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UI and Disincentive Effects

Question: Does unemployment insurance (UI) encourage jobless workers to avoid work and increase unemployment?

Answer: A disincentive impact of UI benefits is well accepted. Acknowledging that UI benefits influence claimants' behavior means only that unemployed individuals are not unique when it comes to economic incentives. The contested points about incentives are the degree to which UI increases the duration of unemployment and how disincentive effects are balanced by positive impacts flowing from UI's income support for jobless workers. A fair reading of the many studies shows that disincentive impacts of UI are modest and balanced by other positive impacts on job finding and economic stimulus.

The impact of federal benefit extensions on job finding and unemployment durations are examined in a series of papers issued during and after the Great Recession. UI recipients who exhausted their regular benefits were entitled to additional federal emergency benefits between July 2008 and December 2013. These recent papers furnish important observations about how UI receipt affected job finding and labor market participation. A paper by Bivens, Smith, and Wilson of the Economic Policy Institute (2014) provides an overview of microeconomic research concerning the relationship between UI benefits and the duration of unemployment. Bivens observes that this recent research had undercut the vitality of traditional concerns by economists focused upon moral hazard.

One important empirical paper written since Bivens is by Katharine Bradbury (2014). Bradbury uses CPS data from 2005 to 2013 to look at monthly flows between employment, unemployment, and non-participation. She finds that job finding by UI recipients was distributed throughout their time on benefit extensions. In Bradbury's words, "There is no discernible relationship between . . . UI availability and transitions from unemployment to employment." Overall, benefit exhaustion did not lead to more job finding, but rather to higher rates of exit from the labor force. In plainer English, UI extensions did not significantly impact job finding rates, but did support workers' continued labor force participation. Upon exhaustion, workers did not find work; they finally dropped out of the labor force.

A similar conclusion based upon a somewhat different approach to CPS data was reached by Henry Farber, Jesse Rothstein, and Rob Valetta (2015). This paper is a follow up to earlier studies by each of these authors about UI effects during the recession years. They summarize their earlier work and then go on to update their analysis for months involving the phase-down and eventual expiration of federal benefit extensions between mid-2012 and the end of 2013. The authors conclude: "A stronger implication of our results is that the UI extensions have not had large moral hazard effects on recipients' job finding rates, either during the worst period of the Great Recession or during the subsequent recovery."

In an earlier study, Farber and Valetta (2013) used CPS data covering the Great Recession and the milder recession of the early-2000s to estimate disincentive effects of extensions. They found that UI induced modest increases in two types of exits from unemployment; finding employment and ending work search. They estimate an increase in the unemployment rate due to the availability of extensions of 0.12 percentage points in 2003 and 0.4 percentage points in 2010. In an earlier study for Brookings

Institution, Jesse Rothstein used CPS data on job flows to assess the role of benefit extensions in increasing unemployment during the Great Recession (2011). Rothstein found disincentive effects caused by extensions, with higher levels shown by the ranks of the longest-term unemployed recipients. He estimated that unemployment rates were 0.1 to 0.5 percentage points higher in 2011, but found that about half that effect was because UI delayed recipients' exit from the labor force—something that is positive from a policy perspective.

In a 2010 paper for the San Francisco Federal Reserve Bank, Rob Valletta and Katherine Kuang compared the duration of spells of unemployment of involuntary job losers, voluntary job leavers, new labor force entrants, and re-entrants to the labor force. Valletta and Kuang's paper showed that involuntary job losers during the recession remained unemployed for approximately the same length of time as unemployed workers ineligible for benefits. The paper estimated that benefit extensions contributed only 0.4 percentage points to the 6.0 percentage-point total increase in unemployment that the U.S. had experienced by that point in the recession.

Figura and Barnichon (2014) extend their similar analysis of job finding and labor force participation to include the availability of federal benefit extensions during recessions dating back to the late-1970s. They confirm that UI benefits had only a small effect on rates of unemployment rates and labor force participation during the Great Recession and earlier recessions.

In short, recent microeconomic studies indicate that macro models that predicted higher disincentive effects were not confirmed, at least in the extremely weak labor markets during and following the Great Recession. In addition, these recent studies showed that many jobless workers maintained connections to the labor market by searching for work while on UI, and that many give up their connection once their benefits were exhausted.

Question: Doesn't the "spike" of individuals observed exiting UI when exhausting UI benefits prove that jobless workers prefer getting benefits and waiting to find work?

Answer: Within the field of UI experts, a commonly known phenomenon is the "spike" of job finding by UI recipients observed near the time their benefits run out. (The observed "spike" appears on a line graph of exits from unemployment near the time of benefit exhaustion.) For example, Robert Moffitt (1985), using state UI wage records, looked at the relationship between exits from unemployment and exhaustion of UI benefits. Moffitt found that the exit rate from UI benefits was three times the average observed exit rate in the month prior to benefit exhaustion. For those workers eligible for a 13-week extension, the exit rate was roughly twice the regular exit rate. He concluded that this spike in exit rates was largely explained by the moral hazard created by UI benefit receipt.

Later commentators have observed that Moffitt assumed that exiting unemployment represented job finding, but some individuals he counted as job finders likely stopped their work-search and exited the labor force instead. These individuals dropping out

of the labor force do not show moral hazard for UI, but show that UI's requirement that claimants maintain an active search for work prolonged their job searches. In addition, claimants on temporary layoffs necessarily exit unemployment when they return to their former employers, but their exits from unemployment show us nothing about moral hazard effects of UI, as the length of their unemployment spell and UI claim was determined by recalls initiated by their employers. As a result of these questions, what appears to be a straightforward finding becomes more difficult to interpret.

A 2007 paper by David Card, Raj Chetty, and Andrea Weber shows that the magnitude of the "spike" is much smaller when spells of unemployment are measured from the time of job loss to the next job, as opposed to time spent on UI benefits. As Card et al. noted, using data on durations of benefit receipt is adequate for determining direct program costs. However, using data regarding the full length of time between job loss and reemployment is a better measure of the disincentive impacts of UI. After surveying the literature, the authors concluded, "Overall, our reading of the existing literature is that spikes in hazards around benefit exhaustion are generally smaller when duration is measured as time to next job rather than time unemployed." Using data from Austria's Social Security registry, Card and his co-authors then conducted a new analysis of the spike at benefits exhaustion based on time from job loss to reemployment, finding that fewer than one percent of unemployed workers wait to accept a job until around the time they run out of unemployment benefits.

David Card was lead author of a 2015 NBER paper that used Missouri administrative data to estimate the magnitude of disincentive effects of UI for a 10-year period from 2003 through 2013. The investigation found that duration elasticities were about 0.35 prior to the recession and ranged from 0.65 to 0.9 during the recession. These findings fall into the lower range of prior estimates of disincentive effects, and show that UI benefits were extending the duration of unemployment by somewhere between three percent and nine percent in Missouri during the period of study.

Meyer and Mok (2014) provide a recent overview of the earlier studies regarding spikes. In addition, they present results from their new study of disincentive effects arising from significant maximum weekly benefit increases (of 36 percent) taking effect in 1989 and 1990 in New York. They report duration elasticities between 0.1 and 0.2. Relatively larger effects were found for workers older than 40 and for women. In other words, jobless individuals do react to increases in benefit amounts with slightly longer spells, but the magnitude of that reaction is modest. As noted below, Young (2012) also found no spike in job search activities near benefit exhaustion in his statistical review of UI administrative records.

In summary, questions regarding spikes near benefit exhaustion and what they tell us about disincentive effects of UI don't give us the full story about disincentive effects. Study design has clearly affected findings, and more recent studies have tended to find impacts of a smaller magnitude. At this point, the certainty expressed by UI critics based upon earlier papers is no longer warranted. Disincentive effects are smaller than previously thought and claimants' observed behavior is more consistent with what should be expected from individuals who want reemployment.

Resources:

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Rob Valetta and Katherine Kuang, "Extended Unemployment and UI Benefits," Federal Reserve Bank of San Francisco Economic Letter (April 2010), http://www.frbsf.org/economic-research/publications/economic-letter/2010/april/extended-unemployment-insurance-benefits/.