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Unemployment Insurance Does Not Stimulate the Economy

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With the economy weakening, some analysts have argued for increasing unemployment insurance (UI) benefits from 26 weeks to 39 weeks to stimulate economic growth. Few studies support the idea that extending unemployment benefits significantly stimulates the economy. In addition, extending UI benefits would do the following:

- Encourage unemployed workers to stay out of work longer to collect benefits;
- Encourage employers to wait longer to rehire laid-off workers; and
- Do relatively little to increase consumption.

To stimulate the economy and create jobs, Congress should increase the incentives for businesses to invest.

No Economic Stimulus. The government provides unemployment benefits to workers who are involuntarily laid off from work. These benefits replace a fraction of the workers' weekly income, to a maximum set by state law, for up to 26 weeks. Unemployment benefits can cushion the blow of job loss and provide the unemployed with income support while they search for a new job.

The Congressional Budget Office (CBO) recently issued a report claiming that extending the length of time that workers can collect UI benefits to 39 weeks would be one of the most effective stimulus measures Congress could pass.[1] The report argues that this would transfer money to workers likely to immediately spend it, boosting consumption. Notably absent from the CBO report was actual research that supports this claim.

Economists in the 1960s thought that unemployment insurance could function as an important, automatic economic stabilizer.[2] Research in the 1970s demonstrated that this was not the case, and most studies since then have concluded that unemployment insurance plays a relatively small role in stabilizing the economy.[3] State-level studies find that unemployment benefits provide virtually no economic stimulus.[4] The lack of evidence for this connection is not surprising, because unemployment insurance is not designed to stimulate the economy.

Extending UI Extends Unemployment. Unemployment insurance gives money to workers that they lose once they find a job. This encourages workers to remain unemployed to collect benefits. Even for conscientious workers, UI reduces the pressure to seek employment. Unsurprisingly, research shows that when the government increases the duration of UI benefits, the length of time workers spend unemployed also increases.

Figure 1 comes from a study of unemployed workers collecting benefits in Pennsylvania.[5] It shows the probability that unemployed workers in Pittsburgh will find work, either with a new employer or with their old employer, as they

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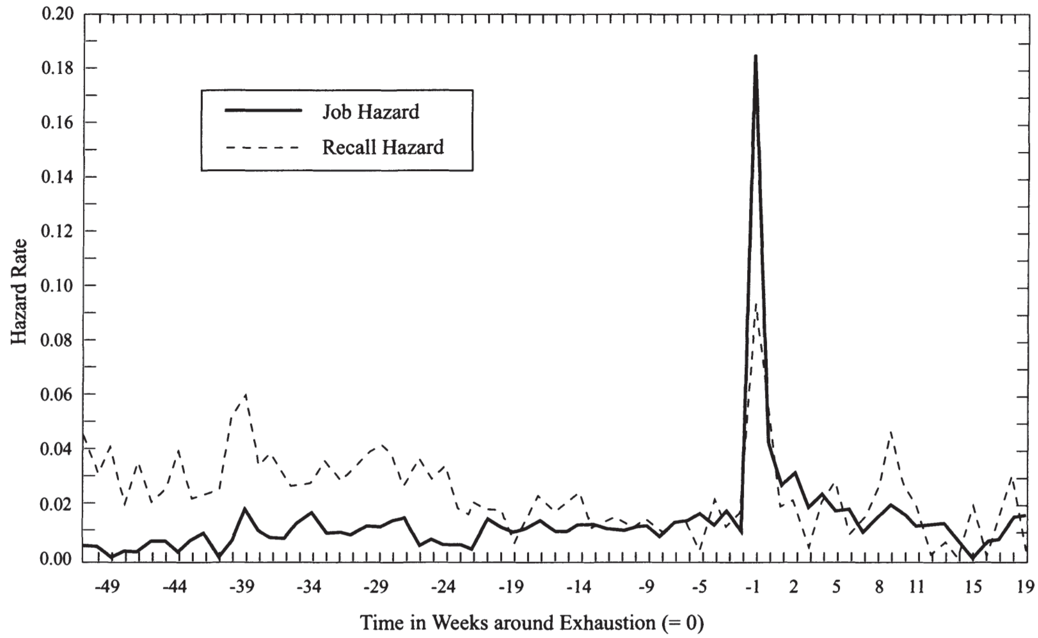
Figure 1 WM 1777

Probability of Finding a New Job or Being Rehired by Previous Employer in Pittsburgh as UI Benefits Are Exhausted



Source: Stepan Jurajda and Frederick J. Tannery, "Unemployment Duration and Extended Unemployment Benefits in Local Labor Markets," *Industrial and Labor Relations Review*, Vol. 56, No. 2 (January 2003), p. 332, Figure 3. © Cornell University

exhaust their UI benefits. Relatively few workers started work on any given week. However, a full 28 percent of workers who had not yet found jobs found them as soon as their UI benefits ran out—10 percent with their old employer and 18 percent with a new employer. Unemployment insurance encourages many workers to delay starting work while they collect benefits.

Many other researchers have come to the same conclusion.[6] Researchers at Harvard found that extending unemployment insurance eligibility by 13 weeks increases by two weeks the amount of

1. Congressional Budget Office, CBO Paper, "Options for Responding to Short-Term Economic Weakness," January 2008, pp. 17, 22, at *http://cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf*.
2. For example, George E. Rejda, "Unemployment Insurance as an Automatic Stabilizer," *The Journal of Risk and Insurance*, Vol. 33, No. 2 (June 1966), pp. 195–208.
3. George M. Von Furstenberg, "Stabilization Characteristics of Unemployment Insurance," *Industrial and Labor Relations Review*, Cornell University, Vol. 29(3), (April 1976), pp. 363–376. Alan J. Auerbach and Daniel Feenberg, "The Significance of Federal Taxes as Automatic Stabilizers," *Journal of Economic Perspectives*, American Economic Association, Vol. 14(3) (2000), pp. 37–56.
4. Kyung Won Lee, James R. Schmidt, and George E. Rejda, "Unemployment Insurance and State Economic Activity," *International Economic Journal*, Vol. 13, No. 3 (Autumn 1999), pp. 77–95.
5. Stepan Jurajda, and Frederick J. Tannery, "Unemployment Duration and Extended Unemployment Benefits in Local Labor Markets," *Industrial and Labor Relations Review*, Vol. 56, No. 2 (January 2003), pp. 332–334. Figure 1 replicates Figure 3 in the paper.

time that workers remain unemployed. Each additional week that the government extends UI benefits extends the length of time the average worker stays unemployed by 0.16 to 0.20 weeks.[7] Since some workers find jobs in the first month of unemployment, extending UI means significantly longer periods of unemployment for those who do not start work quickly.[8]

Some analysts argue that greater benefits have less of a disincentive effect during times of high unemployment.[9] The facts refute this argument: Labor market conditions have little effect on how workers respond to additional UI benefits.[10]

Employers Wait Longer to Rehire. Extended UI not only encourages workers to take longer to start working again but also encourages companies to wait longer before rehiring workers they have laid off. Employers take into account the fact that their laid-off workers will receive UI and are slower to hire them back. Figure 1 shows that fully 10 percent of unemployed workers who exhausted their UI benefits in Pittsburgh were hired the next week by their previous employer.

It is extremely unlikely that employers did this because of a sudden jump in business the week benefits ran out. Instead, employers appear to use UI to hold their workforce together without paying their workers during times of low demand. This hurts the well-being of workers and their families and leaves them without important health benefits. Extending UI benefits an additional 13 weeks would allow employers to keep their workers "on call" without paying them for a longer period.[11]

Extended unemployment insurance lengthens unemployment. It encourages workers to stay unemployed and companies to delay rehiring laid-off workers. Higher unemployment and fewer workers do not promote economic growth.

Modest Increases in Consumption. The theory behind the UI–stimulus proposal holds that the government should transfer money to workers who will immediately spend it, because greater spending increases aggregate demand and stimulates the economy. This is a recycled version of Keynesian economic theories that economists and policymakers rejected after they failed during the 1970s.

These discredited theories stated that, in economic downturns, investment stops responding to the interest rate, and any money that is saved is essentially taken out of the economy, caught in a "liquidity trap." Thus, the only way to boost the economy is to increase consumption. However, little evidence suggests that liquidity traps exist in the real world outside of economic theory. Milton Friedman also demonstrated that workers do not consume a fixed percentage of any income they receive. Rather, they base their consumption decisions on their expected permanent income. Thus, temporary increases in income that result from government transfers have only modest effects on consumption.

6. See 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*, Vol. 78(1-2) (October 2000), pp. 107–138. Stepan Jurajda, "Estimating the Effect of Unemployment Insurance Compensation on the Labor Market Histories of Displaced Workers," *Journal of Econometrics*, Vol. 108(2) (2002), pp. 227–252. John T. Addison and Pedro Portugal, "How Does the Unemployment Insurance System Shape the Time Profile of Jobless Duration?" *Economics Letters*, Vol. 85(2), (November 2004) pp. 229–234. Alan B. Krueger and Bruce D. Meyer, "Labor Supply Effects of Social Insurance," in A. J. Auerbach and M. Feldstein (ed.), *Handbook of Public Economics*, First Edition, Vol. 4 (2002), pp. 2327–2392. Rafael Lalive, Jan Van Ours, and Josef Zweimüller, "How Changes in Financial Incentives Affect the Duration of Unemployment," *Review of Economic Studies*, Vol. 73(4) (October 2006), pp. 1009–1038.
7. 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*, Vol. 41(1) (1990), p. 44.
8. *Ibid.*, p. 44.
9. Congressional Budget Office, CBO Paper, "Options for Responding to Short-Term Economic Weakness," January 2008, p. 17, at *http://cbo.gov/ftpdocs/89xx/doc8916/01-15-Econ_Stimulus.pdf*.
10. Jurajda and Tannery, 2003.
11. Paul Kersey, "Emergency Unemployment Benefits Not Needed as Economy Recovers," Heritage Foundation *Executive Memorandum* No. 914, February 13, 2004, at *www.heritage.org/Research/Labor/em914.cfm*.

Even if policymakers believe that increasing consumption is the best way to stimulate the economy, research shows that extending unemployment benefits is not the way to do it. Workers respond to the incentives the UI system creates and do not spend every additional dollar of UI benefits. The spouses of unemployed workers with UI benefits work substantially shorter hours than those with benefits. For married men, each dollar of benefits reduces their wives' earnings by between 36 and 73 cents.[12] Workers on UI also spend less of their savings than those without benefits.[13] For many families, extended UI benefits would do less to increase consumption than to provide alternative financing for consumption that would nonetheless take place. Research shows that each additional dollar spent on UI increases total consumption by roughly fifty cents.[14]

Furthermore, this research finding—that only 50 cents of each dollar is spent—does not account for another way that UI reduces consumption. Since UI increases the amount of time workers stay unemployed, it increases the amount of time they go without earning full wages or employee benefits. This artificially extended unemployment further reduces the effect that additional UI benefits have on increasing consumption.

Conclusion. Congress understandably wants to prevent the economy from slipping into a recession. However, Congress should ensure that its actions are effective. Extending unemployment benefits creates incentives for workers to remain unemployed and for employers to wait longer to rehire their workers. Both of these consequences harm the economy. Arguments that UI stimulates the economy rely solely on the theoretical benefit of transferring money to people who will quickly spend it. Actual studies conclude that unemployment insurance provides little economic stimulus. Even if Congress wants to boost consumption, studies show that workers spend just 50 cents out of every dollar in additional UI benefits.

Congress should not extend unemployment insurance benefits to 39 weeks. Congress should instead increase incentives for businesses to invest in the economy, such as through accelerated depreciation. This will stimulate economic growth while making it easier for unemployed workers to find jobs.

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12. J. B. Cullen and J. Gruber, "Spousal Labor Supply as Insurance: Does Unemployment Insurance Crowd Out the Added Worker Effect?" Journal of Labor Economics, 18(3) (2000), pp. 546–572.
13. Eric M. Engen and Jonathan Gruber, "Unemployment Insurance and Precautionary Saving," *Journal of Monetary Economics*, Vol. 47(June 2001), pp. 545–579.
14. Jonathan Gruber, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, Vol. 87 (March 1997), p. 195. Note that a 10 percent increase in the replacement rate (representing a 10 percent increase in individual income) reduces the fall in individual consumption by 2.65 percent. Footnote 9 notes that the average recipient gets 48 cents out of every additional dollar he or she is eligible for, because not all workers eligible for benefits receive them. Thus when UI raises incomes by 4.8 percent, consumption rises by 2.65 percent. Consumption is less than household income, so each dollar spent on UI raises consumption by roughly 50 cents.