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CONGRESSIONAL TESTIMONY

The Economics of Extending Unemployment Benefits

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My name is Karen Campbell. I am a Policy Analyst in Macroeconomics at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

I want to thank the members of the Finance Committee for this opportunity to address you concerning Unemployment Insurance and where we go from here. Today I will discuss the overall economic consequences of extending unemployment insurance particularly in light of current economic conditions.

Sources of Unemployment

As you know, economists have identified three sources of unemployment. Two of the sources are normal and necessary for a vibrant and dynamic economy. That is unemployment due to frictions where individuals are free to move from job to job in order to find the best employment and unemployment due to structural changes where new technology or new needs and wants requires a different set of skills or a different location for the individual.

The third type, cyclical unemployment, is typically what policymakers try to minimize. This occurs due to downturns in the business cycle. However, while an unemployment stint may be initially due to a cyclical downturn, as the recession plays out, the business landscape is altered. Businesses that did not survive the downturn either must re-emerge with different cost structures, which usually involves different technology and processes or must permanently close its doors. Further, recessions may change the needs and constraints that individuals and businesses face. This means investments in new businesses and employment skills may be needed to meet the changed needs of the marketplace.

Thus cyclical unemployment can quickly become structural unemployment. While unemployment insurance provides a safety net for individuals who find themselves between jobs, longer term unemployment spells point towards a structural unemployment problem for which unemployment insurance is too blunt a policy tool and is counterproductive.

Trade-offs and Incentives

Counter productivity sets in when the incentives of an insurance policy become unbalanced. Insurance policies alter the incentives individuals face and have the well known perverse effect of nudging the very behavior that would lead to a pay-out of the insurance policy. That is, the problem of moral hazard. Economists have found unemployment insurance affects an individual's incentive to find a job by changing the constraints and opportunity cost of finding a job.

Unemployment benefits reduce the incentive and the pressure to find a new job by making it less costly to remain without work. Consequently workers with UI benefits look for new jobs less rigorously than do workers without them. The typical unemployed worker spends about 32 minutes a day looking for a new job.[1] Workers eligible for UI benefits spend about 20 minutes a day looking for work during their 15th week of unemployment. They look much harder when their benefits are about to end, spending more than 70 minutes a day job hunting in the 26th week of unemployment.[2] Since workers with unemployment benefits search less rigorously for work until their benefits are about to expire, it typically takes them longer to find new jobs. Labor economists estimate that extending the potential duration of unemployment benefits by 13 weeks increases the average amount of time workers on UI remain unemployed by two weeks.[3]

This has economic consequences. Workers do not create economic wealth during the additional weeks they remain unemployed. They save and consume less because UI replaces only a portion of their wages. Labor markets become less flexible because it takes more time for workers to transition from one industry or state to another. This hinders overall economic growth.

Balancing the Interests of Society

For a risk-averse population, unemployment insurance provides an opportunity for individuals to smooth their spending in the event of a loss of income. Depending on the

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[1] Alan B. Krueger and Andreas Mueller, "Job Search and Unemployment Insurance: New Evidence from Time Use Data," IZA Discussion Paper No. 3667, August 2008, p. 11, at http://ssrn.com/abstract=1261452 (November 13, 2008).

[2] Ibid., pp. 20-21. Note that this study occurred when extended benefits were not in effect, so benefits expire after the 26th week.

[3] Lawrence Katz and Bruce Meyer, "The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment," Jour-nal of Public Economics, Vol. 41, No. 1 (1990), pp. 45-72. Note that an elasticity of 0.16 implies that increasing the duration of unemployment insurance by 13 weeks results in a roughly two-week longer (13 * 0.16 = 2.08) unemployment spell. Also note that this is the same estimate used by the Congressional Budget Office in its 2008 survey of stimulus options.

level of the pay-out benefit, the unemployed individual may not be forced to make less optimal consumption choices. This, in turn, allows the ripple effects of income losses to be minimized. For this benefit, individuals through their employer's contribution, pay a premium during the times the individual is employed. The unemployment insurance policy, in addition to defining a benefit level, defines the maximum length of time the benefit will be paid.

Designing policies that best balance the incentives of all members of society is an extremely challenging task. Many labor economists have studied the optimal UI policy both in terms of duration and level of benefit that best balance the overall interests of society in theory.

As with any model used to investigate a problem, many details of the overall economy are abstracted from in order to focus on one particular aspect of the issue. In designing good policy, though, many aspects of the problem must be considered and weighed. In the case of S. 1647, the policy proposes to extend the duration of emergency UI benefits into 2011. This is not a true insurance policy in that the funds are not paid with current premiums. Rather this is an additional government spending proposal that must be financed by borrowing. Whenever debt is used to finance a proposal, a relevant metric is whether the proposal earns greater income on the borrowed funds than it must pay in interest on the debt.

Empirically, at the national level, an imperfect, but useful proxy for how well a policy balances the interests of all its citizens is whether the overall standard of living, measured by GDP, would ultimately increase or decrease. The payment of our national debt also comes out of our Gross Domestic Product. Thus a way to analyze whether borrowed funds earn a positive return is whether the use of the borrowed money will increase the productivity of the U.S. economy such that our GDP will increase by more than the principle and interest on the borrowed funds.

My colleague James Sherk and I dynamically estimated the effect of borrowing money to pay additional weeks of unemployment insurance. The dynamic model takes account of the interactions between the positive effects on income and spending smoothing, the borrowing effects of interest rates and investment levels and the productivity effects in terms less labor time. We found the net overall effect to be negative. That is, for every

$1 the government borrowed, GDP increased by only at most $0.25.[4] As this negative seventy-five percent return is siphoned out of the economy, over time these losses are felt in less new investments taking place, which leads to less new capacity and less opportunity for workers in the future.

State of Current Economy

Lastly, there are a number of current economic conditions that are relevant for evaluating whether enacting S. 1647 will contribute to greater economic growth and stability or, in fact, make it more difficult for individuals to find work in the future.

First, the Federal Reserve, as well as a number of other independent economic forecasts, are seeing stabilization and a slowly recovering economy beginning in the third quarter of 2009.[5] The sustainability of the recovery will depend on the ability of individuals and businesses to invest in both human and physical capital to meet the needs of the changed landscape of the economy. As the government borrows more and more from savers, the ability of private individuals to make the investments they need to make may be hindered.

Second, the CBO is projecting that the U.S. debt is on a course to reach $9.1 trillion dollars in the next ten years.[6] Furthermore, the growth in the U.S. debt is outpacing the growth rate of U.S. GDP. If this trend continues, the U.S. debt will eventually be larger than the U.S. economy. As more and more of our national income is used to finance debt, we will have less income to invest in wealth building assets. This deterioration of the U.S. economy's balance sheet is already worrying countries, such as China, that hold U.S. debt.

Third, although the business cycle is seen to be turning upward, there are many political contingencies that are interacting with business investment decisions. The policy to extend unemployment insurance benefits cannot be viewed in a vacuum. Its overall effect will depend on whether and what direction other fundamental reforms will take.

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[4] James Sherk and Karen A. Campbell. "Extended Unemployment Insurance--No Economic Stimulus." *The Heritage Foundation*, Center for Data Analysis Report #08-13, November 18, 2008 at http://www.heritage.org/Research/Economy/cda08-13.cfm.

[5] Minutes of Federal Open Market Committee, August 11-12, 2009 at http://www.federalreserve.gov/monetarypolicy/fomcminutes20090812.htm (September 13, 2009).

[6] "Mid-Session Review Budget of the U.S. Government: Fiscal Year 2010," Office of Management and Budget, August 25, 2009, at *http://www.whitehouse.gov/omb/assets/fy2010_msr/10msr.pdf* (September 9, 2009)

Some of these reforms are the structure of financial sector oversight, markets for obtaining health insurance and medical care and the needed reforms to Social Security and Medicare programs that will put those on a sustainable path going forward.

The uncertainties regarding what the rules of the marketplace will be going forward can be a contributing factor to delayed decision making and can hinder a recovery.[7] Extending unemployment benefits further adds to the paralysis by increasing the bar of the certain or known level of status quo income against which a decision to take a new employment situation, with an uncertain or unknown outcome, must be weighed.

Fourth, it is well known that unemployment is a lagging indictor and that the unemployment rate can rise even after a recovery has started. Yet it should also be noted that the information economy brought about by the internet is affording many more opportunities for free lance and other forms of self employment that may currently go under the radar. Understanding the way individuals are employed in the 21st century and adapting unemployment insurance, as well as a many other currently debated policies, accordingly will be a key to fostering a sustainable recovery.

Conclusion

The economic recovery will take time and, perhaps more importantly, confidence in the stability of the economy going forward. New investments need to be made and brought online, new businesses must be created to fill the gaps in the market left by businesses that did not survive the recession, new supply channels need to be forged and employer and employee matches must be made in light of the new skills and technology that are now needed. All of these market adaptations must take place within the institutions of government policies. This is why policies must be careful not to hinder the very outcome they are trying to promote.

Using a tool meant as a temporary safety net for workers who find themselves involuntarily unemployed is too blunt a tool to address the needs of individuals who find themselves unemployed for longer durations during the next years of economic recovery. More effective policies will be those that foster economic stability, allow individuals and

[7] This problem of inertia is studying in the literature on decision making under uncertainty. Recent models that can account for ambiguity are particularly useful for gaining insight into a bias for remaining with the status quo.

businesses to invest in new skills and technology that will better utilize our resources and encourage new job creation.

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