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Productivity gains from unemployment insurance

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Abstract

This paper argues that unemployment insurance increases labor productivity by encouraging workers to seek higher productivity jobs, and by encouraging firms to create those jobs. We use a quantitative model to investigate whether this effect is comparable in magnitude to the standard moral hazard effects of unemployment insurance. Our model economy captures the behavior of the U.S. labor market for high school graduates quite well. With unemployment insurance more generous than the current U.S. level, unemployment would increase by a magnitude similar to the micro-estimates; but because the composition of jobs also changes, total output and welfare would increase as well. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

This paper argues that unemployment insurance increases labor productivity by encouraging workers to seek higher productivity jobs, and by encouraging firms to create those jobs. We use a quantitative model to investigate whether this effect is comparable in magnitude to the standard moral hazard effects of

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unemployment insurance (UI). Our results indicate that a decrease in the generosity of UI from its current U.S. level would not only decrease welfare but also reduce the level of output.

Most analyses of unemployment insurance focus on its consumption-smoothing and risk-sharing roles. For example, Gruber (1997) finds that workers who receive more generous unemployment benefits experience a smaller drop in consumption following the loss of a job. Standard approaches to unemployment insurance compare this benefit with the adverse moral hazard effects, and compute the optimal amount of UI by equating marginal costs and benefits (Shavell and Weiss, 1979; Hopenhayn and Nicolini, 1997).

While this tradeoff is likely to be important, UI could also affect the type of jobs that workers look for and accept.¹ According to the theory we develop, in an economy without any UI, workers avoid the risk of unemployment by applying to low productivity jobs that are easier to obtain. Firms offer implicit insurance to workers by opening jobs with low unemployment risk, and charging an insurance premium in the form of lower wages. The resulting composition of jobs is inefficient and can be improved by a moderate level of unemployment insurance, which encourages workers to take on more risk, and increases both welfare and the level of output (see also Acemoglu and Shimer, 1999a).

Although this effect is qualitatively reasonable, a major goal of this paper is to show that it is likely to be quantitatively important as well. In a realistic environment, it must outweigh two significant forces. First, unemployment insurance will encourage workers to reduce their search effort, lowering employment and output. Second, workers can self-insure by saving, considerably reducing the need for unemployment insurance.

To address these issues, we consider a quantitative dynamic economy. Workers are risk averse, with constant relative risk aversion (CRRA). They optimally choose their consumption, labor supply, and search effort while unemployed. Unfortunately, this model cannot be solved analytically,² because the workers' optimal policy (their consumption, labor supply, and search rules) depends on their wealth level, which is itself determined by the optimal policy. We therefore undertake a calibration exercise, anchoring our model to plausible preferences and to the unemployment rate and unemployment insurance system

¹ In the data, Ehrenberg and Oaxaca (1976) find that workers who receive more UI find higher wage jobs. On the other hand, Meyer (1989) finds no evidence that more generous UI results in higher earnings for covered workers. His estimates have large standard errors, however, and cannot rule out substantial earnings effects.

² In Acemoglu and Shimer (1999a), we provided closed form solutions for the case with constant absolute risk aversion. In this paper, we use the more conventional CRRA preferences, which imply that poorer workers may be unwilling to accept gambles that richer workers find attractive. The utility cost of low consumption is also much larger with CRRA preferences, increasing the role of insurance.

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