3 Questions: Making unemployment work

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(PhysOrg.com) -- The worst of the economic recession may be behind us, but the unemployment rate stubbornly remains around 10 percent, the highest since the early 1980s (the Bureau of Labor Statistics is set to release its latest figures on Friday, Jan. 8). So how should the government help the jobless? Traditional United States policy limits unemployment benefits to about half a year, to encourage people to find new jobs; this fall, Congress extended that period, as have some states.

But in a widely read paper published in the American Economic Review in 2008, MIT economist Ivan Werning, and Robert Shimer from the University of Chicago, proposed a different idea: What matters is not the length of benefits as much as their level. An ideal policy, they suggest, would allow people to collect unemployment insurance indefinitely, and let the unemployed borrow or save money. This way, unemployment insurance would not merely be a financial band-aid letting people take risks on the job market and endure some jobless spells, but a critical source of "liquidity," allowing the unemployed to keep spending reasonable amounts of money — which in turn helps create demand, something sorely lacking from the economy at the moment. Since a good unemployment policy can help the economy help itself, MIT News asked Werning what kind of plan he would design.

Q. For how long should workers receive unemployment insurance benefits?

A. In most countries, unemployment insurance benefits can be collected for a limited amount of time — 6 months in the United States, although that is often extended during recessions, as it has been now. The conventional view is that limiting benefits prevents workers from gaming the system. While this idea seems appealing, in my research, I found that limiting benefits is not optimal.

When you think more about it, limiting benefits makes less sense. After all, those with the longest unemployment spells are those with largest losses from foregone earnings. In other insurance arrangements we see the reverse: In health or car insurance, you are not covered for the small expenses, but are fully covered for the larger ones.

We should remain mindful of the incentive effects of unemployment insurance benefits and prevent anyone from manipulating the system. However, instead of limiting the duration of benefits, we need to get the level of benefits right.

Q. What determines the right level of benefits?

A. The level of unemployment insurance benefits must trade off the severity of the moral-hazard incentive effects [that is, the benefits must be low enough to motivate people to find new jobs] with the desire to help unemployed workers. Both sides of the equation depend on how well workers can cope with transitory losses of income while they are out of work. Typically, if workers have good access to liquidity, from their savings or access to credit, then optimal benefits should be relatively low. If instead, workers are liquidity-constrained, and consume primarily "hand to mouth" from current income, then benefits should be relatively higher.

For this reason, in my work, I find it important to distinguish liquidity from insurance. Current unemployment policy ties both together. But, ideally, one could try to address these issues separately. In particular, if workers are credit- constrained, then we should consider policies that improve the liquidity of unemployed workers, without subsidizing unemployment. There are some proposals along these lines, include promoting special saving accounts, which workers contribute to while employed and draw from while unemployed. Negative balances in these saving accounts could be a way of providing unemployed workers with credit.

Q. With some states now providing roughly 100 weeks of unemployment for some workers, are policy-makers beginning to change their thinking?

A. I'm not sure. Of course, there may be good reasons to vary insurance with the state of the economy. But perhaps this isn't so much due to that, nor to a change in thinking as you say, as much as an acknowledgment that we really haven't bought into a system that actually limits benefits, to any significant degree. In the United States, during normal or boom times, relatively few workers remain unemployed long enough to actually exhaust their unemployment insurance benefits. In deep recessions, when more workers experience longer spells of unemployment, the duration of benefits is routinely extended. Going back to an earlier point, it makes sense to insure those with the largest losses, and it seems that the policies we actually implement in practice accept that [when governments extend benefits]. However, a better system could be designed by explicitly taking this point into account.

Source: Massachusetts Institute of Technology