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Unemployment compensation finance and labor market rigidity

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Abstract

The systematic use of experience rating is an original feature of the U.S. unemployment benefits system. At first glance, experience rating does not appear to be a desirable choice for a lot of European labor markets, which are characterized by high firing costs. We provide a simple matching model of a rigid labor market that includes firing costs, temporary jobs and a minimum wage in order to analyze this issue. Our analysis leads us to argue that experience rating is likely to reduce unemployment and improve the welfare of low-skilled workers in France, and more generally for low-skilled workers in a typical, rigid Continental European labor market.

Keywords: Experience rating; Firing costs; European labor market

1. Introduction

The systematic use of experience rating is an original feature of the U.S. unemployment benefits system. In most states, unemployment benefits are financed by taxing firms in proportion to their separations. Experience rating is a way to require employers to contribute to the payment of unemployment benefits they create through their firing decisions. It is striking that experience rating is absent from the unemployment compensation systems of other OECD countries, where benefits are usually financed by payroll taxes paid by employers or employees, and by government contributions (Holmlund, 1998). The absence of experience rating in the other OECD countries leads us to ask the

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following questions: is experience rating only adapted to the U.S. labor market? Would it be suitable for other countries? Indeed, the U.S. labor market is special, in that it is always considered as being dramatically flexible: there is no job protection (OECD, 1999) and the minimum wage is low with respect to many other OECD countries (OECD, 1998). Thus, we may ask if experience rating is only suitable in a very flexible labor market, and undesirable in a labor market that faces strong job protection and high minimum wages?

A lot of research has been devoted to understanding the consequence that experience rating has on unemployment and welfare (see Holmlund, 1998, for a survey).

Feldstein (1976) is among the first to offer a theoretical analysis of experience rating. Feldstein presents a model of temporary layoffs, which are frequent in the U.S. economy. For this model, he considers the behavior of a firm, with an exogenous number of employees that is facing demand shocks. He argues that unemployment insurance subsidies cause layoffs when they would otherwise have not occurred, and magnifies the size of the layoffs that do occur.

Feldstein's contribution, extended by Burdett and Wright (1989) and Marceau (1993), examines the consequences of experience rating on *temporary* layoffs. It is assumed that a pool of workers is attached to the firm, and that they do not find jobs elsewhere when unemployed. As Feldstein has stressed, this analysis is likely to be relevant in the manufacturing sector in the U.S. Temporary layoffs are scarce, however, in most European labor markets. Accordingly, some papers have looked at the consequences of experience rating in models that allow workers to be mobile across firms. Within this framework, experience rating has the same consequences as a combination of an increase in firing costs and a decrease in payroll taxes. As shown by Mortensen and Pissarides (1994), Millard and Mortensen (1997) and Mortensen and Pissarides (1999a,b), an increase in firing costs has an ambiguous impact on unemployment: it reduces both job creation and job destruction. The decrease in the payroll tax is usually beneficial to employment. Millard and Mortensen (1997) find that increasing the experience rating decreases unemployment for reasonable values of the parameters in a matching model with endogenous job destruction and wages that are bargained at the firm level. As Millard and Mortensen do not explicitly introduce a balanced budget for the unemployment benefit system, the increase in the experience rating has exactly the same effect on unemployment as a rise in firing costs. In fact, it can be argued that introducing a balanced budget constraint would magnify the decrease in unemployment due to the experience rating, since the payroll tax should be reduced by the increase in the experience rating. From this point of view, Albrecht and Vroman's (1999) contribution is of particular interest, because they explicitly introduce a balanced budget constraint for the unemployment benefits system. They examine the consequences of experience rating in an efficiency wage model where workers' heterogeneity gives rise to imperfect monitoring and endogenous layoffs. They compare two self-financing unemployment compensation systems: one in which benefits are financed by a proportional payroll tax, and another where firms are taxed in proportion to their layoffs. They find that experience rating is favorable to employment, wages and production for any level of unemployment benefits. That is because experience rating, which increases separation costs, induces firms to pay higher wages in order to avoid layoffs. Thus, Albrecht and Vroman are able to show that higher wages, lower unemployment and higher production are obtained with experience rating for relevant values of the parameters.