NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

UNEMPLOYMENT INSURANCE

Enacted as part of the Social Security Act of 1935, Unemployment Insurance (UI) serves as a safety net for American workers, providing temporary financial assistance when workers lose their job. Today, the federal and state governments cooperate to provide UI, each sharing part of the costs (2). Most state governments provide benefits for up to 26 weeks of unemployment. If the federal government wants individuals to receive UI for a longer period, it kicks in funds for the additional benefits. During bad economic times, the federal government often extends UI to help struggling job-seekers. One example: following the 2008 financial crisis and recession, the federal government provided some workers with UI for as long as 99 weeks.

Governments pay for UI benefits by taxing employers on a percentage of their employees' paychecks, resulting in lower wages for employees. Employers generally pay the same basic UI tax, but some states levy additional taxes on companies that recently laid off workers.

GENEROUS UNEMPLOYMENT INSURANCE BENEFITS PROLONG JOBLESSNESS

Guaranteeing a minimum level of income through UI benefits sounds nice, but there are two unintended consequences that lead to extended joblessness and keep labor markets from getting back into balance.

First, in many cases individuals will engage in "excessive search"—holding out for that perfect job opportunity far longer than is reasonable or applying for jobs they are unlikely to receive. With UI benefits in place, engaging in excessive search is a win-win for job seekers: even if they don't get that perfect job, they can continue to receive UI payments for weeks on end. Second, UI benefits also increase what economists refer to as a workers' "reservation wage," the minimum compensation level a job-seeker will demand before they accept a new job offer. Workers can feel free to pass on lower-paying job opportunities because UI benefits keep them comfortable in the meantime. This also prevents wages from adjusting to economic conditions, which is sometimes a necessary correction in a market economy during a downturn.

An individual's ability to voluntarily seek and accept jobs for which they are qualified and which allow them to employ their skills in return for compensation is absolutely essential to the proper functioning of a free market economy. But UI payments encourage individuals to needlessly extend their job search and hold out for unrealistically high paying jobs, not at their own expense, but at the expense of the millions of taxpayers supporting them.

Several studies have confirmed that, in practice, UI does encourage individuals to remain unemployed for longer. Alan Krueger, a Princeton economist and head of the President's Council for Economic Advisors, co-authored a recent study showing that UI benefits prolong joblessness and contribute to higher unemployment rates (3). Jesse Rothstein of the University of California Berkley recently confirmed Krueger's observation: extended UI benefits increased unemployment during the Great Recession (4).

QUICK FACTS

- Unemployment insurance actually contributes to higher unemployment by encouraging individuals to remain jobless.
- Unemployment insurance taxes push businesses to needlessly lay off employees because it increases the cost of hiring and retaining workers.

NOTABLE & QUOTABLE

"Europe's generous unemployment compensation system has made an important contribution to sustained high European unemployment...[I]f, in the United States, we create a system where unemployment and disability benefits are permanently extended in their generosity and their duration, we will inadvertently put ourselves into the situation that much of Europe has suffered for three decades."

\- **Thomas Sargent**, Economist (1)

Other studies have shown that some workers may hold out just long enough to maximize the benefits received while on UI: Lawrence Katz and Bruce Meyer of Harvard and Northwestern University, respectively, find out that there are sharp increases in reemployment right before UI benefits are scheduled to run out (5)

DO UNEMPLOYMENT INSURANCE CHECKS STIMULATE THE ECONOMY?

Proponents of generous UI benefits argue that UI stimulates the economy because it gives jobless consumers more money to spend on goods and services. To pay for such "stimulus," however, government must increase UI taxes (which take resources away from current workers) or borrow more money (which takes resources away from future generations). UI benefits merely transfer money from one employee to another, or from future generations to the present.

As economist Arthur Laffer explains: "While the unemployed may spend more as a result of higher unemployment benefits, those people from whom the resources are taken will spend less. In an economy, the income effects from a transfer payment always sum to zero. Quite simply, there is no stimulus from higher unemployment benefits" (6). The Cato Institute's Alan Reynolds adds: "Whether the government pays people to work or to stay on the dole, it has to get the money by taxing, borrowing or printing money — all of which reduce real income and employment opportunities in the private sector... If every dollar of unemployment benefits really added $1.61 to real GDP, then putting everyone on the dole would make us all much richer" (7). This clearly cannot be the case.

UI taxes themselves can be a drag on the economy. One report from the Advisory Council on Unemployment Compensation showed that UI taxes pushed employers to lay off more workers than they originally planned. Taxes can become so burdensome that employers lose money they need to pay their current employees and, eventually, employers have to let them go (8).

CONCLUSION

Unemployment insurance causes both job-seekers and employers to make decisions that depress employment in the economy. Job-seekers receive benefits that encourage them to remain unemployed while employers pay taxes so burdensome that they have fewer resources to pay their current employees. While UI is undoubtedly well-intentioned, policymakers should keep these severe unintended consequences in mind.

Endnotes:

1. Federal Reserve Bank of Minneapolis, Interview with Thomas Sargent, The Region (September 2010) (online at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4526).
2. Joseph D. Henchman, Unemployment Insurance Taxes: Options for Program Design and Insolvent Trust Funds, Tax Foundation, Background Paper No. 61 (October 2011) (online at http://www.taxfoundation.org/news/show/27673.html).
3. Lachlan Markay, White House's New Top Economist: Unemployment Benefits Are Not Stimulus, The Heritage Foundation (August 2011) (online at http://blog.heritage.org/2011/08/29/white-houses-new-top-economist-unemployment-benefits-are-not-stimulus/).
4. Jesse Rothstein. Unemployment Insurance and Job Search in the Great Recession. University of California, Berkeley (October 2011) (online at http://gsppi.berkeley.edu/faculty/jrothstein/published/rothstein-ui-july132011.pdf)
5. Lawrence F. Katz and Bruce D. Meyer, The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment, NBER Working Paper No. 2741 (July 1990) (online at http://www.nber.org/papers/w2741).
6. Arthur B. Laffer, Unemployment Benefits Aren't Stimulus, The Wall Street Journal (July 8, 2010) (online at http://online.wsj.com/article/SB10001424052748704862404575351301788376276.html)
7. Alan Reynolds, Can Unemployment Benefits Create Jobs?, The Cato Institute, Cato @LibertyBlog (January 2010) (online at http://www.cato-at-liberty.org/can-unemployment-benefits-create-jobs/).
8. Advisory Council on Unemployment Compensation, Collected Findings and Recommendations: 1994-1996, at 39 (1996).

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