Economic Research Note

US: unemployment benefits, participation, and the Fed

- **Extended unemployment benefits are scheduled to expire on January 1**
- **Expiration of these benefits could lower labor force participation**
- **This, in turn, would depress the unemployment rate, by perhaps 0.25%-0.50%-pt**
- **Any further decline in the unemployment rate could complicate the Fed's communications efforts**

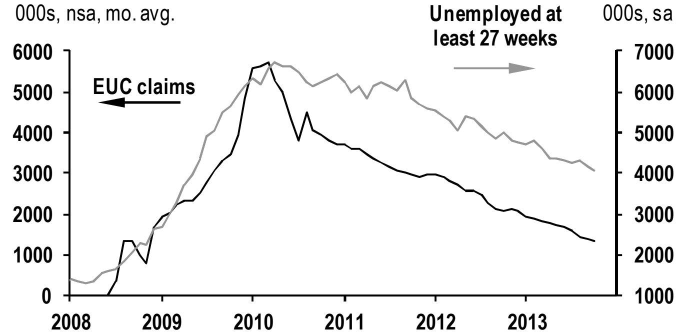
Funding for the Emergency Unemployment Compensation program (EUC) is scheduled to dry up on January 1. This program currently provides extended unemployment benefits for about 1.3 million enrollees, and its expiration could have a noticeable effect on the economic data, particularly as it relates to the labor market. This isn't the first time that EUC has been scheduled to lapse, and in the past Congress has found the funds to keep the program going. While we don't know how Congress will approach the upcoming expiration of EUC, major media sources are indicating that there is less support for extending EUC than there has been in the past.

The labor market impact of EUC has been the topic of intense study in recent years, with much of the analysis focused on how this program has affected the unemployment rate. In principle, the presence of a program like EUC could raise the unemployment rate through two channels. First, there is an employment effect. Unemployment benefits may raise an individual's "reservation wage" —the minimum acceptable wage from a job offer—such that job search time is increased, and matches between unemployed individuals and vacant jobs is decreased. Second, there is a participation effect. Individuals who might otherwise leave the job market are incentivized to stay in the labor force as long as they receive unemployment benefits, which are only available to jobseekers.

Unemployment benefits can impact labor market outcomes through channels other than jobseeker behavior. For example, increased consumer spending due to jobless benefits could boost overall economic growth and thus job creation, while at the same time higher reservation wages could decrease employers' propensity to create new job vacancies—two channels we discuss further below.

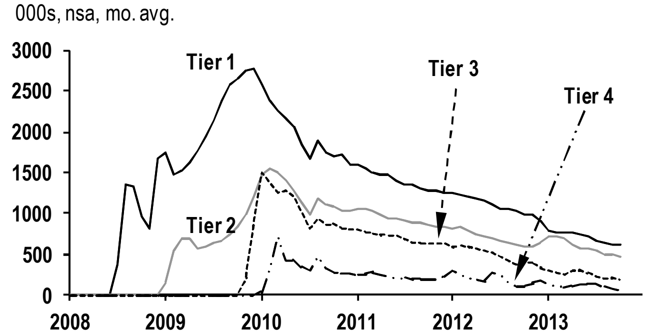
Estimates of the effect on the unemployment rate vary, but the average estimate indicates about a 1%-pt increase in the

EUC claims and people unemployed at least 27 weeks



Source: DoL, BLS

EUC claims by tier



Source: DoL

unemployment rate due to EUC. These studies also differ in assessing the relative importance of the employment vs. participation effect, though the evidence seems to lean slightly in favor of the participation effect being more important. These estimates were generally formed earlier in the recovery, when the unemployment rate was higher and EUC enrolled greater numbers, creating some issues in using this research to form a point estimate of the effect of an expiration of EUC on the labor market. However, applying the results of some of this research would indicate that the lapsing of EUC could lower the unemployment rate by perhaps 0.25%-0.50%-pt, with much of the effect coming through reduced labor force participation, rather than increased employment. Setting aside the normative aspect of whether from a public policy perspective this is a desirable or undesirable outcome, such a fall in the unemployment and participation rates could create some tricky choices for Fed policymakers as they assess the health of the labor market.

A big program

In normal times, unemployment benefits are generally available for about 26 weeks. In 2008, as the economy began to weaken, EUC was established to provide additional aid for laid-off jobseekers who could not find work within the normal six-month period. In subsequent years EUC was expanded to include four tiers of extended benefits, with the maximum length of availability varying by state depending on the prevailing unemployment rate in each state. While Congress has enacted extended benefits in past periods of economic weakness, EUC was generally much more extensive than those past programs, at one point helping to provide a maximum of 99 weeks of unemployment benefits to jobseekers in hard-hit states. Over the life of the program, EUC has paid out over $225 billion, making it one of the more important federal responses to the economic weakness experienced in recent years.

One-handed economists, many of them

Given the size of the EUC program, there is little wonder that it has attracted considerable attention from researchers. Economists within the Federal Reserve System have been particularly active in trying to assess the impact of extended benefits on the labor market. The table on the right summarizes the Fed research that pertains to the extension of unemployment benefits. As noted earlier, the center point for most estimates indicates a 1%-pt increase in the unemployment rate due to the presence of extended benefits. To the extent that the research attempts to distinguish the employment effect from the participation effect, most, but not all, find the participation effect more important.

The dated nature of the research makes a direct application of these estimates problematic. One observation that could set an upper bound on thinking about a participation effect is to hypothesize that all 1.3 million EUC claimants exit the labor force after benefits expire in 1Q (again, should Congress allow that to happen). In that case, the unemployment rate would fall by 0.8%-pt, obviously an extreme example. Some of the Fed studies can help to narrow the range of outcomes. One of the more recent works (Farber and Valletta from the San Francisco Fed) indicates that about a fifth of long-term unemployment is due to extended benefits. With just over 4 million long-term unemployed recently, this would imply that the absence of extended UI benefits could lower the unemployment rate by 0.5%-pt. An even simpler application of the earlier research is to observe that EUC currently has about one-fourth the enrollment it did at its peak, and thus the participation and unemployment rate effect might be one-fourth as large, or about 0.25%. Taking account of the assorted evidence, while the depressing effect on the unemployment rate from the expiration of EUC could range from 0.0% to 0.8%-pt, we see as more likely something in the middle: 0.25%-0.5%-pt.

Federal Reserve System research on labor market effects of extended unemployment benefits

Researcher	Quote/comment
Aaronson, Mazumder and Schechter (Chicago, 2010)	Extension of benefits raised the unemployment rate by 0.7%-point in late 2009
Elsby, Hobijn and Sahin (New York and San Francisco, 2010)	Extension of benefits raised the unemployment rate by between 0.7% and 1.8%-point in late 2009, though likely toward the bottom of this range
Valletta and Kuang (San Francisco, 2010)	“we calculate that, in the absence of extended benefits, the unemployment rate would have been about 0.4 percentage point lower at the end of 2009”
Fujita (Philadelphia, 2011)	"extended benefits in recent years have raised male worker' unemployment rate by 1.2 percentage points" Finds employment effect more important
Hu and Schechter (Chicago, 2011)	From Oct 2009 to Jan 2011 between 0.1 and 0.3% of the unemployment rate decline (or 10-25%) was due to unemployment benefit exhaustion. Finds participation effect more important
Mazumder (Chicago, 2011)	“extension of unemployment insurance benefits during the recent downturn can account for somewhere in the neighborhood of 1% point of the increase in the unemployment rate.”
Nakajima (Philadelphia, 2011)	“the ongoing UI benefit extensions are found to have raised the unemployment rate by 1.4% points”
Farber and Valletta (San Francisco, 2013)	"substantial fraction (15-25%) of long-term unemployment…is due to the availability of extended UI benefits" Finds participation effect more important.
Ghayad (Boston, 2013)	Places an upper bound of one-half on the shift in the Beveridge curve attributable to unemployment benefits

Source: Various Federal Reserve System documents

But wait, there’s more…

The research cited in the table generally looks at the impact on jobseeker behavior due to the presence of extended unemployment benefits. However, other effects are possible. For example, researchers from the NY Fed (Hagedorn, Karahan, Manovskii, and Mitman) find a substantial decrease in employer job creation due to extended benefits. Another potential effect is through reduced spending by benefit recipients. EUC currently pays out benefits at around a $20-25 billion annual rate; should that flow dry up, consumer spending could take a hit in 1Q, perhaps subtracting around 0.4%-pt from annualized real GDP growth in that quarter.