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The Unemployment Dilemma

Thomas F. Cooley and Peter Rupert 08.11.10, 6:00 AM ET

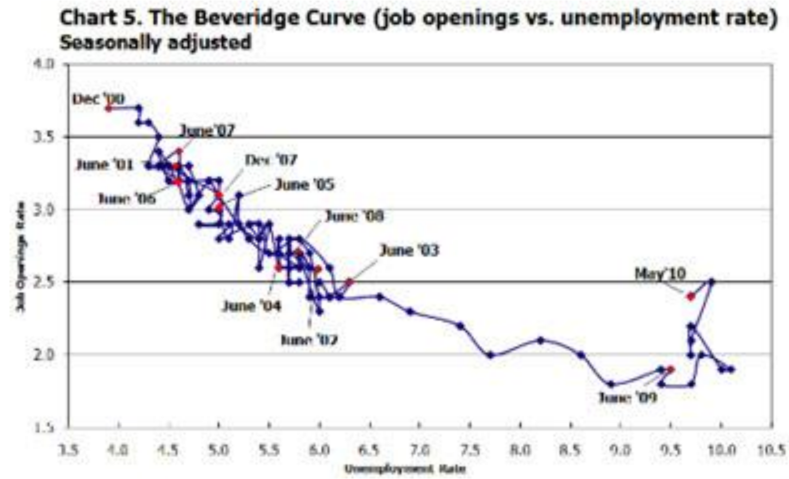
When President Obama finally signed a law extending unemployment benefits up to 99 weeks another bruising political battle fought largely along party lines came to an end. *The New York Times*' resident Mr. Nasty, Paul Krugman, called the opposition "a coalition of the heartless, the clueless and the confused." While there is no doubt that some of the opposition was heartless, some of it was concerned about how to pay for the benefits, a different issue entirely. But is it really true that nothing about this extension should give one pause? Does showing concern about the overall impact of extended benefits merit this thuggish dismissal?

The U.S. labor market is in a very dire state, and the prospects for the unemployed--particularly the long-term unemployed--are terrible. The *prima facie* case for extending benefits is strong. But some economists and policy makers have legitimate concerns about the unintended consequences of an extension. In a nutshell, extending unemployment benefits extends the duration of unemployment, and the longer the duration of unemployment the more difficult it is to find subsequent employment--i.e., it may make the problem worse on the whole. If true, this seems like a legitimate concern. Let's consider the evidence rather than dismiss it out of hand.

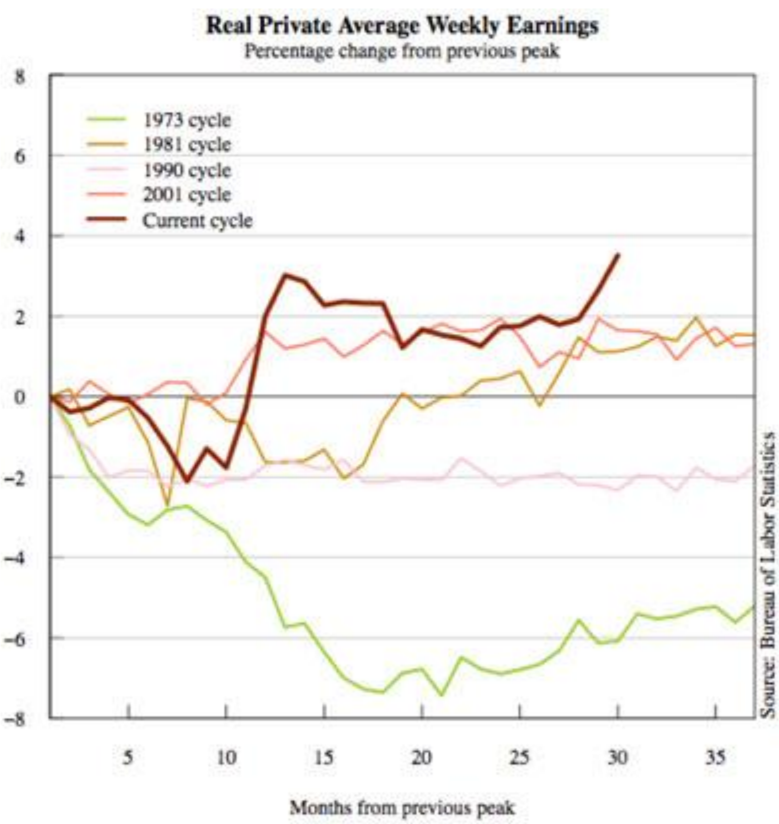
Unemployment benefits vary by state, but the typical state-mandated maximum length of unemployment benefits is around 26 weeks, and the ratio of benefits to earnings (the replacement rate) varies between one third and one half of earnings. The standard model of the aggregate labor market is based on the idea that, because it takes time for a worker to find the right job and time for a firm to find the right worker, the economy will have some positive rate of unemployment regardless of how well the economy is performing. Search is productive. In the basic version of the model, unemployment benefits raise workers' reservation wages (the minimum they are willing to accept to take a job), and hence the wages of employed workers. As a result firms have less incentive to open vacancies and unemployment increases. In particular the ratio of unemployed workers to job openings will increase.

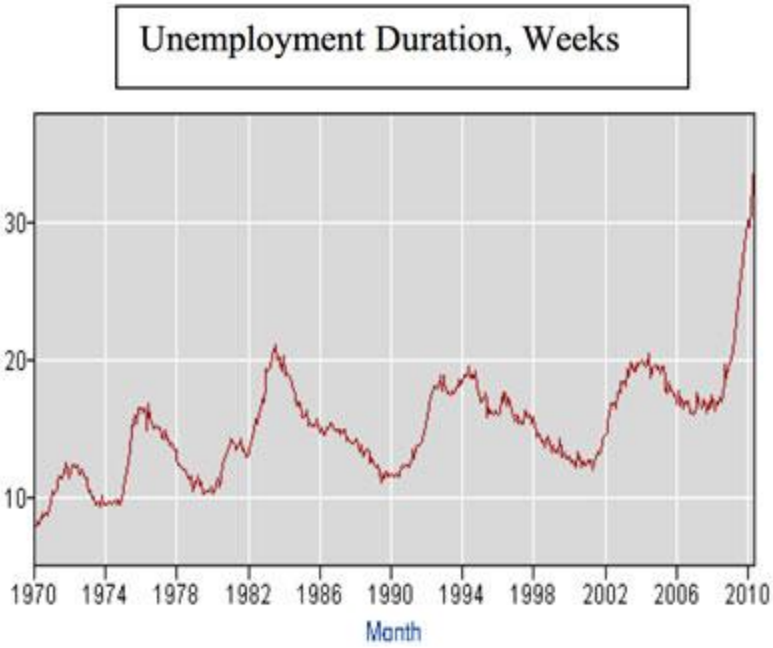
In the standard model individuals choose the intensity of their job search--that is, how much time, resources and effort they spend looking for a job. It should be fairly obvious that the higher the benefits are, the less intensively one might search and the choosier one becomes about which jobs to accept. In economics this is known as moral hazard. The introduction of insurance can have perverse effects. In the context of the labor market insured workers tend to search with a lower intensity, and that increases the average duration of an unemployment spell.

Figure 1 (labeled as Chart 5), taken from the Bureau of Labor Statistics, is a plot of job vacancies and unemployment--a relationship known as the Beveridge curve. What it shows is that even though the vacancy rate, or job openings, increased over the last few months, the unemployment rate has changed very little. As the points move north it implies that the labor market is becoming less efficient at matching workers to firms. This is exactly what the model we just explained would predict, and presumably the basis for analysts who suggest the U.S. labor market is becoming more sclerotic. Across the Atlantic, Eurosclerosis is a term that has been heard for decades, describing persistently high rates of long-term unemployment in European labor markets caught in a vice between high- and long-duration benefits and high and progressive taxation on income from work.



To summarize, the standard model of the labor market works in a very intuitive way. If workers get higher benefits when unemployed they will wait longer for a better job (yes, this is a potential beneficial aspect), they become choosier and thus will receive a higher wage. Figure 2 shows that average wages fell initially in the recession but have been rising ever since. The model also suggests that unemployment duration will increase as workers hold out for better jobs. Figure 3 shows that the duration of unemployment has increased over this recession as unemployment benefits have increased.





These plots are simply casual visual evidence. What do more serious academic studies show about the effect of an increase in unemployment insurance on the duration of unemployment? The evidence is mixed. In the *Handbook of Labor Economics* (1999), Mortensen and Pissarides show that they can account for nearly all of the difference between U.S. and European unemployment rates by differences in labor income taxes and unemployment insurance benefits. Economists Lawrence Katz and Bruce Meyer, in a 1990 study, showed that an increase of one week of benefits increased the duration of unemployment by about 0.2 weeks. Note that some benefits have been extended up to 99 weeks. A back-of-the-envelope calculation means that going from 26 weeks of benefits to 99 would increase unemployment duration by about 14 weeks very close to the increase in duration shown in Figure 3. Recently, however, in a testimony to the Joint Economic Committee (April 29, 2010) the very same Katz said that the effects are small. The difference between the 1990 study and his current finding is that, according to his research, permanent job loses as opposed to temporary layoffs have played a bigger part in this recession.

While there are different estimates of the size of the direct effect of insurance on the duration of unemployment, there are some additional consequences that are worth thinking about. Long-term unemployment is typically associated with a depreciation of workers' human capital--their skills. Unemployment will, then, be more persistent in economies with greater benefits compared to an economy with shorter-duration unemployment. If current policies are contributing to the increase in the duration of unemployment the findings suggest that it may be more important to focus policy on programs that directly address the human capital of unemployed workers. Having unemployed workers back at work might be much more of a stimulus than paying them to remain unemployed.

The bottom line is that there is plenty of evidence that is consistent with the standard view of the effects of increasing unemployment insurance on the labor market. It may have made the labor market less efficient (the shifting out of the Beveridge Curve), it may have something to do with the rise in wages during the recession and it may have something to do with the increasing duration of unemployment. None of this means that we shouldn't increase unemployment benefits for other (compassionate?) reasons. It does mean that effects of that increase may exacerbate the longer-term problems in the labor market. Armed with the evidence you can now decide for yourself, unless of course you are heartless and still clueless.

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