

Beyond Sound Bites—Understanding the Impact of Unemployment Insurance on the Severity of Unemployment

Introduction

Millions of Americans are counting on Congress for the lifeline of extended unemployment benefits. NELP estimates that 1.2 million Americans will be cut off the rolls by the end of June if Congress fails to take action. At this crucial policy juncture, a noticeable cadre of political commentators and editorialists has begun to assert the old argument that extending unemployment benefits increases the nation's unemployment rate and leads to longer unemployment spells. These pronouncements are rationalizing political resistance to further benefit extensions, such as this recent statement by U.S. Senator John Kyl:

[Unemployment insurance] doesn't create new jobs. In fact, if anything, continuing to pay people unemployment compensation is a disincentive for them to seek new work.¹

But, these negative pronouncements are based upon widely held misunderstandings regarding what economic researchers actually say about unemployment insurance (UI). In this quick overview, we take a balanced look at economists and what they have said about the behavior of jobless workers, the labor market role of UI, and the overall impact of UI on our economy.

Most commentators opposing extensions of Emergency Unemployment Compensation (EUC) have oversimplified the conclusions of economic research on UI. Others are presenting one-sided studies, taking findings out of context and going so far as to cite questionable studies in support of their opposition to further benefit extensions. Too much is at stake for policy makers to base decisions on economic studies that are founded upon assumptions with little application in today's labor market. This short paper presents an overview of economic perspectives on the ongoing debate about extending unemployment benefits.

Executive Summary

A review of economic findings concerning the impact of UI in the labor market shows that significant considerations are often ignored when presenting economic research in the context of the current debate over extending Emergency Unemployment Compensation. In short, a careful review of the research finds:

1. **Today's severely depressed job market—not unemployment insurance—is the cause of long unemployment duration:** Previous research assumed that work is readily available (full employment). These studies do not apply with equal force in today's slack labor market where there are 5.6 workers for each job opening and when a far greater proportion of workers has been subject to permanent rather than temporary layoffs. With odds of finding a job this slim, any possible disincentive effect of UI is drowned out by labor market effects.
2. **Newer research debunks old assumptions about the impact of unemployment benefits on unemployment duration:** Estimated impacts of UI on the duration of unemployment spells vary greatly, depending on research design and the underlying data used. Compared to older studies, several estimates based on new research show any disincentive impact is very modest. For example, recent research by influential economist David Card found that the incentive effect was less than half as much as the widely cited estimates by Katz and Meyer.
3. **Unemployment benefits boost the economy, and help employed workers by stabilizing demand:** Many older studies concerning the impact of unemployment insurance benefits on unemployment did not account for ways in which benefits may actually lower the unemployment rate (e.g., by sustaining consumer spending and leaving jobs available for uninsured workers). This was because they used data solely related to insured jobless workers and did not assess the effect of UI on the overall labor market and economy.
4. **The positive social welfare impact of unemployment benefits far outweighs the marginal impact of UI on the length of jobless spells:** Unemployment insurance enables workers and their families to preserve their savings (e.g., retirement accounts and life insurance policies) as well as avoid severe financial hardship (e.g., foreclosure, bankruptcy, and hunger). And, with the worst long-term unemployment since World War II, benefit extensions play a critical role in preventing poverty and economic hardship in 2010. In other words, even if UI extends the time jobless workers are laid off, these workers and the economy are better off for having received the assistance.

The following is a brief—by no means comprehensive—account of UI economic research. Our review shows that important findings about the duration of unemployment and the countervailing benefits of unemployment aid have been widely ignored by many debating the effect of benefit extensions on jobless workers.

Improved Research Design Reduces Estimates of Disincentive Effects

In recent months, economists have reported that the actual impact of UI on the duration of unemployment spells lies at the low end of previously estimated ranges. For example, Michael Elsby and others have explained that research studies at the high end of the range attempt to exploit differences in benefit schedules across states and time.² Elsby cautions that this research strategy, which does not account for the fact that states extend UI benefits during recessions, may overestimate the impact of benefits on the duration of unemployment.

A 2000 study by David Card and Phillip Levine estimated that a 13-week extension would result in a one-week increase in the average number of weeks of regular UI collected by workers.³ Card and Levine's estimate is considerably lower than the oft-cited 2–2.5-week increase estimated by Katz and Meyer in 1990.⁴ In contrast to previous studies, Card and Levine took advantage of a state policy change adding extended unemployment benefits in New Jersey during a period of relative labor-market stability. The New Jersey Extended Benefit program included a 50 percent increase in the number of benefit weeks (up to an additional 13 weeks) for workers who lost their jobs between June 2 and November 24, 1996, with a retroactive provision for claimants whose benefits had expired as far back as December 2, 1995. By researching this short-term policy change, Card and Levine were able to compare the duration of benefits and exit rates with time periods pre- and post-policy change. In comparing the behavior of jobless workers getting the state extensions to the behavior of those who were unemployed prior to and just after that time period, Card and Levine found a lower level of disincentive effects from benefit extensions than older studies.

More recently, economists Rob Valletta and Katherine Kuang at the Federal Reserve Bank of San Francisco concluded that in regard to the unemployment rate, “. . . extended unemployment insurance benefits have had a relatively modest effect.” Valletta and Kuang's analysis of data on unemployed workers decomposed by reason for unemployment found that the unemployment rate at the end of 2009 would have been about 0.4 percentage points lower, or 9.6 percent instead of 10.0 percent if there had been no EUC program in place.⁵ Valletta and Kuang compared the unemployment spells of workers within the Bureau of Labor Statistics' four categories of unemployed workers: involuntary job losers, voluntary job leavers, new labor market entrants and re-entrants.

The researchers tested to see whether the duration of unemployment spells differed between involuntary job losers, who are typically eligible for UI, and job leavers and labor market entrants, who are usually not eligible for unemployment benefits. If extended UI benefits increase the duration of unemployment, then one would expect benefit recipients, (those in the job losers category) to remain unemployed longer than those less likely to get UI (job leavers and entrants). However, contrary to this expected outcome, Valletta and Kuang's paper clearly shows that job losers are remaining unemployed for only slightly longer than unemployed workers who are not eligible for unemployment benefits. Both unemployment benefit recipients and non-recipients are staying unemployed longer than ever in the current severe recession.

New Thinking Shows that Unemployment Benefit Recipients Do Not Just Wait Until Benefits End to Find Work

Shortly before Congress voted on April 15, 2010 to continue EUC, popular media reported on research showing that recipients of unemployment insurance wait until benefits are about to expire before they seriously begin to search for work.⁶ Or, as articulated by David Card, Raj Chetty and Andrea Weber:

One of the best known empirical results in public finance and labor economics is the spike in the exit rate from unemployment around the expiration of jobless benefits. This sharp surge in the hazard rate is widely interpreted as evidence that recipients are waiting until their benefits run out to return to work.⁷

Recently published research by Card and his co-authors shows that the magnitude of this well-known "spike" is much smaller when spell lengths are defined as time from job loss to next job as opposed to time spent in UI programs. There is a subtle but important difference between the duration of unemployment benefits and the time until reemployment. As Card notes, using data on durations of benefit receipt is adequate for determining direct program costs. However, data regarding the time from job loss until reemployment is a better and more relevant measure of the economic efficiency of unemployment benefits.

After surveying the literature, the authors conclude, "Overall, our reading of the existing literature is that spikes in hazards around benefit exhaustion are generally smaller when duration is measured as time to next job rather than time unemployed."⁸ Using data from Austria's Social Security registry, Card and his co-authors conduct their own independent analysis of the spike at benefits exhaustion based on time to reemployment, finding that less than 1 percent of unemployed workers manipulate the day they are reemployed to coincide with the exhaustion of unemployment benefits.⁹

Severe Labor Market Distress Throws Doubt on Economic Arguments that Unemployment Benefits Cause Unemployment

The argument that jobless workers are responsible for high unemployment rates and long unemployment spells does not hold up in the face of employer-based data from the U.S. Department of Labor's Job Openings and Labor Turnover Survey (JOLTS). In contrast to the unemployment rate, a measure of the excess supply of labor, JOLTS data derived from an employer-based survey measures the demand for labor. At this time, there are **5.6** workers for each job opening. In comparison, when the economy is strong, the ratio of workers to job openings is close to one-to-one, and during the 2001 recession and recovery, the ratio barely exceeded 2 workers per job opening.

Many critics of UI programs wrongly assume that the behavior of jobless workers largely determines when they find a job. This criticism ignores the reality that employers have to offer employment before jobless workers can find work. Nobel Prize-winning economist Paul Krugman describes the current labor market situation, one obvious to unemployed workers, in this manner: "What's limiting employment now is lack of demand for the things workers produce. Their incentives to seek work are, for now, irrelevant."¹⁰ In other words, concerns about the theoretical potential that UI creates a work disincentive is entirely misplaced when the larger issue is that there are virtually no jobs available.

University of Chicago economics professor Casey Mulligan and *Bloomberg* columnist Amity Shlaes recently attacked the Krugman line of reasoning, citing research based on Pittsburgh UI data from the early 1980s, an analogous period of high unemployment, showing that 36 percent of workers who exhaust benefits find work within the following week.¹¹ One interpretation of these findings is that even in a slack labor market, workers can, and in fact do, find employment once UI benefits run out. What Mulligan and Shlaes fail to mention is that not only were the results from this study extremely high when compared to other studies, a re-examination of the data by independent researchers found a coding error that overstated these results.¹²

Older evidence in support of Krugman's viewpoint, namely, that labor market slackness matters, is summarized by Stephan Woodbury and Murray Rubin.¹³ Four independent studies of workers who exhausted unemployment benefits found that more than one half of workers were still unemployed 12 weeks after exhaustion. However, as Woodbury and Rubin note, only one of the four studies, which took place in the mid-1970s, was carried out during an economic downturn. This study of workers in Atlanta, Chicago, Baltimore and Seattle determined that

during a recession less than one-quarter of exhaustees found work after 12 weeks, compared to 33.5 to 44.0 percent of workers in the other three studies, which were based on data from non-recessionary periods.

During recent Congressional testimony, economist Lawrence Katz, noting the shortcomings of his own prior research as applied to the current employment situation, gave further reason to believe that unemployment benefits have a small impact on unemployment:

[T]he most compelling research suggests only modest impacts of UI extensions on the search effort and duration of unemployment of unemployment insurance recipients. . . . Furthermore, previous estimates of larger impacts of unemployment durations of UI extensions for the United States . . . are based on data from the 1970s and early 1980s with much of the responsiveness coming from firms and industries using temporary layoffs and the sensitivity of recall dates to unemployment insurance benefits.¹⁴

In other words, in the past, employers would temporarily lay off workers and then rehire them as unemployment benefits were about to expire. Workers, knowing they would be rehired, stayed on unemployment benefits but did not seriously search for work. As evidence in support of Katz's claim that older studies do not apply to today's labor market, temporarily unemployed workers as a percentage of total unemployed workers stands at 9 percent, a historical low and well below the percentage prevalent in the late 1970s and early 1980s, the time period on which Katz's older research is based.¹⁵

Positive Economic Impacts and Social Benefits of UI Outweigh Any Marginal Impact of Unemployment Insurance on Duration of Joblessness

One shortcoming of much empirical research on UI is that studies do not consider the net positive effect of unemployment benefits on the U.S. economy. As mentioned before, unemployed workers often have little or no savings to rely on when they lose work. Without unemployment benefits, individuals and families would have to curtail essential spending on basic goods and services. Average UI benefits are not much—only \$310 per week—and these benefits allow individuals and families to continue essential spending during periods of job loss. In this way, unemployment benefits are cycled back into the economy.

For a simplified example, when an unemployed worker spends \$1 of benefits at a local business, the business owner has \$1 to pay her employees. In turn, these employees are then able to spend their paychecks on goods and services at other businesses, thereby creating a virtuous cycle known as the “multiplier effect.”

According to economist Mark Zandi, each dollar of unemployment benefits a worker spends increases economic activity by \$1.61.¹⁶ A similar analysis by the nonpartisan Congressional Budget Office (CBO) found that increased aid to unemployed workers (i.e., extending the duration of unemployment benefits, increasing weekly benefit amounts by \$25, and subsidizing 65 percent of the cost of COBRA health insurance) has the greatest impact on Gross Domestic Product (GDP) and employment of all available policy options.¹⁷ CBO estimates that for each dollar of budgetary cost, unemployment benefits will cumulatively increase GDP by as much as \$1.90 between 2010 and 2015. This recognized positive impact of UI on the overall economy is rarely, if ever, mentioned by critics when they are trumpeting studies about disincentive effects of UI.

Many older studies of UI programs used UI data that did not include those ineligible for UI benefits when assessing the impact of UI on unemployment. This omission tends to overstate the net impact of UI on the overall labor market since UI should also have an indirect effect on unemployed workers not getting UI as well as upon employed workers who benefit from the extra demand in the economy provided by UI benefits.¹⁸ In short, workers covered by UI who stay unemployed for a somewhat extended period of time will leave more jobs available to job seekers not covered by UI.

Critics who focus solely on impact of UI on the unemployment rate and the duration of unemployment ignore a fundamental goal of the program, which is to “prevent poverty by immediately providing a cash payment to help the worker sustain some of the financial objectives normally supported by the lost wage income.”¹⁹ In reality, unemployment benefits enable jobless workers with little savings and limited access to credit to maintain a decent standard of living while searching for a suitable job. Economist Jonathan Gruber found that prior to becoming unemployed, the median worker has zero net financial wealth (liquid assets net unsecured debt). Gruber’s study demonstrated that half of unemployed workers report having zero liquid wealth when they lose their jobs, leaving them unable to smooth consumption over the course of unemployment spells.²⁰ Given this distressing reality, maintaining some form of income for jobless workers is extremely important to affected families as well as to our overall economy.

A recent paper puts these social benefits of UI into a more complex context than earlier studies. These studies considered “moral hazard” as the only explanation for the effect of UI on duration of unemployment. Economist Raj Chetty’s paper on unemployment benefits calls into question the assumption that moral hazard is the main explanation for why unemployment insurance may increase the duration of unemployment spells.²¹ Chetty argues that jobless workers have limited net worth at the time of job loss and that unemployment benefits correct credit and insurance market failures in the private sector, thereby allowing unemployed

workers to avoid taking *any* job simply to meet daily expenses. As a result, UI has a “liquidity effect” that is socially beneficial, as opposed to the “moral hazard” impact of UI which is “welfare reducing.” Based on his analysis of differential changes in UI benefit levels across states and variations in the receipt of lump-sum severance payments, Chetty concludes that 60 percent of the increased duration of unemployment spells attributed to unemployment benefits is due to this liquidity effect. Chetty’s findings provide research support for the noted function of UI in promoting more effective job search and job matching.

Finally, no discussion of disincentive effects of UI should take place without mentioning the low levels of UI benefits being paid in most cases. In 2009, for example, average weekly UI benefits were only \$310 with some states paying much lower benefits (a low of \$192 in Mississippi).²² On average, unemployment benefits are equivalent to just 36 percent of average weekly wages —enough to maintain a modest standard of living, but hardly enough for a princely lifestyle.²³

Conclusion

Given the lack of available jobs, low unemployment benefit amounts, and severe hardships experienced by long-term jobless workers, concerns about disincentives from unemployment benefits are exaggerated. More importantly, concerns based upon uninformed assumptions about what economists say regarding UI provide insufficient grounds to justify denying essential benefit extensions to jobless workers caught up in the biggest labor market downturn in post-war U.S. history.

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Endnotes

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- ² Michael Elsby, Bart Hobijn and Ayşegül Sahin, "The Labor Market in the Great Recession," (paper presented at Brookings Panel on Economic Activity, Mar. 18-19, 2010, Washington D.C.), 28, http://www.brookings.edu/~media/Files/Programs/ES/BPEA/2010_spring_bpea_papers/spring2010_elsby.pdf.
- ³ David Card and Phillip B. Levine, "Extended benefits and the duration of UI spells: evidence from the New Jersey extended benefit program," *Journal of Public Economics* 78 (2000): 107-138.
- ⁴ Lawrence F. Katz and Bruce D. Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment."
- ⁵ Rob Valletta and Katherine Kuang, "Extended Unemployment and UI Benefits," Federal Reserve Bank of San Francisco Economic Letters (Apr. 2010), <http://www.frbsf.org/publications/economics/letter/2010/el2010-12.html>, accessed May 2010.
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- ⁷ David Card, Raj Chetty and Andrea Weber, "The Spike at Benefit Exhaustion: Leaving the Unemployment System or Starting a New Job?" *American Economic Review* 97, no. 2 (2007): p. 113.
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- ¹⁰ Paul Krugman, "Supply, Demand, and Unemployment," *New York Times*, The Conscience of a Liberal Blog, Mar. 7, 2010, <http://krugman.blogs.nytimes.com/2010/03/07/supply-demand-and-unemployment/>.
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- ¹³ Stephen A. Woodbury and Murray Rubin, "The Duration of Benefits," in *Unemployment Insurance in the United States*, edited by Christopher J. O'Leary and Stephen A. Wandner (Kalamazoo: W.E. Upjohn Institute for Employment Research, 1997), 239.
- ¹⁴ U.S. Congress, Joint Economic Committee, Long-term Unemployment: Causes, Consequences and Solutions, testimony of Dr. Lawrence F. Katz, Apr. 29, 2010 (citations omitted).
- ¹⁵ Katz's 1990 study was based on state-level data from 1978 to 1983 when temporarily unemployed workers as a percentage of total unemployed workers averaged 16.4 percent and reached a peak of 23.4 percent in June 1980. See Lawrence F. Katz and Bruce D. Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment," *Journal of Public Economics* 41 (1990): 45-72.

¹⁶ U.S. Congress, Senate Finance Committee, Using Unemployment Insurance to Help Americans Get Back to Work: Creating Opportunities and Overcoming Challenges, testimony of Mark Zandi, Chief Economist, Moody's Analytics, Apr. 14, 2010.

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¹⁸ See Paul Decker, "Work Incentives and Disincentive," *supra*, pp. 300-303.

¹⁹ Saul J. Blaustein, Wilbur Cohen and William Haber, *Unemployment Insurance in the United States: The First Half Century*, (Kalamazoo: W.E. Upjohn Institute for Employment Research, 1993), 51.

²⁰ Jonathan Gruber, "The Wealth of the Unemployed," *Industrial and Labor Relations Review* 55, no. 1 (2001): 79-94, <http://econ-www.mit.edu/files/102>.

²¹ Raj Chetty, "Moral Hazard vs. Liquidity and Optimal Unemployment Insurance," *Journal of Political Economy* 116, no. 2 (2008): 173-234. We note that we do not pretend to understand the mathematics in this paper.

²² U.S. Department of Labor, UI Data Summary, 4th Quarter 2009, downloaded from U.S. Department of Labor website May 19, 2010.

²³ *Ibid.*