

Use Cost-Benefit Analysis and not Political Parties to Determine Government Expenditure Decisions

Robert J. Brent*

Department of Economics, Fordham University, 441 East Fordham Road, Bronx, New York 10458.

Abstract: Government expenditures produce both benefits and costs. In terms of unemployment insurance, especially the Federal Pandemic Unemployment Compensation program, the benefits are in terms of consumption smoothing, and the costs are expressed as moral hazard. Political parties in the US make government expenditure decisions by following their party platforms, which typically means that they are always in favor, or always against government involvement in the economy. In the process, they implicitly either concentrate just on the benefits, or just the costs. Since both benefits and costs are important, government expenditure decision-making should instead be made on the basis of Cost-Benefit Analysis. Only using this economic evaluation method would ensure that government expenditure decisions, such as on unemployment insurance, would be determined by the size of the difference between the benefits and costs, and therefore be decided on the basis of whether they are socially worthwhile or not.

Keywords: Cost-Benefit Analysis; Government expenditures; Political parties; Federal Pandemic Unemployment Compensation; Moral hazard; Consumption smoothing.

1. INTRODUCTION

In a recent contribution – hereafter the “Stiglitz article” – the proper role of the government and the market in the economy was reexamined, especially in the context of responding to the current Covid-19 Pandemic.¹ It was confirmed that the extent of government involvement in the economy depends largely on weighing up the size of market failure relative to that of government failure. Market failure is caused by externalities, the lack of competition, and the absence of risk markets. Government failure arises from corruption and the lack of incentives for government decision-makers.

The point was also made that economics cannot be separated from politics. In the context of measuring the relative sizes of market and government failure, this non-separation of economics and politics is unfortunate. This is because political parties in the US have already made their conclusions based on economic reasoning void of any actual empirical evidence. For the right-leaning parties the government should play a minimal role in the economy, and for left-leaning parties the government should play a significant role.

Even though economics cannot be separated from politics, it is important to separate economic decision-making from political party decision-making. The objective of this article is to build on Stiglitz’s analysis of the proper role of government in the market economy by providing the next step,

which is to explain *how* government expenditure decisions should, and should not, be determined. Government expenditure decision-making should depend on data, because government expenditure decisions cannot be determined in advance of knowing the data, which is how political decisions are usually made.

In the next section, we analyze an actual government expenditure decision that was a response to the Covid-19 epidemic covered by the Stiglitz article, known as Federal Pandemic Unemployment Compensation (FPUC). This was part of the \$2.2 billion package called the Coronavirus Aid, Relief and Security Act (the CARES Act). We explain the type of economic reasoning that the two political parties would use to justify, or not justify, this particular government expenditure following the Stiglitz framework. In section 3, we present an alternative type of economic reasoning for evaluating public expenditures that is more comprehensive, called Cost-Benefit Analysis (CBA). We explain the basic principles of CBA and show how carrying out an economic evaluation of FPUC would automatically incorporate the concerns of both political parties, yet not prejudice the social desirability of the policy decision. We close with the summary and conclusions.

2. UNEMPLOYMENT INSURANCE SUPPLEMENTATION DURING COVID.

Unemployment insurance is a joint, federal-state partnership with eligibility, benefit levels and duration of benefits set by states, and the federal government providing funds for the administrative costs.² FPUC provides a temporary \$600 per

*Address correspondence to this author at Department of Economics, Fordham University, 441 East Fordham Road, Bronx, New York 10458; E-mail: brent@fordham.edu

¹See Stiglitz (2021).

²Berkowitz and Basu (2021).

week addition to the normal unemployment benefits for which a worker would have already been eligible. Some workers that previously were not considered to be employees also became eligible for the unemployment benefits. These consisted of independent contractors or freelancers who do short-term work for multiple clients (the so-called gig workers). The expansion of coverage was considerable as the new claims for unemployment insurance was 40 percent of all continuing claims as of January 2021.³ FPUC expired in July 2021. It was replaced by the Lost Wages Assistance program that provided 6 weeks of \$300 supplemental payments that itself expired in September 2020.

THE POLITICAL PARTIES' PERSPECTIVES

2.1. The Republican Party Emphasis

Most Republican politicians, who are usually against any form of publicly funded unemployment insurance, focus on the work disincentive effects of the unemployment insurance. Being unemployed is less of a drawback if one has the financial assistance of the insurance available. The higher the benefits relative to the wage, called the "benefit replacement rate", the less necessary it is for a person to work to maintain their standard of living. This drawback, called a moral hazard problem in the Stiglitz article, is always expected during normal times.⁴ However, during the pandemic, the moral hazard problem can be expected to be particularly large as the benefit replacement rate was greater than 100 per cent, and there were health and childcare issues associated with working. The Republican party emphasis is therefore only on the firms who need workers to stay in employment for production to take place. By discouraging workers from seeking employment, unemployment insurance would not be considered to be market friendly.

2.2. The Democratic Party Emphasis

The main reason most Democratic politicians support publicly funded unemployment insurance is because private unemployment insurance is generally not available. This is the market failure case for government involvement in unemployment insurance that the Stiglitz article explains. Workers find unemployment insurance worthwhile because of the need for "consumption smoothing". That is, unemployment insurance enables consumption to remain relatively the same during hard times (when wages cannot be obtained due to a loss of employment caused by a recession) and good times (when employment provides the necessary wages).⁵ If workers cannot purchase private unemployment insurance, then government unemployment insurance allows consumption smoothing to take place. The Democratic party emphasis is therefore mainly on the employees, who need income to survive during recessions when workers are involuntarily laid

off. By filling in this income gap, unemployment insurance is worker friendly.

3. THE COST-BENEFIT PERSPECTIVE

The CBA perspective is neither exclusively market friendly, nor worker friendly, but is simply socially friendly. It includes both the Republican and Democratic Party perspectives, but is much wider as it includes all perspectives and not just those of workers and firms. The data that is relevant for government decision-making relies on knowing not only who gains and who loses, or even knowing how many people gain or lose, but depends crucially on knowing the relative size of these gains and losses. Cost-Benefit Analysis (CBA) is the most comprehensive way of assembling economic evidence for deciding government expenditures. This is because it expresses both the gains and losses in monetary terms so that the difference, the net-benefits, can be determined. Only if the net-benefits are positive should any government expenditure decision be approved. This is the "how" of Stiglitz's weighing up of the size of market failure relative to that of government failure needs to take place.⁶

In political decision-making concerning economic policies, data does not really matter. What is decisive is whether the policy is thought to generate moral hazard, or thought to promote consumption smoothing. Yes, there will always be someone who will not seek employment if unemployment insurance exists; and yes, there will always be someone who does not have the resources to survive when a worker loses a job due to a recession and unemployment insurance does not exist. In CBA, what is decisive is how large is the moral hazard loss, and how large is the consumption smoothing gain, and the size of the loss relative to the gain. The relative sizes of the losses and gains depends crucially on the details of the unemployment insurance, and how complete are the estimates of the gains and losses. Here we explain some of the general principles for valuing the benefits and costs and do this in the context of FPUC.⁷

3.1. In CBA, Details Matter

Just as it does not make economic sense to say that one approves government spending on education, without first stating what type of education, age group, location, etc. are involved, it does not make sense to say that one is in favor of, or against, unemployment insurance no matter the details.

In the case of FPUC, it was a temporary intervention, with a start date of March 27th, 2020 and an end date of July 31st 2020.⁸ As emphasized by Stiglitz, this took place in the context of COVID19 where the population was very needy. This was because of losing jobs due to the recession, the demand for health care to deal with COVID-19 sickness, and the re-

³Ruffini and Wozniak (2021).

⁴Schmieder and von Wachter (2016) give a survey of the moral hazard effects of unemployment insurance in normal times.

⁵Private risk markets are absent because they cannot set insurance premiums that are actuarially fair (would lead to no financial loss to the firm) due to the existence of adverse selection (only high-risk workers would sign up) and moral hazard that we have emphasized earlier.

⁶For a survey that explicitly estimates the monetary gains of correcting market failure from the absence of risk markets, which is called "income smoothing" and is covered in section 2 of this article, see Morduch (1995). For a study that explicitly measures the monetary losses that government corruption provides, see Brent (2009).

⁷For more on the general principles of how costs and benefits are evaluated for any type of government intervention, see any CBA textbook, such as Brent (2006, 2014, 2017).

⁸Though it was extended at a reduced \$300 rate until Sept 6th, 2021.

quirement to home school one's school-age children. The past history of unemployment insurance may not be of much relevance in this context.

The supplementation was designed to replace 100 per cent of the average wage when combined with existing benefits. This was how the \$600 a week payment was determined. It turned out that the median replacement rate was 134 percent.⁹ This means that beneficiaries would receive 34 percent more by *not* working than if they were working. This fact has pluses and minuses. The minus is the moral hazard problem previously explained and examined further below. The plus is that if the median replacement rate was so much higher than the average, this has to have meant that the typical recipient was poorer than other workers. Thus, the FPUC had the advantage of being an antipoverty intervention, making the consumption smoothing benefits large.¹⁰

3.2. Society Consists of Everyone Affected by the Public Expenditure

CBA is a *social* evaluation of government expenditures because it records the effects of everyone in society who is affected by the intervention. Of course, for the PFUC, firms doing the hiring, and employees receiving the compensation, would be the main groups affected. But, many other groups would also be affected, which could include taxpayers, consumers, and firms and employees who are not directly affected by the government expenditures. Stiglitz uses the term externalities to relate to effects on persons other than the government incurring the expenses, and the workers who receive the benefits. The externalities are especially relevant to FPUC as it is not just sufficient to know the employment effects of those receiving compensation. How the labor market as a whole reacts to the unemployment insurance is also important.

One type of externality mentioned by Stiglitz was the Macro economic employment effects of PFUC. One way that the employment effects of PFUC can be estimated is by seeing how many jobs increased when PFUC had ended in July 2022. Ending the program reduced the replacement rate roughly from 145 to 84 percent. Micro studies of the end of PFUC show that employment rose. Dube (2018) reports one estimate that claimed that job creation was as high as 3-5 million. However, Dube recognized the reality that ending PFUC meant that aggregate demand would be reduced, and therefore employment would fall as a response to this Macro externality. Dube estimated, from state-wide differences in replacement rates, that PFUC had a surprisingly little effect on overall employment. The moral hazard effects should therefore play no part in a CBA of the program.

With only consumption smoothing benefits to consider, the PFUC would be clearly found to be socially worthwhile using a CBA. Evidence of the positive consumption smoothing effects can be seen by focusing on food insufficiency (whether people sometimes or often had not enough food to

eat). Berkowitz and Basu (2021) found that the adjusted risk difference for food insufficiency was 5.01 percentage points lower for those who received unemployment insurance relative to those who did not. An alternative outcome measure is to look at how health care spending was bolstered by PFUC. Spending was increased by 0.8 percent in Medicaid expansion states, and 1.3 percent in nonexpansion states, for every percentage point increase in the unemployment insurance claims rate.¹¹ More generally, unemployment insurance prevented 5.5 million from experiencing poverty in 2020.¹²

4. SUMMARY AND CONCLUSIONS

The only way that government expenditure decisions can always be decided in advance, without reference to data, is to have a narrow focus such that one either emphasizes only the costs, or only the benefits, and thereby ignore the other side of the equation. This is mainly how political parties currently make government expenditure decisions. For the Republican party, government expenditures only have costs. Therefore, they are not to be approved. For the Democratic party, government expenditures only have benefits. Thus, they should be approved.

In reality, government expenditures have benefits and well as costs. The desirability of government expenditure using CBA is to be decided on the relative sizes of the benefits and costs. Only if the benefits are less than the costs should a particular government expenditure not be approved; and only if the benefits are greater than the costs should a government expenditure be approved. In the context of PFUC, given that the moral hazard costs were negligible, unemployment insurance would have been found to be socially worthwhile. But, in other contexts, that had different details, this may not have been the CBA conclusion.

Federal agencies in the US have been required to carry out CBAs of regulations since the 1970's, and this requirement was restated in Executive Order 12866 in 1993. On January 20, 2021, President Biden issued a presidential memorandum reaffirming the basic principles of Executive Order 12866.¹³ Thus, for regulations, CBA is well established. All that is necessary now is that CBA be required for government expenditure decisions generally.

REFERENCES

- Berkowitz, S.E., Basu, S., 2021. Unmet social needs and worse mental health after expiration of COVID-19 federal pandemic compensation. *Health Affairs*, 40, 426-434.
- Brent, R.J., 1984: Use of distributional weights in cost-benefit analysis: A survey of schools. *Public Finance Quarterly*, 12, 213-230.
- Brent, R.J., 2006. *Applied Cost-Benefit Analysis*, 2nd ed. Edward Elgar, Cheltenham, UK.
- Brent, R.J., 2009. Cost-Benefit Analysis and the evaluation of the effects of corruption on public projects. "In Brent, R.J. (ed), *Handbook on Research in Cost-Benefit Analysis*". Edward Elgar, Cheltenham, UK.
- Brent, R.J., 2014. *Cost-Benefit Analysis and Health Care Evaluations*, 2nd ed. Edward Elgar, Cheltenham, UK.
- Brent, R.J., 2017. *Advanced Introduction to Cost-Benefit Analysis*. Edward Elgar, Cheltenham, UK.

⁹See Ganong *et al.* (2020).

¹⁰In CBA, equity effects are incorporated into the evaluation by the use of income distributional weights applied to whom receives the benefits and whom incurs the costs. See Brent (1984, 2022).

¹¹Evangelist, Wu and Shaefer (2022).

¹²Fox and Burns (2021).

¹³Congressional Research Service (2022), March 8, 2022.

- Brent, R.J., 2022. Use of distributional weights in benefit-cost analysis revisited. Working Paper, Fordham University, Department of Economics, NY.
- Congressional Research Service, 2022. In Focus: <https://crsreports.congress.gov>, March 8, 2022.
- Dube, A. 2021. Aggregate employment effects of unemployment benefits during deep downturns: Evidence for the expiration of the Federal Pandemic Unemployment Compensation. National Bureau of Economic Research, Working Paper 28470, Cambridge, MA.
- Evangelist, M., Wu, P., Shaefer, H.L., 2022. Emergency unemployment benefits and health care spending during Covid. *Health Services Research*, 57, 15-26.
- Fox, L.E., Burns, K. 2021. The supplemental poverty measure: 2020. Report No. P60-275, September 14.
- Ganong, P., Noel, P, Vavra, J., 2020. US unemployment insurance replacement rates during the pandemic. SSRN Scholarly Paper ID 3601492, Social Science Research Network, Rochester, NY. <https://papers.ssrn.com/abstract=3601492>
- Morduch, J., 1995. Income smoothing and consumption smoothing. *Journal of Economic Perspectives*, 9, 103-114.
- Ruffini, K., Wozniak, A., 2021. Supporting workers and families in the pandemic recession: Results in 2020 and suggestions for 2021. *Brookings Papers on Economic Activity*, Spring.
- Schmieder, J.F., von Wachter, T. 2016. The effects of unemployment insurance benefits: New evidence and interpretation. *Annual Review of Economics*, 8: 547-581.
- Stiglitz, J.E., 2021. The proper role of government in the market economy: The case of the post-COVID recovery. *Journal of Government and Economics*. Volume 1, Spring, 100004.

Received: July 19, 2022

Revised: July 25, 2022

Accepted: September 12, 2022

Copyright © 2022– All Rights Reserved

This is an open-access article.