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Comments on 'The Recession of 2001 and Unemployment Insurance Financing'

Although interest in the details of unemployment insurance financing is a minority pastime, even among economists, the topic is nonetheless an important one. This is because unemployment insurance is not just a way of ameliorating the impacts of a recession on the unemployed; it is also has a potential role to play in making the recession itself less severe through its traditional 'automatic stabilizer' role. Someone who has just lost their job is likely to severely curtail their spending, which reduces overall aggregate demand, further exacerbating the economic downturn. A properly designed UI program can help reduce the impact of higher unemployment by supporting the consumption of the unemployed. UI also has the advantage of responding quickly to a downturn; unlike discretionary fiscal policy such as tax cuts, additional money is injected into the economy as soon as unemployment starts rising; there is no need to wait for the Administration to put a bill through Congress.

Thus it is important for policymakers to ask themselves whether the UI programme is fulfilling its macroeconomic role effectively, especially after a significant downturn in the economy. The paper by Dr Vroman allows us to do precisely that, by providing an in-depth investigation of how state UI systems responded to the 2001 recession.

* All interpretations and comments in this comment are the author's own, and should not be attributed to the Government of Canada.

The paper argues that although the decline in GDP was mild by historical standards, the average duration of unemployment was longer than usual. Furthermore, claims for regular UI benefits remained at a persistently high level for a significant period. This put pressure on state UI systems, especially those states that did not build up their trust funds during the economic boom years of the 1990s. Some states raised UI payroll taxes to cope with the deterioration of their UI trust funds, whereas others were required to borrow. Because borrowing from the U.S. Treasury can be very expensive, a few states have issued bonds in the private capital markets in order to maintain the solvency of their trust funds. Interestingly, those states that issued bonds in previous recessions did not have lower reserve ratios going into the 2001 recession.

From the perspective of someone concerned with macroeconomic policy, the paper raises three important questions. First, was there really something unusual about the 2001 recession? Or could state UI programmes have predicted the magnitude of the impact on labour markets and thus on trust fund balances? Second, did the state UI programmes respond as they ought to a negative macroeconomic shock? Did these programs perform their automatic stabilizer function? Thirdly, is the federal UI framework in which state system function appropriate? Is borrowing from the U.S. Treasury too onerous for states, forcing them to raise benefits or cut benefits, thereby exacerbating the impact of the recession? Or is borrowing too easy, giving states an incentive to be fiscal imprudent?

Beginning with the issue of the severity of the 2001 recession, the peak level of unemployment, 6.3 per cent, was, as Vroman notes, well below the peak in previous recessions. However, from the perspective of state UI systems it is the *change* in the unemployment rate that is most relevant for explaining the *change* in reserve ratios. Here again, though, the trough-to-peak change in the unemployment rate in the 2001 recession was only 2.5 percentage points, slightly lower than the 2.8 trough-to-peak change in the 1991 recession. On the face it, then, it might seem that states should have been able to predict, if not the timing[1], then at least the impact of the 2001 recession on trust fund balances.

One possible response to this conclusion is that the unemployment rate is the product of both the incidence of unemployment and its duration, and that how a given change in the

[1] Although the ten year interval between the 2001 recession and 1990–1991 recessions was the longest on record, giving states more than the usual amount of time to restore their balance sheets. See http://www.nber.org/cycles/cyclesmain.html.

unemployment rate is distributed among the unemployed population can have important implications for state UI systems. Vroman notes that unemployment durations were particularly long following the 2001 recession.

However, it is not obvious that longer unemployment durations put a much greater strain on *state* UI systems. It is true that very short UI spells tend to be relatively less costly for UI programmes, because many people will simply not bother to file a claim for a spell of unemployment only lasting a few weeks. It is also true that the proportion of short spells falls during a recession: the proportion of the unemployed who had been without work for less than five weeks rose fell from 45 per cent in 2000 to 32 per cent in 2003. However, there has also been a significant increase in the proportion of those who have been unemployed for more than 26 weeks, from 11 per cent in 2000 to 22 per cent in 2003. These people would normally have exhausted their entitlement to state UI benefits-—although they might be eligible for temporary federal benefits—and so would not be a drain on state UI funds.

Furthermore, the decline in the proportion of short-duration unemployed and the increase in the proportion of the long-duration unemployed that occurred as a result of the 2001 recession were very similar to the those that occurred in the wake of the 1991-1992 recession. Once again, it appears hard to argue that states could not have predicted the impact of the 2001 recession on the solvency of their UI funds.

One puzzle, then, that the paper leaves unanswered, is why reserve ratios were not built up during the 1990s in the same way as happened after the admittedly more severe recession in 1982. Did states simply fall prey to the idea that the 'Goldilocks' economy was a permanent feature of the economic landscape? Or was it simply more difficult to gain political support for raising contribution rates? This is an important question, because states will need to begin restoring reserve ratios soon if they are to be ready for the next downturn in the economy. It is a sobering thought that the average expansion since the war has lasted less than 5 years.

The second key issue raised by the paper is whether state UI programmes reacted appropriately to the 2001 recession. As we argue above, UI has an important macroeconomic policy role to play as an automatic stabilizer to the economy.

In general, it appears that most state UI systems did perform their stabilizer function at least as well as in earlier recessions: reserve ratios fell by one per cent of payrolls, a somewhat greater decline than in the early 1990s, and this despite the fact that reserve ratios were somewhat lower at the beginning of the 2001 recession than they had been before the 1991-1992 recession.

Some states, however, did raise UI taxes and lower benefits in order to offset some of the impact of the recession on reserve ratios. This clearly diminishes the counter-cyclical potential of UI, and seems undesirable from a macroeconomic perspective. It is important to remember that experience-rating already has a tendency to make UI payroll taxes procyclical, since firms which have laid off workers will typically see their tax rates rise automatically.

Another way of assessing the extent to which UI counteracts the impacts of recessions is to examine the so-called BU ratio—the ratio of UI beneficiaries to total unemployment. During the boom years of the 1990s this ratio hovered around 35 per cent, implying that only a little more than a third of the unemployed received benefits at any point in time. There is nothing inherently wrong with this: when the labour market is strong many of the unemployed are people who quit their jobs or are seasonal workers who fully expected to be laid off, and many unemployment spells are of short duration. However, when a recession hits, one would expect that ratio to increase, as proportionately more of the unemployed will have been permanently laid off, and unemployment durations will rise. The BU ratio did rise in 2001, but only to 45 per cent, a figure which includes temporary federal benefits. Thus less than half the unemployed were receiving UI, even at the height of the recession.

This leads to the final question that the paper raises—the role of the federal UI framework. The interest rate charged by the U.S. Treasury on loans to state UI programmes (other than short-term loans for cash flow management purposes) is around six per cent—much higher than market interest rates on state debt. This seems high, given that the default risk for the U.S. Treasury on such loans is virtually non-existent, as the Treasury has statutory power to recoup any money by reducing federal UI tax credits.

One potential argument for charging states a high rate of interest on loans from the U.S. Treasury is that easy access to loans might encourage fiscal profligacy on the part of state UI funds, which might never rebuild their reserve funds and simply accumulate larger and larger debts. However, this does not seem borne out by historical experience. The paper finds that those states that issued bonds in the past had succeeded in rebuilding their reserve ratios by the end of the 1990s.

In conclusion, this paper offers a wealth of information to policymakers; one hopes that conclusions it points to are taken seriously, so that UI can continue to play an important part in overall macroeconomic policy.