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Labor Supply and COVID-19 Unemployment Insurance

Andreas Hornstein, Marios Karabarbounis, André Kurmann, Etienne Lalé, and Lien Ta. “Disincentive Effects of Unemployment Insurance Benefits.” Federal Reserve Bank of Richmond Working Paper No. 23-11, November 2023.

The COVID-19 pandemic brought about the largest expansion of unemployment insurance (UI) in U.S. history. The 2020 CARES Act lowered eligibility requirements, increased stimulus amounts, and lengthened maximum benefit durations — roughly tripling the number of unemployed individuals obtaining financial assistance through UI programs. These novel expansions have been credited with limiting the detrimental effects of unemployment during the pandemic. However, assessing the effects of this change on job-seeking and employment is difficult because UI may have effects in opposing directions. On one hand, UI disincentivizes workers from looking for work. On the other, it provides purchasing power to the unemployed, in turn increasing consumption, demand for local goods and services, and demand for workers.

Recent research by Richmond Fed economists Andreas Hornstein and Marios Karabarbounis, along with André Kurmann, Etienne Lalé, and Lien Ta, has attempted to isolate and estimate the disincentive effects of UI by controlling for local demand effects. They found that there are different stories for low-wage businesses and high-wage businesses.

To disentangle the countervailing labor supply and demand effects, the researchers used high-frequency employment and wage data and compared the employment responses

of neighboring high- and low-wage businesses. By examining an environment where it is reasonable to assume that both business types experienced the same labor demand increase from UI expansion, they could attribute any differences in employment between high- and low-wage businesses to disincentive effects, after accounting for other factors.

The authors first examined the gap in the employment recovery between both business types in the same labor market relative to their pre-pandemic levels. They noted a dismal story for low-wage businesses during the time of the CARES Act. After a large initial drop in employment for low-wage businesses relative to high-wage businesses at the start of the pandemic, low-wage businesses began to catch up. But once the CARES Act’s \$600 weekly supplement was implemented, the employment gap continued to widen until the policy was about to expire.

To further evaluate the effect of the income supplement on the employment recovery gap, the authors estimated the impact of the gap in replacement rates — the amount of UI payments an unemployed worker receives relative to the wage a business offers — between low- and high-wage businesses. The results suggested that so long as there were policies that increased replacement rates and widened the replacement rate gap, there would be a lag in the employment recovery of low-wage businesses compared to those with higher wages. Specifically, the estimates implied the \$600 UI supplement led to a 1.5 percentage point decline in low-wage employment relative to high-wage employment.

The authors additionally constructed a labor search model for pandemic UI disincentive effects. Workers separate

from their jobs, become UI eligible with benefits dependent on past wages, receive job offers, and accept job offers. Notably, the model allows for the possibility that UI recipients who refuse a job offer lose their eligibility, which affects an individual’s probability of accepting a job. The model incorporates elements of the main CARES Act UI expansions: temporary increases in the amount of benefits reflect the additional \$600 weekly supplement; increases in the likelihood of becoming eligible for benefits reflect the relaxed eligibility requirements; and increases in the probability of remaining eligible reflect the extended eligibility duration. All of these elements reduce incentives to accept job offers.

After breaking down the estimated pandemic recovery gap along business type, the authors found that low-wage businesses experienced a slower recovery of workers post-UI changes relative to high-wage businesses. Lower-paying jobs are more likely to attract unemployed workers who are not UI eligible, but expanded eligibility reduced the number of non-eligible workers.

When the three pandemic UI policies were evaluated independent of one another, all resulted in minimal employment losses. Taken together, however, the policies decreased employment recovery significantly.

The authors suggested, however, that even though UI expansion may depress employment outcomes through the disincentive effect, other unobserved channels, such as stimulated labor demand, can help accelerate employment recovery. They concluded that policymakers should be aware of all implications of UI policies rather than only the net effect, especially for the benefit of businesses that pay lower wages. **EF**