

Unemployment Insurance : a Comment

by Anders Björklund *

The paper by Professor Malinvaud provides an excellent exposition of the main policy issues in the field of unemployment insurance as well as the available literature dealing with these issues. It is hard to find anything in the previous research that needs to be added to this paper. Therefore my ambition is to stress some important issues which, in my view, have been neglected in the literature. The comments are stimulated by the present Swedish debate and research, but hopefully they have more general interest.

My **first point** is related to the role of search costs in the theory of optimal unemployment insurance. The most common approach is to postulate that certain search activities must be undertaken in order to find a job. More specifically, and in terms of the notation of the paper, “ c ” must be paid as search cost in order to get a certain probability of finding a job, “ α ”.

The analysis shows that, *in the absence of moral hazard*, the optimal unemployment benefit, “ b ”, should cover foregone income plus search costs. This result raises at least three separate but related questions: What search activities enhances the probabilities of finding a job? How much resources should be spent on such activities? Should the unemployed pay the search costs out of his unemployment benefit or should the search activities be free for him?

Obviously many activities can be undertaken to enhance the probability of finding a job and the costs for these activities can be substantial. Information is needed about available vacancies, travelling costs must be paid to visit employers, etc. These are search costs in a rather narrow sense.

However, one can also look at search activities in a broader way. Those unemployed whose skills have become obsolete because of structural change in the economy probably need to undertake more costly activities to get a new job with reasonable pay. Counselling might be useful to find out what type of jobs one is capable to do, retraining might be useful to get new skills and geographical mobility might be needed to find a new job. No doubt such activities increases the probabilities of getting a job.

How many resources should be spent on such activities in an optimal unemployment insurance system? This issue is neither theoretically nor empirically analyzed in a

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satisfactory way in the literature. My intuition is that many people have a high willingness to pay for an unemployment insurance which covers not only forgone income but also substantial costs for various types of search activities. According to the analysis in the paper this would imply a very high benefit level to cover these costs.

However, when moral hazard is taken into account, problems might arise. If the unemployed receives a high benefit level, why spend it on search activities instead of on private consumption? Fortunately there is a solution to this dilemma because labor market information, counselling, mobility grants and retraining courses can be given to the unemployed *in kind*. Note that mobility grants can be paid to the unemployed conditional upon accepting a job at the new place of residence.

Summarizing then, my guess is that an optimal system should consist of both cash payments to cover (some fraction of) foregone income and relatively free (or inexpensive) access to services from employment offices, retraining courses and mobility grants conditional upon accepting a new job. Actually the Swedish labor market policies can to some extent be regarded as such a part of a "total" unemployment insurance system. In addition to free services from the employment offices, all unemployed (plus those who run the risk of becoming unemployed) are eligible to mobility grants which cover the direct mobility costs plus an extra grant which amounts approximately to two monthly salaries. Retraining courses are also available for most unemployed; the trainee receives a stipend which equals the unemployment benefit.

For many years much more resources have been spent on subsidizing such search activities than on cash payments. Some data are presented in Table 1.

Table 1. Expenditures on cash payments and various labor market policies in Sweden (Thousand Swedish crowns)

	<i>Cash payments</i>	<i>Employment offices</i>	<i>Mobility grants</i>	<i>Retraining</i>
1979/80 (cyclical peak)	1870	832	165	3714
1982/83 (cyclical downturn)	4525	1022	146	3810

These labor market policy measures are also related to the "work test" in the UI-system. (Actually nothing is said in the paper about the work test but as far as I know it exists in most countries. If it is implemented efficiently it might help "solve" the moral hazard problem.) In Sweden there is an attempt to use the following rule: If the unemployed wants to stay in his current locality he should be willing to retrain. If he wants to keep his current occupation he should be willing to move. I do not know how this rule actually is enforced in practice. No good evaluations of the implementation of the work test are available. What I want to stress is that measures like mobility grants and retraining might facilitate the implementation of the work test. In that case the social costs of all these measures might be much lower than they look at first glance.

My **second point** is related to the problems which are created by the lack of experience rating in the financing of the system. When the cash payments are financed by rather general taxes, certain industries and firms will benefit more than others. In particular, industries with unstable employment over the year benefit more than others ; an implicit wage subsidy is given to these industries. Professor Malinvaud argues that this problem is rather small in Europe in contrast to the U.S. where the problem by many economists — especially Martin Feldstein — is regarded as severe.

In Sweden the implicit wage subsidy to the building industry created by the unemployment insurance system is about four times higher than the average subsidy. Fishermen receive an even higher subsidy amounting to approximately three quarters of a monthly salary.¹ Of course it is hard to get an estimate of the efficiency losses created by these subsidies but they can hardly be neglected completely.

However, the absence of experience rating might also create problems of a quite different nature. Consider the incentives facing a trade union and its opposite party of employers when negotiating about wage increases. Both parties have to consider the consequences of too high wage increases. The employers will suffer from lower profits and deteriorated competitiveness especially if the industry is facing international competition. The trade union must take the unemployment risks into account.

However, when unemployment compensation primarily is financed by general taxes the costs of excessive wage increases can, at least partly, be shifted over on others. Therefore the presence of unemployment compensation financed by general taxes decreases the incentives to prevent unemployment caused by excessive wage increases. The system can become a destabilizing factor in the economy.

This is a moral hazard problem of a different nature than the traditional one dealt with in the literature. The natural remedy to reduce this problem is of course to tie the financing of the system closer to the firms or industries which have created unemployment. This can be done in two ways : One is to finance the payments by taxes on firms which are directly related to previous lay-offs. Another is to rely on fees paid by employees to an unemployment insurance fund organized for every specific industry. In both cases the incentives to avoid excessive wage increases are reduced. In the former case — when the payments are financed by taxes on firms — the incentives created are similar to those created by a so-called TIP-system.² TIP — tax based incomes policy — is a tax on firms wages increases in order to reduce wage inflation. The main disadvantage with TIP is that there are administrative problems to implement a tax on wage increases. These problems can be avoided in an experience rated unemployment insurance system. Such a system deserves, in my view, greater attention in the debate on incomes policies to reduce inflation and unemployment.

My **third point** is related to the traditional moral hazard problem, namely the adverse effects on the behaviour of the unemployed.

¹ See Björklund and Holmlund, "Unemployment Compensation in Sweden", The Industrial Institute for Economic and Social Research, Stockholm (1984).

² See e.g. Layard, "Is Incomes Policy the Answer to Unemployment?" *Economica*, vol. 49 (1982), pp. 219-39.

First, I am surprised about the results from the study by Clark and Summers presented in the paper. According to this study the effects of unemployment compensation on the outcome of the search process seem to be minor. I believe the "consensus view" from other studies of English and American data is that the effect is stronger.

Still, I think that the available empirical evidence must be interpreted with great care. The basic reason is that most studies are based on a partial search theoretical framework. The unemployed faces a given wage distribution and unemployment benefit and makes an optimal choice of reservation wage which in turn determines the expected duration of unemployment. The effect of higher benefits on unemployment duration is analyzed conditional upon a given wage distribution. However, in a more realistic general equilibrium model one should take into account that the wage distribution can change too. Actually, some of my colleagues have done some interesting theoretical analysis of the effects of unemployment benefits in a general equilibrium framework.³

Some surprising results emerge when the effects on the wage distribution are taken into account. In my view it is an important task for the empirical work in this field to go in this direction too.

³ See Albrecht and Axell, "An Equilibrium Model of Search Unemployment", *Journal of Political Economy* 92, No. 5, 1984, pp. 824-840, and Lang, "Comment on Feldsteins and Poterba's Unemployment Insurance and Reservation Wages", Working Paper No. 127, The Industrial Institute for Economic and Social Research, Stockholm, 1984.