

Testimony to the Ways and Means Subcommittee on Income Security and Family Support

Unemployment Insurance: Considerations for Extending Benefits

April 10, 2008
10:00 AM

Rayburn House Office Building

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Introduction

Chairman McDermott, Ranking Member Weller, and Members of the Subcommittee, thank you for the opportunity to testify this morning on the topic of unemployment insurance. My name is Alex Brill, and I am a research fellow at the American Enterprise Institute (AEI). This morning, however, I am conveying my own views and not those of the AEI or any other organization with which I am affiliated.

My testimony today will address five topics: first, the current economic outlook from an aggregate, sector and regional perspective; second, the theoretical concepts for optimal unemployment insurance design; third, the importance of labor market flexibility for economic growth and lessons from Europe; fourth, extended unemployment insurance as a tool for economic stimulus and finally, alternatives to consider to the existing UI system.

Current Economic Outlook

At present, the aggregate growth of the U.S. economy is at a near standstill. Growth in the fourth quarter of 2007 was a paltry 0.6 percent (all GDP growth figures are annualized rate) and indicators for the first quarter of 2008 suggest that growth remained very slow and was possibly negative. An excessive supply of residential housing, inflated home prices, and turmoil in the credit markets are at the center of the current economic weakness. Other sectors and industries could become ensnarled as well. The outlook for the economy for the remainder of 2008 is highly uncertain. Many economists expect an improvement in the second half of the year, though such a timely return back toward trend growth depends on a prompt recovery of credit markets and financial institutions.

While the performance of the *aggregate* U.S. economy is a useful thumbnail for gauging the simple trends of the economy, our economy is an amalgamation of numerous sectors, industries and distinct labor markets. Looking more closely at specific sectors and geographic areas reveals considerable variation in our economic performance. Our economy is clearly faltering in some areas while growth remains relatively robust in other areas.

Consider the fourth quarter of 2007, the most recent period for which we have complete data. In the aggregate, the U.S. economy expanded 0.6 percent but the components of GDP performed very quite differently. The service sector of the economy grew 3.1 percent while the

goods-producing sector contracted 1.6 percent. Export growth added 0.8 percentage points to GDP while the decrease in motor vehicle output reduced the overall growth by 0.9 percentage points.¹

GDP growth varies considerably by region as well, though government statistics are not as timely for state output as they are for state employment or industry production. That said, the Far West, Rocky Mountain, and Southwest regions of the U.S. have been growing considerably faster than the Plains, Great Lakes, and New England states. For example, Washington State grew 5.6 percent in 2006 while Illinois grew 3.0 percent.²

Similarly, labor markets are performing differently across the country and across industries, with some areas of elevated unemployment and other areas where jobs are still relatively plentiful. For examples, employment in the healthcare sector increased nearly 1 million from January 2003 to September 2006 and has since grown by an additional 530,000 jobs. In the construction sector, employment also increased by about 1 million from January 2003 to September 2006 but has since fallen by 400,000 jobs.

By state, the employment situation varies considerably as well. During the twelve months from February 2007 to February 2008, twenty-six states and the District of Columbia saw an increase in their unemployment rate and twenty states saw a decrease in their unemployment rate. In February, the unemployment rate was the highest in Michigan at 7.2 percent and lowest in Wyoming at 2.7 percent. Figure 1, reproduced from the Bureau of Labor Statistics (BLS), illustrates the variation in unemployment by state for February 2008.

Forty-three states and the District of Columbia saw employment gains in February 2008. The largest percent increases in employment were in Wyoming, Texas, Utah, Washington, and Colorado. Seven states experienced declines in employment, the largest of which were Rhode Island, Michigan, Florida, Wisconsin, and Nevada.³

¹ See "Gross Domestic Product: Fourth Quarter 2007 (Final)," Bureau of Economic Analysis News Release, March 27, 2008, Appendix A. Accessible at <http://www.bea.gov/newsreleases/national/gdp/2008/pdf/gdp407f.pdf>.

² See "Gross Domestic Product (GDP) by State, 2006," Bureau of Economic Analysis (BEA) New Release, June 2, 2002. Accessible at http://www.bea.gov/newsreleases/regional/gdp_state/gsp_newsrelease.htm

³ See "Regional and State Employment and Unemployment: February 2008," Bureau of Labor Statistics News Release, March 28, 2008. Accessible at <http://www.bls.gov/news.release/pdf/laus.pdf>

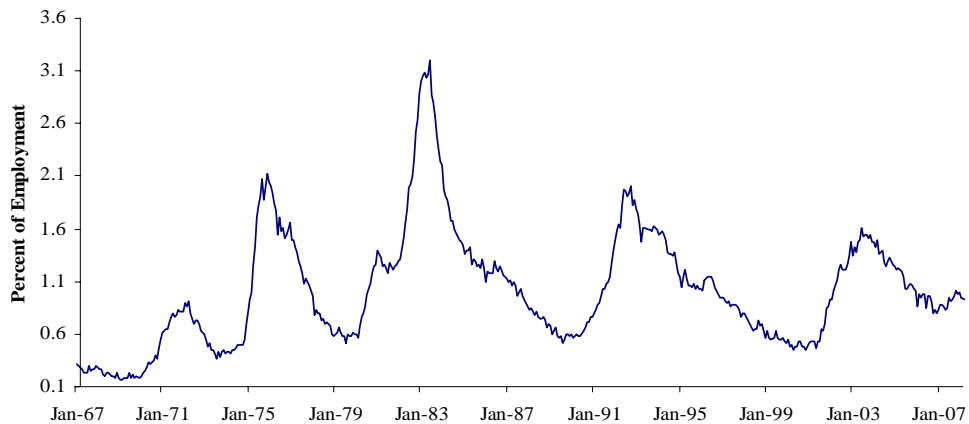
rate increased significantly from February to March. While gross job creation and gross job destruction are both over 2 million a month, net job creation has been negative for three consecutive months. Neither the long-term unemployment rate nor the share of unemployed that are long-term unemployed are high by historical average. Both initial jobless claims and long-term unemployment as a share of total employment have increased over the past year but remains low by historical comparison (See Figure 2 and Figure 3). Finally, aggregate labor market conditions, even after controlling for shifts in the workers' age, are better than when extended benefits were passed by Congress in February 2002 (See Table 1).

Figure 2. Weekly Initial Jobless Claims as a share of total employment, monthly averages, 1967-present



Source: Author's calculations using data on unemployment insurance weekly claims, Department of Labor and total nofarm employment data from Bureau of Labor Statistics Current Employment Survey; data is seasonally adjusted

Figure 3. Long-term unemployed as a share of total employment, 1967-present



Source: Author's calculations using data on workers unemployed 27 or more weeks and total nofarm employment data from Bureau of Labor Statistics Current Population Survey & Current Employment Survey; data is seasonally adjusted

Table 1. Unemployment Rate by Age Group			
Ages	Unemployment Rate (percent)		
	Mar-08	Feb-02	Aug-91
16-19	15.8	16	18.9
20-24	9.3	9.7	10.8
25-34	5.3	5.8	7
35-44	3.8	4.4	5.3
45-54	3.5	3.9	4.6
55+	3.4	3.9	3.9
Aggregate Unemployment Rate	5.1	5.7	6.9
Mar-08 Unemployment weighted by Feb-02 Labor Force Share		5.2	
Mar-08 Unemployment weighted by Aug-91 Labor Force Share			5.5
Note: February 2002 and August 1991 were when Congress first voted to provide extended UI benefits in previous cycles			
Source: Bureau of Labor Statistics for distribution of worker's and unemployment rate by age category. Concept based on Rebecca Blank (2008)			

Theoretical view on optimal unemployment insurance

The theory of optimal unemployment insurance design suggests a balancing act between two competing forces. On one hand, labor market rigidities (such as minimum wage, union bargaining powers, and employment protections), liquidity constraints for many households (namely the inability for many households to borrow against future earnings), and a tax system that distorts the decision between current consumption and savings (thereby discouraging precautionary savings for unemployment spells), make it appropriate for a program such as unemployment insurance to assist displaced workers so that they have resources to obtain the next best employment opportunity.

On the other hand, too much unemployment insurance (determined by the duration of benefits, the replacement rate of previous wages or both) will lead to an increased duration of unemployment through a decreased incentive to find a job. This will lead to a higher unemployment rate and lower levels of economic output and growth.

Furthermore, the unemployed are a heterogeneous population. Unemployed workers have varying degrees of precautionary savings (including zero) and may or may not have spousal income

to rely on during a period of unemployment. As a result, optimal unemployment insurance varies across the unemployed population and therefore a single benefits rule is inherently imperfect.

The optimal duration of unemployment benefits for a given worker is also a function of current labor market conditions that are inherently local in nature and skill specific. Therefore, when conditions deteriorate in a particular labor market, it is reasonable to offer additional benefits since finding a job is likely to take longer. Of course, the current law extended benefit (EB) program is designed to address these concerns by providing additional benefits for states with high and rising unemployment. However, due to a variety of changes to the U.S. economy, population, and labor market, these triggers may be too high to be effective. In general, the triggers for the current law EB program were set when the natural rate of unemployment was considerably higher. Therefore in today's economy, EB is considerably less likely to be triggered during a period of weak labor markets than when it was first implemented.⁴

Therefore, when Congress considers changes to unemployment insurance to provide additional assistance to unemployed workers, it is important to design a targeted program that, to the extent possible, provides additional benefits only to workers where labor markets are slack and only on a temporary basis.

The Stimulus Digression

I would like to emphasize that the benefit of a well-designed UI system is that it promotes labor market efficiencies and long-run economic growth. One commonly emphasized economic perspective of unemployment insurance (UI) is that providing extended benefits is an effective tool for economic stimulus. I disagree and believe that while a well designed system, which compensates for labor market imperfections and rigidities will boost economic growth in the long-run, providing UI benefits that exceed the optimal level and duration will not provide measurable positive short-term stimulus.

Why do I believe that there are only small short-term effects? First, while providing additional dollars to unemployed workers is likely to result in a relatively large share of those dollars being used to stimulate aggregate demand, there is a potentially offsetting effect as workers may remain out of the workforce longer. As a result, they will not contribute to aggregate supply

⁴ The Congressional Budget Office estimates the natural rate of unemployment in the U.S. to be 5.0 percent, a decrease of over 1 percentage point since 1981 when the extended benefits program was last changed. See Brauer, David, "The Natural Rate of Unemployment," Working Paper Series 2007-06 Congressional Budget Office, April 2007.

and not receive as much income as they would if employed. Second, even the most generous proposals for extending unemployment benefits are small relative to the \$14 trillion U.S. economy. Furthermore, estimates of the multiplier effect of UI cited by some policy analysts (Chimerine, et al. 1999) relate to the effects of the current program, not the marginal effect of an expansion of the program. Finally, Harvard University Professor of Economics Martin Feldstein testified in 2007 that notes, “[w]hile raising unemployment benefits or extending the duration of benefits beyond 26 weeks would help some individuals ... it would also create undesirable incentives for individuals to delay returning to work. That would lower earnings and total spending.”⁵ UI policy should be based on labor-market efficiency, not short-run stimulus.

Labor market flexibility

Unemployment insurance is a key government policy that affects the degree of labor market flexibility in an economy and labor market flexibility is a key for economic growth. Countries with more generous unemployment insurance tend to have higher levels of unemployment and slower growth. The International Monetary Fund’s 2003 *World Economic Outlook* noted that “The persistence of high unemployment in a number of industrial countries... is arguably one of the most striking economic policy failures of the last two decades. A wide range of analysts and international organizations... have argued that the cause of high unemployment can be found in labor market institutions.”⁶ The IMF also estimates that if Europe were to adopt labor market institutions and structures similar to the United States that economy could experience additional economic growth of five percent.

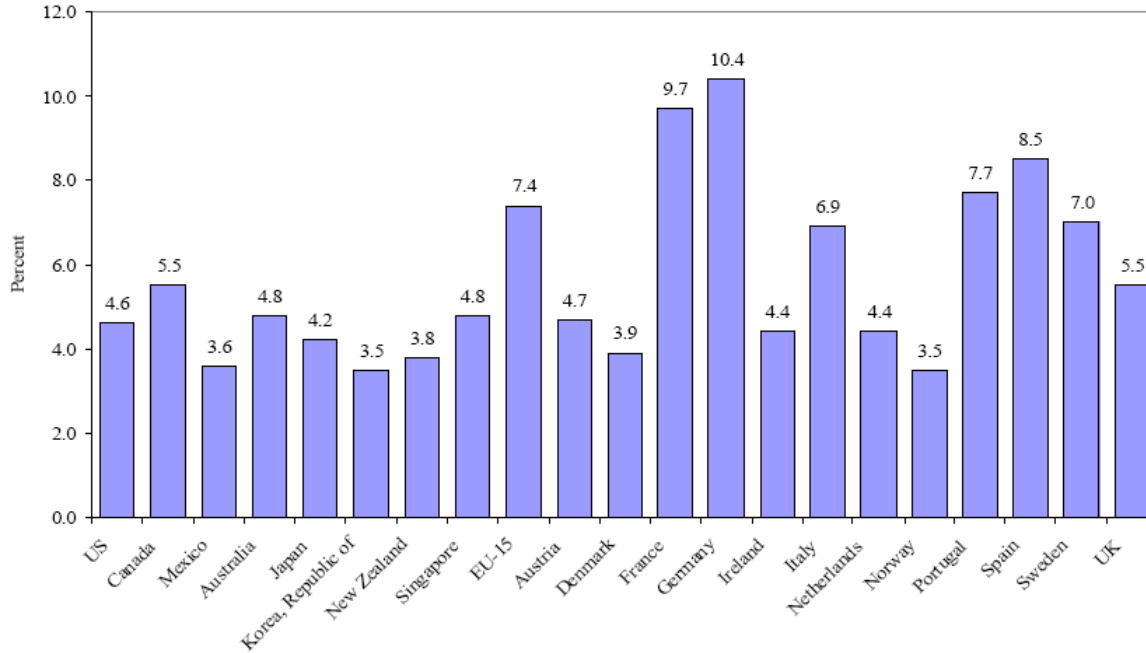
While extending unemployment benefits beyond 26 weeks is only one change in labor market protections among the many differences that exist between the U.S. and Europe, it is one that in a full-employment economy would tend to raise unemployment and slow economic growth. As the following charts indicate, the U.S. had a lower unemployment rate and a lower long-term unemployment rate lower in 2006 compared to most OECD countries. The U.S. also has smaller public expenditures on labor market programs as a share of GDP, less labor market regulations, and lower income and social security tax burdens for average workers than most OECD countries. Over the last ten years, the U.S. economy has grown faster on a per capita basis than all of Western Europe except Ireland, Spain, and Sweden. Taken together, this data suggests that increasing the

⁵ The Senate Finance Committee, “Testimony of Martin Feldstein” January 24, 2007 <http://www.senate.gov/%7Efinance/hearings/testimony/2008test/012408mfest.pdf>

⁶ The IMF, *World Economic Outlook: Growth and Institutions*, 2003.

generosity of unemployment benefits to be more similar to other developed countries could likely lead to higher unemployment and slower growth in the U.S.

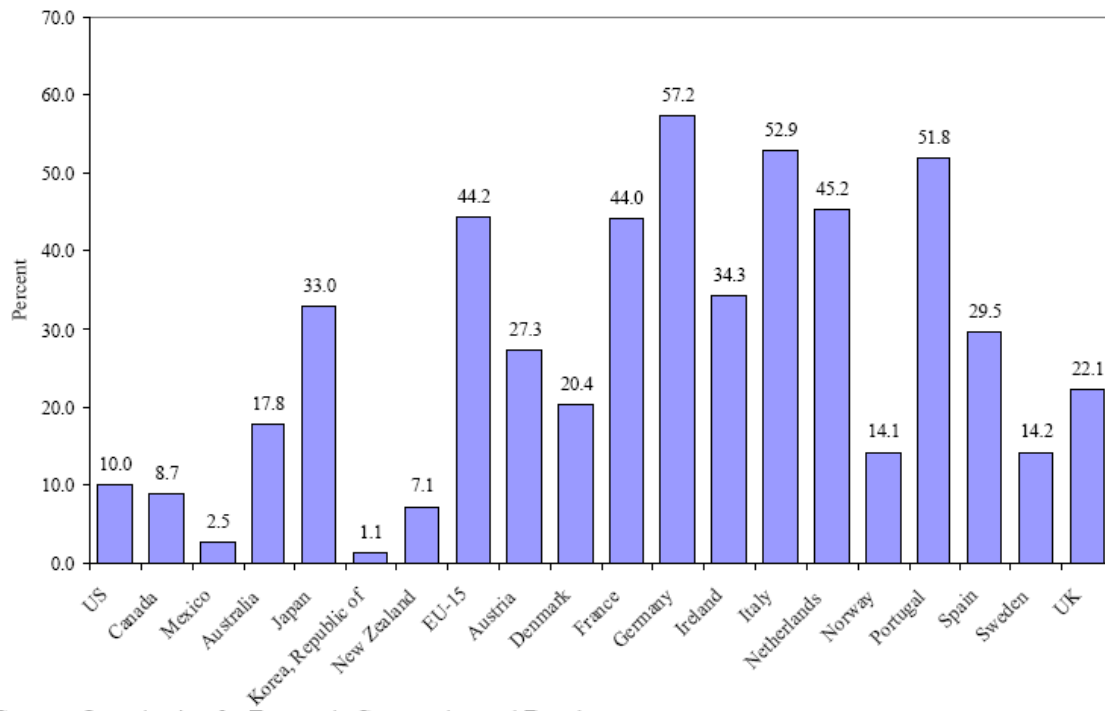
Figure 4: Unemployment Rate, 2006



Note: 2004 for Singapore

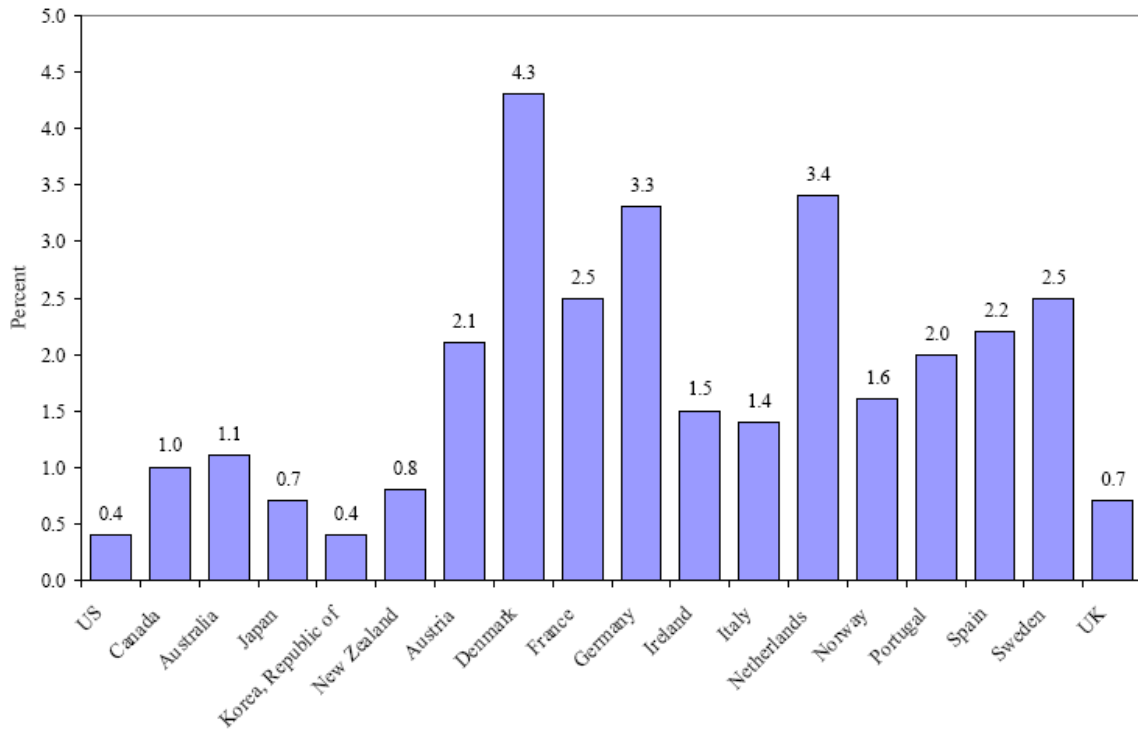
Source: Bureau of Labor Statistics, Organization for Economic Cooperation and Development, and International Labor Office

Figure 5: Persons unemployed one year or longer, 2006



Source: Organization for Economic Cooperation and Development

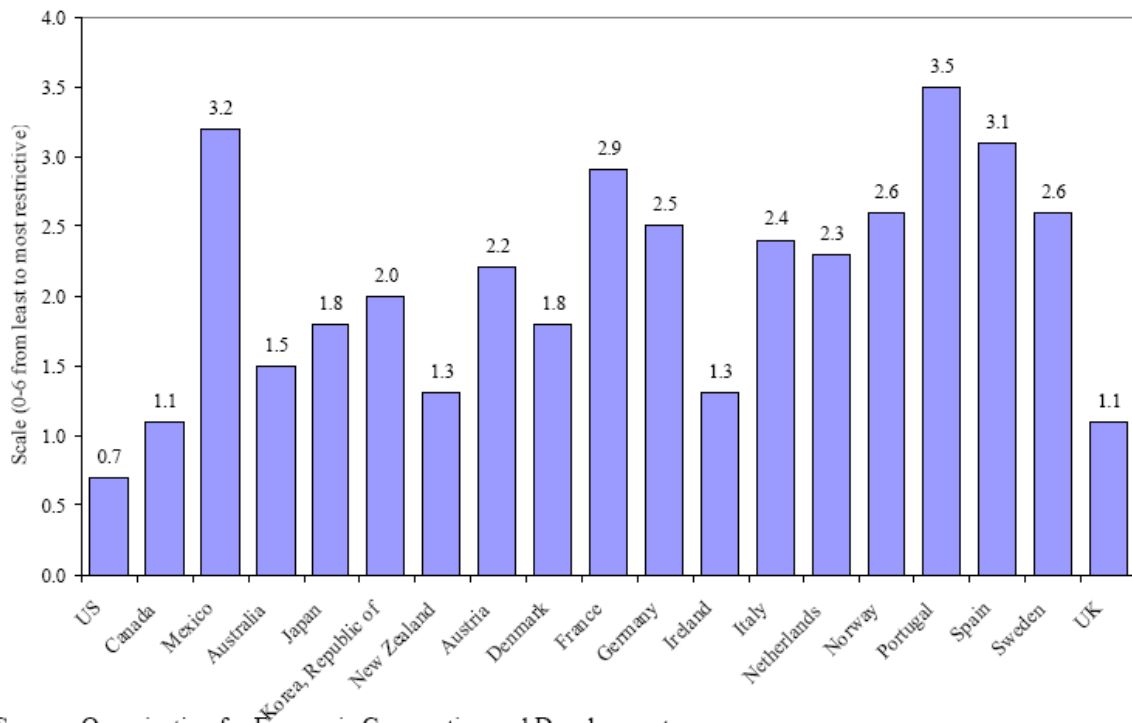
Figure 6: Public Expenditures on labor market programs as a share of GDP, 2005-06



Note: 2005 for the Republic of Korea, Austria, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, and Sweden. Fiscal year 2005 for the United Kingdom. Fiscal year 2006 for the United States, Canada, Australia, Japan and New Zealand.

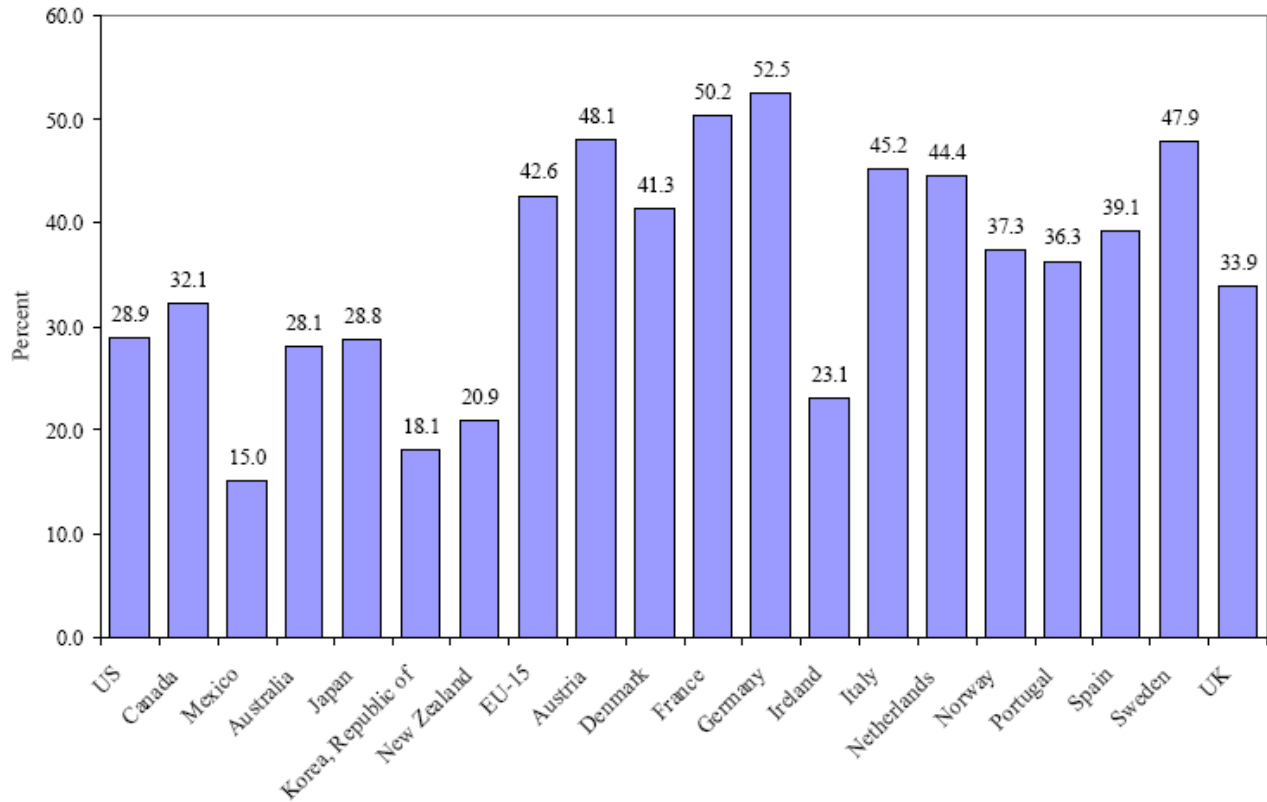
Source: Organization for Economic Cooperation and Development

Figure 7: Measures of regulation on labor markets, 2003



Source: Organization for Economic Cooperation and Development

Figure 8: Share of labor cost taken by tax and social security contributions, 2006



Note: Data refer to single persons without children at the income of the average worker
 Source: Organization for Economic Cooperation and Development

Alternatives to current unemployment insurance program

I would like to conclude my testimony by noting that alternatives to the current unemployment insurance program could be designed to adequately address the limited liquidity of a large fraction of unemployed and other short-comings in labor markets without creating a discouraging job search. For example, Joseph Stiglitz and Jungyoll Yun (2005)⁷ propose combining an unemployment insurance system with the public pension system (Social Security). Martin Feldstein and Daniel Altman (2007)⁸ propose unemployment insurance savings accounts (UISAs), where workers would contribute a share of their wages and be allowed to draw from the account should they become unemployed. The UISA accounts would provide an incentive for workers to

⁷ Stiglitz, Joseph and Yun, Jungyoll “Integration of unemployment insurance with retirement insurance,” *Journal of Public Economics*, Vol. 89. December 2005, pp. 2037-2067.

http://www2.gsb.columbia.edu/faculty/jstiglitz/download/2005_Unemployment_Insurance.pdf

⁸ Feldstein, Martin S. and Altman, Daniel. "Unemployment Insurance Savings Accounts." in James Poterba, ed., *Tax Policy and the economy*. Vol. 21. Cambridge, MA: MIT, 2007, pp.35-58.

find employment promptly. Only those with a negative balance in their account would face the biased incentives which exist in the current system.

Other alternatives are also worthy of consideration, including mandating that employers purchase private insurance to provide unemployment insurance to their workers, or offering reemployment incentives to encourage shorter unemployment spells. Wage insurance is yet another alternative or complimentary policy that could assist workers during changes in labor markets. Finally, more incremental reforms could also improve the efficiency of the current system such as reforms to improve the experience rating system – which currently imprecisely relates the employers' history of laying off workers to their unemployment tax.

Conclusion

While the U.S. labor market has deteriorated in the last few months, aggregate conditions are not worse than they were when extended UI benefits were enacted in 2002. More important than national statistics are those related to specific labor markets and industries. Any legislation to provide additional unemployment benefits should be carefully targeted to limit the moral hazard effect. Furthermore, any extension of benefits should be temporary so not to continue when the economy returns to trend growth. Finally, I encourage the Committee to consider fundamental reforms to the UI system as alternative approaches may improve labor market efficiencies, raise employment and strengthen the U.S. economy.

I am happy to answer any questions.