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Unemployment Insurance: Economic Lessons from the Last Two Recessions

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In this Economic Brief, we give an overview of the changes that have taken place in the unemployment insurance system during the last two severe economic episodes: the Great Recession and the COVID-19 pandemic. We discuss how unemployment benefits supported households' consumer spending and whether it slowed labor market recovery.

The unemployment insurance system provides an important financial cushion to people who have lost their job and are actively seeking reemployment. The design of the system balances two considerations: benefits and costs.

Regarding benefits, the partial replacement of wages and salaries helps unemployed people to resume a relatively normal level of spending on goods and services. In ordinary times, this system replaces around half of workers' lost earnings for a duration of about half a year.

Empirical evidence has shown that the unemployed spend a large fraction of their unemployment insurance income, which also helps the overall economy to recover faster from a recession. Furthermore, the financial assistance allows workers to search longer for a desirable job, enhancing the productivity and ensuring the longevity of the job match.

Regarding costs, workers receiving unemployment insurance have less financial incentive to search for a new job. Further, they may also decline suitable job offers in hopes of landing better ones.

In turn, this can also cause firms to create fewer new vacancies. If unemployed workers have more ability to wait for higher wages and posting new vacancies requires some costs, companies may wait to create jobs until these workers are more willing to accept lower wages.
In this *Economic Brief*, we discuss the empirical evidence surrounding these two aspects of unemployment insurance:

- The consumer spending response upon receipt of unemployment benefits
- The effect of unemployment benefits on employment recovery

We use as reference the rich literature that has emerged following the last two severe economic episodes: the Great Recession and the COVID-19 pandemic. Both periods had a very large (by historical standards) rise in unemployment and a generous expansion of the unemployment insurance system.

**The Three Categories of Unemployment Insurance Programs**

Unemployment insurance programs can be classified in three categories:

- Regular unemployment benefits program
- Extended benefits program
- Emergency benefits program

**Regular Unemployment Benefits Program**

The regular unemployment benefits program is funded by states. It typically provides 26 weeks of unemployment benefits and replaces around 45 percent of lost earnings. States pick the parameters, such as the replacement ratio, the duration of benefits and who is eligible.

A universal requirement is that workers must have lost their jobs through no fault of their own and are actively searching for a new job. Unemployment insurance does not cover people entering the labor force for their first time, people reentering the labor force after leaving voluntarily, self-employed workers and gig workers.¹

**Extended Benefits Program**

The extended benefits program provides an additional 13-20 weeks of unemployment insurance to people who have exhausted their regular benefits and who live in states experiencing a severe economic downturn. Extended benefits are triggered by changes in the level or rate of increase in a state's unemployment rate, and funding for the benefits is split between the state and federal government.

**Emergency Benefits Program**

During an economic crisis, the federal government can pass laws to provide additional unemployment insurance in terms of longer duration of benefits and/or a higher replacement ratio. Historically, emergency unemployment insurance has been fully funded by the federal government.
In response to the Great Recession, Congress significantly expanded the duration of unemployment benefits. The Emergency Unemployment Compensation (EUC) provided an additional 34 weeks of unemployment benefits to all states uniformly, while states with a very high unemployment rate were eligible for an additional 13-19 weeks. Thus, people in states with very high unemployment were eligible for a maximum of 99 weeks of benefits:

- 26 weeks of the regular program
- 20 weeks of extended benefits
- 53 weeks of EUC

In response to the unprecedented job loss due to COVID-19, Congress passed the CARES Act in March 2020, which provided a $600 weekly supplement to unemployed workers on top of any regular unemployment benefits. This supplement meant total unemployment benefits replaced around 1.5 times the lost earnings of the median worker. The $600 supplement expired at the end of July 2020, and a $300 supplement was enacted in January 2021 for the period through September 2021 (after initially being enacted for only six weeks).

An additional provision was the expansion of benefits to self-employed individuals, part-time workers and those who otherwise would not qualify for regular unemployment compensation. Also, people who were unable or unavailable to work because of the health consequences of the COVID-19 pandemic were also considered eligible.

**How Unemployment Insurance Impacts Spending**

The consumption response to government programs is traditionally hard to measure. Data on consumption are scarce and often plagued with significant measurement error, which makes statistical inference difficult and imprecise.

In a series of papers, Peter Ganong and Pascal Noel overcome this problem by using individual-level transactions from debit and credit cards. In their 2019 paper "Consumer Spending During Unemployment," they tracked bank accounts of individuals between 2014-2016 and documented the following patterns:

- Spending declines by about 6 percent when unemployment begins and remains at this level during the duration of unemployment.
- People who find a new job slowly increase their spending but don't reach the same pre-unemployment spending level even a year after reemployment.
- Individuals further decrease their spending by another 12 percent if they don't have a new job when their benefits expire.

Overall, the authors estimate that an extra dollar from unemployment insurance results in $0.27 being spent on nondurable goods.
The authors (with additional co-authors) expanded their exercise to study the consumption response of unemployment recipients to the $600 supplement provided by the CARES Act. According to their 2021 working paper "Spending and Job Search Impacts of Expanded Unemployment Benefits," both the income and the spending of unemployment recipients in the beginning of the pandemic rose by around 25 percent and 20 percent, respectively, relative to pre-pandemic levels. This finding is explained by the large replacement ratio provided by the CARES Act to unemployed individuals (as mentioned, around 1.5 times the usual weekly earnings).

On the other hand, the spending of employed individuals declined during the first months of the pandemic. This is consistent with the findings of Raj Chetty and co-authors' 2020 working paper "The Economic Impacts of COVID-19," which documents that high-income households experienced a larger decline in spending (30 percent) between February and the end of March than low-income households (20 percent).

**How Unemployment Insurance Impacts Labor: Individual Workers**

While there are only a few articles documenting the consumption response to unemployment insurance, there is a large literature analyzing the employment effects arising from extending unemployment benefits.

In their 2010 paper "Job Search and Unemployment Insurance," Alan Krueger and Andreas Mueller find that the maximum weekly benefit amount for unemployment insurance eligible workers decreases the time they spend looking for a job. Furthermore, they find that job searches intensify in the weeks prior to benefits running out and decline after they end, suggesting perhaps that unemployed people are discouraged about their employment prospects.

While researchers agree that unemployment insurance prolongs recipients' unemployment spells, the effects are typically estimated to be small. In his paper "Unemployment Insurance and Job Search in the Great Recession," Jesse Rothstein finds that unemployment insurance extensions have small negative effects on the probability that the eligible unemployed would find jobs.

**How Unemployment Insurance Impacts Labor: Firms and Job Openings**

Nonetheless, unemployment benefits can also impact the overall job finding rate. Creating and filling jobs is costly for any firm, and if job offers are more likely to be declined, firms might create fewer vacancies in the first place. In addition, unemployment insurance may raise the labor costs of production by enabling unemployed workers to wait for higher wages, further deterring some firms (especially unproductive units) from posting new positions or actively searching for new candidates.
Indeed, a decline in firms' recruitment efforts has been proposed to explain the divergence after the Great Recession between the relatively high number of vacancies created and the slow employment recovery.

However, there is mixed evidence regarding the macro effects of unemployment insurance. In the working paper "Unemployment Benefits and Unemployment in the Great Recession," Marcus Hagedorn and co-authors used employment data from the Great Recession to compare the employment recovery of counties that are adjacent but are in different states. This method allowed the authors to compare similar economic entities (adjacent counties) that experience changes in unemployment insurance for reasons tied to the state's performance and not necessarily their own.

The authors find that counties that extend unemployment benefit duration experience large negative employment effects compared to neighboring counties across state borders that don't. They interpret their findings as capturing the macro effect of unemployment insurance: Unemployment benefits affect firms' decisions to create vacancies.

On the other hand, the 2021 paper "Unemployment Insurance Generosity and Aggregate Employment" by Christopher Boone and co-authors employs the same research design but use a different dataset and a longer time period. The authors find that the negative macro effects of unemployment insurance are much smaller. And subsequent research that uses data on job applications and variation in real-time measurement error of the unemployment rate also point to a small macro effect of unemployment insurance. (Examples include Ioana Marinescu's 2017 paper "The General Equilibrium Impacts of Unemployment Insurance" and the 2019 paper "The Macro Effects of Unemployment Benefit Extensions" by Gabriel Chodorow, John Coglianese and Loukas Karabarbounis.)

**How Unemployment Insurance Impacts Labor: COVID-19**

How did the generous unemployment insurance supplement affect labor supply decisions during the pandemic? The first type of evidence shows modest or zero effect of unemployment insurance on employment. The 2020 working paper "Employment Effects of Unemployment Insurance Generosity During the Pandemic (PDF)" by Joseph Altonji and co-authors found that hourly workers in small businesses with larger expansion in their replacement ratio did not experience differential declines in employment relative to workers with smaller expansion in their replacement ratio after the CARES Act passed. Arindrajit Dube's 2021 working paper "Aggregate Employment Effects of Unemployment Benefits During Deep Downturns" also finds little impact of job gains from the benefit.

Building on the same bank-level data mentioned earlier (that is, individual-level transactions from debit and credit cards), the aforementioned paper "Spending and Job Search Impacts of Expanded Unemployment Benefits" finds negative yet small effects of unemployment insurance. The authors also document substantial instability in the pandemic labor market, with entry and exit being four times higher than usual.
Conclusion

Unemployment insurance offers an important safety net to people who lose their job. There is a broad consensus about the stimulating effects of unemployment insurance on consumer spending. Unemployed workers suffer large declines in their spending during the unemployment spell, and evidence suggests that the decline would be substantially higher absent the unemployment supplement.

But there is wide disagreement on how much unemployment insurance discourages unemployed people from quickly rejoining the work force. It is important to recognize all aspects of the unemployment insurance system so policymakers can offer long-term financial assistance without significantly disrupting the labor market.

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¹ We should also note that not all eligible workers collect their unemployment benefits. Even during the Great Recession, the recipiency rate did not rise above 40 percent, as noted in the 2019 paper "Unemployment Insurance and Macroeconomic Stabilization."

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