THE HIGH COST OF RECESSIONS
AND THE KEY ROLE OF EMPLOYMENT INSURANCE

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The current Canadian recession is not like the previous three recessions that occurred in 1957-1961, 1982-1983 and 1990-1993. Those were <u>strategic</u> recessions that were initially engineered by your favorite corner central bank to combat inflation. This one is a <u>systemic</u> recession. It has originated in the economic system itself, basically in the US financial industry. The recent near-panic in the US financial sector bears some resemblance with banking panics that used to accompany pre-World War II recessions, including the Great Depression of the 1930s. Fortunately, few Cassandras predict a disaster of that order of magnitude this time around. If we are not unlucky, the 2009-2010 recession in Canada could be at most of the same order of magnitude as the 1982-1983 recession.

In this presentation, I will first report on the macroeconomic cost of the last four recessions: those of the 1930s, the 1950s, the 1980s and the 1990s. I will then emphasize a basic fact of recessions: that they impact on middle- and low-income classes much more severely than on high-income classes. Finally, I will argue that in the present context access to employment insurance benefits ought to be prudently increased.

The economic cost of recessions is very large

Chart 1 traces the trend in Canadian unemployment back to 1921. The output and income data needed to assess the macroeconomic cost of recessions are available in four instances: 1930-1933, 1957-1961, 1982-1983 and 1990-1993. The recession of the 1930s was an order of magnitude deeper than the three postwar recessions. Its maximum unemployment rate was 19%, in 1933. In contrast, the highest unemployment rates in the three later recessions were only 7% in 1961, 12% in 1983 and 11% in 1993.

Chart 1
The unemployment rate in Canada from 1921 to 2009
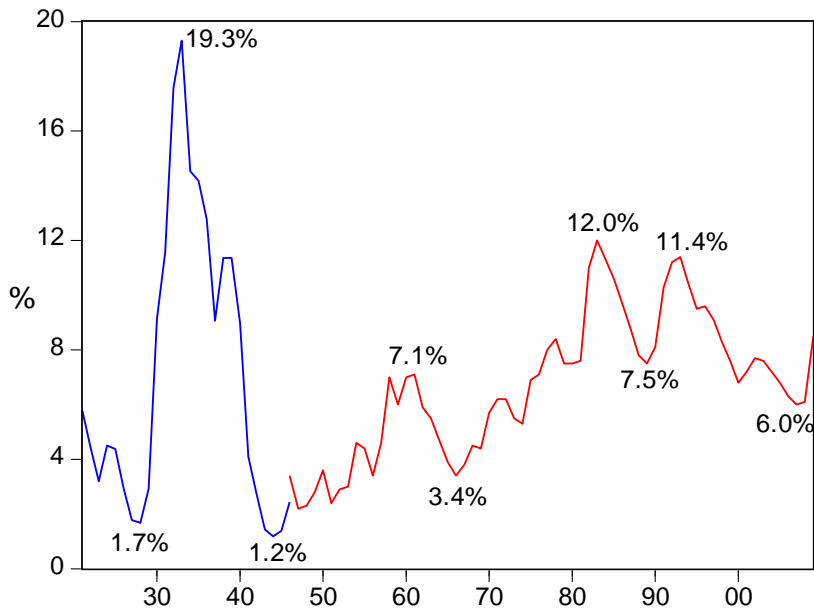
Source: Statistics Canada.

Charts 2a to 2d show how actual and potential output evolved during the four recessions and ensuing recoveries. Potential output is roughly estimated by simply assuming log-linear trends from peak to peak of actual output. Table 1 presents summary statistics. The disaster of the 1930s was by far the longest and most crushing. The worst year was 1933. In that year, actual GDP fell to 37.4% below potential. In this terrible 12-year episode, the economy lost cumulatively more than three full years of production at normal levels. As the last column of the table implies, the equivalent cost of this nightmare today would be close to five trillion dollars in lost output and real income.

Of the three postwar episodes, the recession of the 1980s was the shortest and least costly. That of the 1990s was the most protracted and costly. The three postwar setbacks lasted between six and ten years, with maximum annual output gaps ranging from 6% to 9% of potential. Cumulative gaps amounted to between 22% and 62% of a year's potential GDP, which translated into 2009 equivalent losses of between $370 billion for the smallest recession and a little over $1 trillion for the largest.

Table 1. Length, depth and macroeconomic cost of four past Canadian recessions

Episode	Length	Max. output gap	Cum. output gap	2009 equivalent cost
1930-1941	12 years	37.4% in 1933	302.6%	$4,990 billion
1957-1965	9 years	7.9% in 1961	42.1%	$690 billion
1982-1987	6 years	6.2% in 1983	22.4%	$370 billion
1990-1999	10 years	8.9% in 1993	62.3%	$1,030 billion

Note: The background time series for this table are the published figures for actual real GDP, and estimated values for potential real GDP. As pictured in charts 2a to 2d, potential GDP is simply assumed to follow log-linear trends from peak to peak of actual real GDP, i.e., from 1929 to 1942, 1956 to 1966, 1981 to 1988, and 1989 to 2000. The output gap in a given year is the percentage by which actual GDP falls short of potential GDP in that year. The cumulative output gap is the arithmetic sum of annual output gaps over all years of a given episode. The 2009 equivalent cost tells how much the calculated cumulative output gap would be worth as a percentage of 2009 potential output (which is taken to be $1,650 billion).
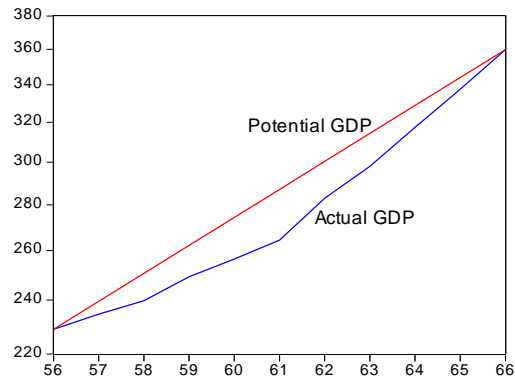Sources: Statistics Canada, CANSIM Tables 380-0017 and 380-0040; author's calculations.

Chart 2a
Actual and potential real gross domestic product (GDP), Canada, 1929-1942 (billions of 2002 dollars)
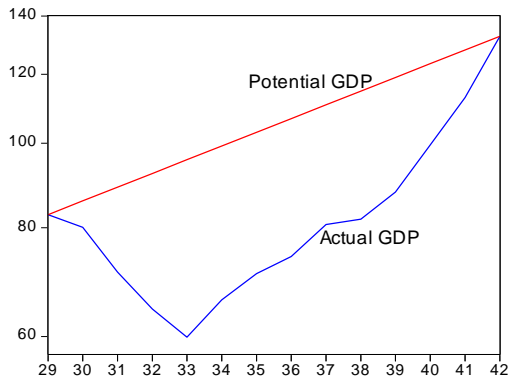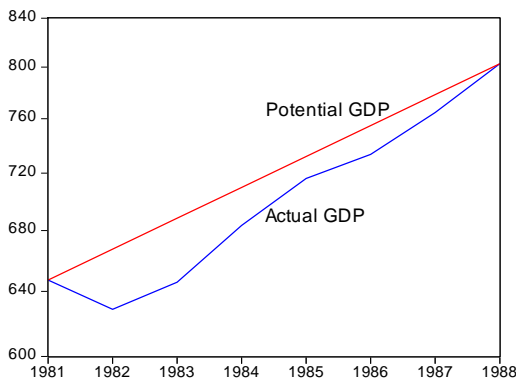
Source: StatisticsCanada; author'scalculations.

Chart 2b
Actual and potential real gross domestic product (GDP), Canada, 1956-1966 (billions of 2002 dollars)
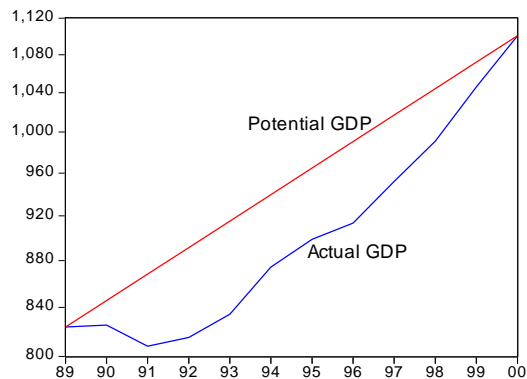
Source: StatisticsCanada; author'scalculations.

Chart 2c
Actual and potential real gross domestic product (GDP), Canada, 1981-1988 (billions of 2002 dollars)

Source: StatisticsCanada; author'scalculations.

Chart 2d
Actual and potential real gross domestic product (GDP), Canada, 1989-2000 (billions of 2002 dollars)

Source: StatisticsCanada; author'scalculations.

Don't ask me to predict how large and costly the current recession is going to be. We know that real GDP growth was 0.5% in 2008. It is generally forecast to be negative at -3% in 2009 and positive again at 2.5% in 2010, but much depends on how the U.S. and international situation unfolds. We seem to be heading for output gaps of at least 6% in 2009 and 2010, which would therefore add up to a cumulative gap of 12% or $200 billion for these two years. God knows what will happen beyond 2010. If the Federal Reserve and the Treasury are successful in unclogging U.S. financial markets, a swift recovery similar to that of the 1980s is a possibility. With a maximum unemployment rate below 10%, the cumulative cost of the recession could be held down to less than

$400 billion. But if the financial sector takes a long time to recover or if the fiscal-monetary stimulus is withdrawn too early, a dragged scenario like that of Japan in the 1990s is also possible. In this case, the macroeconomic cost could rise to, say, $800 billion. Even under the best circumstances, the recession is going to be very costly.

Recessions impact more severely on middle- and low-income classes

When assessing the broad income consequences of recessions, an important consideration is that their incidence on various income classes is unequal. Recessions hit all income classes, but middle- and lower-income classes more severely than higher-income classes. Table 2 provides a check by looking at what happened to the average real disposable income of household quintiles in the last two recessions. It indeed turns out that in each case the percentage drop in income was smaller in the highest two quintiles than in the middle and lowest two quintiles. Rising unemployment, which is known to hurt lower-wage earners more than higher-wage and salary earners, must be an important reason for this phenomenon.

Table 2. Peak-to-trough decline in average real disposable income of Canadian families in the recessions of 1982-1983 and 1990-1993, by quintile

Quintile	Change from 1981 to 1983	Change from 1989 to 1993
Lowest quintile	-9.3%	-11.7%
Second quintile	-9.3%	-12.7%
Middle quintile	-7.1%	-11.2%
Fourth quintile	-5.3%	-7.9%
Highest quintile	-2.6%	-5.6%

Note: The peak year of the recession is the year just preceding the recession. The trough year is that of maximum output gap (as per Table 1).
Source: Statistics Canada, CANSIM Table 202-0701.

Access to employment insurance benefits should be prudently increased

An obvious corollary is that reasonable access to employment insurance benefits is crucial for avoiding excessive distortions of income distribution during the recession and the ensuing recovery. But in present circumstances a potential difficulty is that access to EI benefits has been significantly reduced by major amendments to the EI Act adopted by Parliament between 1990 and 1996. Chart 3 shows that the number of EI beneficiaries declined sharply from over 80% of the estimated number of unemployed toward the end of the 1980s to 45% in 1997. Such a drop in the beneficiaries-to-unemployed, or BU, ratio could be due to changes in the duration of unemployment. In recessions such as that of the early 1990s, jobs become harder to find, unemployment spells last longer, and more unemployed exhaust their EI benefits. Much of the decline in the BU ratio was initially interpreted as a consequence of these events. However, Charts 3 and 4 in combination show that, even if in the past ten years long-term unemployment has returned to its low level of the 1970s, the BU ratio has not been reestablished at its previous higher level. It has remained stuck around its 1997 level of 45%. This is clear evidence that EI program changes have been a major cause of the drop in the ratio.
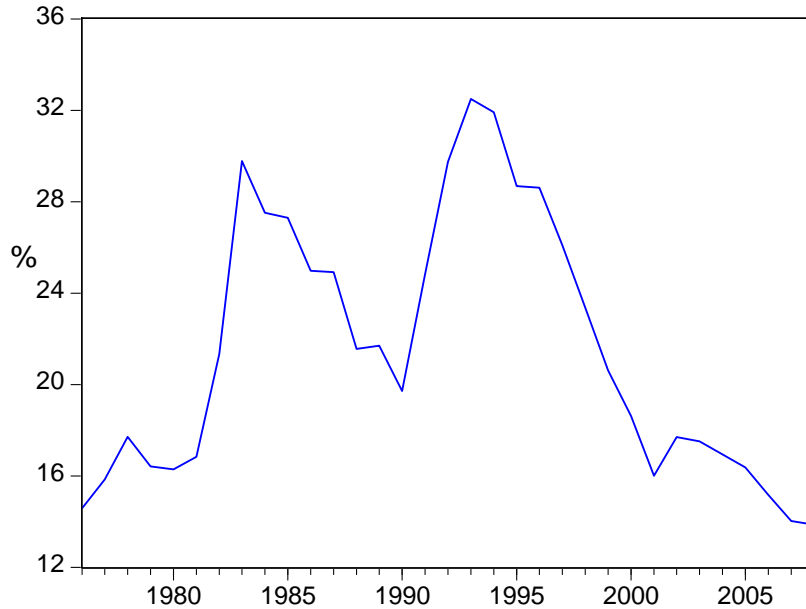
Chart 3
The BU ratio: number of employment insurance beneficiaries
as a percentage of the estimated number of unemployed
in Canada, 12-month moving average from 1977 to 2009
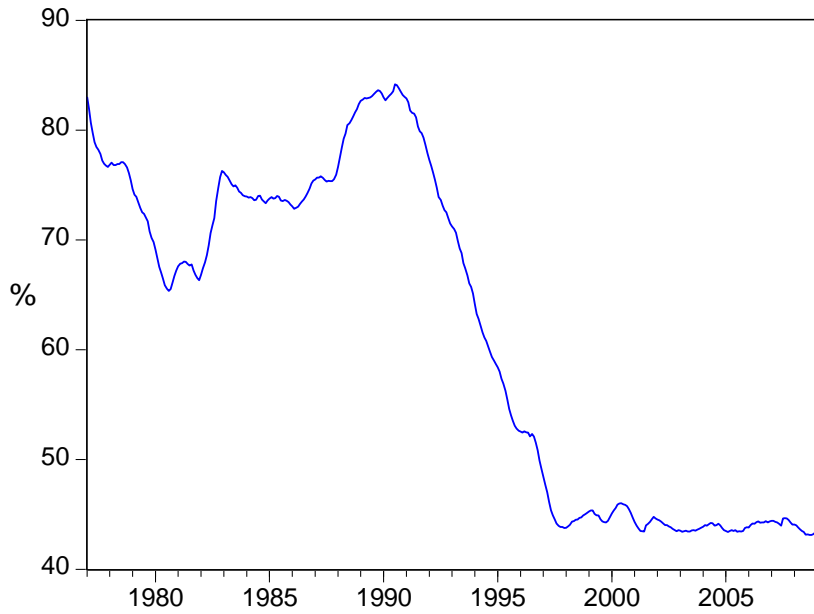
Source: HRSDC; Statistics Canada.

Chart 4
Unemployed 6 months or more as a percentage
of total unemployed, Canada, 1976-2008

Source: Statistics Canada.

How different is the current EI program from what it was 20 years ago? Basically, more hours and weeks of work than before are required to qualify for benefits; a smaller fraction of wages is replaced by benefits; and the potential benefit period has been shortened. All these changes have had the effect of reducing the ratio of total potential benefits to qualifying-period earnings and, hence, the BU ratio.

An important message from Chart 4 is that, just as it did after 1982 and 1990, long-term unemployment will likely increase again in 2010 as jobs will become harder to find. With more limited access to EI and more rapid exhaustion of benefits than 20 years ago, the number of unemployed without resources is bound to increase rapidly, particularly among the middle- and lower-income classes.

In response to this incipient development, the January 2009 Budget announced that all regular EI benefit entitlements would be increased by five extra weeks subject to a maximum of 50 weeks for 2009 and 2010. This is clearly a step in the right direction, but one that may be insufficient given the magnitude of the problem that Canadian workers are going to face. A temporary ten-week extension subject to the same 50-week ceiling would be more effective. If you want a benchmark, recall that the extended benefits program that is available in periods of high unemployment in the U.S. provides

up to 13 additional weeks of benefits (in some states, up to 20 weeks) to the standard 26 weeks of potential benefits. I think this is where the main policy priority lies.

There is also something to be said in favour of the Liberal proposal to reduce the minimum requirement for eligibility to EI benefits to 360 hours of work in the qualifying period (which could be nine 40-hour weeks, ten 36-hour weeks, etc.) independent of the regional unemployment rate. It could even be made a permanent feature of the Canadian EI system. Again, taking the U.S. regime as benchmark, the median state requires only about 140 hours of work in the base period to allow access to UI benefits. That is less than half the number of hours suggested by the Liberal proposal.

However, it is crucial to note that the U.S. system requires that total potential benefits be limited to a fraction, usually between 25% and 50%, of base-period earnings. There is a basic element of prudence to be observed here. Open access to benefits for the insured population does make sense – if you pay premiums, you should be entitled to benefits – but benefits should be commensurate with premiums. We may want to impose a ceiling higher than in the U.S. on the ratio of potential benefits to qualifying-period earnings. After all, this is Canada, not the United States. But we should do so within limits. We should be loath to transform employment insurance into social assistance again and fall into the major disincentive trap that was created by potential benefits that could represent up to 252% of base-period wages in some areas in the 1979-1989 period. We were finally able to escape from this trap in the 1990s, and we would not want to return to it.

Summary

Let me summarize what I said. First, our last four recessions have been extremely costly. In 2009 equivalent terms, the tab has ranged from $370 billion in the 1980s to $1,000 billion in the 1990s and to $5,000 billion in the 1930s. This recession will be no exception to the rule. It will cost at least $400 billion. Second, recessions hit all income classes, but middle- and lower-income classes harder than higher-income classes. They are costly for everyone, but more for some than for others. Third, easing entrance requirements to EI benefits and extending the period of benefit entitlement are clearly indicated if we want to spread the cost of the recession more equally across income classes. The 360-hour work requirement advocated by the Liberal Party is entirely acceptable if it is matched by benefits that are commensurate with qualifying-period earnings. The benefit period should also be temporarily extended. In this case, a ten-week extension would seem to be more effective than the five-week addition that Parliament has already adopted.