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The Folly of Subsidizing Unemployment

My calculations suggest the jobless rate could be as low as 6.8%, instead of 9.5%, if jobless benefits hadn't been extended to 99 weeks.

By [ROBERT BARRO](#)

Congressman John Boehner recently suggested that President Obama replace his top economic advisers. I think he may have a point. The economic "recovery" has been disappointing, to put it mildly, and it has become increasingly clear that the blame lies with the policies of the Obama administration, not with those of its predecessor.

In general, the current administration has been too focused on expanding government, redistributing more from rich to poor, and stimulating aggregate demand. I have previously criticized the stimulus package as cost-ineffective. In particular, whatever tax reductions were in the package did not involve the cuts in marginal income tax rates that encourage investment, work effort and productivity growth.

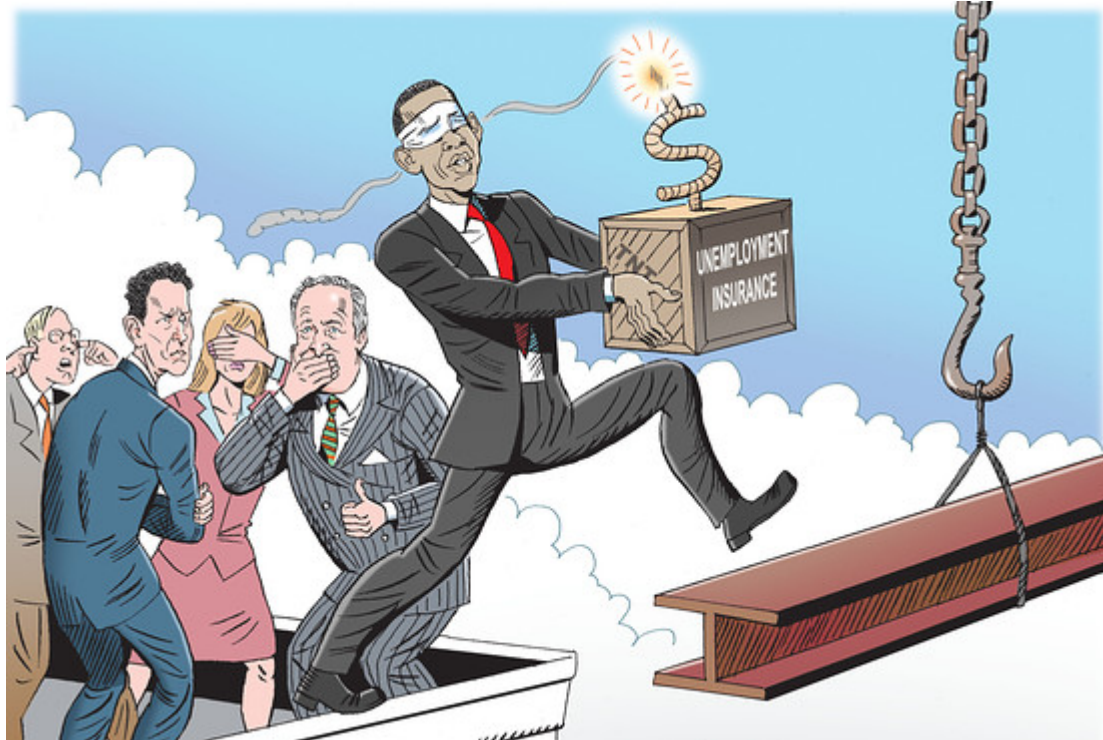
Now the administration wants to kill the 2003 income-tax cuts, at least the parts that reduced marginal income tax rates for high-income earners and for all recipients of dividend income. This proposal is particularly disturbing because the 2003 law was George W. Bush's main economic achievement; unlike most of Mr. Bush's policies, this one was well-conceived and effective.

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I want to focus here on another dimension of the Obama administration's policies: the expansion of unemployment-insurance eligibility to as much as 99 weeks from the standard 26 weeks.

The unemployment-insurance program involves a balance between compassion—providing for persons temporarily without work—and efficiency. The loss in efficiency results partly because the program subsidizes unemployment, causing insufficient job-search, job-acceptance and levels of employment. A further inefficiency concerns the distortions from the increases in taxes required to pay for the program.

In a recession, it is more likely that individual unemployment reflects weak economic conditions, rather than individual decisions to choose leisure over work. Therefore, it is reasonable during a recession to adopt a more generous unemployment-insurance program. In the past, this change entailed extensions to perhaps 39 weeks of eligibility from 26 weeks, though sometimes a bit more and typically conditioned on the employment situation in a person's state of residence. However, we have never experienced anything close to the blanket extension of eligibility to nearly two years. We have shifted toward a welfare program that resembles those in many Western European countries.

The administration has argued that the more generous unemployment-insurance program could not have had much impact on the unemployment rate because the recession is so severe that jobs are unavailable for many people. This perspective is odd on its face because, even at the worst of the downturn, the U.S. labor market featured a tremendous amount of turnover in the form of large numbers of persons hired and separated every month.

For example, the Bureau of Labor Statistics reports that, near the worst of the recession in March 2009, 3.9 million people were hired and 4.7 million were separated from jobs. This net loss of 800,000 jobs in one month indicates a very weak economy—but nevertheless one in which 3.9 million people were hired. A program that reduced incentives for people to search for and accept jobs could surely matter a lot here.

Moreover, although the peak unemployment rate (thus far) of 10.1% in October 2009 is very disturbing, the rate was even higher in the 1982 recession (10.8% in November-December 1982). Thus, there is no reason to think that the United States is in a new world in which incentives provided by more generous unemployment-insurance programs do not matter much for unemployment.

Another reason to be skeptical about the administration's stance is that generous unemployment-insurance programs have been found to raise unemployment in many Western European countries in which unemployment rates have been far higher than the current U.S. rate. In Europe, the influence has worked particularly through increases in long-term unemployment. So the key question is what happened to long-term unemployment in the United States during the current recession?

To begin with a historical perspective, in the 1982 recession the peak unemployment rate of 10.8% in November-December 1982 corresponded to a mean duration of unemployment of 17.6 weeks and a share of long-term unemployment (those unemployed more than 26 weeks) of 20.4%. Long-term unemployment peaked later, in July 1983, when the unemployment rate had fallen to 9.4%. At that point, the mean duration of unemployment reached 21.2 weeks and the share of long-term unemployment was 24.5%. These numbers are the highest observed in the post-World War II period until recently. Thus, we can think of previous recessions (including those in 2001, 1990-91 and before 1982) as featuring a mean duration of unemployment of less than 21 weeks and a share of long-term unemployment of less than 25%.

These numbers provide a stark contrast with joblessness today. The peak unemployment rate of 10.1% in October 2009 corresponded to a mean duration of unemployment of 27.2 weeks and a share of long-term unemployment of 36%. The duration of unemployment peaked (thus far) at 35.2 weeks in June 2010, when the share of long-term unemployment in the total reached a remarkable 46.2%. These numbers are way above the ceilings of 21 weeks and 25% share applicable to previous post-World War II recessions. The dramatic expansion of unemployment-insurance eligibility to 99 weeks is almost surely the culprit.

To get a rough quantitative estimate of the implications for the unemployment rate, suppose that the expansion of unemployment-insurance coverage to 99 weeks had not occurred and—I assume—the share of long-term unemployment had equaled the peak value of 24.5% observed in July 1983. Then, if the number of unemployed 26 weeks or less in June 2010 had still equaled the observed value of 7.9 million, the total number of unemployed would have been 10.4 million rather than 14.6 million. If the labor force still equaled the observed value (153.7 million), the unemployment rate would have been 6.8% rather than 9.5%.

Consider how the prospects for Democrats in the November elections would look if the unemployment rate were now only 6.8%. Obviously, this change would make all the difference, and President Obama can reasonably blame his economic advisers. They should have protected their boss by standing firm and arguing that a reckless expansion of unemployment-insurance coverage to 99 weeks was unwise economically and politically. Congressman Boehner's advice to Mr. Obama seems correct, though possibly too late to matter.

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