



Is it socially efficient to impose job search requirements on unemployed benefit claimants with hyperbolic preferences?



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ABSTRACT

DellaVigna and Paserman (2005) and Paserman (2008) have shown that imposing job search requirements on sophisticated unemployed benefit claimants with hyperbolic time preferences is Pareto improving in that it raises welfare for the unemployed, by limiting harmful procrastination, and for employees, since the enhanced search boosts the job finding rate, thereby reducing the contributions required for the funding of benefits. This paper demonstrates that the range of Pareto improvements is much reduced if the analysis takes into account the fact that benefit claimants may not comply with the requirements, especially if the monitoring technology displays imperfections induced by caseworker discretion or measurement error.

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1. Introduction

Long-term unemployment is a major problem, in particular in a number of European labor markets (OECD, 2011). This pattern comes along with evidence that the unemployed have a very low search activity (Manning, 2011; Krueger and Mueller, 2010). It is well known that the provision of Unemployment Insurance (UI) raises moral hazard problems, i.e. the more generous the UI, the lower the search incentives for the unemployed (e.g. Lalive et al., 2006). Many countries impose job search requirements on benefit recipients to cope with moral hazard in UI (OECD, 2007). To verify compliance, job search effort is monitored and, in the case of non-compliance, benefit recipients are sanctioned. However, as any policy addressing moral hazard, monitoring involves an insurance–efficiency trade-off (Boone and van Ours, 2006; Boone

et al., 2007; Cockx et al., 2011). Restoring incentives comes at the cost of reducing the capacity of UI to adequately insure workers against the risk of unemployment. Job search monitoring is different from other policy instruments as it does not directly affect the unemployment benefit (UB) level. However, monitoring increases job search costs and decreases the average quality of prospective jobs, since rational, forward-looking unemployed workers typically reduce their reservation wage in response to the higher job search requirements. Hence, the expected lifetime utility of the unemployed is negatively affected.

These results apply for individuals with standard exponential time preferences. These individuals discount the future at a constant rate and, hence, behave consistently over time. However, both laboratory experiments and empirical studies find evidence that procrastination in intertemporal choices is common (e.g. see Ainslie, 1992; Loewenstein and Thaler, 1989; Thaler and Shefrin, 1981; for a critical review see Frederick et al., 2002). That is, people seem to show self-control problems whenever they have to commit to a plan entailing present costs and future rewards (or vice versa). They may keep postponing the costly task over time and end up not achieving the future rewards, even if it was rationally optimal to reach them. This is evidence of *hyperbolic* discounting. Individuals exhibit a high degree of discounting in the short run and a relatively low degree of discounting in the long run. To cope with this

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limitation, a new branch of economics has been investigating intertemporal choices under the assumption of hyperbolic time preferences (e.g., Loewenstein and Prelec, 1992; O'Donoghue and Rabin, 1999).³

Recently, based on a longitudinal experiment on intertemporal effort choices, Augenblick et al. (2013) found limited evidence of a present bias in choices over monetary payments. By contrast, individuals procrastinate substantially in effort choices. Moreover, these individuals are more likely to choose a commitment device that forces them to complete more effort than they instantaneously desire, since they are aware of their present bias and take actions to limit their future behavior, i.e. they are *sophisticated* hyperbolic agents. This is consistent with earlier research by DellaVigna and Paserman (2005) – hereafter referred to as PDV – and Paserman (2008) who find evidence that hyperbolic preferences are particularly relevant to explain the patterns of job search behavior observed in the US. Job search effort typically entails immediate costs and delayed benefits. Consequently, individuals with hyperbolic preferences are always tempted to delay job search. Since unemployed workers engage too little in job search, PDV show that they are willing to pay a positive price for a commitment device that forces them to search more intensively if they are sophisticated hyperbolic agents. Job search monitoring could be such a commitment device. Based on simulations of an estimated structural job search model on US data, Paserman (2008) has indeed demonstrated that, if workers are impatient, monitoring job search can improve their long-run utility by lowering the expected duration of unemployment and raising the expected wages. In other words, to the extent that monitoring is relatively cheap to implement (Boone et al., 2007; Cockx et al., 2011), it can unambiguously lower government expenditures and increase social welfare without facing an insurance–efficiency trade-off. This contrasts with the conclusions for unemployed people with exponential time preferences.

Empirical evidence does not unambiguously support these positive conclusions with regard to job search monitoring. Neither does the job finding rate, nor the job quality always increase, and sometimes the unemployed rather exit to inactivity. For instance, Klepinger (1998), McVicar (2008) and Cockx and Dejemppe (2012) find that monitoring enhances the job finding rate. By contrast, Ashenfelter et al. (2005) find that tighter search requirements have insignificant effects on transitions to employment, and Klepinger et al. (2002) even find negative effects. In addition, Petrongolo (2009) reports negative impacts on the job quality (mainly earnings and employment duration) and, together with Manning (2009), she reports evidence that tighter search requirements lead to abandoning the UB claimant status.

In this paper, we show that these ambiguous findings on the effectiveness of job search monitoring need not be incompatible if the unemployed behave as agents with hyperbolic time preferences. This is because the decision to comply with the imposed job requirements does not depend on the long-run utility of these agents, but rather on the short-run utility of the current self for whom the benefits of enhanced search are shown to be smaller. Consequently, even if job search requirements are set at a sub-optimal, i.e. too low, level from the perspective of the future selves, unemployed procrastinators may nevertheless stop complying because the search requirements are too demanding from their perspective. Hence, it is shown that increasing job search requirements to a level that is optimal from the perspective of the future selves or from the perspective of society may after all still lead to a sub-optimal level of search effort and a long-run utility that

is even lower than it was in the absence of job search requirements. Furthermore, we show that imperfections in the monitoring technology induced by caseworker discretion or by measurement error reinforce this problem.

The policy implication of this analysis is that job search monitoring may improve social welfare unambiguously only if the job search requirements are not set at too high a level. Moreover, it is shown that if, as a consequence of measurement error, benefit claimants always face a strictly positive sanction probability, job search monitoring may not be socially efficient. This means that other policies, such as job search assistance, may be more efficient socially than a system imposing job search requirements on hyperbolic unemployed benefit claimants. In the end, determining whether this is the case is an empirical matter.

The model extends the basic partial equilibrium job search model (Mortensen, 1986) in three directions. First, we introduce hyperbolic discounting as in PDV. We consider agents with sophisticated hyperbolic preferences. The case of agents with naive preferences is relegated to a Supplementary Online Appendix.⁴ Second, we include a perfect job search monitoring scheme in this model, in a very similar way to what Manning (2009) and Petrongolo (2009) do for individuals with exponential preferences. Finally, we allow for imperfections in the monitoring technology by allowing, first, caseworkers to have some discretion regarding whom they sanction and, second, search effort to be measured with error (see e.g. Boone et al., 2007; Cockx et al., 2011). We contribute to the literature on hyperbolic discounting by developing a graphical exposition of the impact of hyperbolic preferences on the choice of job search effort and the reservation wage. This graphical exposition contributes to a better intuitive understanding of the main results of this paper.

The rest of the paper is organized as follows. Section 2 describes the basic model. In this model, the monitoring technology is assumed to be perfect. We describe the assumptions and notations, the optimization problem of the sophisticated agent and present the first-order conditions of the solution. We devote a separate Section to the graphical analysis of the solution. In Section 4, we discuss why raising the job search effort of benefit recipients with hyperbolic preferences can be socially efficient and how non-compliance affects this property. In Section 5, we generalize the model by incorporating an imperfect monitoring technology. First, we consider the case in which the caseworker has discretionary power as to whether a non-complying benefit claimant should be sanctioned or not. Second, we allow job search effort to be measured with error. In Section 6, we briefly contrast monitoring search with job search assistance. A final section concludes. All propositions are proved in the Appendix to this paper, while the case of a naive agent is treated, as mentioned, in a Supplementary Online Appendix.

2. The basic model

2.1. Assumptions and notations

We develop a partial equilibrium job search model under hyperbolic preferences in a stationary discrete-time setting. Infinitely-lived unemployed workers choose their reservation wage x and a scalar search-effort intensity σ to maximize their expected discounted lifetime utility. We denote $c(\sigma)$ the cost of effort and make the standard assumptions that $c(0) = 0$, $c'(\sigma) > 0$ and $c''(\sigma) > 0$. Unemployed workers are entitled to a flat unemployment benefit (UB) with no time limit. The total income while unemployed, $y_b > 0$, is equal to the UB plus any other external income (e.g. income from a partner). The payment of the UB is conditional on a search requirement $\bar{\sigma} > 0$. In our stylized benchmark representation, we assume that monitoring is perfect, meaning that job search effort is observed with perfect precision and that, if search effort falls below the requirement $\bar{\sigma}$, a sanction is imposed with

³ Researchers have studied the implications of this different behavioral assumption on various economic decisions. For instance, among others Laibson (1997) and Angeletos et al. (2001) examined saving–consumption decisions, while Carrillo and Mariotti (2000) focused on learning decisions and Fang and Silverman (2009) on labor supply and welfare participation. Others investigated specific consumption decisions: e.g. Mullainathan and Gruber (2005) focused on smoking, Fang and Wang (2010) on preventive health care, while DellaVigna and Malmendier (2006) studied contract choices and attendance to health clubs.

⁴ See <http://users.ugent.be/~bcocckx/Anaive.pdf>.

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