THE SOCIAL INSURANCE PERSPECTIVE ON FISCAL POLICY:

IMPLICATIONS FOR MONETARY POLICY

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Abstract

This paper begins by reviewing the social insurance perspective on pandemic fiscal policy advocated by Romer and Romer (2022). It goes on to expand on Romer and Romer's discussion of insights from the social insurance perspective into how fiscal policy should respond to other recessions. It then turns to the implications for monetary policy. It shows that in the case of social insurance, the natural baseline is not coordination with fiscal policy, but a hierarchy of decisions: social insurance actions should be chosen first, followed by choices about conventional monetary policy, potentially followed by some combination of unconventional monetary policy and general fiscal stimulus. There are good reasons for monetary policy to not directly support the social insurance role of fiscal policy, but there is room for some exceptions.

The recession of 2020 differed fundamentally from every U.S. recession over the previous hundred years. It was triggered not by a shock to aggregate demand, but by a pandemic whose most direct and immediate impact was on supply. In Romer and Romer (2022), Christina Romer and I explain why it called for a very different fiscal policy response than usual recessions. Aggregate demand stimulus to try to rapidly return output and employment to normal would have been both dangerous (because of the potential impact on the spread of the disease) and likely unsuccessful (because certain sectors were almost certain to remain almost entirely closed as long as the disease was unchecked). Instead, fiscal policy's proper role was to provide social insurance—that is, to provide the individuals most severely affected by the pandemic with the insurance they would have liked to have if they had contemplated the possibility of a pandemic.

This brief paper makes three contributions. In Section I, it reviews the social insurance perspective on the fiscal policy response to the pandemic and our assessment of major aspects of the U.S. policy response through the lens of that perspective. Section II builds on the discussion in the concluding section of Romer and Romer (2022) to draw out broader implications for countercyclical fiscal policy, including fiscal policy in conventional recessions. Section III discusses the implications for monetary policy. I argue that the social insurance perspective points not to fiscal-monetary cooperation but to an ordering of policy decisions, with social insurance interventions chosen first, followed by decisions about conventional monetary policy taking those interventions as given, and then potentially followed by choices of some combination of general fiscal stimulus and unconventional monetary policy. I also explain why the normal presumption should be that monetary policy should not play a direct role in supporting the social insurance side of fiscal policy, and consider when it might be appropriate to depart from that presumption.

The most closely related contributions to our work on the social insurance perspective on pandemic fiscal policy are Milne (2020), who presciently argued for a "retrospective insurance" approach to policy in March 2020; Guerrieri, Lorenzoni, Straub, and Werning (2022), which I discuss further below; and Woodford (2022). Related to our discussion of the application of the

social insurance approach to fiscal policy in conventional recessions, McKay and Reis (2016) analyze the welfare effects of automatic stabilizers in recessions and find that their welfare benefits through social insurance dwarf those through stimulus. And there is of course a vast literature on social insurance; see for example Hoynes and Luttmer (2011). I am not aware of any previous work discussing the implications of the social insurance perspective on fiscal policy for the conduct of monetary policy.

I. THE SOCIAL INSURANCE PERSPECTIVE ON PANDEMIC FISCAL POLICY

Basics. In Romer and Romer (2022), we begin with a simple static model of a two-sector economy where there's a possibility of a concentrated shock that shuts one sector—a pandemic. Crucially, we assume there are no private markets for pandemic insurance, In the model, we impose this directly. However, it's easy to think of reasons this might be the case. Perhaps people just hadn't contemplated the possibility of a pandemic; or perhaps they had, but the costs of spelling out every possible contingency and exactly describing the dividing line between normal affairs and a pandemic made writing a contract for pandemic insurance cost-prohibitive.

The baseline version of the model, which is deliberately stripped down to yield stark, transparent results, delivers two key messages. The first is that the government can use ex post targeted taxes and transfers to replicate the outcome that would have occurred with an ex ante market for pandemic insurance. Specifically, the government taxes individuals in the sector that remains open and transfers the proceeds to the individuals whose sector is shut. In the simplest case, the amount of the tax on the employed equals what those workers normally spend on the output of the closed sector, and the proceeds allow the unemployed to maintain their usual spending on the output of the open sector.[1]

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[1] An equivalent way of describing the effects of the taxes and transfers is to say that they replicate what would have occurred if there had been a complete set of markets for Arrow-Debreu date- and state-contingent commodities (for example, "home exercise equipment in April 2020 in the event of a pandemic that shuts all fitness centers"). Although this is obviously more abstract than the pandemic-insurance framing, it makes the desirable welfare features of the policy very clear.

Other combinations of taxes and transfers can achieve the same outcome. For example, in a two-period model where the pandemic occurs in the first period, policymakers can use targeted transfers in the first period coupled with across-the-board taxes in the second.

The second key message is that the government policy involves no "stimulus". In the simplest case, the policy is implemented through balanced-budget taxes and transfers. And even with other implementations, overall output and employment are the same as they would be without the government intervention.

Together, these two messages show that the optimal policy takes the form of social insurance. The government intervenes not to try to increase aggregate output and employment, but to provide individuals harmed by the pandemic with insurance that private markets failed to give them.

Intuitively, these messages make sense. The downturn was caused by a pandemic that made much of economic activity dangerous, so it would have been foolish to try to stimulate the economy to quickly bring output and employment back to normal. And the economic effects of the pandemic were highly concentrated in certain sectors and activity in those sectors was unlikely to rebound as long as the pandemic lasted, so the best way to help the workers who'd lost their jobs in those sectors was through direct government support.

Complications and extensions. We consider numerous variations on the baseline case in our paper. In many of them, the main results are unchanged, or softened somewhat but qualitatively unaffected. Here, I highlight three more interesting messages that come out of the variations.

The first concerns hazard pay. To model this, we introduce a third, high-risk sector whose output is especially valuable in a pandemic, together with an assumption that fairness or asymmetric-information considerations rule out allocations where employed workers are worse off than the unemployed. These assumptions lead to the result that workers who are employed in the high-risk sector should receive extra payments from the government in the pandemic—that

is, government-provided hazard pay.

The second concerns incomplete insurance. In the baseline, there are no costs or frictions in providing insurance, which leads to the result that the insurance should be complete.[2] However, we consider a variation with two features: costs to providing insurance (such as administrative costs and distortions from the insurance and from the taxes needed to finance it), and some ability for workers to smooth their consumption through saving and borrowing that is increasing in workers' pre-pandemic income. The result is that optimal insurance is less than complete, and the extent to which it's incomplete is increasing in income. Moreover, if the effects are strong enough, the government provides no insurance at all to workers above some income level.

The third message, which follows Guerrieri, Lorenzoni, Straub, and Werning (2022), is that there may be a need for some aggregate demand stimulus. With incomplete insurance, the unemployed would like to borrow and the employed would like to save. In a simple case, the two forces just balance at the pre-pandemic real interest rate, and the earlier result that optimal policy involves no aggregate stimulus continues to hold. But if, as is surely the case, there are liquidity constraints or other barriers to borrowing with no corresponding barriers to saving, the increase in saving dominates, and so there's an aggregate demand shortfall at the pre-pandemic interest rate. Thus in this case optimal policy involves stimulus, whether through monetary or fiscal policy or a combination.

The U.S. fiscal policy response to the pandemic. In our paper, we examine several major aspects of the United States's response to the pandemic through the lens of our model. Table 1 gives an overview of our assessment. The entries in the first column describe the prescriptions of the social insurance perspective, and the entries in the second column characterize whether the policy response followed those prescriptions.

Panel A of the table considers unemployment insurance (UI). A central implication of the

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[2] "Complete" in the sense that the after-tax-and-transfer incomes of the workers who lose their jobs are the same as those of the workers who remain employed. Because the pandemic reduces overall output, in the baseline case all workers' after-tax-and-transfer incomes are lower than before the pandemic.

Table 1

The Prescriptions of the Social Insurance Perspective and the U.S. Fiscal Policy Response

Prescription	*Actual policy?*
A. Unemployment insurance	
UI should have broad coverage.	YES
Search requirements should be relaxed.	YES
Duration should be extended to match the duration of the pandemic.	MIXED
Replacement rates should be less than or equal to 100%, and decreasing in pre-pandemic income.	MIXED
It is an advantage if it is an effective way of stimulating aggregate demand.	LARGELY YES
B. Hazard pay	
There should be hazard pay.	LARGELY NO
Hazard pay should be fairly narrowly targeted and/or tiered.	NO
The magnitude should roughly compensate for the additional risks.	PERHAPS
Hazard pay should likely phase out at high incomes.	LARGELY YES
It is an advantage if it is an effective way of stimulating aggregate demand.	LARGELY YES
C. Stimulus	
There should not be massive, repeated measures to raise aggregate demand.	NO

Note: The entries in the first column summarize the prescriptions of the social insurance perspective. The entries in the second column summarize how the U.S. policy response compared with the prescriptions. See text for details.

social insurance approach to responding to a shock like the pandemic is that government benefits should be targeted to those who suffer direct economic losses from the shock. Since unemployment is an obvious and widespread indicator of harm, UI should therefore play a major

role in the policy response. Because job loss was common beyond the workers who are the traditional focus of UI—workers in conventional employment relationships who'd left their jobs involuntarily—providing broad help required greatly expanding the pool of workers covered. And because it was neither feasible nor desirable for the enormous number of unemployed workers to return to work rapidly, sensible policy called for relaxing or eliminating the usual requirement that beneficiaries be actively looking for work. As the first two lines of Panel A indicate, U.S. UI policy in the pandemic largely followed these two crucial prescriptions.

The remaining lines of the panel show that the record of actual UI policy was more mixed on other dimensions. Logically, the changes in UI should have been tied to the duration of the pandemic. Policymakers did extend many of the modifications as the severe disruption from the pandemic lasted longer than expected. But the extensions were never explicitly tied to the course of the pandemic, and they were variable and accompanied by considerable uncertainty and last-minute drama. Replacement rates were lower for higher income workers, consistent with the social insurance view. But a range of unusual and idiosyncratic factors led to replacement rates well above 100 percent for many workers, inconsistent with the implications of our analysis. Finally, since there's likely to be some shortfall of aggregate demand, it's an advantage if UI provides some general stimulus. Because the unemployed generally have high marginal propensities to spend, enhanced UI is for the most part effective stimulus. But the effect was muted by the high replacement rates that caused many workers' incomes to be temporarily high, inducing them to save.

Panel B turns to hazard pay. The most important entry in the table is the first one: contrary to the implications of our analysis, the United States almost entirely failed to adopt hazard pay. It was proposed but not adopted at the national level, with the result that there were only a few local programs, most notably one in Pennsylvania.

The remaining rows focus on the features of the main national proposal and the Pennsylvania program. In our paper, we show that heightened risk appears to have been

concentrated in a few occupations, and thus that hazard pay should have been targeted fairly narrowly. Both the national proposal and the Pennsylvania program, in contrast, were very broad. We also discuss the considerations that should go into determining the size of the payments and attempt rough estimates of the relevant magnitudes. We find numbers not far different from the Pennsylvania program, but well below those in the national proposal. Consistent with the implications of our approach, the two programs had hazard pay entirely or largely phasing out at high incomes. And because the workers who are the strongest candidates for hazard pay generally have low incomes (and thus likely high spending propensities), hazard pay is likely to be at least moderately effective at providing stimulus.

Finally, Panel C returns to one of the key messages of the baseline model and one of the themes of our paper. Because the focus of the fiscal policy response to the pandemic should be social insurance, enacting repeated large-scale, broad-based stimulus packages with features such as multiple stimulus payments to most of the population isn't the right response to a pandemic (even if there's a need for *some* stimulus). As the final line of the table indicates, the United States didn't follow this prescription (with apologies for the double negative: policy didn't follow the prescription to not have massive stimulus).

To sum up, the actual U.S. fiscal policy response matches up well with the prescriptions of the social insurance approach with regard to unemployment insurance (particularly in light of the enormous challenges of making policy in real time in the face of the massive upheavals triggered by the pandemic). But it matches up poorly with regard to hazard pay and general stimulus.

II. BROADER IMPLICATIONS FOR FISCAL POLICY

The analysis in Romer and Romer (2022) focuses on the pandemic. We argue in the conclusion of our paper, however, that our analysis has implications for fiscal policy in other contexts.

Most obviously, going forward there are likely to be other shocks large enough to have

significant macroeconomic consequences that, like Covid-19, affect both aggregate demand and aggregate supply and whose effects are concentrated in certain parts of the economy. Possible examples include future pandemics, which unfortunately are all too likely, and future climate disasters, perhaps similar to scaled-up versions of the Australian wildfires of 2019–20 or the California wildfires of 2020, or a U.S. hurricane season substantially worse than any experienced so far.

Our analysis applies directly to recessions triggered by these types of shocks. Returning output and employment quickly to normal is certainly not a good idea in a pandemic, and it's probably not feasible in the aftermath of a disaster that destroys a large amount of capital and upends the lives of millions of people. Moreover, general stimulus is at best a highly inefficient way of helping workers whose sectors are shut because of a pandemic, or ones who've lost their homes and workplaces in a climate-fueled catastrophe. Direct government-provided aid to individuals who've been directly harmed and who would have bought insurance against the event if they could have—that is, social insurance—provides the right framework for devising the appropriate response.

More subtly and more interestingly, the social insurance perspective has important implications for the fiscal policy response to conventional recessions. Though the harms of such recessions are less narrowly concentrated than those of a pandemic, they're nonetheless highly concentrated—notably on the unemployed, and within that group, on workers who permanently lose jobs that would have been long-lasting. As with income losses in a pandemic, these are harms for which private insurance isn't available and that individuals would very much like to have insurance against. Thus, there is a clear case for social insurance.

What might this mean in practice? First, as emphasized by McKay and Reis (2016), it means that we should examine the role of the social safety net in recessions not just through the macroeconomic lens of automatic stabilizers and the impact on aggregate outcomes, but through the microeconomic lens of social insurance and the impact on individual welfare for given

aggregate outcomes. Indeed, as I noted in the introduction, McKay and Reis's analysis suggests that the welfare benefits of the safety net in recessions through social insurance are much greater than their benefits through damping fluctuations.

Second, it points to a more generous safety net in recessions. Concretely, consider unemployment insurance. The optimal generosity of UI involves a tradeoff between lower incentives for job-finding and greater consumption-smoothing (Baily 1978; Chetty 2006). In a recession, the job-finding side of the equation is less important than usual at a given level of benefits, both because individuals have less ability to determine whether they're employed and because overall employment is more dependent on the level of aggregate demand and less on individuals' job-finding efforts (Kroft and Notowidigdo 2016; Landais, Michaillat, and Saez 2018). On the consumption-smoothing side of the equation, there's evidence that the costs of job loss to an individual are greater in a recession (Davis and von Wachter 2011). As Kroft and Notowidigdo show, both considerations mean that optimal UI is more generous in recessions (through higher replacement rates, greater duration, and/or weaker search and other requirements). A similar analysis applies to other safety net programs.

Third, it suggests that policymakers might want to consider social insurance against other cyclical developments. A concrete example of a possibility along these lines would be support for distressed homeowners in the Great Recession. The fact that there are benefits to social insurance isn't enough to answer the question of whether such support is desirable on microeconomic efficiency grounds. But it does help identify factors one would want to consider. On the positive side, a highly unexpected, large, nationwide fall in home prices that pushed many borrowers underwater on their mortgages is something for which there were no private insurance markets and which many homeowners would have liked to insure against if they could have. On the negative side, homeowners are generally not in the lower part of the income distribution; as we discuss in the context of UI in the pandemic, this would limit the optimal size of any social insurance. Further, it's harder to determine for this type of shock than for the others I've discussed

(pandemics, disasters, job loss in recessions) where to draw the line between a shock that warrants social insurance and one that doesn't, and who should be covered by any social insurance; this would raise the cost of any social insurance through greater transaction costs, greater lobbying, and related channels. Nonetheless, although the social insurance perspective doesn't immediately deliver a clear bottom line, it's valuable in helping identify the relevant considerations and what should determine how to balance them.

III. IMPLICATIONS FOR MONETARY POLICY

A proposed baseline hierarchy of decisions. One issue we don't discuss in Romer and Romer (2022) is the implications of the social insurance perspective on fiscal policy for monetary policy. But any analysis of decisions about fiscal policy obviously raises the issue of how those decisions should interact with monetary policy. Perhaps surprisingly, the rationale for social insurance implies that for the social insurance side of fiscal policy, the ideal interaction with monetary policy isn't the usual one of coordination, with each set of policymakers adjusting their actions in response to the others in pursuit of shared goals. Rather, it takes the form of a hierarchy or ordering of decisions. Table 2 lays out the proposed hierarchy: fiscal policy decisions about social insurance should be made first, followed by monetary policy decisions about conventional monetary policy, followed by joint (and in this case, coordinated) decisions about some combination of unconventional monetary policy and general fiscal stimulus. Notice that the hierarchy is about decisions, not actions: while the decisions should be made sequentially, there's no reason for the associated actions to not be undertaken roughly simultaneously.

The logic behind the hierarchical approach and the proposed ordering is straightforward. The reason for decisions about social insurance to come first is twofold. First, social insurance is warranted on microeconomic, efficiency grounds, and so should be pursued regardless of the state of aggregate demand. Second, it affects aggregate demand, and so is something that should be taken into account when decisions about demand policy are made. The reason for putting

Table 2

A Proposed Baseline Hierarchy of Decisions

Step 1: Fiscal authorities choose actions implied by a social insurance perspective.

Step 2: Taking those choices as given, if the resulting level of aggregate demand is not what is wanted, the central bank decides how to use conventional tools to manage aggregate demand.

Step 3: If Steps 1 and 2 are not enough to generate sufficient aggregate demand, fiscal authorities and the central bank decide on some mix of general fiscal stimulus and unconventional monetary policy.

decisions about conventional monetary policy next is simply that, as many others have observed, conventional monetary policy is the most flexible and general tool for affecting aggregate demand. In the case of a desire for greater demand in a recession, lower interest rates incentivize current spending relative to future spending, but let private agents choose their most preferred ways of making that substitution. And decisions about interest rates can be made—and changed—quickly. Finally, the lower bound on interest rates may mean that conventional monetary policy doesn't have enough room to generate the desired level of demand. In this case, the tools available to policymakers are general fiscal stimulus and unconventional monetary policy. But these have drawbacks relative to conventional monetary policy, which is why they come last in the ordering.

Regarding the last step, which one of fiscal policy and unconventional monetary policy (or what mix) should be used and the specific form each should take when they're needed aren't issues I will wade into here. But I will make two observations about this step. First, here the two sets of policymakers need to work together to make sure they are aiming for the appropriate level of aggregate demand, so coordination is called for. Second, if the decisions about social insurance in the first step are made optimally, at the margin the efficiency cost of making social insurance more generous is zero. Since more generous social insurance would increase aggregate demand, this suggests that if conventional monetary policy is insufficient, expanding social insurance at least somewhat beyond what's called for on purely microeconomic grounds should be part of the

additional measures to increase demand. The most natural policies along these lines would be increasing the amount or duration of UI benefits and raising benefits to the poor.

Importantly, there's nothing in the logic behind the hierarchy that's specific to "pandemic-like" recessions. Thus it applies to all recessions, including conventional ones.

<u>Should monetary policy support the social insurance role of fiscal policy?</u> The proposed hierarchy involves a separation between the social insurance role of fiscal policy and the stabilization role of monetary policy. But that doesn't fully answer the question of whether monetary policy should help support the social insurance role of fiscal policy.

There are good reasons for thinking that a good starting point for answering that question is simply "no". Social insurance by its nature is targeted, while conventional monetary policy is not. Thus conventional monetary policy cannot be used to further social insurance (beyond its role in ensuring sufficient aggregate demand, which has broad-based benefits, including to the individuals fiscal policymakers are trying to help through social insurance). The central bank does, however, have other tools at its disposal, such as customized lending programs at below-market rates, that can be targeted and so could be used to further social insurance. But there are strong arguments rooted in political economy and principles of democratic accountability for policies targeted to specific sectors to be mainly the province of elected officials.

Should this "no" answer be absolute? As with most questions about central banks and absolutes, probably not. After all, even conventional monetary policy actions have distributional effects, so monetary policy can never be fully divorced from distributional issues. And real-world, real-time policymaking is never straightforward.

A case where involvement of the central bank in targeted lending to achieve social insurance goals seems almost completely unproblematic is when the program is designed by the fiscal authorities and any fiscal cost is borne by the treasury and not the central bank. In this case, the central bank is little more than the financial agent of the treasury, handling only the implementation of the program.

A modest step away from that is when the program is designed jointly by the treasury and the central bank but the final version has the approval of the treasury, and where the treasury provides enough funding or a strong enough backstop that the risks of losses to the central bank are small. Given the complexities of actual policymaking and the inherently blurry line between fiscal and monetary policy, it's hard to see a deep objection.

That's roughly where I would stop. Social insurance isn't like the imminent collapse of a major financial institution that threatens to trigger a severe economy-wide downturn. In that case, there's a strong case that central bank intervention may be appropriate even if it's not clear (as it almost never is) whether the institution is just facing a temporary liquidity problem or is insolvent, and even if there's no promise of treasury support to the central bank in the event of losses. In real time, waiting to dot every democratic *i* and cross every fiscal *t* before acting is likely to amount to deciding to let the institution fail, with the accompanying harms. Social insurance isn't like that. The impact of ordinary citizens is palpable and direct, and so is likely to focus elected officials' attention; and crucially, while a short delay would be painful for those affected, it wouldn't switch the economy onto a very different and much worse path.

Regardless, these observations are about possible exceptions to the baseline rule, not about the rule itself. That rule is the one laid out above: decisions about social insurance should be made first, and they are properly the province of fiscal policymakers, while the main responsibility of monetary policymakers is to manage aggregate demand.

IV. CONCLUSIONS

The main messages of this analysis are straightforward:

- Social insurance provides a good way of thinking about desirable fiscal policy in "pandemic-like" recessions.

- In the pandemic, the United States's record in following the social insurance approach was very mixed.

- The social insurance approach has implications for fiscal policy in conventional recessions.

- The social insurance approach points to an ordering of policy decisions: decisions about social insurance should come first, followed by decisions about conventional monetary policy, followed by decisions about fiscal stimulus and unconventional monetary policy.

- To a large extent, social insurance should be left to the fiscal authorities and macroeconomic stabilization to the central bank.

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