



Can welfare abuse be welfare improving?

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ABSTRACT

I analyze quantitatively a model of labor search with unemployment insurance (UI), savings, voluntary quits and various labor attachment requirements. In particular, I study welfare consequences of a powerful reform giving UI entitlement to workers quitting their jobs voluntarily in order to search for another one. Results of the model calibrated to the US labor market show that there may be significant welfare gains associated with pursuing a generous entitlement policy for quitters as compared to the US status-quo. Moreover, I employ the assumption of monetary search costs and show that it can explain the empirically documented unemployed worker search behavior. Finally, by inducing different unemployment benefit eligibility requirements, the model identifies a concrete policy that could help us understand differences in the unemployment rate, match quality and income inequality between the US and Europe.

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1. Introduction

In the late 1970s the labor markets in the US and Europe began to diverge and these differences are profoundly visible until today. Unsurprisingly, this contrasting evolution has attracted interest of many economists. Among many topics related to it, arguably the most attention has been devoted to unemployment insurance (UI) systems (vide e.g. the research program ran by Ljungqvist and Sargent). In this paper, I model one particular aspect of UI which differs strikingly between the two continents: the benefit entitlements for workers quitting jobs voluntarily. While in the US no quitter is eligible for receiving unemployment benefits,¹ the entitlement policy in Europe is generally more generous and usually allows for payment of benefits in such cases subject to some sanctions. The exact

requirements and sanctions have been described by Venn (2012). In general, there is a fixed work experience (or rather a social security contribution) requirement which is the same for both fired workers and quitters – usually it varies between 6 and 18 months of employment within the last 12–36 months preceding unemployment. On top of it, in order to discourage quitting, there are sanctions² in form of payment suspensions: in Lithuania and Slovakia there are no such sanctions, in Denmark there is a 3-week sanction, in Austria – 4; in Belgium – 7; in Sweden – 9; in Germany – 12. Nevertheless, there are also European countries not paying out the benefits for voluntarily unemployed, like Estonia, Italy or the Netherlands. To the best of my knowledge, there is no research analyzing the welfare effects of these policy choices. This paper is trying to fill this gap.

To this extent, I construct and calibrate to the US labor market a job search model where fired workers are eligible for time-limited UI and ask what is the optimal entitlement policy for voluntarily unemployed, i.e. whether such quits should be punished by no UI entitlement or, if not, for how long should such workers be employed before being awarded UI entitlement. In order to pick the best policy I perform a social welfare analysis. This is a natural approach as

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¹ Some states in the US allow quitters to apply for benefits if backed with a "good cause". Nevertheless, as Venn (2012) reports, most (including e.g. the seven largest states where almost 50% of the U.S. population lives) do disqualify all the voluntary quits.

² These sanctions are often not executed if the employer does not contest worker's UI claim.

it requires a consistent accounting for both benefits (such as more time and resources available for job search) and adverse incentive effects of the UI (such as workers being more picky, generating possibly higher unemployment rate and consequently higher tax rate to finance the welfare system).

In particular, when an ex-ante homogenous worker becomes unemployed she consumes her savings or unemployment benefits (defined as the replacement ratio tied to her most recent wage). Furthermore, in order to find a job, she exercises costly search effort. The search effort is random meaning that although the expected wage offer is increasing in amount of the search effort exercised, some unemployed are luckier and receive higher wage offers than others. Consequently, workers set optimally their reservation wages and reject all the wage offers below it. Moreover, some employed workers find it optimal to behave opportunistically and quit their jobs. Thus, workers become ex-post heterogeneous with respect to their employment status, income received and savings.

The latter means that there are some jobs in the economy which workers enter solely in order to build up their saving accounts and (if the policy allows for it) regain eligibility for the benefits, quit the job short after and search for a better one thereafter. I refer to this opportunistic behavior as a welfare abuse since if the search effort was perfectly observable, workers would clearly exercise a higher effort and so in such a case the policy of entitlement for quitters might be unnecessary. Consequently, this moral hazard related behavior results in an excessive use of the welfare system and thus a higher tax burden on employed workers.

In fact, there is evidence that workers do behave as predicted by the model employed in this paper. First of all, although quitters in the US are not entitled to the UI, on average 10% of unemployed workers are job leavers (according to the CPS data set). Moreover, [Christofides and McKenna \(1996\)](#) studied data from Canadian Longitudinal Labour Market Activity Survey for 1986/87 and found a significant increase in the job separation probability in the week right after a worker satisfies unemployment benefit eligibility. This finding was later confirmed by [Green and Riddell \(1997\)](#) and [Baker and Rea \(1998\)](#) who studied the same data for the year 1990. Similarly, [Jurajda \(2002\)](#) studied the US labor market and found that entitlement for unemployment insurance significantly increases the probability of a lay-off. Importantly, these studies do not look explicitly at voluntary quits. Nevertheless, given that we should not always blindly believe in a dichotomy between lay-offs and voluntarily quits (as discussed for example by [Feldstein \(1976\)](#)), it is surely possible for many quitters to pass themselves off as being fired. However, it also seems very reasonable that there is still a significant share of quits due to personal reasons of the employees (especially in labor markets where quitters receive benefits). In what follows, I am modeling the latter phenomenon where there is a clear distinction between the two groups.

Furthermore, in the model presented below workers behave opportunistically in order to improve upon the match quality. Indeed, [Tatsiramos \(2009\)](#) presents empirical evidence for the role of unemployment insurance in correcting the misallocations in labor markets: he finds that for workers entitled to receiving benefits the subsequent employment spells are longer and that this relationship is more profound in countries with relatively more generous welfare systems.

Results suggest that, in spite of the associated fiscal costs in form of a higher unemployment rate and so a higher tax rate, the optimal policy is characterized by entitlement to UI for quitters. In particular, pursuing a generous entitlement policy leads to long-run welfare gains equivalent to 4.38% of life time consumption. Importantly, these results should be robust to the possibility of quitters passing themselves off as being laid-off, as surely not every worker is able to do this and as firing a worker is associated with non-negligible firing costs (for example in the US the unemployment insurance tax

is experience rated). The intuition for the result is two-fold. Firstly, as already mentioned, the policy allows for average match quality improvement. It does so by reducing the income risk associated with quitting a job in order to look for a better one. Secondly, it extracts many long-term unemployed into employment by increasing the non-wage value of low paid jobs and so by lowering the reservation wage of those workers.

Interestingly, the results of the model also suggest that the policy studied here may be a force pushing characteristics of the US labor market towards the European one. Firstly, following the optimal policy generates a higher unemployment rate. This is due to the fact that next to fired workers, the policy increases the mass of voluntarily unemployed ones. Secondly, it reduces both the pre- and after-tax income inequality (i.e. there is no efficiency-equity trade-off). This is due to two effects induced by the entitlement policy: (1) a significant reduction in mass of unemployed on social assistance; and (2) an increase in the budget balancing tax rate bringing the income of employed individuals closer to the income of unemployed. Thirdly, the average match quality post-reform is higher, in line with evidence in [Manacorda and Petrongolo \(1999\)](#) that the labor market mismatch has grown much faster in the US as compared to Europe.

Moreover, I investigate the assumption of monetary (or non-separable) search costs which is mostly ignored in the literature. Results show that this assumption is able to generate the empirically documented spike in search effort at the benefit exhaustion. Furthermore, it also generates an initial decrease in search effort at the beginning of unemployment spell – in line with the recent evidence in [Faberman and Kudlyak \(2016\)](#). On the other hand, as is already acknowledged in the literature (see e.g. [Krueger and Mueller \(2010\)](#)), the usually employed in the literature assumption of separable search costs does not deliver such features. Significantly, as opposed to the latter assumption, increasing generosity of unemployment benefits in the model with monetary search costs does not necessarily decrease the search effort. Finally, the model generates important testable implications about differences in search effort and reservation wage behavior, and so in labor market outcomes for similar workers differing only with respect to their financial wealth.

My paper builds on a long literature of unemployment insurance. While the most common rationale for the payment of unemployment benefits is to provide risk averse workers with income insurance allowing for consumption smoothing, there is also a smaller strand of research work starting with [Burdett \(1979\)](#) which does not see the unemployment insurance solely as a serious distortion but rather argues for the role of insurance as a subsidy to search. In this literature the role of unemployment insurance is not only to give unemployed the time and resources to find a job but also to find the right one, i.e. it allows the workers to improve upon the quality of matches in labor markets. In this paper, I argue for a similar role of unemployment insurance.

While searching for reasons of labor markets divergence, [Ljungqvist and Sargent \(1998\)](#) argued that although in times of low micro-economic labor volatility the presence of unemployment insurance system has moderate impact on the unemployment rate, the systems which are relatively more generous may have a much more profound effect on the number of unemployed in times of high turbulence. In a more recent contribution, [Kitao et al. \(2015\)](#) explain this divergence with higher minimum wages in Europe and human capital depreciation during unemployment. On the other hand, [Mariimon and Zilibotti \(1999\)](#) used a model with both heterogeneous workers and firms, search frictions and skilled-biased technological change coupled with the assumption of complementarity between capital and capital-specific skills to show that the differences in generosity of unemployment systems may account for the observed discrepancies between the US and European labor markets. In particular, they showed that although upon the technology-specific shock the economy with more generous unemployment welfare system

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