### COVID’s Next Challenge

### Analyzing the Economic Disincentives Created from the CARES Act on the US Labor Market

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A group of people posing for the camera

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Summary:

* People receiving supplemental unemployment insurance who are at the lower end of the earning spectrum have financial incentives to remain unemployed until the expiration of the weekly $600 federally-funded supplement.
* This distorted incentive system will complicate the speedy recovery of the economy as governors begin to loosen restrictions on the opening of businesses.
* The authors recommend that the CARES Act be amended to: a) temporarily eliminate the FICA tax on the first $10,000 of income earned between after June 1st and July 31st; b) expand the earned income tax credit for low wage earners who return to work before July 31st.

Article

COVID’s next challenge will be shortages in the availability of low-skilled laborers, and this could severely hinder the economic recovery. How can there be a shortage in the supply of labor with the unemployment rate hovering around 15%? The cause is easy to understand: in order to mitigate the economic impact of the COVID pandemic on the newly unemployed, the CARES Act temporarily enhances and expands unemployment insurance. Specifically, the law provides an additional flat payment of $600 per week to the amount regularly available for unemployment insurance under individual state laws; this provision is in effect through July 31, 2020. For a typical worker, the weekly unemployment benefit is now about $850 per week which means that anyone who makes less than approximately $40,000 per year has a short-term financial disincentive to return to work.[[1]](#footnote-1)

We have all heard the stories over the past few weeks. Here are a few:

* The swimming pool service company which has a long backlog of jobs because workers are making more on employment than the company can afford to pay them
* The restaurant owner who is planning to pay her workers under the table until July 31st
* The college student who has no financial motivation to seek summer employment
* The landscaper who is unable to find laborers to service customers

During the CARES Act Senate debate, Senator Benjamin Sasse (R- Nebraska) proposed an amendment stipulating that supplemental federal unemployment payments not result in individuals receiving unemployment compensation in excess of the amount of wages that they earned prior to becoming unemployed. The amendment failed to pass largely on a party line vote (48 Yeas, 48 Nays, 4 not voting). As a consequence, many low wage earners are now receiving unemployment compensation in excess of their prior employment income. How many unemployed workers fall into this category?

It is surprisingly difficult to provide an exact answer to this question because unemployment insurance is administered at the state level and the base level of unemployment insurance varies by state. Moreover, data capture and reporting on the prior earnings of the newly unemployed is sparse and incomplete in most states. However, we estimate the number of workers who presently receive UI in excess of their prior wages at between approximately 15 million and 23 persons. This range was calculated by multiplying the total number (39 million) of newly unemployed persons since the unset of the Coronavirus during the week ending on March 21, 2020 by an estimate of the percentage of these workers (39% for households and 60% for individuals) who earn less than $40,000 annually.[[2]](#footnote-2)

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The authors recognize than many of these 15 to 23 million persons are unable to return to work even without the financial disincentive. For example, many unemployed need to care for family members impacted by COVID or work for employers that are still closed. Moreover, there are surely millions of unemployed who make less than $40,000 per year who would prefer to return to work for a variety of reasons including:

* Feeling the sense of self-worth that employment provides
* Achieving long-term occupational goals
* Retaining their job/income for the longer term beyond July 31st
* Making a larger contribution to the world
* Experiencing companionship and affiliation with their work team

Although these non-monetary incentives are powerful, we argue that there are several categories of workers where some of these motivations are less important. Among these categories include: seasonal workers, temporary employees, gig workers, students, and certain groups of unskilled laborers. Given these additional factors, what can the federal government do to mitigate an individual’s financial disincentive to return to work?

The federal supplement to unemployment insurance is in place until July 31st and it is both unwise and politically infeasible to repeal this provision. In fact, one can make a solid argument that the July 31 deadline should be extended if large swaths of occupations remain unable to return to work. Clearly, a repeal of the supplemental UI provision of CARES is a political non-starter.

Instead, we believe that the federal government needs to provide an income boost to low income wage earners who return to work before July 31st. We have 2 ideas as to how this can work as follows:

* Temporarily change the 7.65% FICA tax such that the first $10,000 in income earned after June 1st and before July 31st is taxed at zero; this change could be coupled with a temporary increase in the social security wage base of $137,700 to mitigate the impact on the solvency of the Social Security trust fund. The effect would be felt immediately in weekly pay checks and would be especially important for low wage earners.
* Alternatively, expand and improve the existing Earned Income Tax Credit (EITC) so as to reach more low-income families who are currently excluded from the EITC provisions and change the current IRS system from a tax refund at year end to weekly checks to incentivize employment. The EITC subsidizes low-income workers, in addition to their normal salary, in order to raise their annual income. Research from The Center on Budget and Policy Priorities (CBPP) demonstrates that “[the EITC] leads to benefits at virtually every stage of life, including improved school performance, higher college enrollment, and increased work effort and earnings in adulthood.”[[3]](#footnote-3) However, currently the EITC excludes most workers without dependents and requires EITC applicants to file for the benefits at the end of the year only.[[4]](#footnote-4) These loop holes should be amended so that more low-income Americans are eligible for the program and so weekly benefits are paid to EITC recipients (just like with unemployment insurance).

Conclusion

COVID has had extraordinary effects on the global economy and the American labor market, but its next challenge might be due in part to our governmental legislation aimed to combat the crisis. Having analyzed the unemployment benefits currently being provided to out-of-work Americans, the authors advocate for urgent policy changes to amend the economic disincentives created by the CARES Act. First, we call for a change to the FICA tax and second to the EITC. If these changes are not made, we worry that the labor market might not rebound as anticipated not only due to the Coronavirus contraction, but also because of governmental policies.

About the Authors

Peter McKelvey is the President Emeritus of L.E.K. Consulting, The Americas. Peter was with L.E.K. for 29 years and specialized in corporate strategy development and merger and acquisition advisory services. He currently serves as a senior advisor to early stage businesses and is a part-time Adjunct Instructor of economics at Williams College.

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1. Calculating the average state unemployment benefit for the United States is complicated by various underlying factors related to the recipient, including their previous salary and state of residence. Although research from The Center on Budget and Policy Priorities states that the average state unemployment benefit is $378, to be conservative, our team estimated the average benefits at about $250. [↑](#footnote-ref-1)
2. The authors estimated these figures using publicly available data and analyses from the Federal Reserve Bank of St. Louis (FRED), the Federal Reserve SHED Survey, the Bureau of Labor Statistics (BLS), and the New York Times. The two numbers listed draw upon assumptions for either households or individuals receiving unemployment insurance between March 21, 2020 and May 16, 2020 and also earning less than $40,000 annually. The authors’ calculations can be found on their GitHub page here: https://github.com/jschneids13/Covid\_UI. [↑](#footnote-ref-2)
3. (Center on Budget and Policy Priorities 2016) [↑](#footnote-ref-3)
4. (IRS 2020) [↑](#footnote-ref-4)