

Work Incentives, the Recovery Act, and the Economy

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Is Government Effectively Addressing the Unemployment Crisis?”

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by

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Chairman Jordan, Ranking Member Cartwright, members of the committee: thank you for the opportunity and honor to discuss with you today how public policy has changed the reward to work. A multitude of programs affect that reward, and thereby affect who is employed.

Unfortunately, the monetary reward to work can often be zero, or worse, because retaining or accepting a job creates tax expenses and denies subsidies with a combined value that sometimes exceeds the paycheck from working.

Nobel laureate James Tobin was a leading Keynesian economist and key adviser to President Kennedy, and pointedly described 100 percent implicit tax situations. He said that they “caus[e] needless waste and demoralization.... It is almost as if our present programs of public assistance had been consciously contrived to perpetuate the conditions they are supposed to alleviate.” (Tobin 1965, 890)

Overview

A basic economic principle is that the monetary reward to working has important effects on how many people are employed, and how much they work. By definition, the monetary reward to working is the difference between the resources a person has available to use or save if she works and what she has available when she does not work.

People without jobs or otherwise with low incomes sometimes receive benefits from social safety net programs. The benefits are rarely called taxes by laymen, but economists understand the benefits to have many of the characteristics of tax rates because a program beneficiary loses some or all of her benefits as a consequence of accepting a new job. The more income that a person receives when *not* working, the less is the reward to working.

The combined effect of taxes and subsidies on the reward to accepting a new job can be summarized as a job acceptance penalty: that is, the effective amount that is lost from paying taxes and replacing benefits associated with not working. I like to express the penalty as a rate: namely, as a percentage of employee compensation.

If there were no penalty, then the rate would be zero. Thanks to a labyrinth of tax and subsidy programs, the job acceptance penalty rate can equal or exceed 100 percent, which means that the reward to working is zero or less. In such cases, a person might have *more* resources available to use or save as a consequence of working *less*.

Legislation that “cuts” or “credits” taxes can nonetheless reduce the reward to working, and increase the job acceptance penalty rate, if it cuts taxes more for those who work less than it cuts taxes for those who work more.

The reward to working affects behavior. High job acceptance penalty rates are associated with small incentives to seek, create, and retain jobs. The consequences of high penalty rates are

felt all over the economy, even by persons whose individual penalty rates might not be all that high.

At the same time that safety net programs implicitly tax job acceptance, they also implicitly subsidize layoffs because the programs absorb some of the income and production that employer and employee together lose when an employee stops working. Layoff subsidies give employers and employees less incentive to take steps that might avoid or delay layoffs.

America absolutely must have taxes and safety net programs, even though they reduce the reward to working and subsidize layoffs. But if this Congress wants to understand what is happening in the labor market or to the budgets of social programs, it would be counter-productive to approximate job acceptance penalty and layoff subsidy rates as zero, or to assume them to be eternally constant regardless of what incentives are embodied in new legislation.

Of course, unemployment insurance program benefits are now available longer into unemployment spells than they were six years ago. But also don't forget that new modernization provisions now provide unemployment benefits in a variety of circumstances when benefits were formerly unavailable. While it lasted, the 2009 American Recovery and Reinvestment Act (hereafter, ARRA) also added a bonus to weekly unemployment checks, and helped unemployed people pay for their health insurance. The food stamp program expanded in a variety of dimensions.

The combined effect of these and other changes through 2012 was to reduce the reward to work for most of the non-elderly population. Among the 23 million layoffs experienced by non-elderly American household heads and spouses during the recession, at least 4 million of them resulted in penalty rates near or above 100 percent.

The height of the bar in the chart I've shown is the average penalty rate among the 4 million layoffs I mentioned. 100 percent means that the entire compensation from the job offer – fringe benefits and all – would be devoted to paying added tax expenses and replacing withdrawn benefits.

It did not have to be this way. The bar on the right shows what would have happened to the same 4 million penalties if there had been no Recovery Act. The white space is the reward to working – it's what's left over after expenses are paid and withdrawn benefits are replaced. Yes, the reward is small compared to all of the expenses, but it was something and by looking at the left bar we can see how the Recovery Act completely erased it.

This chart also shows us how several programs combined to create these penalties. Unemployment insurance is the single largest disincentive, but without the others the reward to working would have been pretty large.

We shouldn't have been surprised to see layoffs surge during the recession at the same time that new laws were adding to the layoff subsidies or to see unemployment durations lengthen as new rules added to job acceptance penalties. A presumably unintended consequence of the recent safety net expansions has been to reduce the reward to working and thereby keep employment rates low, keep unemployment and poverty rates high, and keep national spending low, longer than they would have been if safety net program rules had remained unchanged.

The remainder of my testimony offers more detail as to penalty and subsidy rate changes in recent years, and how they relate to the government safety net. The testimony is my own and does not necessarily reflect the views of the University of Chicago.

A Labyrinth of Public Policies Combine to Reduce the Reward to Working

The monetary reward to working is the difference between the resources a person has available to use or save if she works and what she has available when she does not work. Federal, state, and local governments deal in massive amounts of resources, and affect the reward to working both in the process of obtaining revenue and in the process of distributing revenue to beneficiaries.

The Bureau of Economic Analysis estimates that income, payroll, sales, and excise taxes amounted to about 23 percent of national income and over 30 percent of the nation's labor income, on average between 2000 and 2010. Even if none of that revenue had been spent on safety net programs, the tax collections by themselves would have reduced the reward to working.

Safety net program spending is also significant, especially during the last several years. Federal, state, and local spending on non-elderly beneficiaries of unemployment insurance, nutrition assistance, Medicaid, and other means-tested subsidies occurred at a combined rate of more than \$400 billion per year in 2009 and 2010, measured in fiscal year 2010 dollars (Mulligan 2012). Even if governments had somehow been able to fund these programs without any taxes, the process of distributing the program benefits would have reduced the reward to working.

Legislation that "cuts taxes" can nonetheless reduce the reward to working, and increase the marginal tax rate appropriate for labor market analysis, if it cuts taxes more for those who work less than it cuts taxes for those who work more because the reward to working depends on the difference between taxes (net of subsidies) paid when working and taxes (net of subsidies) paid when not working.

The effects of public policy on the reward to working and thereby the labor market and the economy can be summarized in terms of various measures of marginal tax rates. My testimony discusses two of those measures: the job acceptance penalty rate and the layoff subsidy rate.

The job acceptance penalty and layoff subsidy rates are marginal tax rate concepts related to the decision margins of when to accept a new job and when to experience a layoff. Among the variety of measures that economists use to study the reward to working, these two concepts of the marginal tax rate have the advantages that (a) they readily capture important combined incentive effects of a multitude of tax and subsidy programs and (b) they relate to decisions to exit and reenter employment (Gruber and Wise 1999).

The job acceptance penalty rate is the difference between taxes paid net of subsidies received when working and net taxes paid when not working, sometimes expressed as a fraction of the total compensation to be earned on the new job. The layoff subsidy rate is the difference

between taxes paid net of subsidies received when working on the previous job and net taxes paid after a layoff, inclusive of former employer payroll tax liabilities, sometimes expressed as a fraction of the amount of compensation earned on the previous job.

Thanks to the labyrinth of relevant programs moving large amounts of resources, both rates can equal or exceed 100 percent in some cases, which means that the reward to working is zero or negative. In such cases, a person might have *more* resources available to use or save as a consequence of working *less*.

The reward to working affects behavior. High job acceptance penalty and layoff subsidy rates mean small incentives to seek, create, and retain jobs, and to make the sacrifices of time, hassle, etc., naturally required by employers, customers, and clients in exchange for a paycheck. The consequences of a low reward to working are felt all over the economy, even by persons whose individual reward to working might not be all that low.

The economic distortions created by job acceptance penalty and layoff subsidy rates are not proportional: an increase from 90 percent to 100 percent has a greater effect on incentives than an increase from 40 to 50 percent, which itself has a greater effect on incentives than an increase from 0 to 10 percent. A rate increase from 0 to 10, for example, still leaves a worker with 90 percent of her reward from working, whereas a rate increase from 90 to 100 leaves her with no reward.

Recent Changes in Government Safety Net Rules Related to the Reward to Work

At least a dozen new and important federal and state safety net benefit rules have collectively changed the reward to working, especially for groups whose employment rates are particularly sensitive to safety net benefits.

The unemployment insurance (hereafter, UI) program offers weekly cash benefits to people who have lost their jobs and have as yet been unable to find and start a new one. On average they receive about \$300 a week until they start working again, until they stop looking for work, or until their benefits are exhausted. Before the recession, an unemployed person in a typical state without high unemployment would often have his benefits limited to a maximum of twenty-six weeks (United States Department of Labor 2007). The federal law in place before the recession included some local labor market “Extended Benefit” triggers that, based on the statewide unemployment rate, would automatically lengthen the maximum benefit period. These automatic triggers began to extend the duration of benefits around the nation in the middle of 2008 (United States Department of Labor 2011a). At about the same time, the Supplemental Appropriations Act of 2008 included new “Emergency Unemployment Compensation” (EUC) legislation that extended maximum benefit periods for the entire nation. The Worker, Homeownership, and Business Assistance Act of 2009 further extended the EUC periods, so that unemployment insurance benefits could be paid up to 99 weeks (United States Department of Labor 2011b), which continued until 2012.

It is widely recognized that the UI benefit duration rules changed over the past couple of years (see Elsby, Hobijn and Sahin (2010), Shimer (2010), Daly, et al. (2012) and the studies cited in Council of Economic Advisers (December 2010)). Nor is it a surprise that a person

unemployed more than 26 weeks saw her job acceptance penalty rates increase as a result of the rule changes, because they provided benefits that would terminate if and when she went back to work before the benefits were exhausted. More surprising is that other safety net expansions collectively served to increase job acceptance penalty rates significantly more than the new UI benefit duration rules did, not to mention reinforce the labor market impacts of the latter (Mulligan 2012).

The February 2009 American Recovery and Reinvestment Act expanded eligibility by encouraging states to “modernize” (and relax) their UI eligibility requirements by processing earnings histories through an “alternative base period,” including persons who quit their job for compelling family reasons, adding 26 weeks of eligibility for persons enrolled in training programs, and/or paying benefits to persons who search only for part-time work (United States Department of Labor 2009). The modernization provisions raised job acceptance penalty and layoff subsidy rates for people who would have found it difficult or impossible to qualify for UI under the previous rules.

The ARRA also raised job acceptance penalty and layoff subsidy rates by exempting the first \$2,400 of unemployment benefits received by an unemployed person from 2009 federal income tax (United States Department of Labor 2011b). This provision is an example of a “tax cut” that nevertheless reduced the reward to working because it reduced taxes for people who experienced unemployment sometime during 2009 and did not reduce taxes for people who worked throughout the year.

The ARRA’s Federal Additional Compensation (FAC) provision also raised job acceptance penalty and layoff subsidy rates by adding \$25 per week to unemployment compensation checks. This \$25 per week was not available to people who were working, because unemployment compensation checks are reserved for people who are unemployed.

For laid off workers who wanted to remain on their former employer’s health plan, the ARRA’s COBRA subsidy offered to pay 65 percent of the cost. For a \$13,027 annual family health insurance premium (Crimmel 2010), that subsidy was worth more than \$700 per month. Many of the unemployed did not receive the COBRA subsidy, but the subsidy increased job acceptance penalty and layoff subsidy rates for people who did receive it, or would have received it had they not been working.

The Department of Agriculture’s food stamp program, now known as Supplemental Nutrition Assistance (SNAP), provides funds to low income households for the purpose of buying food (Social Security Administration 2008), often in conjunction with cash assistance programs. The rules for SNAP eligibility were relaxed in and around the 2008-9 recession as states were eliminating the “asset test,” as the 2002 Farm Bill permitted them to do. The asset test elimination increased job acceptance penalty rates because households could receive SNAP benefits based solely on their net income, and not based on the value of their assets. For persons in the few states that retained asset tests, federal asset eligibility rules were relaxed by the 2008 Farm Bill (Eslami, Filion and Strayer 2011, 6).

Both the 2008 Farm Bill and the 2009 ARRA increased the amount of the SNAP benefits paid to eligible households, and thereby increased job acceptance penalty and layoff subsidy rates.

Prior to the recession, able-bodied adults without dependents who were not working or participating in a work program had their receipt of SNAP benefits limited to three months in a three year period (United States Department of Agriculture, Food and Nutrition Service 2012).¹ Entire states could obtain waivers from the work requirement whenever the Department of Labor indicated that the state was eligible for extended unemployment benefits (United States Department of Agriculture, Food and Nutrition Service 2009). The ARRA waived all states through October 2010. Since then, almost all states have obtained waivers pursuant to the Department of Labor triggers (United States Department of Agriculture, Food and Nutrition Service 2011). Altogether, the state-wide waivers and ARRA changed eligibility requirements in the direction of making SNAP eligibility more inclusive than it would have been if able-bodied adults without dependents were required to work (or have their benefits limited), as they typically were before the recession began.

The Housing and Economic Recovery Act of 2008 created a first-time home buyers' tax credit of up to \$8000, but it phased out as annual family income varied beyond the income limitation. This provision is another example of a "tax cut" that nevertheless reduced the reward to working because it reduced taxes for people below the annual income limit more than it reduced taxes for people earning above it (people who work fewer weeks during the year are more likely to earn below the annual income limit required to obtain the full credit).

The 2009 ARRA created a refundable personal income tax credit for calendar years 2009 and 2010 called the "Making Work Pay Tax Credit" (hereafter, MWPTC). For most people, the MWPTC had no effect on the reward to working because they or their household would have received the same amount of the credit regardless of an individual's work decision. A few persons saw their reward to working increase from the MWPTC (by itself), a few others saw it reduced.

In contrast to the many provisions cited above, the employee portion of the federal payroll tax was cut – effective between January 2011 and December 2012 – and thereby reduced job acceptance and layoff subsidy rates during that time frame. The combined effect of all of these changes through early 2013 is job acceptance penalty rates for the median household head or spouse about five percentage points greater than they were in 2007, accounting for the fact that many people do not participate in safety net programs even when they are not working (Mulligan 2012). Job acceptance penalty rates have increased even more for less-skilled people and for unmarried people (Mulligan 2013a). Job acceptance penalty rates were at their peaks in 2009 and 2010: during the ARRA.

The Patient Protection and Affordable Care Act was passed in March 2010. As a result of this legislation, Medicaid enrollment and spending are expected to increase significantly in 2014, when the program is made "available to able-bodied adults with incomes up to 133 percent of the federal poverty level" in many states (Sack 2010). By increasing the resources that part of the population can have when their incomes are low, this provision of the Act will increase their job acceptance penalty and layoff subsidy rates. Other provisions of the Act, such as means-tested health insurance premium support, means-tested medical cost sharing, employer penalties,

¹ States could exempt up to 15 percent of such persons from the work requirement, or request a waiver for people in areas with an unemployment rate over 10 percent.

and hardship waivers from the individual mandate, will also further increase job acceptance penalty and layoff subsidy rates.

In Millions of Cases, Public Policy Erased the Reward to Working

Job acceptance penalty and layoff subsidy rates can equal or exceed 100 percent in some cases, which means that the reward to working is zero or negative. My work has begun to estimate the frequency with which non-elderly American workers and their families have been presented with these very high and, as James Tobin put it, wasteful and demoralizing rates. I have also calculated how the frequency might have been different under alternative tax and subsidy rules (Mulligan 2013b).

My estimates consider the combined incentives of several subsidies: unemployment insurance (UI), Federal Additional Compensation (FAC), the ARRA's COBRA subsidy, SNAP, and Medicaid. The dollar value of Medicaid participation is taken as one-half the amount the program spends on medical care per non-elderly non-disabled participant, times the number of family members who are calculated to be Medicaid eligible on the basis of weekly income. Taxes include payroll taxes, state personal income taxes, the regular federal income tax (i.e., the amount on line 44 of Form 1040), and several federal income tax credits: the earned income tax credit (EITC), Child Tax Credit (CTC), Additional Child Tax Credit (ACTC), and Making Work Pay Tax Credit (MWPTC).² I also estimate work expenses, such as the expenses associated with commuting to a job.

A worker's job acceptance penalty and layoff subsidy rates depend on the type of job to be accepted (or terminated), the size and composition of his household, and the amount and composition of his household's income. Hundreds of different rates are therefore present in the population, and some are more common than others. I used the Census Bureau's Current Population Surveys to estimate the frequency of the various household and tax situations when the ARRA was in force.

One of the common situations was a middle class dual-earner couple with no children earning about \$600 per week and the other earning about \$800 plus health insurance. If the latter earner were laid off from his job and participated in the UI program under the ARRA, just a couple of items would by themselves push his penalty rate (for accepting a similar job) over 70 percent: his basic UI benefit, his UI bonus (FAC), payroll taxes, employment expenses, and the ARRA COBRA subsidy. State and federal income taxes would push it even higher.

Accounting for the rich variety of tax and family situations present in the population, I found that, among the 23 million layoffs experienced by non-elderly American household heads

² In order to calculate personal taxes and credits, I use the actual personal income tax schedules for a household taking its standard deduction and assume that: the work decision interval is 16 weeks, the person was unemployed six weeks and employed 30 weeks during the remainder of the calendar year, employees with health insurance pay 35 percent of the premiums and those payments are excluded from the payroll and personal income tax bases, and the spouse (if any) earns \$600 weekly (plus fringe benefits) throughout the calendar year.

and spouses during 2009 and the second half of 2008, at least 4 million of them resulted in job acceptance penalty rates near or above 100 percent.

The attached chart shows more about those 4 million extraordinary job acceptance penalties. The height of the left bar is the average penalty rate among the 4 million. 100 percent means that the entire compensation from the job offer – fringe benefits and all – would be devoted to paying added tax expenses, paying employment expenses and replacing withdrawn benefits.

It did not have to be this way. The bar on the right shows what would have happened to the same 4 million penalties if there had been no ARRA. The white space between 100 percent and the top of the bar is the reward to working – it's what's left over after tax and other employment expenses are paid and withdrawn benefits are replaced. Yes the reward is small compared with all of the expenses, but it was something and by looking at the left bar we can see how the Recovery Act completely erased it.

The chart also shows us how several programs combined to create these penalties. Unemployment insurance is the single largest disincentive, but without the others the reward to working would be pretty large.

More than two million non-elderly household heads and spouses had layoff subsidy rates near 100 percent, meaning that they could be (and perhaps were) laid off with little or no short-term reduction in their disposable income even if they had to compensate their employer for the UI payroll tax liabilities associated with the layoff as a consequence of “experience-rated” UI financing. The large majority of these workers were in that situation because of the safety net rule changes implemented by the ARRA.

Job acceptance penalty and layoff subsidy rates would have been even higher if the ARRA had been bigger in terms of the help it offered the poor and unemployed. Under a “bigger stimulus,” more than half of the 23 million layoffs of non-elderly household heads and spouses could have job acceptance penalty rates near 100 percent. Roughly 20 million non-elderly household heads and spouses could have been laid off from their job with a subsidy rate near 100 percent, even accounting for their employers' payroll tax liabilities.

My findings of large, even confiscatory, job acceptance penalty and layoff subsidy rates are not the result of “cliffs” in transfer program formulas in which many dollars of benefits are lost for earning a single marginal dollar (Yelowitz 1995) because I look at the consequence of more “discrete” decisions of accepting a job, or initiating a layoff, that change calendar year income by thousands of dollars. Instead, my findings reflect the combination of tax and subsidy rules, especially unemployment insurance.

Wage Garnishment and Related Private Sector Activities Raising Marginal Tax Rates

The Internal Revenue Service, Department of Agriculture, and state unemployment agencies are not the only institutions looking at a person's employment status and federal individual income tax return to determine how much she should pay or receive. My own employer, the University of Chicago, and thousands of other universities, colleges, and schools

look at federal income tax returns through their financial aid programs to determine how much a parent should pay for her child's education. While we welcome the opportunity to help students from disadvantaged families, economists have long recognized that financial aid practices affect incentives for students' parents to work and save (Dick and Edlin 1997).

Workers sometimes have their wages garnished by creditors. Garnishments may be a necessary part of a well-functioning credit market, but they also serve to reduce the reward to working by the person whose wages would be garnished.

Even if these private sector actions affecting the reward to work had been constant over time, they still interact with the safety net expansions cited above because the economic distortions resulting from marginal tax rates depend on the sum total of all taxes, subsidies and garnishments that derive from a person's wages. In other words, the presence of private sector marginal tax rates made the government safety net expansions more distortionary than they would have been without the private rates.

Moreover, it does not appear that the private sector's influence on marginal tax rates has been constant over time. A new federal bankruptcy law went into effect in late 2005. Perhaps the most dramatic single increase in job acceptance penalty rates has been associated with the federal guidelines for the settlement of "under-water" home mortgages. Mortgage modification initiatives have been one of the main ways the federal government has sought to reduce home mortgage foreclosures, especially when those foreclosures are motivated by negative home equity (Congressional Oversight Panel 2009, 4). In 2008, the Federal Deposit Insurance Corporation (FDIC), Federal National Mortgage Association (Fannie), and the Federal Home Loan Mortgage Corporation (Freddie) all announced debt forgiveness or "loan modification" formulas. The Treasury Department continued this work under President Obama's administration with its "Home Affordable Modification Program" (HAMP) as part of its "Making Home Affordable Initiative," which replaced the Fannie and Freddie programs.

These programs often recommend a new mortgage payment amount that is lower than the payment specified in the original mortgage contract. More important in terms of marginal tax rates, the new payment is set in proportion to the borrower's income at the time of the modification. The more the borrower is earning, the more she will be required to pay her lender over the next five to seven years, or more. The marginal tax rate on income earned at the time of modification can easily exceed one hundred percent and sometimes exceed two hundred percent as a result of the federal modification guidelines, not to mention the many other taxes and subsidies that also reduce the reward to working (Mulligan 2012; Herkenhoff and Ohanian 2011).

The Income Maximization Fallacy

It is sometimes claimed, by non-economists at least, that the safety net does not prevent anyone from working because everyone strives to have more income rather than less, and would gladly take any available job that paid them more than the safety net did. This "income maximization" hypothesis is contradicted by the most basic labor market observations, not to mention decades of labor market research.

Before the recession began, over 80 million American adults were not working. To be sure, some of them could find no reward in the labor market and would be stuck without gainful employment no matter how lean the safety net got. But many others were not working by choice. You probably know skilled stay-at-home mothers or fathers who could readily find a job but believe that the net pay from that job would not justify the personal sacrifices required. They are examples of people who deliberately do not maximize their income. Other examples are people who turn down an out-of-town promotion in order to avoid relocating their families, and workers who eschew higher paying but less safe occupations. Earning income requires sacrifices, and people evaluate whether the net income earned is enough to justify the sacrifices.

When the food stamp or unemployment programs pay more, the sacrifices that jobs require do not disappear. The commuting hassle is still there, the possibility for injury on the job is still there, and jobs still take time away from family, schooling, hobbies, and sleep. But the reward to working declines, because some of the money earned on the job is now available even when not working.

A related fallacy is that employees would do absolutely anything to avoid a layoff, regardless of the layoff subsidy rate. It's true that employers sometimes experience reductions in demand from their customers, as auto manufacturers and home builders did early in the recession. But layoffs are not always the inevitable result. Employers and employees could adapt to less demand by work-sharing (D. Baker 2011), reducing prices charged to customers, reducing wages, or have pursued a less cyclical line of business in the first place. Heavy layoff subsidies give them less reason to pursue the alternatives to layoffs (Topel and Welch 1980).

Decades of empirical economic research show that the reward to working, as determined by the safety net and other factors, affects how many people work and how many hours they work. To name a small fraction of the many studies: Hoynes and Schanzenbach (2012) show how potential participants stopped working or reduced their work hours when the food stamp program was introduced. Studies of unemployment insurance find that program rules have a statistically significant effect on how many people are employed, and how long unemployment lasts. Yelowitz' (2000) research shows how a number of single mothers found employment exactly when, and where, state-level Medicaid reforms increased their reward from working. Gruber and Wise (1999) and collaborators show how the safety net for the elderly results in less employment among elderly people. Autor and Duggan (2006) and the Congressional Budget Office (2010) explain how the number of disabled people who switch from work to employment-tested disability subsidies depends on the amount of the subsidy relative to the earnings from work. Murphy and Topel (1997) show how poor wage growth among less-skilled men helps explain their declining employment rates during the 1970s and 1980s.

Because economists have identified many other cases in which means-tested and employment-tested subsidies caused people to work less (Krueger and Meyer 2002), it should be no surprise that the same kinds of behavioral responses occurred since 2007: a larger safety net reduced aggregate employment and hours worked.

Programs assisting the poor and unemployed interact with private-sector demand shocks in determining the number unemployed. An adverse demand shock increased unemployment more under the ARRA than it would if the same demand shock had been experienced under 2007 tax and subsidy rules because each dollar that wages are reduced is a bigger proportion of the

reward to work for someone whose reward has been largely whittled away by tax and subsidy programs than it is for someone who keeps a large fraction of what she earns.

Other Misconceptions about the Reward to Working

I previously cited at least a dozen changes in subsidy rules that served to raise job acceptance penalty and layoff subsidy rates. Any one of them may appear insignificant by itself, especially for the purpose of aggregate labor market analysis. But that doesn't mean that the combination of a dozen or more potentially small job acceptance penalty and layoff subsidy rate increases is itself small.

Focusing on just one of any of the safety net expansions is also misleading as to the magnitude of the overall increase in job acceptance penalty rates and therefore potentially misleading as to the sources of the major changes in the labor market since 2007. It is even possible that attention to one program in isolation of the wider safety net could motivate backwards public policy responses.

To see this, imagine that UI rules became more generous, and that added to the number of households who were unemployed and with less income than they have when working. A number of the added unemployed people apply for food stamps, which from the food stamp program's point of view makes it look like "the economy is getting worse," so food stamp officials recommend enhancing food stamp benefits, which further increases the job acceptance penalty rate. But, in this example, the added food stamp applications come from higher job acceptance penalty rates created by UI, and the right food stamp policy response may be to reduce benefits in order to stabilize the overall job acceptance penalty rate. The point of this example is not that the actual safety net expansions were excessive but rather that the economics of the safety net can be different when the safety net is viewed as a whole rather than on a program-by-program basis. The distinction is more than academic: recent events involved expansions of the safety net in many dimensions, and all of that occurred on top of a multitude of other safety net programs.

Another misconception is that most of the growth of federal income security program spending came from the recession, and not from more generous program rules (Krugman 2011). My estimates suggest the 2007 to 2010 rate of increase of inflation-adjusted per capita government spending on Unemployment Insurance and SNAP was at least triple of what it would have been if the real benefit and eligibility rules had remained what they were in 2007 (Mulligan 2012).

Among the hundreds of labor market studies, two of them – Rothstein (2011) and Ben-Shalom, Moffitt and Scholz (2011) – have been misrepresented as showing that recent safety net expansions had no visible effect on employment. Ben-Shalom et al. (2011) looks at the pre-recession safety net, and thereby does not consider the safety net expansions that have occurred since then. Rothstein (2011) looks at the allowable duration of unemployment benefits, finding that benefit durations have a statistically significant effect on unemployment exits, but does not examine a single one of the safety net program parameters that are examined in the chart

attached to my testimony. Neither study considers layoff subsidies or what happens when job acceptance penalty rates approach one hundred percent.

The number of job openings per unemployed person fell sharply during the recession (U.S. Bureau of Labor Statistics 2013). This fact has been misinterpreted by journalists as proving that unemployment subsidies are not a significant factor depressing the labor market. To the contrary, expanding unemployment subsidies can by themselves, or in conjunction with other factors, reduce job openings per unemployed person (Pissarides 2000). If you want to understand what caused and prolonged the recession, you have to look beyond the ratio of job openings to people unemployed.

It is sometimes thought that safety net transactions only impact the people who participate in the programs. To the contrary, the safety net is funded by taxpayers, lenders, owners of government debt, beneficiaries of government programs other than the safety net, or some combination thereof. As a portion of the beneficiaries opt to earn less, they also opt to spend and save less, as their household budget constraint frequently requires. They lawfully pay less tax. Businesses anticipate having fewer employees and invest less. These behavioral changes are bad news for employers in general, for people who produce the consumer and investment goods that beneficiaries would be buying if they were back at work (and goods the program funders would be buying if they were not funding the expansions), and for people who live in places like Michigan whose economies are especially intensive in the production of such goods (Galí, Gertler and Lopez-Salido 2007).

Research has shown that the poor and unemployed tend to quickly spend what they have on basic needs, which is why helping them is intrinsically valuable (Gruber 1997), but “stimulus” advocates sometimes further assert that spending patterns of the poor are why redistribution serves as a great boost in total spending and thereby total employment. Even if redistribution did not depress the reward to working, the stimulus assertions would be wrong because they ignore the spending of the people who fund the programs. Redistributing resources to the poor from everyone else changes the composition of spending and employment in the direction of industries like discount groceries that disproportionately serve poor customers and away from industries like high-end restaurants serving relatively few poor customers, but redistribution by itself has little effect on *aggregate* spending.³

When redistribution is combined with increases in job acceptance penalties and layoff subsidies – as a number of recent policies have done – it significantly reduces aggregate spending because people typically spend less when they are not working.⁴

³ Redistribution to the poor may reduce aggregate labor demand if the poor tend to purchase goods and services that are less labor intensive in their production than are the rest of the goods and services in the economy. Also note that (a) government transfers are very different from government purchases of goods and services such as military spending or highway construction, which have been shown to significantly increase GDP in many instances (if nothing else, government purchases are automatically considered part of GDP, whereas transfers are not), and (b) aggregate spending is the sum of investment spending, consumer spending, government purchases, and net exports.

⁴ Aguiar and Hurst (2005). To the extent that it redistributed resources to low-income families, the 2011-12 payroll tax cut is an exception because it achieved its redistribution while increasing the reward to work.

Conclusions

The bottom line is that helping the poor and economically vulnerable has a price in terms of labor market inefficiency. Since 2007, we have been paying more of that price: American public policies moved significantly in the direction of less labor market efficiency, and perhaps more than was necessary for providing assistance to those who need it.

First of all, 100 percent job acceptance penalty rates are difficult to justify as a reasonable balance between equity and efficiency and the recent safety net expansions documented here added millions to the number of people facing such rates.

Second, rather than making people feel safer, a number of the safety net expansions may themselves be a source of uncertainty via the political process because, among other things, they must be repeatedly renewed by Congress, and taxpayers are still unsure of exactly who will pay for them (Baker, Bloom and Davis 2011).

Third, my testimony explains how multiple parties – governments, lenders, and courts – have claims on the income that appears on a person's tax return. Multiple tax collectors can lead to excessive marginal tax rates, as each individual collector might not value the effect of his extraction on the revenues received by the other collectors (Olson 2000).

For these reasons, it is likely possible to reduce job acceptance penalty rates, reduce layoff subsidy rates, and enhance labor market efficiency without giving up much or any of the genuine benefits America enjoys from safety net programs.

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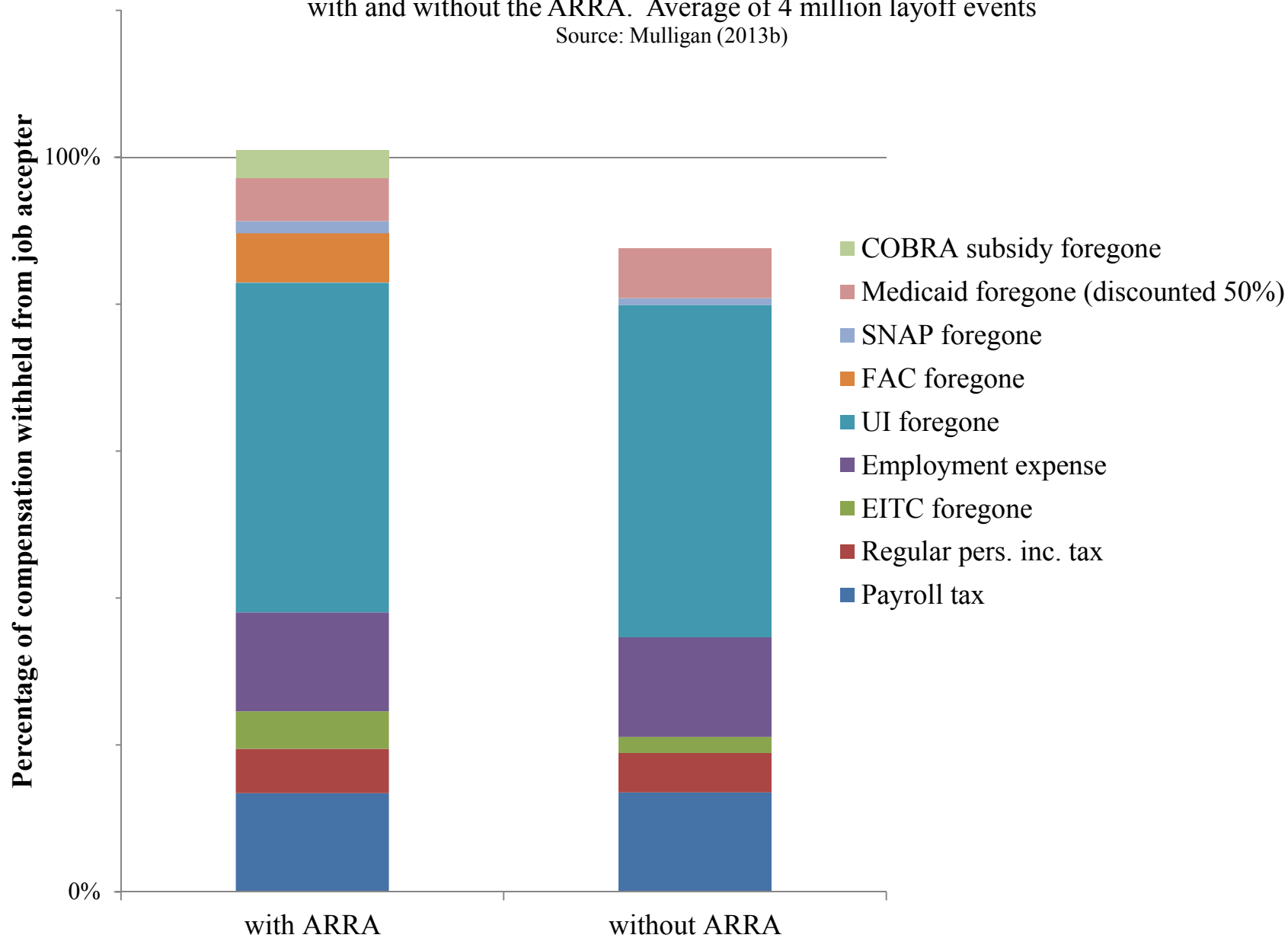
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Job-Acceptance Penalty Rate Components

with and without the ARRA. Average of 4 million layoff events
Source: Mulligan (2013b)



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Committee on Oversight and Government Reform
Witness Disclosure Requirement - "Truth in Testimony"
Required by House Rule XI, Clause 2(g)(5)

Name:

1. Please list any federal grants or contracts (including subgrants or subcontracts) you have received since October 1, 2010. Include the source and amount of each grant or contract.

None

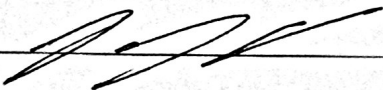
2. Please list any entity you are testifying on behalf of and briefly describe your relationship with these entities.

None

3. Please list any federal grants or contracts (including subgrants or subcontracts) received since October 1, 2010, by the entity(ies) you listed above. Include the source and amount of each grant or contract.

N.A.

I certify that the above information is true and correct.
Signature:



Date:

2/11/13