

## Economic Brief

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# Government Programs and Their Effects on Welfare and Employment: A Conference Recap

By John Mullin

How did the expansion of unemployment benefits during the pandemic affect aggregate spending and job search? What are the short-term and long-term effects of federal minimum wage hikes? Why do the effects of public pension retrenchments depend on how they are phased in? These were among the questions addressed by economists during a recent research conference.

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Economists from the Richmond Fed and research universities met in Richmond for a conference in March. Researchers presented papers on topics related to public policy, including expanded unemployment benefits, disability insurance, the minimum wage, public pensions and economic stimulus payments. This *Economic Brief* summarizes those presentations.

## Expanded Unemployment Benefits: Better-than-Expected Results

In response to the COVID-19 pandemic, the U.S. implemented the largest expansion of unemployment insurance (UI) benefits in its history. Weekly supplemental UI benefits ranged between \$300 to \$600 per person. The supplemental \$600 nearly tripled the usual benefits for the median UI recipient, whose resulting total benefits replaced 145 percent of lost income. The historically high level of benefits raises two important questions:

- How much did the expanded benefits increase consumer spending?
- How much did they discourage job finding?

Pascal Noel of the University of Chicago presented research that addresses these questions. The paper he presented — "[Spending and Job Search Impacts of Expanded Unemployment Benefits: Evidence From Administrative Micro Data](#)" — was co-authored

with Peter Ganong and Joseph Vavra of the University of Chicago and the National Bureau of Economic Research, and Fiona Greig, Max Liebeskind and Daniel M. Sullivan of the JPMorgan Chase Institute.

The researchers used anonymized bank account data covering millions of households to estimate workers' consumption and job search responses to the unprecedented UI benefits expansion. They found that — in sharp contrast to normal times when workers' spending *declines* after a job loss — workers who received supplemental UI benefits during the pandemic *increased* their spending. Using quasi-experimental research designs, they estimated a large marginal propensity to consume out of expanded UI benefits. Notably, they found that spending responses were large even for households that had built up substantial liquidity through prior receipt of expanded benefits, which contradicts the predictions of standard economic models.

Simple job search models predict a sharp decline in search in the wake of a substantial expansion of UI benefits, followed by a sustained rebound when benefits expire. Instead, the researchers found that the job finding rate remained quite stable during the pandemic.

According to the researchers, their findings suggest that expanded UI benefits during the pandemic were a more effective policy than predicted by standard structural models. Abstracting from general equilibrium effects, they estimated that the benefits expansion increased overall U.S. spending by a substantial 2.0 percent to 2.6 percent, while lowering employment by only 0.2 percent to 0.4 percent.

## **Expanded Unemployment Benefits: Isolating the Disincentive Effect**

Between March 2020 and April 2020, the U.S. economy shed 22 million jobs, a consequence of stay-at-home orders and business restrictions to slow down the spread of COVID-19. This, in turn, triggered the expansion of UI programs, which has fueled a vigorous debate about the extent to which it contributed to labor supply shortages and slowed economic recovery.

Marios Karabarbounis of the Richmond Fed presented his paper, "Disincentive Effects of Pandemic Unemployment Benefits," which he co-authored with Andreas Hornstein of the Richmond Fed, Etienne Lale of the University of Quebec at Montreal, and Andre Kurmann and Lien Ta of Drexel University. The paper emphasized that the overall effect of UI benefits on employment depends on two countervailing mechanisms:

- UI benefits have a disincentive effect on labor supply, which tends to impede job creation.
- UI benefits increase disposable income and thereby have a stimulative effect on aggregate demand, which tends to encourage job creation.

The authors conjecture that these offsetting effects may explain why some recent studies have found that expanded UI benefits during the pandemic had only a relatively small negative effect on employment.

The paper proposes a new research design to disentangle the disincentive effects of pandemic UI benefits from their stimulus effects. To that end, the authors build a quantitative equilibrium labor search model, which they estimate using payroll data on small service-sector firms provided by Homebase, an online payroll tool used by more than 100,000 small businesses. They find that within narrowly defined localities and industries, employment in low-wage establishments recovered significantly more slowly than employment in high-wage establishments (although employee work hours and wages grew more quickly in low-wage establishments than in high-wage establishments).

Based on these local-industry differences, they estimate that the gap in employment recovery between low-wage and high-wage establishments tends to be more pronounced in local industries with relatively high UI replacement ratios (that is, where UI benefits are high relative to employment income).

## **Subsidizing Firms to Accommodate Injured Workers**

Work-limiting disabilities and health shocks are some of the largest risks that workers face. These risks not only have large consequences for health spending but also affect longer-run labor market outcomes. In 2019, the Social Security Disability Insurance program and state workers' compensation programs provided wage replacement benefits costing \$145 billion and \$63 billion, respectively. Naoki Aizawa of the University of Wisconsin-Madison presented research that attempts to assess the efficiency of these programs. His paper — "[Firm Accommodation and the Design of Social Insurance: Evidence from Return to Work after Workplace Disability \(PDF\)](#)" — was co-authored with Corina Mommaerts of the University of Wisconsin-Madison and Stephanie Rennane of the RAND Corporation.

The paper focuses on an understudied yet potentially key determinant of a worker's return to work: employer flexibility. When employers are willing to adjust the work environment to accommodate the needs of workers who have suffered injuries, it not only encourages worker re-entry into the labor force but also increases worker productivity in the long run. Yet, although various policies have been proposed to encourage such accommodation, little is known about how these policies work in practice.

To study this, the researchers leverage detailed administrative data from a unique workers' compensation program in Oregon that provides wage subsidies to encourage firms to make workplace accommodations. Exploiting a policy change to the wage subsidy, they estimate that accommodation is responsive to wage subsidy incentives, and that accommodation has positive effects on long-term labor market outcomes, including employment and earnings.

They then develop and estimate a frictional labor market model with work-related disability and firm accommodation. The model shows how labor market frictions and worker turnover can lead to firm under-accommodation and inefficient labor market outcomes following workplace injuries. They estimate that a wage subsidy of 40 percent for injured workers would maximize overall worker welfare.

## **The Short-Term and Long-Term Effects of the Minimum Wage**

Recent proposals have been advanced in the U.S. to increase the federal minimum wage from its current level of \$7.25 to at least \$15 per hour. An increase of this size would affect a much larger fraction of the U.S. workforce than previous hikes in the minimum wage. The goal of these proposals is to improve the welfare of workers currently earning less than this new minimum, especially those at the bottom of the wage distribution.

Tom Winberry of the Wharton School presented the paper "The Minimum Wage in the Short Run and the Long Run," which he co-authored with Erik Hurst of the University of Chicago's Booth School, Patrick Kehoe of Stanford University and the Minneapolis Fed, and Elena Pastorino of the Hoover Institute, Stanford Institute of Economic Policy Research and the Minneapolis Fed.

The paper develops a quantitative framework to study the distributional impact of large changes in the minimum wage in both the short run and the long run. The researchers distinguish between the short run and the long run because of two key disparate facts about how the labor market responds to wage and price changes at these different horizons:

- Labor economics literature has found that small changes in the minimum wage have small effects on employment in the short run.
- Macroeconomics literature has found that the decline in the relative price of capital over the past 40 years — which makes labor more expensive relative to capital — has had a large effect on employment and wages in the long run.

The researchers develop a general equilibrium framework with worker heterogeneity, monopsony power and putty-clay frictions. They find that a high minimum wage has perverse distributional impacts in the long run: It reduces the employment, income and welfare of precisely the low-income workers it was meant to help. However, these long-run consequences take 20 years to fully materialize because firms slowly adjust the labor intensity of their capital stock.

The authors examine alternative policies to assist low-wage workers — such as the earned-income tax credit — and find they are much more effective than minimum wage hikes at improving outcomes for workers at the bottom of the wage distribution.

# Public Pension Retrenchment: A Matter of Timing

Over the last half century, public spending on old-age pensions in Organization for Economic Cooperation and Development (OECD) countries has been increasing, albeit at varying rates. With aging societies, policymakers have increasingly focused on pension retrenchments designed to keep their pension systems solvent. The unprecedented fiscal interventions in response to the COVID-19 pandemic will further weigh on governments' fiscal capacity and may motivate future pension retrenchments. An important question for policymakers is how various pension reform proposals may affect government pension expenditures and labor force participation.

Sarah Zubairy of Texas A&M University presented the paper "[Public Pension Reforms and Retirement Decisions: Narrative Evidence and Aggregate Implications](#)," which she co-authored with Huixin Bi of the Kansas City Fed. The paper uses a new dataset constructed by the researchers that records changes in public pension policy for 10 OECD countries between 1962 and 2017. It contains information on four aspects of historical pension reforms:

- The sign of pension changes (whether pensions became more generous or less)
- The policy tools associated with changes in pension policy (whether they involved changes in benefit formulas, coverage, indexation policy or the retirement age)
- The motivation behind policy changes
- The implementation lags (the time elapsed between when a policy change is initially enacted and when it is fully implemented)

With the new dataset, the researchers study the effects of structural pension reforms on labor force participation rates (LFPRs) and pension spending. They find that the effects of structural pension reforms depend greatly on whether they come with phase-in periods.

If structural pension retrenchments are implemented immediately without a phase-in period, LFPRs for groups between the ages of 55 and 64 years tend to rise. In this case, reduced pension benefits (in combination with a higher LFPR for the older population) lead to a decline in pension spending.

However, if it is announced that structural pension retrenchments will be phased in over time, the LFPRs for these groups decline. Consequently, government spending on old-age pensions increases (rather than decreases) over the medium run.

## Stimulus Checks as Substitutes for Monetary Easing

According to standard New Keynesian theory, policymakers can improve economic outcomes by using countercyclical monetary and fiscal policies. In recent years, however, with short-term interest rates close to zero, the space for monetary stimulus has narrowed. A natural question, then, is how to replicate the effects of standard monetary policy through alternative fiscal tools.

Previous work has identified tax policy — often labeled unconventional fiscal policy — as an attractive policy option. The idea is that policymakers can use time-varying tax rates to manipulate intertemporal prices and thereby replicate the effects of the short-term interest rate changes of monetary policy. In practice, however, implementing such a countercyclical fiscal policy is challenging, because it requires policymakers to jointly fine-tune several different taxes and subsidies at business-cycle frequencies.

Christian Wolf of the Massachusetts Institute of Technology presented the paper "[Interest Rate Cuts vs. Stimulus Payments: An Equivalence Result](#)." The paper develops a novel conceptual approach to monetary-fiscal policy equivalence and applies it to a different fiscal policy instrument: lump sum payments or "stimulus checks," a policy tool that was used during the COVID-19 recession. The setting for his analysis is a standard New Keynesian model without capital, extended to feature uninsurable household income risk.

Wolf establishes three main results:

- He specifies the conditions under which policymakers can use lump-sum taxes and transfers to achieve the same macroeconomic results that can be achieved through interest rate policy.
- He characterizes the tax/transfer policies that can be used to replicate various levels of monetary accommodation.
- He uses a New Keynesian model with heterogenous agents to compare macro-equivalent interest rate and stimulus check policies.

He finds that, since stimulus checks directly boost the consumption of those with low asset levels, the policy reduces consumption inequality relative to the macro-equivalent interest rate cut.

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