As labour markets adapt, so too should fiscal policy

Brett Ryan, Justin Weidner

Much of the credit for the US economic recovery this year should go to the two main pillars of the fiscal policy response, namely, the Payroll Protection Program (PPP) and a sizeable expansion of federal unemployment insurance (UI) that supplemented existing state income support mechanisms. Combined with massive monetary support, these innovations were critical.

The next round of policy should be somewhat different. As the continued spread of covid precludes a swift return to pre-virus patterns of economic activity, and potentially accelerates structural changes toward greater automation, the optimal policy mix should shift away from payroll subsidies and towards more income support and job retraining. Longer term, policymakers should consider automating such income support measures, allowing for a quicker response to future exogenous shocks.

To understand why fiscal policy must change, consider the original purpose of the PPP. It was implemented at the beginning of the pandemic and was a novel, appropriate policy response to a short-lived and sharp downturn caused by an exogenous shock. It aimed to prevent small business closures and preserve worker-firm matches so that when labour demand rebounded, a swifter recovery would follow. The program harnessed the ability of the banking system to swiftly distribute about 5.2m fully-forgivable loans totalling $525bn to small businesses. Loan forgiveness was then tied to firms’ willingness to maintain pre-covid payroll levels. The SBA says the program has supported 51m jobs to date.

Just as the PPP was designed to “preserve the status quo”, so too were federal income support measures. These have totalled a little over $550bn, with the majority of that ($460bn) allocated to UI through three separate programs that supplemented existing state benefit schemes. This included the $600 per week supplement that went to those receiving regular state UI benefits that typically average around $360 per week. Some of these programs have expired; others will cease at year end.

As Congress considers the next phase of fiscal support, there is a greater need to subsidise demand relative to maintaining pre-virus levels and patterns of supply. Indeed, a New York Federal Reserve report noted that the introduction of payroll subsidies alone is preferred over a cost-equivalent UI expansion as it preserves highly-productive matches during containment, thus enabling a faster recovery of productivity and output following the lifting of containment measures. When considered jointly, however, a cost-equivalent optimal mix allocates only 20 percent of the budget to payroll subsidies and 80 percent to UI expansion.

Early evidence seems to support the New York Fed report. Since late April, the Census Bureau has conducted a weekly survey of small businesses to measure the impact of the covid pandemic on activity. Going back to early August, the survey has consistently indicated that about two-fifths of businesses have not rehired any paid employees who had been furloughed or laid off after March 13. That may be because under

---

1 Birinci, Karahan, Mercan, See “Labor Market Policies during an Epidemic”, Federal Reserve Bank of New York Staff Reports, no. 943, October 2020.
2 https://portal.census.gov/pulse/data/
ten per cent of firms view the ability to rehire employees as a factor affecting their operating capacity. In short, as the economy has reopened, businesses have adapted and rescaled their operations.

With this in mind, the continuation of PPP in its current form risks misallocating future fiscal capital by exacerbating labour mismatches, especially in an environment where market forces may be accelerating the underlying structural shifts in labour demand.

Automation has played a role in the shift in labour demand. Recent research from the Philadelphia Federal Reserve suggests the pandemic has likely accelerated the process of automation by putting staff in automatable jobs out of work, although it is too early to conclude whether the shift is permanent.³

So as the pandemic drags on, it will be more effective to provide income support to those who may not be rehired than to try to preserve employee-employer relationships that could become obsolete because of structural changes in the economy.

To be sure, the PPP has shown some evidence of success and there is still a role for subsidising small business employers who will inevitably continue to face virus-related financial distress. However, a more flexible and targeted policy designed to ease the transition to a “new normal” operating environment makes more sense as various industries are being affected by the pandemic in very different ways. Consider that a Chicago Fed survey in May indicated that almost nine out of ten restaurants would face financial distress after three months of “moderate” social distancing and party size limits of 50. That compares with just four in ten manufacturing businesses.⁴

Many of the rapid innovations and adaptations to the ways in which we live and work could be permanent. The design of fiscal policy must therefore also adapt. Maybe the broadest lesson of the current crisis is the necessity of automating income support measures. These should be pre-defined and automatically triggered by sharp rises in the unemployment rate. Such a system will be a useful innovation to combat future exogenous shocks.

At the same-time, the withdrawal of fiscal support should also be based on labour market outcomes rather than arbitrary dates. This approach may hold several advantages. First, it would avoid protracted political disputes that can impede a swift and efficient fiscal response to an economic shock. Second, designing outcome-based formulas to the withdrawal of income support based on labour market benchmarks would avoid arbitrary “fiscal cliffs” that have hampered economic recoveries in the past.

With these recommendations in place, automation will go a long way to reducing the uncertainty of future fiscal reactions. That will truncate the risk that an exogenous shock might turn into a more protracted economic downturn.