EXECUTIVE SUMMARY

In recent years, some economists and policymakers have come to believe that the federal-state unemployment insurance (UI) system plays an ever-diminishing role as a stabilizing force in the U.S. economy. This report takes a fresh look at UI=s effectiveness and relative importance as an automatic economic stabilizer. The report reviews the arguments made by critics of the program, updates previous quantitative studies of UI=s economic stabilization effect, and introduces a new, expanded model to test the program=s effectiveness over the last 25 years. The report concludes there is no evidence to support the view that the structure of the economy has changed in any way that diminishes the effectiveness of the UI program. This conclusion is demonstrated by the econometric analyses, simulations, and other statistical measurements undertaken in this study.

Most analysts who argue that UI holds declining importance as a countercyclical economic stabilizer base their conclusions on qualitative indicators that they perceive to reflect fundamental changes in the U.S. economy. They point to the dampening of business cycles since World War II and the huge increase in household wealth, for example, as evidence of diminishing need for UI=s countercyclical role. This study argues that such an interpretation ignores key evidence of widening inequality in income distribution, rising consumer debt, continuing downsizing and layoffs, and growing needs for worker retraining, to name only some of the factors that make the need for UI as a countercyclical safety net as great today as it has ever been.

To demonstrate UI=s effectiveness, the study undertakes a major quantitative analysis of the program=s countercyclical Acushioning@ impact. It examines this effect on an absolute basis using the historical data, and on a relative basis, compared against federal tax receipts. This analysis goes beyond previous work on this subject in several regards: It includes data from the 1990-91 recession; it includes both absolute and relative measurements of UI=s effectiveness; and it offers both aggregate findings on the overall UI program and findings on the effectiveness of UI=s individual component programs (regular, extended, and supplemental).

Specifically, this study shows that:

1) The argument that structural changes, including a dampening of the business cycle, have reduced the need for the countercyclical unemployment insurance program is not supported by the evidence.

a) Some analysts cite the rapid rise in household wealth as a sign of the declining usefulness of unemployment insurance. They argue that family savings now act as a powerful economic cushion during lean times. This study contends that the rise in wealth is, itself, cyclical to some extent, reflecting the rise in stock prices of recent years. This Apaper@ wealth can be reduced suddenly, as it was during the market correction of mid-1998. More important, the rise in wealth has been lopsidedly in the top tier of household income (Federal Reserve data show that the share of household wealth declined between 1983 and 1995 for all but the wealthiest 1 percent of the population). Growing consumer debt levels across the income spectrum also suggest that the family wealth hypothesis for weathering recessions is exaggerated. Moreover, those who lose, or cannot get, jobs tend disproportionately to be those with little or no savings or wealth in the first place.

b) Some analysts argue that the rise of the service sector over manufacturing is contributing to the virtual elimination of business cycles. But the evidence shows that the emergence of the service sector began long before the current era and has not prevented recessionary cycles. Moreover, during the post-World War II period, a period often cited as one of milder recessions than those of pre-World War II, there have been several very steep economic declines accompanied by high unemployment. In virtually all of these recessions, the unemployment rate rose even after the trough in GDP. Further, many jobs in the manufacturing sector have migrated into manufacturing services as a result of outsourcing. These jobs, not counted in manufacturing employment statistics, are nonetheless heavily impacted by any weakness in manufacturing.

c) Another contention is that the less-severe post-World War II recessions are themselves evidence that underlying structural changes are dampening business cycles. This study argues, as have most students of business cycles, that government safety-net programs -- including the countercyclical UI program -- are one major reason for the dampening phenomenon, not fundamental changes in the structure of the U.S. economy. Moreover, increased economic globalization is likely to give policymakers less control over the economy in the future than has been the case in the past; in particular, such factors as recessions in other countries, sharp changes in exchange rates that affect trade flows, sudden shifts in capital flows, oil shocks, and other global supply shocks increase the potential for recessions caused by events external to the U.S. economy. Steep oil-price increases largely caused the economic downturns in 1973

and 1980, but some downplay the importance of these events by noting that the oil-related recession of 1990-91 was milder. That recession, however, was part of a prolonged period of near-stagnant growth that was among the lowest-growth periods since World War II. There is no real evidence on the record that recessions would be milder in the absence of the array of federal programs providing stabilization.

2) UI continues to be an effective automatic stabilizer in the U.S. economy.

Like the last major study of UI as an economic stabilizer (Dunson, et al, 1990, known as the Metrica study), this study employs econometric models of the economy to examine changes in the countercyclical effectiveness of UI and to determine the magnitude of those changes. Wharton Econometric Forecasting's Quarterly Model (the WEFA Model) was adopted because of its capabilities in modeling complex macro-economic relationships involving multiple variables, and because the WEFA Model has established a remarkable track record in the accuracy of its predictions.

Two types of analysis were performed to measure UI's effectiveness over time, with the following findings:

a) Five historical recessions beginning in 1969 were examined using counter-factual simulations. These recession scenarios were studied with and without the effects of UI. The simulations showed that the UI program mitigated the loss in real GDP by about 15 percent over all the quarters in each recession. When multipliers were calculated (the expansionary effect of each UI dollar added to the economy) for each recession, the impact of UI in the 1990's recession was found to be more robust than in the 1980's recession, although less so than in the 1970's recession. The WEFA model showed that over the five recessionary periods, the average peak annual number of jobs saved was 131,000. While the simulations showed a decline in annual jobs saved during the 1980s as compared with the prior decade, the number rose slightly in the 1990s.

b) A single descriptive equation was also estimated to measure the effectiveness of UI and the supplemental programs in the recessions of the 1970s, 1980s (this period includes the short recession of 1980 and the deeper one of 1981-82), and early 1990s. The results indicate that the UI program exhibits a substantial and statistically significant countercyclical effect on changes in real GDP throughout these decades. The equation showed that the recessions over the three decades, as measured by the decline in real GDP, would have been an average of 17 percent deeper if the UI program did not exist. This result is comparable to the 15 percent

produced by the WEFA analysis. Likewise, the evidence for the supplemental programs of UI suggests that, while they were most effective in the 1970s and their effectiveness declined in the 1980s, during the 1990s their effectiveness rebounded.

c) A current Awhat if@ simulation of a recession beginning in November 1998 showed that by the middle of the year 2000, UI would be pumping $10 billion to $15 billion a year (in 1992 dollars, the baseline currently used by WEFA) into the macro-economy, moderating the recession and speeding up the recovery. This simulation corroborated the historical evidence that UI=s impact as an automatic stabilizer has not decreased significantly over time and that it would remain important in a future recession.

These findings counter the conclusion of the 1990 Metrica study B on the basis of evidence from the recessions of the 1970s and 1980s B that UI probably was becoming significantly less effective as an automatic stabilizer over time. The two wholly separate analytical techniques (simulations and descriptive equation) applied in the current study produced closely aligned results showing continuity in UI effectiveness over three decades.

The current study=s finding of a greater cushioning effect by UI, as compared with the Metrica study, reflects a variety of differences in the approaches of the two studies. A key distinction is that the current study focuses on the total macro-economic stimulus represented by all UI expenditures during recessions (including UI=s extended and supplemental benefits programs as well as its regular benefits program). Although the extended and supplemental benefits admittedly are not wholly automatic, the perspective of this study is that the UI program=s effectiveness as an economic stabilizer is a function of the totality of the economic stimulus it provides to shore up the economy during economic downturns. To assess that overall stimulus, the current study analyzes for the first time the aggregate economic impact of all three tiers of UI benefits (regular, extended, and supplemental), as well as the individual economic stimuli provided by the supplemental benefits programs enacted during the last three recessions. There were major discontinuities in the historical data on extended benefits in the Metrica data sets, and the study did not include data on the supplemental UI programs.

In addition, the two studies used different econometric models, with different structures and inherent multipliers, although it is difficult to quantify the precise effects of these factors. Part of the difference also may be explained by the fact that Metrica measured UI=s cushioning effect based on one data point during each recession. The current study uses an average of data points over time, considering that a more

effective approach. The findings of this study are in fact more consistent with the findings of prior analyses -- for example, those of von Furstenburg (1976), de Leeuw, et al (1980), and McGibany (1983).

Other differences between the two studies include the economic specification for the benefit equation used in the simulations, the use of GNP in Metrica and GDP in the current study, and the fact that more timely and complete data sets were available for the current study.

Despite these differences, however, both the Metrica study and this study found evidence of decreased UI effectiveness in the 1980s. But up to now, discussion of the effectiveness of UI as an automatic stabilizer has been based primarily on work completed prior to the 1990-91 recession. This study includes an examination of that recession, which provides significant new evidence that the program=s countercyclical impact remains robust. This appears to reflect a slowing in the decline of the recipiency rate for UI benefits.

3) The argument that UI has become less effective because other economic stabilizers have become more effective or more important, is not supported by this study. UI may become the primary automatic stabilizer in the years ahead.

One analytical test performed in this study produced suggestive evidence that the importance of the UI program has increased relative to one of the primary fiscal-policy instruments for automatic stabilization, changes in federal tax receipts. The analysis found that fluctuations in levels of federal tax receipts have measurably diminished during recent recessionary episodes (most markedly in the 1990s), when declines in real GDP would be expected to engender substantial reductions in automatic (progressive) income tax receipts.

Holding discretionary monetary policy constant, such changes may mean that this historically important countercyclical instrument is becoming less effective in its automatic stabilization role. The reasons probably include the increasing importance of Social Security taxation, the tax treatment of capital gains, and the declining progressivity of the income tax (realized compared to statutory) at the top end of the income distribution, although research on this question is beyond the scope of this study.

It is not clear to what degree this finding, produced in the course of the analyses of the UI program=s functioning in the macro-economy, predicts the pattern of future fluctuations in federal tax receipts. But the finding represents at least preliminary evidence that the relative importance of the UI program as an automatic stabilizer is increasing.

4) It may be possible to make the UI program even more effective as an automatic stabilizer by refining its triggering and funding mechanisms.

Because the burden of automatic stabilization appears to be shifting to the UI program, this study concludes it is imperative to examine ways to modify the aspects of the UI program that could make it more effective as a stabilizer during economic downturns. In particular, such considerations would include finding ways to: (1) Expand the basis of UI recipiency; (2) Make the UI extended and supplemental programs (extension of benefits) more automatic and less subject to the political process, to ensure that they are not only available, but available more quickly in the recessionary cycle, and (3) Strengthen the adequacy of the program=s financing mechanisms.