

PREPARED STATEMENT BY

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**"THE ECONOMIC OUTLOOK AND POLICIES IN LIGHT OF RECENT
EVENTS"**

BEFORE THE

**BUDGET COMMITTEE
UNITED STATES SENATE**

Washington, D.C.

October 2, 2001

Good morning, Mr. Chairman and distinguished members of the Senate Budget Committee. My name is Alan Krueger and I hold the Bendheim professorship in economics and public affairs at Princeton University. I appreciate the opportunity to share my views on recent economic developments in light of the horrific terrorist attacks of September 11th, the economic outlook going forward, and public policies that might be appropriate in the current situation.

I. THE ECONOMIC SITUATION

After growing at a rapid rate in the second half of the 1990s, GDP growth fell precipitously to less than 2 percent per year in the third quarter of 2000, and fell to only 0.3 percent in the second quarter of 2001, the most recently available data. Although it is unclear whether the economy entered a recession, it is clear that growth was essentially stagnant even before September 11th. A slowdown in business investment was a major reason for slower GDP growth. The modest GDP growth that existed was mainly a result of robust consumption growth. Because consumption spending makes up more than two-thirds of GDP, changes in consumption have a large impact on economic growth.

Another major relevant economic development is that the value of the U.S. stock markets fell by close to \$5 trillion in the year preceding September 11th. It was puzzling to many economists that consumption remained so strong in spite of this large drop in wealth. A rough rule of thumb is that a \$1 decline in stock market wealth leads to about a 3 to 4

cent decline in annual consumption.¹ This relationship would imply a \$150 to \$200 billion drop in consumption, which has not materialized.

The events of September 11th are likely to change the short-run economic outlook in many ways. Ordinarily, the loss of life and destruction wrought by the terrorist attacks – horrific as they were – is something that the economy could readily bounce back from. In the past hurricanes and earthquakes have had relatively small short-run effects on national income, and have set off an investment boom that increased measured GDP. But the reaction to the recent terrorist attacks are likely to be different, in part because of the precarious position the economy was in prior to the attacks, and in part because it is unclear what the military reaction to the attacks will be, how long it will last, and how effective it will be. In addition, the attacks came at a time when some observers were beginning to question whether the traditional economic remedy for a slowdown (i.e., interest rate cuts) was working this time.

The main short-run economic concern, in my opinion, is that the terrorist attacks will cause a quick and sharp contraction in consumer spending. First, consumers are scared, shocked and in mourning, and face increased uncertainty for the future. This understandable psychological reaction is likely to cause a cut back in consumer spending, which is beginning to show up in data on consumer confidence, visits to shopping malls and year-over-year retail store sales.² Second, since the markets reopened on September 17th, the value of equities fell by about an additional \$1 trillion. This would be expected to reduce consumer spending by another \$30 to \$40 billion per year. Many economists were already waiting for the consumption shoe to fall, and the terrorist attacks and the stock market decline could set such an effect in motion.

If consumption contracts sharply, economic growth will decline. Moreover, inventories will pile up, investment will decline and unemployment will rise.

A second major risk to the economy is that business failures in some key industries may rise as a direct effect of the attacks. For example, the airline and hospitality industry are obviously directly affected. The attacks also struck at the heart of the financial industry. It is quite impressive, however, that the financial markets quickly returned to close-to-normal functioning. The smooth functioning of the capital markets may be one of the unsung feats of this disaster.

The unemployment rate has been rising for nearly a year, and equaled 4.9 percent in August 2001, after reaching a 30-year low of 3.9 percent in September and October of 2000. Last month's unemployment figures showed a 0.4 point jump, and also indicated that the downturn in the labor market was beginning to take on features of a typical downturn: the unemployment rate jumped more for minorities than whites, and more for less-educated and less-experienced workers than for well educated, more experienced

¹ For an accessible survey of the literature, see James Poterba, "Stock Market Wealth and Consumption," *Journal of Economic Perspectives*, Spring 2000, pp. 99-118.

² "From the Markets to the Bedside Table," *The New York Times*, September 30, 2001, Week in Review Section, p. 4.

workers. The unemployment rate for September will be announced by BLS on October 5, and the survey reference week will contain the week of the terrorist attacks. However, given the definition of employment used in the BLS household and establishment surveys (employed during the reference week), it is unlikely that the unemployment or employment data will reflect much of the impact of the events of September 11th on the economy; instead, they will largely reflect preexisting trends. It is possible that the early effects of the reaction to the terrorists attacks will be reflected in reported work hours, however.

Figure 1 displays weekly claims for Unemployment Insurance (UI). The latest, preliminary numbers pertain to the week ending September 19, 2001, so they reflect the first wave of layoffs in the aftermath of the terrorist attacks. New claims for UI increased from 392,000 to 450,000, the highest level since December 1991.

The terrorist attacks could serve as a focal point, leading companies to make deep cutbacks at a time when many were considering cutbacks anyway. If this is the case, the downturn could be relatively sharp, widespread and perhaps short lived (say 2 or 3 quarters). There is a historical tendency for sharp downturns to have V-shaped patterns, in which growth bounces back quickly after the economy bottoms out. This type of a recovery is certainly not a guaranty, but the odds are probably slightly stronger for a V-shaped than U-shaped business cycle at the moment.

II. ECONOMIC RISKS AND THE APPROPRIATE POLICY RESPONSE

As mentioned, I think the greatest short-run risk to the economy is consumer jitters, causing a collapse in aggregate demand. A sudden, sharp drop in consumption can have a cascading effect, leading to plant closings and layoffs because of a shortage of aggregate demand, and in turn leading workers to cut back consumption further because they have lost their job or perceive an increased risk of unemployment. If consumption remains strong, economic recovery will be swifter, regardless of the short-run performance of the stock market.

The main longer run concern for the economy is that productivity growth falls from the increased level reached in the late 1990s. The current economic situation is unlikely to have much effect on long-term productivity growth. Another longer run concern, however, is that long-term interest rates increase and thereby discourage investment.

In my view, government policy could do a lot to restore confidence and reduce consumer jitters. A number of principles have been proposed for elements of a short run stimulus package. These include: the additional spending or tax cut be temporary, not permanent; the additional spending or tax cut help the short-term economic outlook; the spending or tax cut should stimulate new investment, not reward old investment; the spending or tax cut stimulate demand; and the package should maintain long-term budget discipline. I agree with all of these principles. But to this list I would add another principle: first shore up the traditional safety net. In times of economic difficulty, people turn first to

Unemployment Insurance (UI) and other components of the safety net. A strong safety net helps to automatically stabilize the economy. People are more willing to take risks and maintain more normal consumption patterns in uncertain times if there is a strong safety net beneath them.

III. UNEMPLOYMENT INSURANCE AND JOB TRAINING

Unemployment insurance is an important component of the economy's automatic stabilizers. UI expenditures rise in recessions and fall in booms. For example, outlays for unemployment compensation increased from \$14 billion in 1989 to \$37 billion in 1992, when the unemployment rate peaked, and fell to \$21 billion in 1995 when the labor market improved.³ Unemployment benefits are a strong counter cyclical force because they adjust quickly and automatically to changing economic conditions.

Unemployment benefits are well targeted to families in need, and as a result they help to maintain consumption in a downturn. In addition, an administrative system is already in place to deliver UI benefits quickly and efficiently. And shoring up the UI system as I propose below will not hurt the long-term budget picture.

Most importantly, UI provides an essential source of support for families that have a laid off worker. The amount a family spends on food – a bare necessity – falls by 7 percent, on average, when the head of a household becomes unemployed, according to a study by Jonathan Gruber of MIT.⁴ Absent unemployment benefits, he estimates that a spell of unemployment would cause food consumption to fall 22 percent – about three times as much. And UI benefits probably have an even larger impact helping families maintain consumption of discretionary items, like new clothing for school and books.

Offsetting the salutary "consumption smoothing" effect of unemployment benefits, many economists have also documented a distortionary effect: as benefit generosity increases, workers tend to remain unemployed longer.⁵ Higher benefits apparently reduce the amount of effort people devote to searching for a job. In addition, research indicates that some employees and employers game the system, placing workers on rotating temporary layoff so they can receive benefits while on vacation.

Ideally, the optimal unemployment benefit would balance the desired consumption-smoothing effect against the undesired distortionary effects. Professor Gruber, building on earlier theoretical work by Martin N. Baily, calculates that the average unemployment benefit in the United States, which on average replaces around 40 percent of previous earnings, after taxes, is close to the optimal level given workers' aversion to the risk of

³ Source: *Green Book*, House Committee on Ways and Means, Washington, DC: Government Printing Office, 2000, Table I-5.

⁴ Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87, March 1997, pp. 192-205.

⁵ See Anthony B. Atkinson, John Micklewright, "Unemployment Compensation and Labor Market Transitions: A Critical Review," *Journal of Economic Literature*, Vol. 29, December 1991, pp. 1679-1727.

job loss.⁶ The generosity of UI benefits, however, varies considerably across the states: the maximum weekly benefit last year ranged from a low of \$190 in Mississippi to over \$600 in Massachusetts. Although the cost of living also varies across states, variability in benefits outstrips variability in living costs. So raising the benefit-earnings replacement rate in the least generous states would make economic sense. Because the distortionary effect of benefits is probably less severe in a downturn, one could also argue for a temporary benefit increase.

I believe that additional reforms in two aspects of UI can have a particularly valuable impact in the current economic environment. These reforms concern eligibility requirements and financing, and are discussed below.

A. ELIGIBILITY

States set different standards for eligibility for UI. The typical state requires workers to have earnings exceeding a specified level in four of the previous five calendar quarters to qualify for benefits. In addition, workers are ineligible for benefits if they voluntarily quit their job. In a majority of states, otherwise eligible workers are disqualified for benefits if they are not available for, and seeking, full-time work.

Fewer than one-third of unemployed workers receive UI benefits. This ratio is considerably lower than it was in the 1970s. The UI recipiency rate is below 100 percent because the take-up rate (i.e., fraction of eligible unemployed workers who apply for benefits) has declined over time and because many unemployed workers are ineligible for benefits because their work record does not qualify them for benefits or because they are unable to actively search for full-time (as opposed to part-time) work.⁷

The current downturn could be particularly severe for laid off workers who recently left welfare to join the workforce in response to welfare reform. This group consists primarily of low-income, single mothers. Many of these workers will not qualify for UI because they have worked an insufficient number of quarters of work to meet the eligibility standards, because their earnings were too low, or because they are searching for part-time work due to family obligations and a majority of states exclude part-time job-seekers from benefits. Many of these workers have exhausted their TANF eligibility, or are concerned about exhausting their TANF eligibility. An obvious change to help these workers would be to direct the states to temporarily waive or relax their UI eligibility requirements for applicants who were on TANF or AFDC in the last 5 years.

⁶ Of course, there is a limit to how far one wants to take estimates from this simple model of behavior.

⁷ Evidence suggests that a decline in the take-up rate is mainly responsible for the decline in the recipiency rate in the 1980s. The take-up rate declined because of changes in the regional distribution of unemployment and because of declining real after-tax benefits; see Rebecca Blank and David Card. "Recent Trends in Insured and Uninsured Unemployment: Is There an Explanation?" *Quarterly Journal of Economics*, 106, November 1991.

Probably a better solution, however, would be to temporarily require the states to pay benefits to otherwise eligible workers who are searching for any job, part-time or full-time. This broader change would avoid the necessity to inquire whether individuals have received TANF in the last 5 years, and would also treat workers in similar current circumstances similarly. In addition, this change would recognize that the work and family situation of the workforce has changed since UI was enacted in 1935. Workers who would be made eligible for UI benefits as a result of this change would be primarily single-parent, female, and low-income workers.

In addition, to expand UI eligibility for those who elected to work instead of go on welfare in recent years, an “alternative base period” could be used to determine eligibility for a temporary period.⁸ That is, instead of determining eligibility based on earnings in four of the previous five calendar quarters, states could use workers’ more recent earnings histories. For example, if earnings exceed a certain threshold in two of the previous three quarters, workers could be deemed eligible for benefits. This change would expand eligibility to those who have joined the workforce more recently (many of these may have been on AFDC if the program had continued) and to workers with more inconsistent work experiences. Based on the experience of 12 states that have already moved to an alternative base period, the National Employment Law Project estimates that UI eligibility increased by approximately 4 to 6 percent as a result.⁹

B. FUNDING

To pay for benefits, the UI system builds up reserves during prosperous times and draws them down during slack times. A common measure of the health of trust funds is the reserve ratio: the ratio of accumulated trust fund balances to annual payroll. A higher reserve ratio provides more protection in an economic downturn. Unfortunately, the UI reserve fund in several states – most importantly, New York and Texas – were quite low even before September 11th.¹⁰ Phillip B. Levine, an economist at Wellesley College, calculates that to remain solvent through a severe recession, like the one experienced in the early 1980's, unemployment insurance funds would require a reserve ratio of at least 1.25 percent.¹¹ Using this standard, 15 states were at risk of insolvency in a severe recession based on their reserve funds as of the first quarter of 2001. In New York the reserve ratio was 0.28 percent and in Texas it was 0.22 percent. Figure 2 shows nationwide data on the state trust fund balances as a percent of payroll as from 1970 through 2001Q3. Although the trust funds are in better shape than they were at the end of

⁸ This change has previously been recommended by the Wendell Primus and Isaac Shapiro of the Center on Budget and Policy Priorities and by the National Employment Law Project.

⁹ “Unemployment Insurance: Key Elements for an Economic Stimulus Package,” National Employment Law Project, New York, September 2001.

¹⁰ See Alan B. Krueger, Economic Scene; “Now is the time to reform unemployment insurance -- before it's really needed,” *The New York Times*, January 4, 2001, p. B2.

¹¹ Phillip B. Levine, “Cyclical Welfare Costs in the Post-Reform Era: Will There be Enough Money?” Mimeo., Wellesley College, December 28, 2000.

the 1970s and early 1980s, it is clear that reserves are below where they were prior to the last recession.

This predicament has arisen because many states did not build up their funds during the 1990s, and because experience rating – that is, the extent to which a business’s payments increase with its past record of laying off workers – is poorly implemented. If the funds become insolvent, they will borrow from the federal government at close to market rates, and probably tighten eligibility standards to stem the shortfall. If state funds are on the verge of becoming insolvent, there is a real risk that UI administrators will become more stringent in admitting applicants to the program. States will also be more likely to restrict eligibility standards and less likely to increase benefits. An obvious way to shore up the system is for the federal government to *temporarily* lend to state funds from the federal fund at a below-market or zero interest rates.

As part of this package, I would also recommend that states be required to implement real experience rating and maintain ample fund balances within three years (i.e., after the economy improves). This would shore up the long-run financing of the state programs. In addition, a study by Phillip B. Levine and David Card of U.C. Berkeley estimates that the unemployment rate would decline by six-tenths of a percentage point if industries were fully experience rated – that is, if employers in an industry were required to pay the full additional costs of unemployment benefits for layoffs in that industry.¹²

The federal government sets minimum standards for state unemployment insurance programs and has a history of encouraging experience rating. This is a unique aspect of the American system of UI. Better experience rating could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers, and by requiring the states to have at least 10 different rates (currently, some states have only 2 rates: 0 or 5.4 percent). In addition, I would recommend that the per employee taxable earnings cap – which range from \$7,000 to \$10,000 in most states – should be raised, which would allow better experience rating at lower tax rates and make the financing less regressive. Improved experience rating would discourage employers from laying off workers, and help to internalize the externalities layoffs impose on society.

It is important to note that while the reserve funds in many states are potentially inadequate, the three federal UI funds have been maintained at responsible levels, and currently have around \$38 billion in total, with about \$13 billion in the federal loan account (FUA).

C. EXTENDED BENEFITS

A traditional government response in a recession is to extend the duration of UI benefits from 26 weeks to 39 or 52 weeks. In a severe, long-lasting recession, extended benefits make a great deal of sense. But research has found that the average duration of

¹² David Card and Phillip B. Levine, “Unemployment Insurance Taxes and the Cyclical and Seasonal Properties of Unemployment,” *Journal of Public Economics*, vol. 53, February 1994.

unemployment spells rises if benefit duration is expanded, and effort devoted to searching for a new job declines as a result.¹³ Relatively short benefit durations is one reason why the unemployment rate is lower in the U.S. than in Europe.

If the current downturn is short lived, then extending the duration of UI benefits at this time could inadvertently raise the amount of unemployment above where it otherwise would be. It is impossible to know precisely how long the current downturn will last. As a consequence, on the margin, I would recommend expanding eligibility for benefits over extending benefit duration in the present situation. However, it might make a great deal of sense to legislate extended benefits *conditional* on the unemployment rate surpassing a specified level (e.g., 6 percent) *after* a specified date in the future (e.g., March 2002). Such a policy will not extend benefit duration unless the downturn lingers, and therefore reduce the risk that extended benefits inadvertently prolong the length of the downturn.

D. TRAINING FOR DISLOCATED WORKERS

Money was recently rescinded from the Labor Department's Dislocated Worker Training budget. Now is the time to increase training funds for dislocated workers, not reduce them. Many workers who lose their job in the current downturn will need training to obtain work in other sectors. Research suggests that federal training programs that target experienced workers, and provide training for marketable skills, are effective.¹⁴ From a permanently laid off worker's perspective, dislocated worker training seems to be most helpful when it comes with income support, such as that provided by the NAFTA displaced worker program.

IV. A TEMPORARY PAYROLL TAX CUT PROPOSAL

If tax relief is sought, I would recommend considering exempting the first \$5,000 of earnings from the OASDHI payroll taxes. This temporary tax cut could take effect immediately on January 1st, and the Social Security Trust Fund could be made whole by a transfer from general revenues. All workers would benefit from this tax cut, and low-wage and part-time workers will benefit disproportionately more. Because low-income workers have a high propensity to consume from additional income, this type of tax relief would be particularly helpful at stimulating spending. This type of tax relief will also reach many workers that did not benefit from the income-tax rebate Congress recently enacted. In addition, employer administrative hassles paying the tax would be reduced.

The principle economic drawback of this proposal vis-à-vis many other tax cut proposals is that, except for part-time or part-year workers, the marginal tax rate does not change. But most economists have concluded that the labor supply response to tax cuts is quite

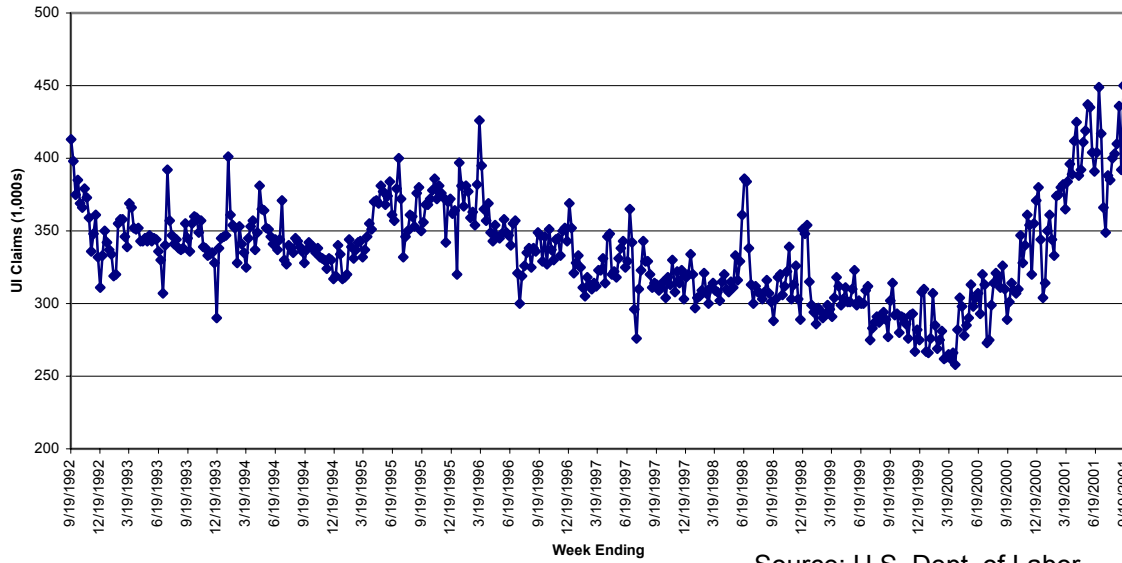
¹³ See Lawrence Katz and Bruce Meyer, "The Impact of Potential Duration of unemployment Benefits on the Duration of Unemployment," *Journal of Public Economics*, XLI, 1990, pp. 45-72.

¹⁴ See U.S. Dept. of Labor, Office of the Chief Economist, *What's Working (and what's not): A Summary of Research on the Economic Impacts of Employment and Training Program*, 1995..

modest.¹⁵ More importantly, in my view, the main goal of a tax cut that is part of a stimulus package should be to stimulate short-term consumer spending, and this tax cut proposal will like have a substantial, immediate effect on consumer spending because it is broad based.

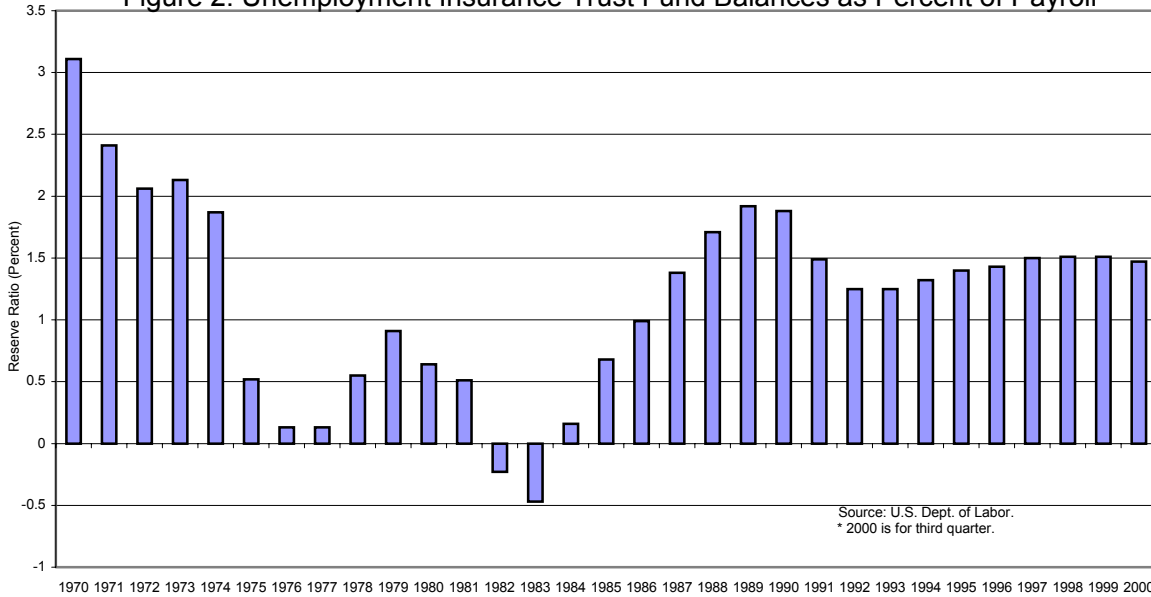
¹⁵ See, for example, the survey of labor and public finance economists in, "Why Do Economists Disagree About Policy?" (with Victor Fuchs and James Poterba). *Journal of Economic Literature*, vol. 36, no. 3, September 1998, pp. 1387-1425.

Figure 1: Number of New UI Claims by Week (Seasonally Adjusted)



Source: U.S. Dept. of Labor.

Figure 2: Unemployment Insurance Trust Fund Balances as Percent of Payroll



Source: U.S. Dept. of Labor.
* 2000 is for third quarter.