CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Tel: 202-408-1080 Fax: 202-408-1056 center@cbpp.org http://www.cbpp.org

November 15, 2001

Unemployment Insurance as Economic Stimulus

by Peter Orszag[1]

The key objective of an economic stimulus is to expand demand for goods and services. The more that any stimulus measure adds to spending, the more effective it will be in short-circuiting the economic slowdown.

Unemployment insurance is a particularly effective stimulus. Not surprisingly, job loss is often associated with a decline in consumption, which then reduces demand for other goods and services as part of a negative cycle of increasing unemployment and declining economic activity. The unemployment insurance program helps to break this negative cycle: By partially compensating for lost income, it lessens the reduction in spending that unemployment can cause.

The crucial role played by unemployment benefits in limiting declines in consumer spending is underscored by recent academic research showing that the amount a family spends on food falls by seven percent, on average, when the head of a household becomes unemployed but would decline by 22 percent in the absence of unemployment benefits.[2] Other research confirms that the unemployment insurance system has been an extremely effective mechanism for stabilizing the economy during a downturn.[3] Both unemployment insurance and the tax system are "automatic stabilizers" — they help to reduce the severity of a recession by automatically supporting spending during a downturn. Recent academic research has shown that, dollar for dollar, the UI system is eight times as effective as the entire tax system in mitigating the impact of a recession.[4]

Unemployment insurance benefits are well-targeted in several ways. They go only to involuntarily unemployed workers, are provided disproportionately in areas and industries that have been hit hardest by the slowdown, and automatically decline when unemployment rates go down. This targeting explains why temporary expansions in unemployment benefits would be an

---

[1] Peter Orszag is the Joseph A. Pechman Senior Fellow in Economic Studies at the Brookings Institution.

[2] Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87, March 1997, pages 192-205.

[3] Lawrence Chimerine, Theodore Black, and Lester Coffey, "Unemployment Insurance as an Automatic Stabilizer: Evidence of Effectiveness over Three Decades," Unemployment Insurance Occasional Paper 99-8, U.S. Department of Labor, July 1999.

[4] Alan Auerbach and Daniel Feenberg, "The Significance of Federal Taxes as Automatic Stabilizers," *Journal of Economic Perspectives*, Vol. 14, Number 3, Summer 2000, pages 37-56. The study found that the unemployment insurance system provides roughly 25 percent of the automatic stabilizer impact as the entire tax system, despite the fact that UI benefits are only about 1.5 percent to 3 percent of the size of total federal revenue. Thus, adjusted for their relative sizes (i.e., "dollar for dollar"), the unemployment insurance system is at least eight times as effective as the tax system as a whole in offsetting the impact of a recession.

effective means of providing additional stimulus to the economy. Households with an unemployed worker usually have experienced a significant decline in income, so their normal level of spending exceeds their current income. The unemployed therefore are very likely to spend a high percentage of any additional income they receive during their period of unemployment. As Nobel prize-winning economist Joseph Stiglitz recently wrote in the *Washington Post*, "give money to people who have lost their jobs in this recession, and it would be quickly spent."[5]

Despite the potential for unemployment insurance to play a significant role as a stabilizing force in the current economic downturn, the effectiveness of the unemployment insurance program at the present time is less than it should be. This is the case for three reasons: (1) The criteria for providing additional weeks of benefits to workers who have exhausted their 26 weeks of regular benefits are excessively restrictive, and no extra weeks of benefits are currently being provided anywhere in the country; (2) certain eligibility rules for unemployment insurance are outdated and often prevent steady part-time workers from receiving benefits when they are laid off; and (3) benefit levels are rather low. Instituting temporary expansions in the unemployment insurance system to address these three shortcomings, as the Senate Finance Committee bill would do, would carry a high "bang for the buck" in terms of economic stimulus.

Those who oppose such temporary expansions in unemployment benefits often argue that the changes would merely reduce the incentives for workers to find jobs. In addition to ignoring the impact of the additional spending created by the expansion in benefits, this concern seems to be less relevant in a deteriorating job market. As the economy slows, longer spells of unemployment are more likely to reflect scarce job opportunities, rather than lack of effort in finding a new job. How many people would be willing to remain unemployed in the middle of a recession in exchange for an extra $25 or so per week?

Expanding unemployment insurance benefits offers also another advantage — it provides economic stimulus when it is needed without causing any damage to the long-term budget outlook. Expanding these benefits temporarily during the downturn has no ongoing cost (apart from a small increase in interest payments from the temporary increase in spending). The unemployment insurance program is able to target the pockets of the economy that need the most stimulus, effectively limit the decline in consumption among those who become unemployed, and dampen the severity of the recession. Temporary expansions in unemployment insurance to extend benefits beyond 26 weeks, cover part-time workers, and raise benefit levels would provide cost-effective stimulus to the economy in the months ahead.

---

[5] Joseph Stiglitz, "A Boost That Goes Nowhere," *The Washington Post*, November 11, 2001, page B01.