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Should Unemployment Benefits Be Extended in Bad Times?

By Camille Landais

In every major recession since the 1950s, Congress has enacted a temporary program providing additional weeks of federally funded unemployment insurance benefits to cope with adverse conditions on the labor market. But rarely has the debate about whether to increase the generosity of the Unemployment Insurance (UI) system been as heated and as politically divisive as since the beginning of the Great Recession and the introduction of the Emergency Unemployment Compensation (EUC) by the Unemployment Compensation Extension Act of 2008. The key arguments of the opponents to UI benefits extensions are that these extensions deepen both the unemployment problem and the government deficit.

Despite a lot of opposition, the EUC program has been extended by Congress to January 3, 2012, by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. But now that Congress is talking about even further extending the program, state politicians are beginning to act on their own to bypass Congress and reduce the generosity of UI benefits in their state. In March 2011, the Florida House approved a measure reducing the maximum benefit period from 26 weeks to as few as 12 weeks, while curbing increases in unemployment taxes paid by employers, even though the jobless rate in Florida is 11.9 percent. In recent weeks, Republican leaders in Michigan and Arkansas have also taken steps to limit their states' contributions by cutting

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the duration of unemployment benefits. Missouri, with an unemployment rate greater than 9 percent, has gone even further: It has literally stopped accepting dedicated federal money to extend payments to 99 weeks from 79. "This is about sending a message to the federal government from the state of Missouri that enough is enough," said Jim Lembke, a state senator. "The federal government is sending us money it doesn't have."

Should government cut back UI benefits? And are extensions just worsening the unemployment situation while increasing public deficit? Is it in the end just a bad idea to increase the generosity of the UI system during recessions? So far, the traditional economic framework on unemployment insurance has not been incredibly helpful in answering these questions and in providing guidelines in this heated policy debate. Fortunately, some recent research is shedding new light on the issue and gives some important insights about whether or not UI generosity should vary over the business cycle, because unemployment is not the same thing in good times and in bad times. First, unemployment spells are structurally longer in bad times and the population of unemployed is different in recession and in booms—people are likely to benefit more from UI extensions in recessions in terms of increased consumption. Second, and most importantly, in good times unemployment originates from job search frictions in the labor market—whereas it is very likely to originate from job rationing in bad times. So, increasing the generosity of UI benefits has less impact on aggregate unemployment in recessions.

The System of UI Benefit Extensions in the United States

One of the main reasons that the debate about extending UI benefits is so controversial is that the system is incredibly complex to begin with and deals with the always disputed issue of state versus federal responsibilities. In regular times, most states offer standard, state-funded unemployment benefits for up to 26 weeks. But when recessions kick in, the system offers extra safety nets for the unemployed. First, the federal government usually enacts temporary programs providing additional weeks of federally funded unemployment insurance benefits. For the current recession for instance, unemployed workers can tap into the federally funded emergency unemployment insurance program, which offers up to 53 weeks of additional benefits, depending on the labor market conditions of the state in which the workers live. If jobless Americans exhaust those benefits, in some states they are eligible for extended benefits for up to 20 more weeks. This extended benefit program (EB) triggers any time a state unemployment rate reaches a certain threshold. Usually, the EB program is funded half by the states and half by the federal government. But for the time being, benefits paid under the EB program are federally funded through the beginning of 2012.

Because of all these extension programs, the UI system has never been more "generous" than in the past couple of years. At the same time, the severity of the situation in the labor market is also unmatched since the Great Depression, with the largest pool of long-term unemployed workers on record. More than 6.1 million Americans had been out of work for more than six months as of March. Of everyone who was unemployed last month, 45.5 percent were considered long-term unemployed. Is that enough to justify increasing the generosity of the UI system? This is typically the type of question that economists should know about. But what do they have to tell us?

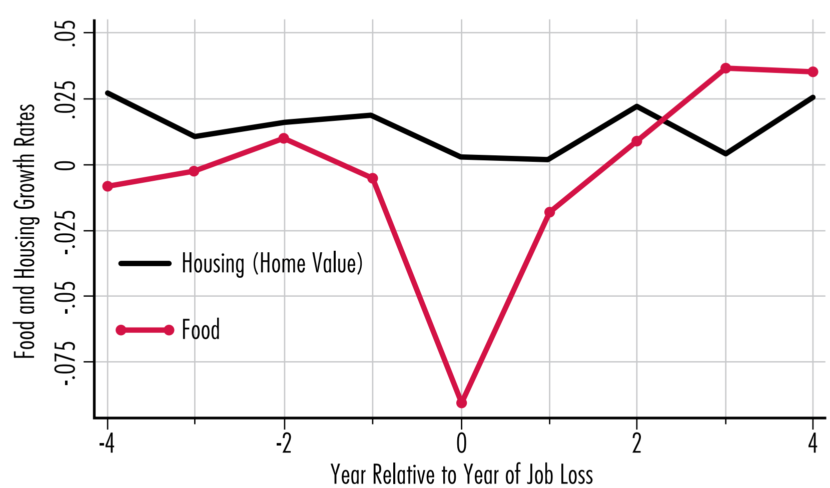
The Framework: Consumption Smoothing Versus Disincentives to Search

The way economists usually think about how generous the UI system should be is fairly simple. Standard economic theory indeed shows that the answer depends on a trade-off between two central factors: on the one hand, the benefits that the UI system provides for the unemployed, essentially via higher consumption; on the other hand, the costs of providing benefits by reducing incentives to find a job.

Let us begin with the benefits side. What the UI system does is essentially to give unemployed individuals the opportunity of higher consumption in a time when income is very valuable.[1] Economists usually call these types of benefits "consumption-smoothing" benefits. One key reason that consumption-smoothing benefits of providing UI are likely to be large is that most unemployed families are cash-constrained. The median unemployed person has less than $250 in net savings prior to job loss and in most instances is subject to heavy borrowing constraints. Moreover, most families have many commitments that they cannot adjust. Typically, they would have to continue paying for their home mortgage or rent, their utilities, the costs for their children, etc. Therefore, most unemployed are forced to cut back on items such as food, clothing, medicines. Figure 1, taken from a study by Chetty and Szeidl (2007), shows that these consumption commitments lead to truly severe consumption drops on food when people become unemployed. Another recent study by Sullivan and von Wachter (2009) demonstrates that job displacement has serious consequences for health: The study estimates that the effect of job displacement corresponds to a loss in life expectancy of 1 to 1.5 years for a worker displaced at age 40.

UI benefits can be very valuable in mitigating these adverse effects due to heavy consumption drops. But the question we have to answer is whether these effects are more severe in recessions, justifying increasing the generosity of the UI system in bad times. We have many reasons to assume that this is the case. In recessions,

Figure 1.
Effect of Unemployment on Food and Housing Consumption



Source: Chetty and Szeidl 2007

1 Apart from consumption smoothing, the potential benefits of UI include the gains from keeping more of the long-term unemployed attached to the labor market, rather than moving onto disability programs, and also the gains from better job matches (UI benefits may lead individuals to find better jobs, as, for instance, an engineer who would otherwise settle for a service industry job to put food on the table). But the latest evidence available (Card et al. 2007) suggests that job matching benefits of UI are actually fairly small.

borrowing constraints are likely to be more severe. On top of that, during recessions, duration of unemployment spells increases structurally and makes consumption drops more stringent for people with very little savings. But unfortunately, rigorous empirical evidence to give us an idea of the exact magnitude of these effects over the business cycle is still crucially missing.

The costs side of UI has been studied for a long time now. Extending UI benefits obviously reduces incentives to find a job by reducing the net pay of work. If UI benefits are $250 per week and a worker earns $400 per week, the net gain of finding a job is only $150. People may search for jobs less intensively because of this work disincentive. Economists call this effect "moral hazard" and it is well known to potentially lead to higher unemployment rates and lower GDP. The fundamental question is therefore how much does this moral hazard cost increase in bad times when the generosity of UI benefits increases. New research (Landais et al. 2010) shows that it is absolutely critical to make the difference between the individual impact of UI benefits on search and the aggregate impact of UI on unemployment. If any individual receives more UI benefits, it is likely that his or her search effort is going to decrease, and this effect has little reason to be different in good times and in bad times. Therefore, the individual impact of increasing UI benefits on search effort is likely to be as bad in recessions as in booms. This fact is actually confirmed by a recent study on German data (Bender et al. 2011), which finds that the individual effect of increasing UI benefits is more or less stable over the business cycle.

But the aggregate effect to the contrary is likely to vary with labor market conditions. Put differently, if individuals exert less effort to find a job, this does not necessarily translate into an identical increase in aggregate unemployment in good times and in bad times. The reason lies in the fact that unemployment is not the same over the business cycle. The long queues of unemployed workers at job bureaus and factory gates observed during the Great Depression suggest that jobs are lacking in recessions, irrespective of frictions in matching unemployed workers to recruiting firms. During recessions, search frictions on the labor market are less likely to explain a large part of unemployment, which stems mainly from job rationing. Existing models of unemployment neglect the possibility of job rationing which makes them inadequate to study recessionary unemployment. In contrast, our model is built on a search-and-matching framework in which jobs are rationed in recessions: the labor market does not clear at the limit where matching frictions are absent.

The key implication of the existence of job rationing in recessions is that even if the government reduced the generosity of UI benefits and people were induced to search more intensively for a job, their probability of finding a job would not go up. To the contrary, because more people would be competing for a limited number of jobs, the probability of everyone to find a job would actually go down: a phenomenon called "negative job search externality." As a consequence, decreasing the generosity of UI benefits when there is job rationing would not have a strong positive impact on the aggregate unemployment rate. Another way of saying this is that the aggregate moral hazard cost of increasing UI is actually less severe in recessions.

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The Road Ahead

The consumption-smoothing benefits of UI are legitimately greater during recessions, and the moral hazard costs milder. It is thus reasonable to think that it is welfare enhancing to increase UI benefits during recessions. Policymakers have legitimate concerns about the nation's unsustainable long-term budget deficit. But continuing federal emergency UI benefits until the job market is stronger will have a negligible impact on the long-term deficit.[2]

Thanks to a whole new strand of research on UI, it seems that there is now an unambiguous set of economic rationales in support of UI benefits extensions. It is socially optimal to make the generosity of the UI system vary over the business cycle. And the generosity of the recent UI extensions (up to 99 weeks with a replacement rate close to 50 percent) may well be close to the appropriate level for the incredibly harsh labor market conditions that the United States has faced in the last couple of years. Does this mean that economists are done with their part of the job? Not really. They still have a lot of work ahead to establish more firmly the basis of most of their claims. In particular, the research agenda should imperatively include providing more empirical evidence on how the consumption-smoothing benefits of UI vary during booms and busts. It should also include more accurate proof that increasing UI benefits is not simply crowding out private savings of individuals. Finally, the focus should also be about the existence of job rationing in recessions, which is a strong rationale for varying the generosity of the UI system over the business cycle. The very presence of job rationing is not an easy thing to identify. And most economists are reluctant to accept the idea that unemployment is indeed due mainly to job rationing in bad times. Empirically identifying job rationing is thus a key piece of the puzzle and more definitive evidence of job rationing is going to be needed.

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2 There are no official estimates, but the cost of extending emergency benefits for another year is likely to be around $50 billion and possibly much less. This is only around 3 percent of the $1.5 trillion of deficit projected by the Congressional Budget Office for 2011.

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