

The cost of business cycles and the stabilization value of unemployment insurance

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Abstract

This paper offers a new perspective on why labor market policies aimed at reducing the cost of business cycles may be warranted and how such policies can be designed in order to improve welfare. To this end, we develop a quantitative dynamic equilibrium model to illustrate how the contractual structure of the labor market may hide significant undiversified wage risk induced by aggregate fluctuations. The environment analyzed is such that the only imperfectly diversified risk workers bear is the risk of losing their job when the market for new contracts is depressed. When we fit the model to replicate the amount of wage variation estimated from micro-data, we obtain estimates of the potential value of stabilization policies that are substantially larger than those found in the literature. We use this framework to examine several policy issues and, in particular, to show why state-contingent unemployment insurance may dominate non-contingent unemployment insurance schemes. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

When analyzing policies aimed at reducing the cost of business cycles, the ultimate goal is to evaluate these policies in terms of their effectiveness in generating welfare gains. However, ever since Lucas (1987) placed in doubt the intrinsic value of eliminating aggregate fluctuations, it has become contentious to claim that any stabilization policy is worth pursuing. In his influential study, Lucas presents a simple estimation of the cost of aggregate instability. His estimate computes the uniform percentage increase in consumption that is needed to leave a consumer indifferent between a consumption stream with the U.S. consumption variability, and a smooth consumption path. This calculation indicates that the business cycle generates an almost negligible welfare cost – less than one-tenth of a percentage point of consumption. Lucas thus concludes that the potential gains attainable from stabilizing the economy may be negligible.

Lucas's computation is based on the assumption that markets are complete and hence all but aggregate risk is diversifiable. Although this is a questionable assumption, Lucas's work clearly shows that stabilization policies generate substantial welfare gains only if they help to reduce some undiversifiable components of business cycle risk.¹ Following this observation, Imrohorglu (1989) and Atkeson and Phelan (1994) have examined the potential gains associated with reducing economic instability in economies where markets are incomplete.² Both papers argue that employment fluctuations are not shared evenly among different individuals. Instead, the burden of recessions falls disproportionately among those few who lose their jobs in recessions. Based on this premise, both papers focus on unemployment risk as the principal undiversified risk associated with the business cycle.

For example, Imrohorglu measures the welfare cost of the business cycle in an economy where individuals have access to a storage technology but limited access to credit and insurance. She compares a cyclical and a stabilized economy that differ only in the transition probabilities between employment and unemployment. In the cyclical economy, the probability of becoming unemployed and the probability of remaining unemployed is more likely during a recession than it is during a boom. Imrohorglu's estimates of the cost of aggregate fluctuations in this environment are also small, on the order of 0.3% of

¹In this view, stabilization policies bring welfare gains only to the extent that they can reduce the volatility of consumer marginal utility. Thus, this view dismisses any effect of stabilization policy on the average level of employment or output. For a discussion of how stabilization policies can affect the mean of output and employment see Delong and Summers (1988).

²Imrohorglu and Hansen (1992) is a closely related paper.

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