Continental Drift: Divergent Strategies in Pandemic Relief

Robert Crump

Originally published in the Chicago Policy Review - August 29th, 2020

Graphic by: Mark Sheppard

> *Structural differences between the US and EU member states' welfare systems have informed the divergence in government intervention.*

Europe and the United States are pursuing vastly different strategies in response to the economic crisis caused by Covid-19. Structural differences between the US and EU member states' welfare systems have informed the divergence in government intervention. Throughout most of Europe, central governments are propping up companies by covering their payroll expenses if they agree not to fire employees forced to shelter in place. The US, by contrast, allowed roughly 20 million people to be fired so they could be eligible for unemployment insurance (UI) through their state governments. Realizing that state UI programs would not be sufficient to keep income levels from declining across the country, Congress passed a $2 trillion stimulus package in late March.

On March 25th, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which, among other expenditures aimed at stimulating the economy, stipulates that UI benefits provided by states shall be supplemented by a tax rebate of $600 per week from the federal government. The CARES Act was a reactive measure for a government unaccustomed to and uncomfortable with expansion of the welfare state. It is a blunt instrument reliant on a model of the macroeconomy that rebalances quickly once demand returns to typical levels. European governments proved to be more capable of a nimble and rapid adjustment to their existing welfare states. Germany, for example, instituted the aptly named €100 billion Economic Stabilization Fund on March 23rd. If the majority of businesses remain intact, so the reasoning goes, then consumers can resume spending quickly once lockdowns are lifted. However, it may prove to be unwise to finance companies that eventually fail despite government assistance. While the European model saved many more jobs, it may hobble the EU recovery by throwing good money after bad business practices.

The US model is significantly more focused on consumer demand and less on securing ample supply from businesses. The success of such a demand-side stimulus relies, in part, on the reliability of the Joseph Schumpeter model of creative destruction. Schumpeter's theory describes cyclical business periods characterized by regular intervals of disruption to old business models. In order to survive, firms must change with the economy by adopting technological or strategic innovations. Companies that are unable to adapt are destroyed and replaced by more creative firms that grow to fulfill demand generated by new markets. In other words, economic growth is not a straight line of incremental developments; it's a cyclical process that requires a certain equanimity towards short term losses and confidence in economic rebound potential.

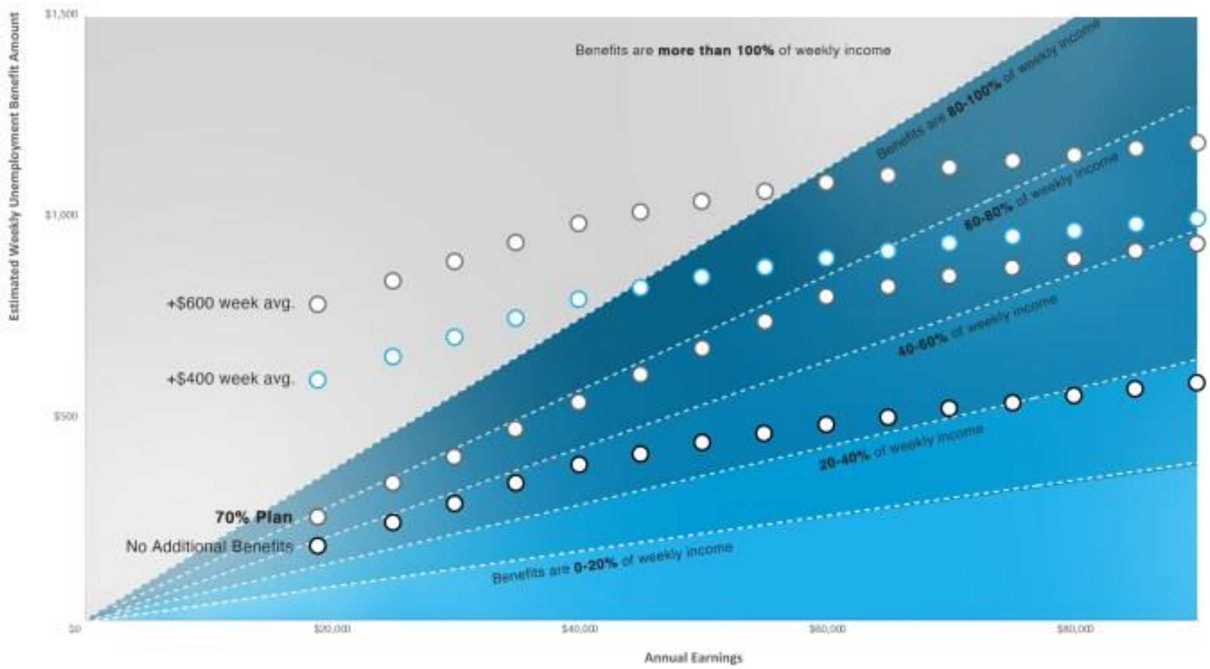
> *"68% of unemployed workers who are eligible for UI will receive benefits which exceed lost earnings.*

Economic dislocation and business failures will clear space for new businesses only if aggregate consumer demand remains stable. Even assuming aggregate demand does remain stable in the short to medium term, creative destruction must coincide with a mostly frictionless labor market for it to be beneficial. New research from The University of Chicago's Becker Friedman Institute for Research in Economics suggests that the CARES Act adds friction to the labor market by distorting wage replacement and potentially depressing demand for employment if federal benefits persist. According to Ganong et al., "68% of unemployed workers who are eligible for UI will receive benefits which exceed lost earnings. The median replacement rate is 134%, and one out of five eligible unemployed workers will receive benefits at least twice as large as their lost earnings."

However, the authors illustrate that choosing the correct fixed dollar amount to supplement state UI benefits is not the most apt policy question for the problem at hand. "It is quite difficult to achieve high replacement rates for most workers without also having replacement rates over 100% for many workers. For example, even at a fixed payment of $300, 42% of workers have replacement rates above 100%. At the same time, this lower fixed payment of $300 would leave one-quarter of unemployed workers with replacement rates below 60% and thus potentially sizable liquidity concerns."

When Congress considers a successor to the CARES Act they should weigh an alternative approach that could lead to greater equity while avoiding income expansion. Instead of paying a flat dollar amount across the country, the next stimulus bill could be made more effective by targeting a proportional replacement rate relative to the wide variance of state UI benefits and income levels between occupations. At least for the moment, ad hoc Executive Orders will have to suffice, although President Trump's order to extend $400 weekly UI payments holds dubious legal merit.

Unemployment Benefit Comparisons



Source: Peter Ganong, Pascal Noel, Peter Robertson and Joseph Vavra, University of Chicago

Chicago Policy Review

Note: Unemployment Insurance of the CARES Act Compared to Additional Plans. Estimated Weekly Unemployment Benefits Relative to Annual Earnings Projections from 2020

Visualization by: Mark Sheppard

We are all in uncharted waters and there are rarely definitive solutions to macroeconomic questions even in the best of times. As the initial panic of Covid-19 settles into a long season of anxiety, political leaders should consider a range of options regarding government spending to stimulate or stabilize national economies. Both the U.S. and European stimulus plans responded to the crisis quickly and with the tools available and each succeeded in preventing (or at least delaying) a massive humanitarian disaster. The totality of consequences between both strategies will take years to observe and comprehend. Uncertainty will remain, but through reflection, refinement, and attempts at foresight, national leaders can build policies more closely fit to purpose.

Ganong, Peter, Pascal Noel, and Joseph Vavra. 2020. "US Unemployment Insurance Replacement Rates During the Pandemic." NBER Working Paper No. 27216. https://www.nber.org/papers/w27216, accessed August 2020.