

# The role of unemployment insurance during the economic and financial crisis

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**Abstract:**

The aim of this paper is to discuss the role of unemployment insurance during recession. Firstly, it presents a brief literature review, according to which unemployment insurance works as a built-in stabilizer for the economy. Secondly, it highlights certain characteristics of these programs in developed and developing countries, in recession periods. Also, it analyzes the evolution of Romanian unemployment insurance indicators during 2004-2009 and finds that public expenditures had an opposite trend to that of GDP and budgetary revenues, decreasing during periods of economic growth and increasing during the current recession, which suggests an interaction with the economic cycle.

**Keywords:** unemployment insurance, economic crisis, unemployment rate

**JEL Code:** J65, E32, E24

## 1. Literature review on the role of unemployment insurance in periods of economic crisis

Literature on automatic stabilizers has mostly concentrated on the role played by taxes, transfers and unemployment benefits. I will present a brief part of the macroeconomic literature on automatic stabilizers in times of recession, which focuses on social benefits, such as unemployment insurance.

For example, the study conducted by Lawrence Chimerine et al. (1999), on the United States, for a period of 30 years, shows that federal unemployment insurance system works as a built-in stabilizer for the U.S. economy, alleviating fluctuations in GDP in periods of economic contraction. According to the study results, in the absence of unemployment insurance programs, the recession would have been 15% deeper and the number of jobs would have reduced on average per year with 131,000. It also confirms that "each extra dollar to unemployment insurance increases the GDP by \$2.15", thus helping revive the American economy (Lawrence Chimerine et al., 1999, p.74). Other studies quantify the contribution of unemployment insurance to reducing the negative effects of the economic recession. A study conducted by Dolls et al. (2009) shows that unemployment insurance is an automatic stabilizer in times of economic crisis, absorbing with about 32% the Europe economic decline, whereas the value of the economic stabilizer for the US is about 19 per cent.

Careful study by Corson, et al. (1999) found that during the recession of the early 1990s, without unemployment insurance benefits, over 70% of unemployed recipients would have fallen into poverty.

Another study, conducted in Canada, by Stokes (1995), demonstrated the stabilizing impact of unemployment insurance program on GDP, as it increased employment during the 1981-1982 and 1990-1991 recessions and reduced it during the boom of the second half of the 1980's. These countercyclical effects also contributed to a rise in participation rates, thereby reducing the stabilizing impact on the unemployment rate. The UI program's impact on other economic indicators was similar to that on employment and GDP. The average reductions in the GDP gaps in

the 1980's were approximately 8, 11, and 4 per cent for the 1981-1985, 1987-1990, and 1991-1993 periods, respectively. In the 1978-1980 periods, the UI program increased the GDP gap by almost 2 percentage points. (Stokes, p.37)

Auerbach and Feenberg (2000) in a study on the USA data show that the unemployment insurance system is at least eight times more efficient than the tax system to offset the impact of a recession, as offers approximately 25% of the total impact of automatic stabilizers, taking into account that unemployment insurance are 1.5-3% of the total size of the federal revenues.

According to Orszag (2001, p.1), unemployment insurance is a particularly effective stimulus which helps to break the negative cycle of increasing unemployment, because by partially compensating for lost income, it lessens the reduction in spending that unemployment can cause.

There are studies that tested the relationship between unemployment insurance and business cycle. Rodrigo Cerda and Rodrigo Verdana (2007, p.473) revealed in their study conducted in Chile, the stabilizing effect of unemployment insurance on the business cycle, enhancing the results of the study conducted by Hansen and Imrohorglu (1992). According to them, individuals who do not have access to the capital market and hence cannot save are forced to consume their income, thus making their consumption more volatile. Such individuals cannot replicate the unemployment insurance program in the capital market, which makes this program potentially welfare improving. Another study is the one conducted by Brown and Ferral (2003), which analyzed the interaction of the business cycle, unemployment insurance and the labor market for young men in Canada. They argued that the design of unemployment insurance is important, proving that in some cases of poorly designed scheme, the program can exacerbate the recessions.

Also, Jonathan Gruber (1997) highlighted, in his study, the crucial role played by unemployment benefits to stop the decline in consumption, and the results showed a decrease of 7% on average, of spending for food when the head of the family is unemployed and 22% if there is no unemployment benefit.

This idea is also supported by the Nobel Prize winner for Economics, Stiglitz (2001, p. B01), who said that if we give money to people who have lost their jobs in this recession, it would be quickly spent, based on the idea that unemployed spends much of any additional income that we receive during unemployment. Sargent (2005, p.1) argues that unemployment insurance is not just a way of ameliorating the impact of a recession on the unemployed. It also has a potential role in making the recession itself less severe through its traditional automatic stabilizer role.

Burtless (2009, p. 5) assigns two functions to the unemployment insurance system: it provides workers with essential income protection when they are temporarily unemployed, as a result of a layoff and secondly, by helping unemployed workers to maintain their consumption during recessions, unemployment insurance gives the national economy an important stimulus in periods when overall unemployment is high or rising.

There are also studies, such as the one conducted by Boeri (2009) in USA, using series data for 1980-2002, which shows that the introduction of unemployment benefits is associated with about 1-2 percentage point increases in the yearly rate of job destruction and a 2.5-3 percentage point increases in job turnover. This implies a positive effect on job creation as well, but this effect was not found to be statistically significant when estimated separately. Taking into account the above mentioned, I can say that public spending on unemployment benefits is seen as having an important role in supporting the economic recovery.

## **2. Characteristics of the unemployment insurance programs in developed and developing countries**

Unemployment insurance programs began to gain importance as the unemployment rate increased during the '70s, in many European countries. Along with job loss, there is a decrease in the

consumption, which in turn reduces the demand for various goods and services. In this context, unemployment insurance is an economic incentive designed to help increasing the demand.

Rising unemployment in times of economic crisis imposes governments to increase public spending on unemployment benefits and also requires the reduction of unemployment budgetary revenues. This helps improving the economic situation of unemployed people affected by the crisis, but on the other hand, worsens the unemployment insurance budgetary fund.

In the context of the current crisis, unemployment across Europe has increased from 8.5% in March, 2009, to 9.4% in December 2009, reaching 9.6% in February, 2010. Among the Member States, the lowest unemployment rates at the end of December, 2009 were recorded in the Netherlands (3.9%) and Austria (4.8%), and the highest rates in Latvia (20.5%) and Spain (18.9%).

Higher unemployment rates have imposed measures to create jobs and grant facilities to companies. Therefore are needed accelerated efforts to combat the unemployment rate. It is known that many countries enacted stimulus packages, watched their automatic stabilizers, such as unemployment benefits and allowed fiscal deficits in response to the deepening crisis.

At the European level there have been a series of changes since October 2008 concerning the rules for determining the eligibility for unemployment benefits. Several Member States extended either the length of benefit eligibility (it is the case of Lithuania, Portugal and Romania) or the amount received (it is the case of Belgium, Bulgaria, France and Portugal). Other Member States, as Finland, France and Portugal expanded the eligibility to full or earnings-related benefits to persons with a short employment history. Countries, such as Portugal, are providing an allowance to compensate workers in part-time work who are seeking full-time employment, or to cover the losses of workers whose working hours have been shortened due to the crisis. There have also been authorized measures to extend the scope of unemployment insurance for young people ending a fixed-term labour contract (France).

Unemployment insurance is the most common program for financial support of the unemployed in developed countries. In these countries, usually provides good protection, covers most employed persons, regardless of occupation or industry. In contrast, introducing social security programs in developing countries is a difficult task given that the insurance and capital markets are underdeveloped, great budget restrictions, while developing countries are characterized by traditional structures of work, higher rates of poverty, implying complex social programs that few governments are willing to assume.

For example, in the U.S., as part of the recovery package, were made a series of reforms on unemployment insurance system, counting on their stabilizing effect of boosting demand, increasing consumption, and in turn, production and jobs.

In USA, as the unemployment rate began to increase toward the end of 2008, federal government typically provided additional weeks of unemployment insurance coverage and has twice extended the maximum number of weeks the unemployed can receive benefits in 2008: a 13-week extension enacted on June 30 followed by a 7-week extension on November 21. (Simms, 2008, p.2). With both extensions, unemployed workers could collect up to 46 weeks of benefits: 26 weeks in the standard state program and 20 weeks of extended benefits, or 59 weeks of benefits for workers in high-unemployment states.

Thus, unemployment insurance is regarded as an economic incentive which contributes to the recovery of the economies affected by the crisis. Actually, this was one of the reasons the program was created during the Great Depression. By extending benefits, the federal government has already taken important steps to help many unemployed workers in this recession.

Also, in developing countries from Asia, Latin America unemployment insurance programs were implemented taking into account their built-in stabilizing effect. For example, in Asia,

unemployment insurance programs are offered by countries such as China, Iran, South Korea, Taiwan, and since 2002 by Kuwait and Turkey. Except for Korea, we know little about these programs. In Korea, the oil shocks of the 1970s generated the need for introducing an unemployment insurance program, through which financial crisis of the late 1990s was less painful to many Koreans unemployed, although fewer people were covered by this system. Similarly, we can take the example of Argentina, a Latin American country, where the unemployment insurance system was adopted in 1992, following a macroeconomic crisis that raised the prospect of a large unemployment rate. Unemployment has been growing quite large, from 6.5% in 1991 to 15.1% in 2001 and 19.7% in 2002.

While there are a variety of active and passive interventions on the labor market to protect workers at this time, the Argentine system is dominated by a passive unemployment insurance program and by the Plan Jefes, a social assistance one. Unemployment insurance expenses reported to gross domestic product have been growing, from about 0.15% in 1996 to 0.19% in 2002, according to the evolution of unemployment rates in this country. In 1998, former minister of Labor, Armando Caro Figueroa, explained that during the years 1991-1992, trade unions and the country began to move from picture to full employment in the formal recognition of the fact that high unemployment accompanies economic crisis (Mazza, 2000, p. 18). Unemployment insurance represented a benefit that unions have accepted as part of a package of responses to the crisis.

It should be considered that the performance of these programs depends not only on unemployment insurance structure, but also on specific factors of a particular country.

### **3. Analysis of the Romanian unemployment insurance indicators. Government measures taken in the context of the economic crisis**

As the financial crisis entered in a phase marked by serious problems since October, 2008, the Romanian government priorities were job creation and helping those who have been hurt by the economic downturn.

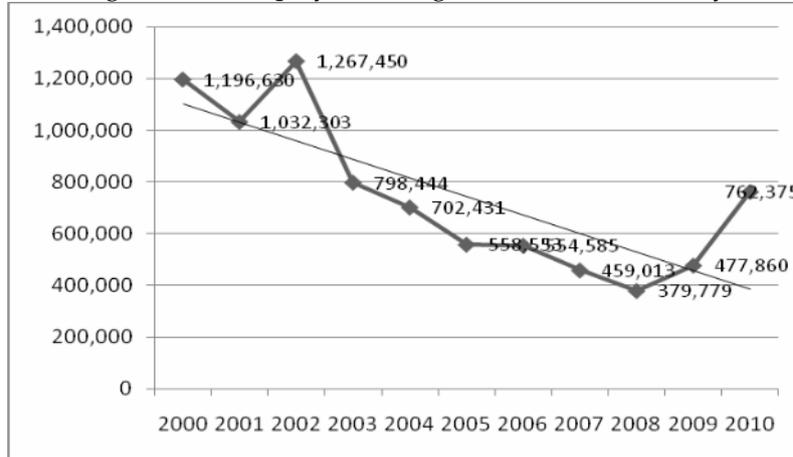
In our country, social protection of the unemployed is done by the unemployment insurance budget. In order to protect the unemployed a number of NGOs are engaged in internal funding programs, foreign or mixed, to improve living conditions of the unemployed. Current legislation in unemployment is given by Law no. 76/2002 regarding the unemployment insurance system and employment stimulation (updated on January 1, 2008), which covers a wider range of issues and objectives such as preventing unemployment and combating social effects of it, employment and back into work those people who are looking for a job, support employment of disadvantaged persons and providing equal opportunities in employment, stimulate employment and employers, increased labor mobility work in terms of structural changes occurring in the economy and protection of the unemployment insurance system.

Unemployment benefit is granted for periods determined differently, depending on the eligibility period, which is between 6 and 12 months. The level of unemployment benefit is a monthly allowance, non-taxable, which represents 75% of the gross minimum wage of the country, on the date of its determination. In addition, they receive an amount determined by applying rates between 3% and 10% (depending on eligibility period) on the average gross monthly wage in the last 12 months of contribution period.

Conditions for the unemployed to receive unemployment benefit are: a minimum contribution period of 12 months in the last 24 months, no income or incomes that are below the gross minimum country's wage, not qualified for retirement and also registered at the employment agency. From 11.2%, which was the unemployment rate in Romania in 2000, it decreased significantly in the coming years, reaching 6.8% in 2004, 5.4% in 2006 and 7.8% in 2009. As the current crisis has generated an unemployment rate that increased from 4.9% to 7.8% between January and December 2009, reaching 8.3% in February, 2010, so that additional costs with unemployment benefits and reductions of unemployment insurance revenues were necessary.

Thus, we can say that unemployment rate is related with the economic cycle, it increases in recessions and decreases in boom's periods. Figure 1 presents the evolution of the registered unemployed in the period 2000-2010 at national level in February, according to data provided by the Ministry of Labor, Family and Social Protection.

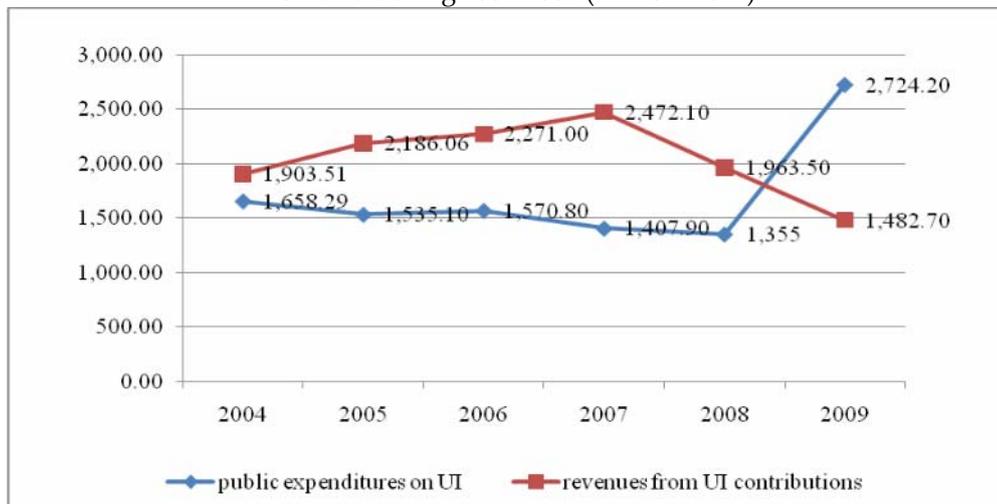
Figure 1: Evolution of registered unemployed during 2000-2010, in February, in Romania



Source: Created by author, based on data from Ministry of Labor, Family and Social Protection.

In December 2009, the number of unemployed was 709,383 persons and in February 2010 it reached 762,375 people, up to 21,393 people more than the previous month. Of the total unemployed, 468,863 were paid unemployed and 293,512 unpaid. Unemployed allowances increased by 9,705 persons, and unpaid unemployed persons increased by 11,688 the previous month. Unpaid unemployed in total unemployed (38.50%) declined in February 2010 compared with the previous month by 0.47 pp. Figure 1 shows a downward trend line for the unemployed, their number decreased with 68% from February, 2000 (1,196,630 unemployed) to February, 2008 (379,779 unemployed), due to positive developments of the Romanian economy. As the financial crisis entered in a phase marked by serious problems, since the end of 2008, the unemployment rate began to grow, reaching 762,375 unemployed in February, 2010, which represents a 2-fold increase compared to 2008.

Figure 2: Evolution of revenues and expenditures of the unemployment insurance (UI) budget in Romania during 2004-2009 (million RON)



Source: Created by author, based on unemployment insurance budget executions for 2004-2009, available on the website of the Ministry of Public Finance

Based on figure 2, we can see that in times of economic downturn, as in 2009, unemployment insurance budget registered higher expenditures (2,724.20 million RON) than revenues (1,482.70 million RON) which turned into a budgetary deficit of 1,241.50 million RON, financed from the state budget.

Also, it shows that in the previous years, 2004-2008, the budget was on surplus. We can say starting from this evolution, that unemployment insurance can act as a built-in stabilizer: during recessions, when unemployment rate is rising, unemployment insurance expenditures increase and revenues decrease, while during boom periods, when unemployment is falling, expenditures decrease and revenues will rise as employment rises.

As we can see from figure 2, public expenditures for unemployment insurance increased by 64.27% in 2009 compared to 2004 and have doubled compared to 2008, due to the economic crisis.

The evolution of public spending on unemployment insurance as a percentage of GDP registered a downward trend between 2004-2008, from 0.69% in 2004 (GDP=238.7 billion RON), to 0.53% in 2005 (GDP=287.2 billion RON) and 0.45% in 2006 (GDP=342.4 billion RON), and the decrease continued to 0.34% in 2007 (GDP=412.7 billion RON) and 0.26% in 2008 (GDP=503.9 billion RON). In 2009, as the unemployment insurance public expenditures doubled compared with the previous year and GDP fell from 503,959 million RON in 2008 to 491,273 million RON in 2009, the share of these expenditures in GDP increased to almost 0.55%.

The contribution of unemployment insurance for employers decreased from 1% to 0.5% in December 2008. For employees, the contribution is 0.5% applied to payroll.

In 2009 there were adopted Government decisions to support up to 50% of the services cost for organized training for a total of more than 20% of unemployed persons. The aim of these measures was to reduce the effects of financial and economic crisis on vulnerable social categories.

As international financial institutions have warned at the end of 2008, Romania spends a lot on unproductive expenditures, such as social assistance transfers, where the budgetary deficits are higher, and this must decline, in favor of investments which foster production, contributing to the country's economic recovery. Social assistance transfers have doubled between 2006 and 2009, reaching 63,962.1 million RON in 2009, which represents 12.7% of GDP. In what concerns the unemployment insurance budget for 2010, it is projected with a deficit of 1.1 billion RON, public spending representing 2.96 billion RON, with 8.83% higher than the previous years.

In the context of the crisis, in order to reduce the increasing number of unemployed and to restore those lost jobs, was adopted an Ordinance in February 2010, to reduce spending for the next period for all social budgets, following a decision of exemption for a period of 6 months the payment of social contributions for employers which employ for at least 1 year unemployed persons, being unemployed for at least 3 months.

It was estimated, based on an impact analysis conducted by the Ministry of Labor together with the Finance Ministry that there is scope for the next 10 months to be employed up to 50,000 unemployed. The impact of such a measure is a very good one, if we take into account that for these persons the state would have paid unemployment benefits amounting 235 million lei, while the exemption costs are about 183 million RON. We can even say that the consolidated budget will record a surplus of 52 million RON.

In May, 2010, in order to stay within the budgetary deficit of 6.8%, established with the IMF and international financial institutions for 2010, the Romanian Government decided to temporary cut spending and not to increase taxes, a measure very argued by the pensioners, Romanian budgetary categories and with an impact on the unemployment insurance budget, whereas unemployment benefits will be reduced by 15%.

#### 4. Conclusions

By providing protection against unemployment, UI program increases the security among employees and provides financial compensation to those who have lost their jobs. The macroeconomic literature shows that the unemployment insurance program alone provides significant relief to the newly unemployed and that it accounts for a large and important countercyclical force to prevent job losses. Also, introducing unemployment insurance program changes the opportunity cost of leisure and may affect hiring decisions, labor market participation and unemployment.

We have to take into account the fact that business cycles are a normal feature of our economy and that the private sector, alone, cannot provide exactly the right supply of jobs all through thick and thin market conditions. It is also important to mention that the performance of an unemployment insurance program depends not only on unemployment insurance structure, but also on specific factors of a particular country.

Analyzing the evolution of Romanian expenditures and revenues of unemployment insurance budget, during 2004-2009, we have seen that unemployment insurance acted as an incorporated stabilizer in the economy, which reflects the capability to dampen fluctuations in GDP during recessions and booms.

Budgetary spending increased in 2009, in period of economic recession, compared with previous years, and decreased in boom years. The evolution was opposite for budgetary revenues. As we can see, the unemployment insurance program injects income into the economy during recessions and withdraws income during expansions through changes in program expenditures.

In times of recession, public authority intervention through fiscal-budgetary measures is a necessary one, in order to help reducing the unemployment rate and create new jobs.

To conclude, unemployment insurance is important especially during recessions, when the unemployment rate increases, contributing to financial support of disadvantaged economic groups. At the same time, solutions must be found by authorities in order to stimulate job creation, to recognize the value of work, because employment is the real solution.

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