4A Economic and Social Impacts of UI

Question: What is the current state of economic thinking about UI?

Answer: Since economics underlies most policy debates, some familiarity with what economists and social scientists are saying is useful when participating in UI policy debates. Readers should keep in mind that the Toolkit is not written for or by economists. We start by saying that, in our experience, peer-reviewed economic journals furnish only a narrow window on the UI world, economic models are only accurate if their assumptions closely approximate the real world, and sometimes assumptions in papers are obscure or only loosely connected to reality.[1] Economists understand these limitations, but those relying upon economists' findings among editorial board writers or in legislative debates rarely acknowledge them.

Much of the economics debate about UI revolves around moral hazard. This is a term used in economics and insurance for the change in behavior that arises from shifting incentives when a third party assumes some risk for the behavior of an individual. As a result, the individual is more likely to engage in the insured risk and shift the costs to the insurer (Marmor, 2014: 10-11). In the context of UI, moral hazard recognizes that since UI lessens the hardships associated with unemployment, unemployment spells will last longer than they would if a UI claimant had no protection from wage losses. This impact is referred to as a disincentive to work. UI programmatically deals with moral hazard concerns by limiting eligibility to those demonstrating an attachment to the labor market, disqualifying those who are not involuntarily unemployed, and only partially replacing lost wages. (In the next section of the Toolkit, we examine UI and disincentives more closely.)

While "economics" sounds like one discipline to outsiders, there are different approaches within the field and different approaches reflected among economists. For our purposes, noting the distinctions between theoretical models and empirical studies is a key factor. Studies of theory, such as "optimal UI," or macroeconomic models of UI are not designed for immediate application in the real world. They are concerned with theoretical disputes within economics.[2] In addition, microeconomists have different approaches than macroeconomists, and the micro approach based upon government survey or administrative data is often more relevant to UI policy debates in our experience.

In this section of the Toolkit we furnish an overview of selected economic studies, as well as useful papers by other relevant disciplines which throw light on questions that frequently arise during UI policy debates. The following is a short—and by no means comprehensive—account of unemployment insurance research with an emphasis on

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[1] In a highly-cited paper reviewing theoretical models casting doubt on the utility of UI, the authors stated "With some notable exceptions . . . the theoretical literature on unemployment benefit largely ignores important institutional features of actual social security schemes." Atkinson and Micklewright (1991: 1688).

[2] See, for example, leading economist Lawrence Summers (1991: 144), who said that "Modern scientific macroeconomics sees a (the?) crucial role of theory as the development of pseudo world's . . . and explicitly rejects the view that 'theory is a collection of assertions about the actual economy.'" (Parenthetical (the?) in original.)

recent studies and those that support UI as a worthwhile social insurance program. To a considerable degree, mainstream economists have shifted their views, not only in response to recent studies about the Great Recession, but as they have developed newer theoretical models of the labor market with more nuanced assumptions over the last 25 years or so. Many economists now have a more sanguine view of UI than in the past. More studies find that UI increases overall welfare. Many economists accept that UI has a positive impact on the economy during economic downturns.

Fine examples of newer models of UI are found in papers by economists Daron Acemoglu of MIT and Robert Shimer of Princeton (1999, 2000). These authors used models of the labor market where increases in productivity occur because UI claimants can look for better jobs due to the support they get from UI benefits. In turn, firms are induced to create higher productivity jobs, and this feedback mechanism improves overall welfare or output. This approach reverses the traditional moral hazard/work disincentive perspective on UI and turns the income support function of UI into a virtue, rather than a shortcoming.

This positive perspective on UI contrasts with the neoclassical view of unemployment. Under this neoclassical view, there is no such thing as involuntary unemployment, since the supply and demand for labor should adjust automatically, producing a "market-clearing wage" and full employment. If jobless workers are out of work under this economic theory, it is because their "reservation wages"—in other words, the lowest wages for which someone would work a job—are too high. A 2011 paper by Chris Edwards and George Leef for the Cato Institute (cited below) is one illustration of this theoretical approach. Under this orthodox view, UI has no positive impact for jobless workers or the economy. Indeed, UI causes unemployment by "paying people to be unemployed" as many of UI's critics claim.

There are many practical (and moral) objections to viewing labor purely as just another commodity whose price is determined by supply and demand. Further, understanding the labor market as operating in the same way as markets for other goods and services is plainly inaccurate. Job seekers and employers are not always rational decision-makers. Discrimination based on race, sex, age, or other characteristics as well as nepotism exist. Information about jobs and job seekers is not equally available to all participants. Labor itself is characterized by differing skills, experience, and education. As a result, the labor market is composed of many occupational segments and geographic regions that prevent truly competitive market conditions.

Useful papers by Morris Altman (2014) and David Howell and Bert Azizoglu (2011), cited below, critique the orthodox views of unemployment, job search, and labor markets. Both reexamine the role of UI in light of those critiques. In doing so, they make useful observations about the gaps between orthodox economic thinking and how unemployment and UI work under more realistic assumptions.

Resources:

Daron Acemoglu and Robert Shimer, “Efficient Unemployment Insurance,” Journal of Political Economy, vol. 107 (no. 5), pp. 893-928 (1999), http://down.cenet.org.cn/upfile/67/200544132322148.pdf.

Daron Acemoglu and Robert Shimer, “Productivity Gains from Unemployment Insurance,” European Economic Review, vol. 44 (issue 7), pp. 1194-1244 (2000), http://www.newyorkfed.org/research/conference/1999/shimer.pdf.

Anthony Atkinson and John Micklewright, “Unemployment Compensation and Labor Market Transitions: A Critical Review,” Journal of Economic Literature, Vol. 29, No.3, 1679-1727 (1991), http://info.worldbank.org/etools/docs/library/230305/Vodopivec2.pdf.

Morris Altman, “Insights from behavioral economics on how labor markets work.” School of Economics and Finance, Victoria University of Wellington (NZ), Working Paper (2014). http://researcharchive.vuw.ac.nz/xmlui/bitstream/handle/10063/3466/Working%20paper.pdf?sequence=1.

Ha-Joon Chang, Economics: The User’s Guide, Chapter 10, “I’ve Known a Few People That Worked.” Bloomsbury Press (2014), pp. 251-270.

Chris Edwards and George Leef, “Failures of the Unemployment Insurance System,” Cato Institute (June 2011), http://www.downsizinggovernment.org/labor/failures-of-unemployment-insurance.

David R. Howell and Bert M. Azizoglu, “Unemployment Benefits and Work Incentives: The U.S. Labor Market in the Great Recession.” Oxford Review of Economic Policy vol. 27, no. 2, 221-240 (2011), http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_251-300/WP257.pdf.

Theodore Marmor, Jerry L. Mashaw, John Pakutka, Social Insurance: America’s Neglected Heritage and Contested Future. Sage Foundation Book (2014).

Lawrence H. Summers, “The Scientific Illusion in Empirical Macroeconomics.” Scandinavian J. of Economics, vol. 93(2), pp. 129-148 (1991), http://www.uh.edu/~bsorense/SummersScandinavian.pdf.