

# COMMENTARY

Although interest in the details of unemployment insurance (UI) financing is a minority pastime, even among economists, the topic is nonetheless an important one. Unemployment insurance is not just a way of ameliorating the impact of a recession on the unemployed; UI 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 curtail spending severely, which reduces overall aggregate demand and helps exacerbate the economic downturn. A properly designed UI programme can help reduce the impact of higher unemployment by supporting consumption by the unemployed. UI also has the advantage of responding quickly to a downturn: unlike discretionary fiscal policy, such as tax cuts, UI injects additional money 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 economic downturn occurs. The paper by Wayne Vroman allows us to do precisely that, by providing an in-depth investigation of how state UI systems responded to the 2001 recession.

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. These factors put pressure on state UI systems, especially on 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 a very expensive undertaking, a few states issued bonds in the private capital market 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 should have to a negative macroeconomic shock? Did these programmes perform their automatic stabilizer function? Third, is the federal UI framework in which state systems function appropriate? Is borrowing from the U.S. Treasury too onerous for states, forcing them to raise or cut benefits, thereby exacerbating the impact of the recession? Or is borrowing too easy, giving states an incentive to be fiscally imprudent?

Beginning with the issue of the severity of the 2001 recession, Vroman notes that the peak level of unemployment,

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6.3 percent, was 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-percentage-point change in the 1991 recession. On the surface, then, it might seem that states should have been able to predict, if not the timing, then at least the impact of the 2001 recession on trust fund balances.<sup>1</sup>

One possible response to this conclusion is that the unemployment rate is the product of the incidence of unemployment and its duration, and that the way in which a given change in the 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 lasting only a few weeks. It is also true that the proportion of short spells declines during a recession: the share of unemployed who had been without work for less than five weeks fell from 45 percent in 2000 to 32 percent in 2003. However, there has also been a significant increase in the proportion of those who had been unemployed for more than twenty-six weeks, from 11 percent in 2000 to 22 percent in 2003. These people normally would have exhausted their entitlements to state UI benefits—although they might have been eligible for temporary federal benefits—and so would not have been a drain on state UI funds.

Furthermore, the decline in the proportion of short-duration unemployed and the increase in the proportion of long-duration unemployed that occurred as a result of the 2001 recession were very similar to those following the 1991-92 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 Vroman's paper leaves unanswered is why reserve ratios were not built up during the 1990s in the same way they were 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. It is a sobering thought that the average expansion since the war has lasted less than five 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 for the economy. In general, it appears that most state UI systems did perform their stabilizer function at least as well as they did in earlier recessions: reserve ratios fell by 1 percent of payrolls, a somewhat greater decline than in the early 1990s—despite the fact that ratios were somewhat lower at the beginning of the 2001 recession than they were before the 1991-92 recession.

Some states, however, did raise UI taxes and lower benefits in order to offset some of the recession's impact on reserve ratios. This strategy clearly diminishes the countercyclical 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, because firms that lay off workers typically will see their tax rates rise automatically.

Another way of assessing the extent to which UI counteracts the impact 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 percent, implying that only a little more than a third of the unemployed received benefits at any time. There is nothing inherently wrong with this scenario: 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 to rise. The BU ratio did rise in 2001, but only to 45 percent, a figure that includes temporary federal benefits. Thus, less than half of the unemployed were receiving UI, even at the height of the recession.

This discussion leads to the final question raised by Vroman—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 6 percent—a much higher rate than market interest rates on state debt. This rate seems high, given that the default risk for the U.S. Treasury on such loans is virtually nonexistent, 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

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funds, which might never rebuild their reserve funds and simply accumulate larger and larger debts. However, this argument does not seem to be borne out by historical experience. Vroman's 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, Vroman offers a wealth of information to policymakers. One hopes that the conclusions he points to are taken seriously, so that unemployment insurance can continue to play an important role in overall macroeconomic policy.

## ENDNOTES

1. However, because the ten-year interval between the 2001 and 1990-91 recessions was the longest on record, it gave states more than the usual amount of time to restore their balance sheets.

See <<http://www.nber.org/cycles/cyclesmain.html>>.

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