

Should Unemployment Benefits be Extended? An Economic Framework and Empirical Evidence

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A Framework for Unemployment Insurance Policy

- Is extending benefits a “good” policy choice?
 - Would extending benefits increase total economic welfare?
- Economic theory shows that answer depends on tradeoff between two central factors
 - Benefits for the unemployed via higher consumption
 - Costs of providing benefits by reducing incentives to find a job
- Economists have made significant advances in measuring the benefits and costs over the past few years
- Can now provide a reasonably scientific answer to the policy question

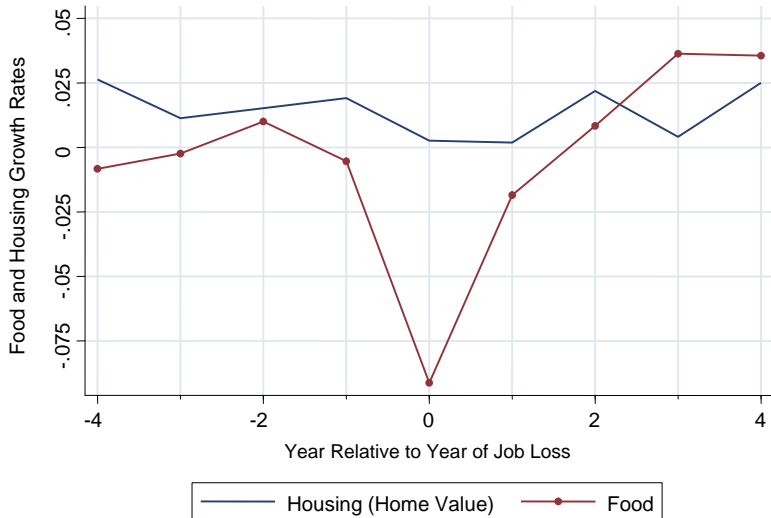
Benefits of Unemployment Insurance

- Three potential benefits of providing UI benefits
 - 1 [Micro] Consumption-smoothing: higher consumption in a time when income is very valuable
 - 2 [Macro] Fiscal stimulus: unemployed spend most of the money they receive → good tool to stimulate aggregate spending
 - 3 [Job matching] UI benefits may lead individuals to find better jobs (e.g., engineer who settles for service industry job to put food on the table)

Benefits of UI: Evidence

- Consumption-smoothing benefit of providing UI large because unemployed families are cash-constrained
- Median unemployed person has less than \$250 in net savings prior to job loss and cannot borrow
- Moreover, most families have many “commitments” that they cannot adjust
 - Ex: have to pay home mortgage, utilities, tuition bills, etc.
- Therefore forced to cut back on items such as food, clothing, medicines
 - Serious consequences for health (von Wachter and Sullivan 2009) and children
 - UI benefits can be very valuable in mitigating consumption drop

FIGURE 1
Effect of Unemployment on Food and Housing Consumption



Source: Chetty and Szeidl 2007

Costs of Unemployment Insurance

- Extending UI benefits reduces incentives to find job by reducing net pay of work
 - If benefits are \$250 per week and worker earns \$400 per week, net gain of only \$150 by finding a job
- People may search for jobs less intensively because of this work disincentive (or “moral hazard”) effect
 - Could lead to higher unemployment rate and lower GDP

Measuring the Work Disincentive Effects of UI

- Two methods of measuring size of work disincentive effects
- Method 1: Do people take a longer time to find jobs when UI benefits are increased?
- Evaluate using variation in UI benefit levels across states in the U.S.

FIGURE 2a

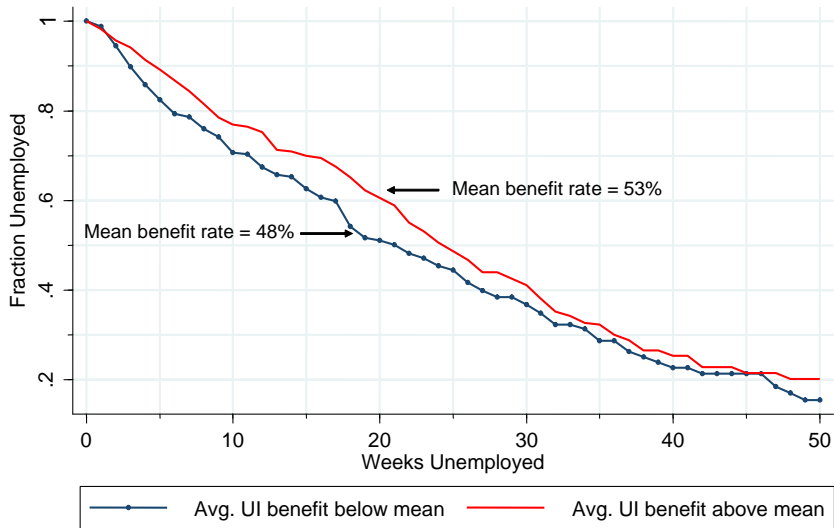
Effect of UI Benefits on Unemployment Durations: Liquid Wealth < -\$2,000



Source: Chetty 2008

FIGURE 2b

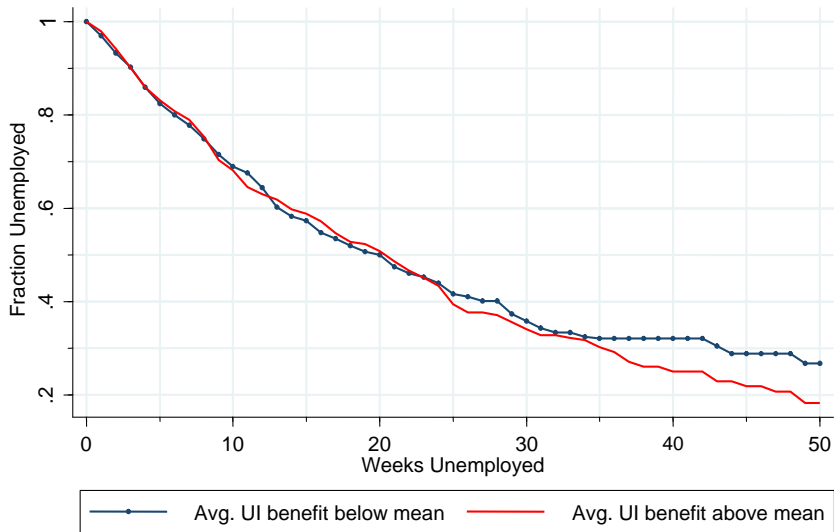
Effect of UI Benefits on Durations: Liq. Wealth Between -\$2,000 and \$200



Source: Chetty 2008

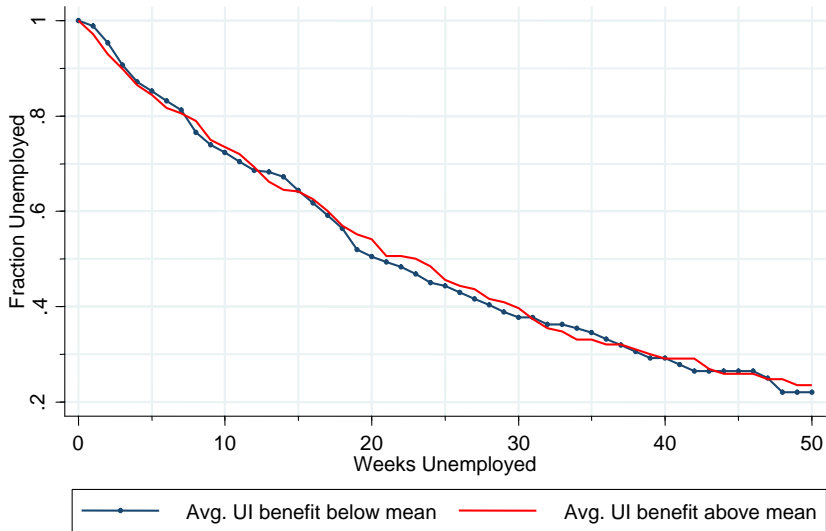
FIGURE 2c

Effect of UI Benefits on Durations: Liq. Wealth Between \$200 and \$22,000



Source: Chetty 2008

FIGURE 2d
Effect of UI Benefits on Durations: Liquid Wealth > \$22,000



Source: Chetty 2008

Are Longer Durations Caused by Work Disincentives?

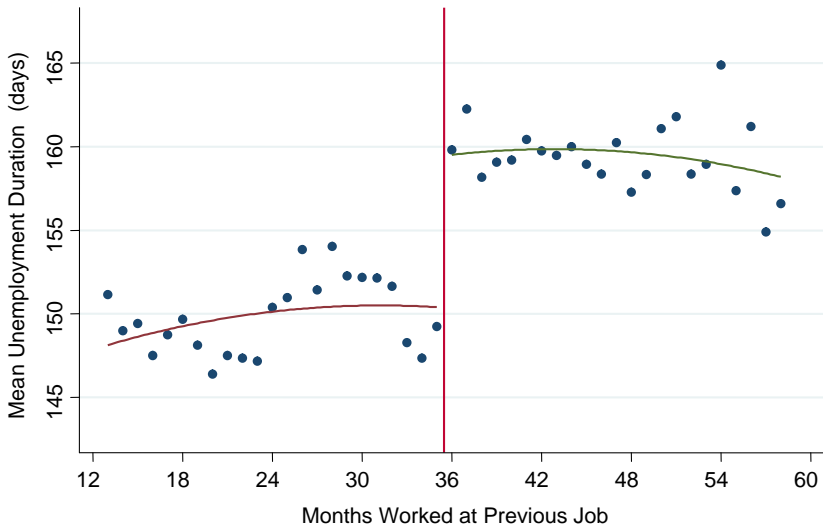
- UI benefits lead to longer unemployment durations, but pattern is not consistent with work disincentives
- Work disincentive effect should occur among higher-wealth households as well
- Alternative explanation for why UI benefits raise durations: cash-on-hand (or “liquidity”) effect
- Consider a single-earner household with children and no savings
- Without any income (i.e. without UI benefits), parent forced to make inefficient choices to put food on the table and pay bills
 - May be forced to spend little time with children or skip medical appointment to devote all her time to job search

Work Disincentive vs. Cash-on-Hand Effects

- For this parent, increase in UI benefits will increase duration
 - She will rationally choose to spend more time with children and search more efficiently and patiently for a good job
- But this increase in duration is not a negative effect generated by distorted work incentives
- Rather, it is a benefit of having more cash on hand
 - With more resources (UI or any source of income), parent can spend some time with children even while unemployed
- How much of the effect of UI benefits on duration is a beneficial cash-on-hand effect rather than a harmful work disincentive effect?
- Turn to a natural experiment in Austria to answer this

FIGURE 3

Effect of Severance Payments on Unemployment Durations in Austria



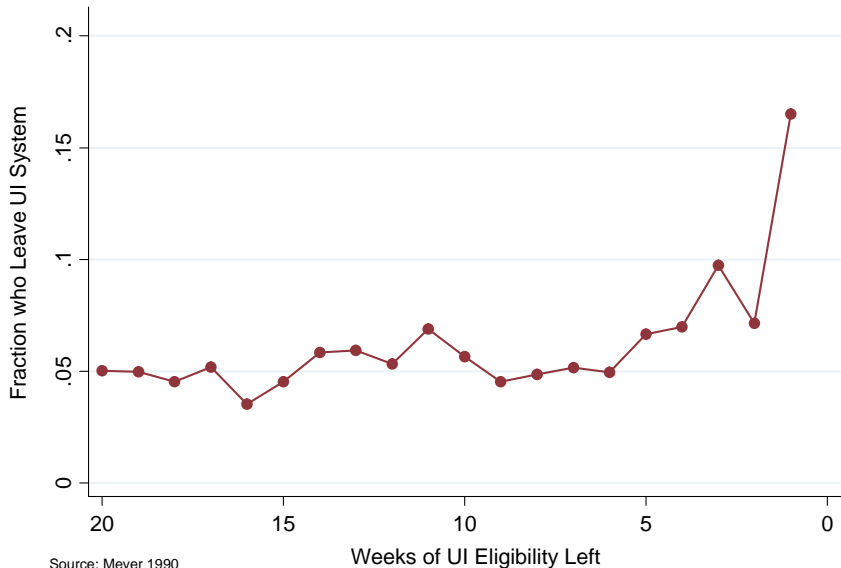
Measuring the Work Disincentive Cost of UI

- Similar findings in U.S. with lower quality data
- Conclusion: 2/3 of the effect of UI benefits on increased durations is a beneficial “liquidity” effect rather than a harmful work disincentive effect

Measuring Work Disincentives: Benefit Exhaustion

- Second method of assessing work disincentives: do people wait to exhaust benefits before finding a job?
- Traditional finding: spike in rate of exiting unemployment at time of benefit exhaustion
- Problem: old studies estimated probability of exiting UI system, not finding a new job
- Recent evidence again suggests that work disincentive effects are much smaller than implied by previous evidence

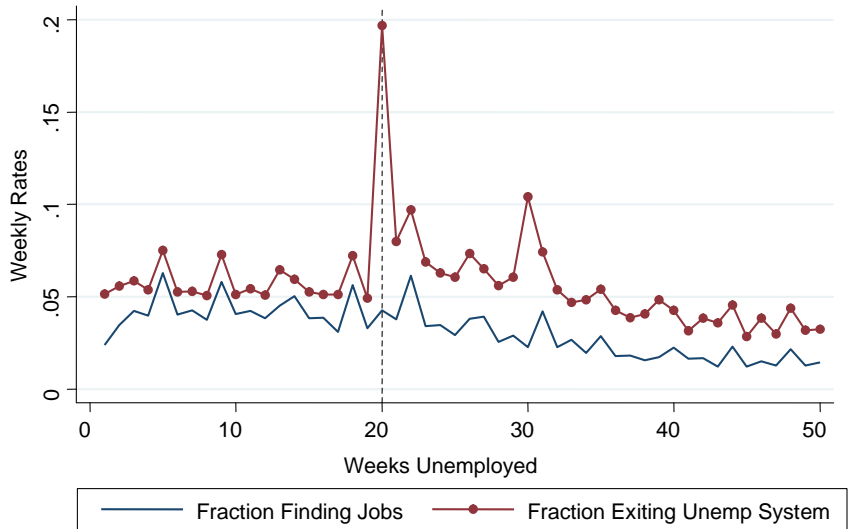
FIGURE 4
Unemployment Exit Rate Relative to Date of Benefit Exhaustion



Source: Meyer 1990

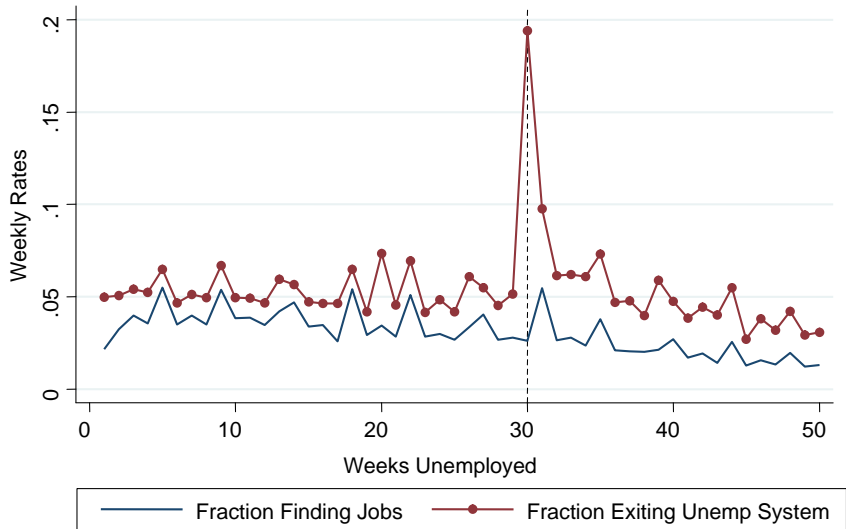
FIGURE 5

Job Finding vs. Exiting Unemployment System in Austria: 20 Week UI



Source: Card, Chetty, Weber 2007b

FIGURE 6
Job Finding vs. Exiting Unemployment System: 30 Week UI



Source: Card, Chetty, Weber 2007b

FIGURE 7

Effect of Benefit Expiration on Job Finding vs. Exiting UI System



Source: Card, Chetty, Weber 2007b

Should We Extend UI Benefits Now?

- Evidence shows that even in normal times, benefits of UI are large relative to work disincentive costs
- Benefits of UI likely to be larger in this deep, long recession
 - Especially for long-term unemployed because of depleted assets, collapse of credit markets, and risk of foreclosure
- And work disincentive effects likely to be smaller than usual now
 - People likely to take any job they can get
- Weighing costs against benefits, extending benefits further in current economy would significantly increase economic welfare

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