Joint Economic Committee Democrats

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The Social Benefits of Unemployment Insurance Far Outweigh the Costs:

An Overview of the Economic Literature

Recent proposals to reform the federal unemployment insurance system (such as the Administration's Personal Reemployment Accounts) would link unemployment compensation (UC) to reemployment. Proponents of those reforms cite the tendency for increased unemployment benefits under the present system to increase the duration of unemployment modestly. They argue that reemployment incentives would get the unemployed back to work more quickly and save the federal government money.

Although some of the proposed reemployment incentive schemes may indeed reduce the duration of unemployment somewhat, none can or should substitute for the more traditional approach of temporarily extending federal unemployment benefits when labor markets are weak. Unemployment insurance has social benefits that are often overlooked in the reform discussions:

- increasing UC maintains incomes and reduces poverty;
- increasing UC effectively stimulates overall demand; and,
- increasing UC can raise productivity.

As a result, temporary extensions of UC can generate spillover benefits for society that far outweigh any additional social costs that may result from a modest increase in the duration of unemployment.

Unemployment Insurance, Income Maintenance and Poverty Reduction

Financed in part by payroll taxes on workers, the unemployment insurance program aims to help workers who have lost their jobs adjust to their income loss until they find new work. Critics of the existing system, such as the Bush Administration, have alleged that the availability of unemployment insurance has led many recipients to wait until their benefits expire before taking jobs.[1]

However, that view is at odds with those of leading economists. Alan Greenspan, for example, observed: "when you get into a period where jobs are falling, then the arguments that people make about creating incentives to work no longer are valid and, hence, I've always argued that in periods like this the economic restraints on the unemployment insurance system almost surely ought to be eased to recognize the fact that people are unemployed because they couldn't get a job, not because they don't feel like working."[2] Indeed, careful statistical studies by leading researchers have found little evidence that higher UC leads recipients to take jobs just before their benefits run out.[3]

During hard times, when overall unemployment is high, few (if any) jobless workers would choose to remain unemployed just for the UC. At best, UC replaces only a small fraction of the recipient's lost income. Well under half of those claiming benefits actually receive the maximum benefit. Moreover, those receiving the maximum benefit are typically replacing less than half of their previous earnings.[4] Accordingly, in hard times, unemployed workers must draw down their wealth holdings to maintain themselves and their families. However, the financial holdings of the unemployed are rarely even close enough to tide them over during hard times. Indeed, nearly a third of all workers do not have sufficient wealth to cover even a tenth of their lost income.[5]

Many workers who lose their jobs are not merely inconvenienced by their unemployment—their very survival is threatened, as is their viability as future providers for themselves and their families. The availability of regular and extended UC has served to reduce poverty and keep many of those who are most vulnerable to economic downturns from falling below subsistence levels of consumption. Without regular and extended UC, nearly three out of every four UC recipient would have fallen into poverty during the 1990 recession; in fact, with UC, fewer than half were impoverished after exhausting their regular benefits.[6] Unemployment insurance also keeps recipients from cutting back on critical needs such as food and housing.[7]

Poverty carries with it social costs that go beyond the dollar loss of income to those who are impoverished. Deteriorating health and rising crime rates associated with increased poverty impinge on society as a whole. As a result, reducing poverty among those workers who are jobless through no fault of their own has spillover benefits for society at large. To the extent that regular and extended UC helps some workers meet their subsistence needs during hard times, the unemployment insurance system helps society maintain a healthier and potentially more productive labor force than would have been the case in the absence of UC.

Unemployment Insurance Works to Stabilize Demand and is an Effective Stimulus

Unemployment insurance has worked to moderate cyclical fluctuations in income. Additionally, temporarily extending regular unemployment benefits is an extremely effective way of stimulating the economy when unemployment is high. Directly lessening the severity of an economic downturn for some members of society indirectly benefits all of society.

Because UC rises with the overall level of unemployment, unemployment insurance blunts some of the force of an economic downturn. Studies have shown that the availability of unemployment insurance has contributed to a significant moderation in U.S. business cycles since World War II.[8]

Studies have shown that temporarily extending unemployment benefits can be an extremely effective way of increasing demand when unemployment is high. Because recipients of extended UC are likely to spend all of the additional benefit, overall demand is boosted to a far greater extent than would be the case with a tax cut.[9] That means that extending UC yields far more bang (stimulus) for the federal buck than other approaches to stimulating the economy.

Unemployment Insurance Can Enhance Productivity

When labor markets are weak, it takes longer to find a job. Some of the jobless will continue searching as long as they can to find productive employment that matches their skills. Others will use their time to improve their skills, enhancing their productive potential for better times. Still others, at the end of their financial rope, will be forced to commit themselves to less productive jobs than they would be capable of in a stronger labor market or drop out of the labor force altogether.

Increasing UC may encourage those who are on the verge of settling for a less productive job to continue searching and possibly land a better job. To the extent that is the case, the increased UC will increase the duration of unemployment modestly. However, some recent research has demonstrated that the social benefits stemming from higher output and productivity tend to outweigh the social costs stemming from modestly increased duration of unemployment.[10]

Endnotes

[1] The Administration argument is presented in Council of Economic Advisers, *The Economic Report of the President*, February 2003, pp. 122-123. That argument is debunked in JEC Democrats, "Unemployment Benefits and Job Search: The Administration's Weak and Misleading Case for Personal Reemployment Accounts," *Economic Policy Brief*, March 2003.

[2] Joint Economic Committee, *Hearing on the Economic Outlook*, Washington, DC, November 13, 2002, , p. 17.

[3] Lawrence F. Katz and Bruce D. Meyer, "The impact of potential duration of unemployment benefits on the duration of unemployment," *Journal of Public Economics*, 1990, vol..41, pp. 45-72.

[4] Alan B. Krueger and Bruce D. Meyer, "Labor Supply Effects of Social Insurance," National Bureau of Economic Research, Working Paper 9014, June 2002.

[5] Jonathan Gruber, "The Wealth of the Unemployed: Adequacy and Implications for Unemployment Insurance," National Bureau of Economic Research, Working Paper 7348, September 1999.

[6] Walter Corson, Karen Needels, and Walter Nicholson, "Emergency Unemployment Compensation: The 1990s Experience," United States Department of Labor, Occasional Paper 99-8, January 1999.

[7] Jonathan Gruber, "The Consumption Smoothing Benefits of U.I.," *American Economic Review*, 1997, vol. 87, no. 1, pp. 192-205; and, Jonathan Gruber, "Unemployment Insurance, Consumption Smoothing, and Private Insurance: Evidence from the PSID and CEX," Advisory Council on Unemployment Insurance, Background Paper, no. 1.

[8] Christina Romer, "Changes in Business Cycles: Evidence and Explanations," *Journal of Economic Perspectives*, Spring 1999, pp. 23-44; and, Darrel Cohen and Glenn Follette, "The Automatic Fiscal Stabilizers: Quietly Doing Their Thing," Federal Reserve Bank of New York, *Economic Policy Review*, April 2000, pp. 35-68.

[9] JEC Democrats, "Effective Economic Stimulus: How Do Congressional Proposals Measure Up?" December 11, 2001.

[10] Daron Acemoglu and Robert Shimer, "Productivity Gains from Unemployment Insurance," *Eurpoean Economic Review*, June 2000, vol. 44, pp. 1195-1224.

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