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Integration of unemployment insurance with retirement insurance ☆

Joseph E. Stiglitz[a,1], Jungyoll Yun[b,*]

[a]Columbia University, 814 Uris Hall, 3022 Broadway, New York, NY 10027, USA
[b]Economics Dept., Ewha University, Seodaemun-ku, Seoul 120-750, Korea

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Abstract

This paper analyzes a social insurance system that integrates unemployment insurance with a pension program, allowing workers to borrow against their future wage income to finance consumption during an unemployment episode and thus improving search incentives while reducing the risks arising from unemployment. This paper identifies the conditions under which integration improves welfare and the factors which determine the optimal degree of integration. We show that when the duration of unemployment is very short compared to the period of employment or retirement, the optimal system involves exclusive reliance on pension-funded self-insurance. This system imposes a negligible risk burden for workers while avoiding attenuating search incentives. We also argue that joint integration of several social insurance programs with a pension program through an individual account is desirable unless the risks are perfectly correlated with each other.

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* Corresponding author. Tel.: +82 2 3277 2775; fax: +82 2 3277 4010.
E-mail addresses: jes322@columbia.edu (J.E. Stiglitz), jyyun@ewha.ac.kr (J. Yun).
[1] Tel.: +1 212 854 1481; fax: +1 212 662 8474.

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1. Introduction

The East Asian crisis brought home to much of the developing world a lesson that the Great Depression brought home to more advanced countries 70 years ago—the importance of a safety net. But as countries like Korea go about constructing their safety nets, they are cognizant of the complaints that have been raised against unemployment insurance systems: they attenuate incentives. To be sure, there are adverse incentive effects (or, as they are today generally referred to, moral hazard effects) in all insurance programs. What worries critics is that the risk reduction benefits might, on the face of it, be outweighed by the adverse incentive effects. For most individuals, a typical spell of unemployment is less than 6 months (and that spell would presumably be shorter, possibly much shorter in the absence of unemployment insurance.) Over a working time of, say, 45 years, an individual with three such spells would lose perhaps 4% of his lifetime income—a risk which presumably the individual could easily absorb if he had sufficient savings or could borrow against future earnings. With the bulk of savings used for retirement, and mostly dedicated to social security programs, the amount individuals have to buffer themselves against these income shocks is limited; and well-documented limitations in capital markets make it difficult for individuals to borrow much against future earnings. Thus compulsory old age public pension programs, while they help resolve one problem–the tendency of individuals not to save enough for their old age, because of the possibility of public "bail-outs"[2]–exacerbate another.

This naturally leads to the suggestion of an integrated unemployment and pension program, which we will call *the integrated unemployment insurance (UI) system*. Such integration makes particular sense with individual accounts, which are increasingly forming the basis of even public pension programs.[3] In such programs, benefits are related to contributions by simple formulae; in the simplest form, there is no redistribution. Such programs are like defined contribution pension programs, though some of the contributions can be used to "purchase" insurance (e.g. against inflation or interest rate fluctuations) which is not available on the market. Although it would be simple to impose redistributions on top, for simplicity, this paper ignores the redistributive components.[4]

Under the integrated UI program, an individual who is unemployed can have his unemployment payments taken out of his individual account. Thus, the individual obtains

[2] Individuals who find their incomes in retirement insufficient because of a failure to save, or because they have invested in risky assets which have failed, will receive some form of assistance from the government. That is, if society feels that it cannot let those with inadequate income to support themselves in their retirement suffer excessively, individuals know that if they do not save, or if they invest in risky assets that fail to yield a return, they will be 'bailed out.' This creates a moral hazard problem, which can be mitigated through forced savings programs which restrict the extent of risk taking. Typical public pension (social security) programs represent a simplified version of such restrictions; individuals must 'save' a certain amount, and the proceeds are invested in treasury bills. See Stiglitz (1993).

[3] See Orzag et al. (1999) and Feldstein (1995) for a more general discussion. Folster and Trofimov (1999) also presented a theoretical analysis of individual savings accounts for social insurance.

[4] Note that any redistribution imposed involves *some* efficiency costs. See Stiglitz (1999). Some of the detailed redistribution issues associated with the integration will be discussed later in this paper.