

Does Unemployment Insurance Discourage Work?

BY KHALID ABDALLA

Established under the Social Security Act of 1935, unemployment insurance (UI) is one of the largest government labor programs in the United States. In most states, UI programs replace 50 percent of a claimant's preunemployment wage up to a maximum benefit level for up to six months. In a new paper, economist Raj Chetty of the University of California at Berkeley presents an evaluation of the efficiency of the UI system.

Chetty begins his paper by noting, "One of the classic empirical results in public finance is that social insurance programs such as unemployment insurance reduce labor supply." Various studies have found that a 10 percent increase in UI benefits is associated with increases in the average duration of unemployment of between 4 percent and 8 percent. The long-established explanation for this finding is that UI benefits create an incentive for workers to remain unemployed. This incentive stems from the fact that receipt of UI benefits is conditional on a worker remaining unemployed. In the language of economics, UI benefits are said to induce "moral hazard" among workers. Such behavior is welfare-reducing — making it undesirable from a policy perspective.

However, Chetty argues that the standard view of the UI program overstates the effect of moral hazard. He argues that UI does not increase unemployment durations solely due to moral hazard. Rather, there is a second channel through which UI causes longer unemployment durations: the "liquidity effect." The liquidity effect is directly tied to the observation that many workers have limited liquid net worth at the time of job loss. These workers are unable to "smooth consumption" over the course of their unemployment. Instead, they have to make cuts in their expenditures, some of which might prove quite difficult. As a result, liquidity constrained workers face greater pressure to quickly find employment than unconstrained workers.

Receipt of UI benefits, however, improves constrained workers' liquidity, allowing them to more easily smooth consumption. Consequently, they may spend more time looking for jobs that match their particular skills. In contrast to the moral hazard effect, the liquidity effect is socially beneficial.

If private credit and insurance markets were free of distortions, then liquidity constrained workers could tap them for liquidity. However, when private market imperfections exist, the UI program can fill the gap by providing liquidity to constrained workers. In such a case, UI-induced

increases in unemployment durations are due to both the liquidity and moral hazard effects. Determining the ratio of the two effects in raising unemployment durations under UI determines the extent to which UI is optimal.

"To the extent that it is the liquidity effect, UI reduces the need for agents to rush back to work because they have insufficient ability to smooth consumption; if it is primarily the moral hazard effect, UI is subsidizing unproductive leisure," Chetty writes.

Chetty takes advantage of changes in benefit levels across U.S. states to compare the effect of changes in benefit levels

"Moral Hazard versus Liquidity and Optimal Unemployment Insurance"

by Raj Chetty, *Journal of Political*

Economy, April 2008,

vol. 116, no. 2, pp. 173-234.

on the unemployment durations of constrained and unconstrained households. He finds that a 10 percent increase in UI benefits is associated with a 7 percent to 10 percent increase in unemployment durations within the constrained group. On the other hand, the unconstrained group is far less affected by increases in

benefit levels. The fact that there is a differential between the constrained and unconstrained groups indicates that the liquidity effect is in play.

However, Chetty notes that while this result is indicative of the existence of a liquidity effect, it doesn't reveal its magnitude. To determine the magnitude of the liquidity effect, Chetty turns to another type of unemployment compensation: lump-sum severance payments. The effect of lump-sum payments on unemployment durations is entirely due to the liquidity effect. This is because receipt of the payment is not conditional on the worker remaining unemployed. Therefore, lump-sum payments do not induce moral hazard. He finds that workers who received lump-sum payments had longer unemployment durations than those who didn't receive the payments. Because moral hazard is unlikely to be driving this difference, Chetty concludes that the liquidity effect is the cause.

He writes, "Using data from the United States, I estimate that the liquidity effect accounts for 60 percent of the marginal effect of UI benefits on durations at current benefit rates. This estimate implies that a benefit equal to 50 percent of the preunemployment wage is near optimal in a UI system that pays constant benefits for six months."

Chetty's findings are at odds with much of the previous literature on unemployment insurance. His provocative paper will likely stimulate further research on this important topic, research that will be of interest to academics and policymakers alike.

RF