their job.