



# Unemployment insurance in Chile: Does it stabilize the business cycle?<sup>☆</sup>

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## Abstract

We explore the stabilizing effects of unemployment insurance in Chile. A dynamic general equilibrium model is calibrated for the Chilean economy for the 1960–2000 period. We assume that the economy is subject to exogenous technological shocks and that a fraction of the population is liquidity constrained. Our main conclusion is that unemployment insurance has some stabilizing effect on the business cycle, especially on consumption, but that this effect is of the second order of magnitude. We also find that the larger the fraction of the population that is liquidity constrained, the more likely the program is welfare improving. Our results suggest that the objective of stabilizing the business cycle would be more efficiently achieved using alternative instruments.

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## 1. Introduction

In October 2002 an unemployment insurance fund was introduced in Chile with the stated aim of protecting workers' income levels when they become unemployed. This paper considers the potentially unintended business cycle effects of unemployment insurance, in particular the question of whether this insurance has stabilizing effects in terms of making the business cycle less pronounced.

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Stabilizing effects ensue if liquidity constrained agents are allowed access to unemployment insurance funds when they become unemployed in a recession, allowing them to reduce their consumption by less than they would have done if there were no unemployment insurance system. As contributions to the fund are larger in booms than in recessions, this potentially provides an additional stabilizing effect. We assume non-diversifiable aggregate technological shocks that produce fluctuations in variables such as production, employment and consumption. People are assumed to be liquidity constrained and they do not have perfect access to the capital market.

The benefits of reducing business fluctuation have been widely studied in the literature. Lucas (1987) voiced doubts as to the value of these benefits, calculating that the effects on welfare are minimal. He compared his estimate of the benefits of attenuating the volatility of the business cycle with the large welfare benefits that attend economic growth, concluding that the profession would do better to focus on growth rather than on stabilization policies.

In the case of unemployment insurance the literature has focused on the stabilization and welfare properties of this insurance when markets are incomplete. Based on a model of unemployment insurance Baily (1977) reports results as to how much insurance should be provided, and in what form. Hamermesh (1982) makes use of a model to determine whether current levels of unemployment insurance (UI) in the US are sufficient to overcome the liquidity constraint faced by the unemployed. He finds that a large portion of UI benefits do little to stabilize the economy, because people consume them as if they were fully expected, reducing their saving behavior when employed. Easley, Kiefer, and Posson (1985) use a two person, two period general equilibrium model with uncertain productivity in the second period. As agents cannot self-insure the introduction of UI implies a potential Pareto welfare improvement. They also make use of a theoretical model to compare the welfare gains of UI vis à vis a negative income tax. Hansen and Imrohoroglu (1992) study the role of unemployment insurance in an economy with liquidity constraints and moral hazard using a quantitative general equilibrium model. They assume that people cannot borrow in the capital market and that agents face exogenous idiosyncratic employment shocks (there are no aggregate shocks). They conclude that if there is no moral hazard the optimal replacement rate may be as high as 0.65 (similar to that found in the US economy) and that the welfare benefits of UI are large. However, if there is moral hazard and the replacement rate is not set at the optimal level, the economy can be worse off with UI than it would have been without it.

Imrohoroglu (1989), and Atkinson and Phelan (1994), argue the unemployed bear a disproportionate burden of the cost of employment fluctuations during recessions. Both papers focus on the unemployment risk as the main undiversified risk associated with the business cycle. Nonetheless, their estimates of the welfare gains of curbing business cycle fluctuations are also small<sup>1</sup> because the data shows very little time variation in the average duration of US unemployment. Hence, the risk of a long period of unemployment in a recession is relatively small. However, Beaudry and Pages (2001) argue that focusing only on unemployment duration may underestimate the welfare gains of stabilization policies. They conclude that mild variability of aggregate wages may hide important business cycle fluctuations in individual wages and that this source of risk implies substantial welfare costs. They also conclude that attention to the design of unemployment insurance is required if UI is to contribute to diversifying the risk of economic fluctuations. More specifically, they find that unconditional UI can be an inefficient way of reducing the cost of business fluctuations, while a state contingent UI scheme that offers more

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<sup>1</sup> Imrohoroglu (op. cit.) finds that the welfare cost of aggregate fluctuations is about 0.3% of consumption.

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