

Commentary: Reducing Supply-Side Disincentives to Job Creation

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As I've listened to the presentations and discussion at this conference over the past two days, I have been fascinated by the clear shift in the professional consensus on unemployment that has taken place during the past two decades. Twenty years ago, when I first started writing about how unemployment insurance and other labor market policies increase the rate of unemployment,¹ these were radical ideas that met with a very hostile reaction. As I listen to Paul Krugman and others at this meeting, I'm having a hard time adjusting to finding my views so much in the mainstream of current thinking about unemployment.

Dale Mortenson's paper on the supply-side disincentives to employment provides a very rich and complex analytic approach to discussing possible supply-side policies. He presents an explicit theoretical framework and gives numerical values to its theoretical parameters. Analytic models like this can be helpful in sharpening our economic intuition. They provide insights that would be missed with less formal and less complex specifications. Of course, all **models—even complex models like this one—are simplifications. Such simplification is necessary if a model is to be tractable. If the simplifications are chosen well, the model helps to sharpen our insights.**

But the simplifications involved in an abstract model like this one mean that we must be very cautious about giving a literal interpretation to the numerical estimates that the model produces. The need for

caution is even greater when, as in this case, the parameter values that are built into the model are very uncertain. Two examples will illustrate the consequences of simplification and of uncertain parameter values.

Hiring bonuses

Professor Mortensen's discussion of hiring bonuses illustrates the way in which an oversimplified description of the economy can lead to inappropriate conclusions. A hiring bonus plan would give employers a payment for hiring a previously unemployed worker. It seems plausible that such a bonus would make it easier for the unemployed to find work and would be a better use of unemployment benefits than continued support for an individual who is not **working**.² It is not surprising that Professor Mortensen and many others therefore favor such hiring bonuses.

In practice, however, a hiring bonus has more complex effects that may make it less desirable or even counterproductive. Studies by the Organization for Economic Cooperation and Development (OECD) show that most of those unemployed who find work with a subsidy would have found a job at roughly the same time even without **such** a subsidy. Such individuals receive a costly subsidy with virtually no benefit in terms of reduced unemployment. Moreover, many of those with subsidies who do get jobs may simply displace others who don't qualify for subsidies. Again this means costs to the taxpayers with little or no net gain in job creation. A recent OECD review of national experiences with hiring bonuses found that the combination of subsidies for intramarginal jobs (that is, for those who would have found work without a subsidy) and job displacement often account for 80 percent to 90 percent of the participants in hiring subsidy schemes.

There is a further adverse effect of hiring bonuses that is also omitted from the Mortensen model. The availability of a bonus or subsidy when a new job is filled with an unemployed worker encourages employees to take the **kind** of work—temporary jobs, seasonal jobs, cyclical jobs—that is likely to lead to more unemployment because there is a wage bonus for passing through a spell of unemployment. This lowers wages in these industries and therefore leads to an

expansion of high unemployment types of activities. Hiring bonuses also encourage firms to lay off workers since there is a subsidy that comes with the new hires who replace them.³

My judgment is that this more complete picture of the effects of hiring subsidies implies that they are likely to be a very bad use of public funds. If 80 to 90 percent of the apparent success are really wasted dollars that do not add to employment and if the program also creates strong incentives for additional unemployment, it may well be that the net effect is actually to increase total unemployment as well as to raise the cost to taxpayers.

To illustrate the importance of the uncertainty of the parameter estimates, let me focus on one key relation in the Mortensen model: the "matching function" that indicates the extent to which turnover in the labor force leads to increased productivity of the labor force (because new workers are a "better match" for their jobs than old workers) and therefore to higher national income. A great deal could be said about such a relationship. I only want to emphasize that the magnitude of the effect is extremely difficult to estimate. A model that depends on a number of such difficult-to-estimate key parameters can be analytically useful in sharpening our understanding of how results depend on particular parameter values. But it would be wrong to give significant weight to the predictions or the cost-benefit calculations implied by such a model with a particular set of parameter values.

For these reasons, I am inclined to regard the Mortensen paper as potentially helpful to us in understanding some of the many positive and negative channels through which government labor market policies can affect unemployment and overall national income. But I do not regard the specific simulation result as a basis for estimating the likely effects of actual policy changes.

The effects of unemployment insurance

In the remainder of my remarks, I will focus on one labor market policy that has been a particularly important source of the high structural unemployment rate in the United States and other major industrial countries: the unemployment insurance (UI) system. The

UI system deserves our attention not only because of its very important adverse incentives but also because experience shows that useful reforms are possible and that the reduction in unemployment through such reforms can be achieved without increasing the number of people in poverty or adversely affecting the living standard of those who are already poor.

Much of the discussion in Europe about the distorting effects of unemployment insurance rightly focuses on the very long durations of insured unemployment that are possible under European rules. The evidence that limits on duration reduce unemployment is very clear.

In the United States, most of those who enter insured unemployment remain unemployed for much less than the maximum period (which is typically six months). Although reducing the maximum duration would reduce unemployment in the United States, most of those who are unemployed are affected more by the level of benefits than by the maximum duration of benefits.

High replacement rates

In most states, the level of weekly benefits is set at 50 percent of the past weekly wage rate (subject to an upper limit). Many states also pay additional benefits for dependents. Since the late 1970s, unemployment benefits have gradually been subjected to income tax and are now fully taxable under the federal income tax. They are not taxable under the payroll tax and are frequently not taxed under state income taxes. This difference between the taxation of wage income and of UI benefits implies that the UI *net* replacement rate—the ratio of net-of-tax benefits to net-of-tax wages—is greater than 50 percent. For example, for someone with the lowest federal marginal tax rate, the asymmetry in tax rules implies a replacement rate of 58 percent.⁴ Since past wages are likely to be higher than the wage that the unemployed individual will earn on a new job, the net replacement rate relative to potential net wages is greater than 60 percent. It would, of course, be higher if the state provides dependent benefits.

The combination of taxes and UI rules means that an individual who can earn \$15 an hour or \$600 a week in pretax wages if employed or

receive \$300 a week in pretax UI benefits if unemployed, is actually facing the choice between \$432 of net wages for **working** and \$255 of net benefits if unemployed. The difference is equivalent to only \$4.42 cents an hour or less than a third of the pretax wage.

The adverse incentives are even greater when the individual is potentially eligible for other benefits if unemployed, including the Earned Income Tax Credit, food stamps, Medicaid, and housing subsidies. This is particularly important for low-skilled, part-year, and part-time employees.

Consider just the effect of the Earned Income Tax Credit (EITC). This federal program matches wage income up to a certain low limit (depending on family size), then provides a flat annual subsidy, and finally is reduced at a rate of 17 cents per dollar of additional earnings. Most recipients of the EITC are in this phase-out range where it raises marginal tax rates on wage income substantially. Since the receipt of unemployment benefits does not reduce EITC benefits, this creates a much greater disincentive to work for anyone whose alternative to work is UI benefits.

A typical EITC recipient might be a woman who would earn \$300 a week in gross wages if she works. An additional week of work would, however, produce additional net income of only \$166 because of the combination of the 15 percent personal income tax, the 7.65 percent payroll tax, the 5 percent state income tax, and the 17 percent EITC benefit reduction. An additional week of unemployment would mean a gross benefit of \$150 and a net benefit of \$128. The net reward for **working** would be only \$38 per week or less than a dollar an hour. The net replacement rate is the ratio of \$128 to \$166 or 77 percent.

The other income-related federal and state subsidy programs—Medicaid, food stamps, housing subsidies, and the like—reduce the reward for **working** even more. It is not surprising that unemployment remains high among low-skilled individuals. Such unemployment means that they have lower money income than they would if they worked and that they do not develop the skills and experience that would help them earn more in the future.

Sources of unemployment

The high replacement rates affect not only the duration of unemployment, but also the flow into unemployment. The duration effect is the most direct and obvious: an individual will remain unemployed as long as the value of leisure and the gain from search outweigh the lost net income. The Mortensen analysis focuses on duration, but the other ways in which UI increases unemployment may be at least as important.

Unemployment insurance encourages temporary, seasonal, and cyclical unemployment. Because the loss of a job involves a smaller financial loss to the individual, the additional wage necessary to compensate for the greater risk of unemployment is less. This reduces the cost of firms and industries that inherently provide more seasonal, cyclical, or temporary jobs and therefore increases the market demand for the products of such firms. A stronger experience rating system would reduce this subsidy and therefore the creation of excess unemployment.

A particularly important form of unemployment in the United States that seems to have little counterpart in Europe is "temporary layoff unemployment" in which the individual will return to the job, but is temporarily not working. Such temporary layoff unemployment now accounts for about one-third of all unemployment that is classified as "job loss" (as opposed to quits, new entrants, and reentrants) and about 40 percent of the unemployed who receive unemployment compensation. Because unemployment insurance subsidizes such unemployment and experience rating does little at the margin to discourage it, firms have much more temporary layoff unemployment (rather than adjustments in hours, inventories, and prices) than would be economically efficient.⁵

The deadweight loss

The deadweight loss caused by the distorted incentives of unemployment insurance depends on the extent to which UI benefits change behavior and on the gap or wedge between the marginal product of labor and the net compensation for working that remains when the

individual is eligible for unemployment insurance. The individual I discussed earlier who earns \$300 a week before tax but who, because of taxes, the EITC, and UI benefits only gains \$38 by a week by working instead of being unemployed has a distorting wedge that exceeds 88 percent of the marginal product of labor.⁶

Such a wedge implies very large deadweight losses from the increased unemployment induced by our UI system. I emphasize that this is the deadweight loss and not just the loss of income. Against that loss of income is balanced the value of unemployment time spent in leisure or in productive job search.

Careful readers of Dale Mortensen's paper will realize that this is not his conclusion. I do not feel comfortable trying to explain the reasons for the difference because I do not understand all of the sources of his estimated increase in productivity associated with unemployment. But I suspect that the difference lies in the simplified structure (which ignores induced job losses) and in differences in the parameter values. Where I see net replacement rates of 50 percent and 77 percent and a deadweight loss wedge of 88 percent, Mortensen summarizes the benefit replacement rate as 25 percent (reflecting a 50 percent statutory rate and a 50 percent participation rate among the uninsured).

Possibilities for reform

The adverse effects of UI used to be worse and need not be as bad in the future as they are today. It is useful to look at a major successful reform of UI that occurred in the United States: subjecting UI benefits to personal income taxation.

When the idea was suggested in the early 1970s, it was deemed to be politically impossible. But such taxation was introduced during the Carter administration on a very partial basis and then expanded to complete taxation under the federal income tax in the 1986 tax reform legislation.

Subjecting benefits to the income tax reduced the replacement rates substantially, particularly for second earners in high income house-

holds. An individual who pays today's 39 percent maximum marginal income tax rate faces a net replacement rate of 63 percent. If benefits were not subject to income tax, the net replacement rate would exceed 100 percent, generating more income for not working than for working!

Studies by Patricia Anderson and Bruce Meyer indicate that subjecting UI to the income tax has been responsible for most of the one-third decline (from 50 percent to 33 percent) in insured unemployment as a fraction of total unemployment (Anderson and Meyer, 1994).

This reform has the virtue that it reduced the highest replacement rates which are the ones that appear to be disproportionately distorting. Moreover, since it only reduced net UI benefits by including benefits in taxable income, it did not reduce net benefits for anyone who is too poor to pay taxes. That experience makes me dissent from Paul Krugman's comment that all policies to reduce structural unemployment are likely to increase poverty.

The experience with taxing UI benefits suggests other possible directions for UI reform that would also improve incentives without creating poverty. One idea would be to treat UI benefits like self-employment income and subject them to the payroll tax and cause them to offset EITC and other benefit payments.

A more radical reform would end the feature of giving more benefits to those unemployed who had previously had above average earnings. A maximum benefit equal to the current average (about \$200 a week) would continue to provide protection while reducing the labor market distortion. Moreover, higher income employed individuals would be induced to save more as a reserve to supplement their UI benefits—a good thing in itself. And this could be encouraged by tax-favored unemployment savings accounts that would cost much less government revenue than the current system.

Endnotes

¹See, for example, Feldstein (1973a, 1973b, 1974, 1975a, and 1976). The first of these studies was prepared for the Joint Economic Committee. Chairman Proxmire was so unhappy with the conclusions that they refused to publish it for several months until they had assembled a group whose critical comments could be included in the same volume.

²In the Mortensen analysis, the hiring bonus reduces unemployment by making the uninsured more willing to accept employment rather than through increasing the desire of the firm to hire them. More specifically, the hiring bonus raises the pay that would go to the employee and that increased opportunity cost of unemployment causes the individual to accept employment sooner than he or she otherwise would.

³The extent to which the hiring bonus leads to higher wages to the employee (and therefore a greater incentive for employees to seek unstable employment) or to lower net-of-subsidy wages to the firm (and therefore an increased output in unstable industries and a greater turnover of workers) is a standard incidence question that depends on the relative supply elasticities of employees and demand elasticities of firms. If enough firms compete for the subsidized new hires, the effect may be to pass along the entire subsidy to the new hires themselves.

⁴For someone who pays a 15 percent marginal federal income tax, a 7.65 percent payroll tax, and a 5 percent state income tax, an additional dollar of gross wage income results in 72 cents of additional net wage income. The 15 percent federal tax reduces a 50 percent gross benefit to a 42-cent net benefit. The net UI replacement ratio is thus $42/72 = 0.58$.

⁵See Feldstein (1975b, 1976, and 1978) for a discussion of temporary layoff unemployment and evidence on how it is affected by UI benefits.

⁶The marginal product of labor is the pretax wage plus the employer's payroll tax of 7.65 percent. Thus the marginal product of labor for this individual is \$323. The wedge is $1 - 38/323 = 0.88$.