Section 7.5.4 Impact of Unemployment Insurance on The Natural Rate of Unemployment

"A U.S. Canada comparison is as close to a controlled experiment as can be the case in economics" Alan Blinder

Unemployment insurance (UI) on a large scale were first made during the inter-war period in U.K. and around 1935 in the U.S.A., in response to the economic hardship caused by unemployment. Just as Keynesian and classical economists differ on the extent of voluntary versus involuntary unemployment, they accordingly differ on the extent to which unemployment insurance payments affect unemployment. From a Keynesian viewpoint, unemployment insurance payments cushion the drop in income and demand in a recession. They are considered to be a macroeconomic built-in stabilizer. The Keynesian viewpoint is explained in detail in Chapter 11.4, following a discussion of the income-expenditure multiplier.

From a classical viewpoint, UI induces the unemployed to hold out for a better job, instead of accepting available offers. Debate on the labour supply impact of UI is usually inconclusive with econometric studies of researchers throwing up different results. The statistical problem of 'reverse causality' is present in most econometric testing. This problem is very acute when examining the impact of UI on unemployment: severe economic downturns trigger legislation leading to more benefits being granted (extended upto 99 weeks in USA in 2009).

Keynesians stress that laid off workers are hardly enjoying leisure. Work provides vital psychological benefits – a sense of self esteem and belonging, especially in industrial countries. A rise in the unemployment rate is known to sometimes push up the suicide rate, and not just in Asian economies with their strong work ethic (provide some evidence).

Classical economists would state that UI reduces the incentive to supply labour. They argue that, whatever the psychic benefits of work and psychic costs of unemployment, observed behaviour is what ultimately matters. Choices and outcomes reveal preferences and UI is observed to raise unemployment. As a practical matter, rejections involved in the job search process are painful. The unemployed may want to avoid these rejections rather than avoid working itself, and UI makes it possible for them to survive financially without searching hard.

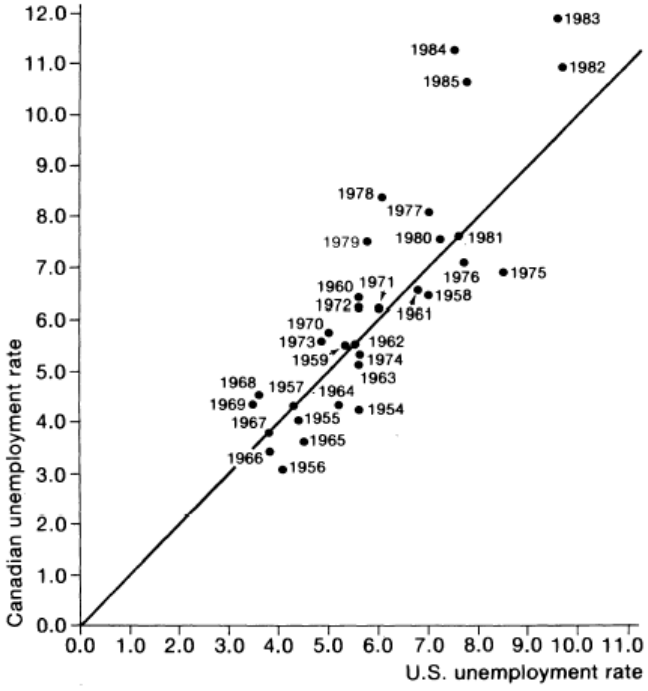
A comparison of U.S. and Canada is valuable in understanding the precise manner in which UI affects the natural rate. This comparison can show how classical (supply determined) and Keynesian (demand determined) unemployment can simultaneously prevail. The comparison is very solid since the countries measure unemployment similarly from a household survey. They have similar economic structures (share of agriculture, manufacturing and services in GDP) and very similar demographic trends, critical to comparing labour force data. Above all, they have closely correlated business cycles and GDP growth. Although comparisons of U.S. and European UI systems are common, they are not so useful since U.S.-Europe differences are vast. As Alan Blinder of Princeton University and former Vice Chairman of the Federal Reserve, commenting on a paper comparing U.S. and Canadian savings rates remarked, "A U.S. Canada comparison is as close to a controlled experiment as can be the case in economics (1970). Indeed, as current Fed Chairman Ben Bernanke pointed out in his tribute to Milton Friedman in

2002, some powerful conclusions of *A Monetary History of the United States* (by Friedman and Anna Schwartz) were based on comparing features of U.S. and Canadian banking systems.

Canada's more generous UI system is generally considered to be responsible for its higher unemployment than the USA. But the evidence is not so direct and unequivocally classical. The scatter diagram shows the puzzling gap in Canadian U.S. unemployment rates only after 1981. Two distinguished Princeton University labour economists, Orley Ashenfelter and David Card in 1986 posed this as a puzzle: Canada has provided more generous UI benefits than the USA going back to the 1950s. But they had very similar unemployment rates until the 1970s, as the 45 degree line shows, and so UI could not be the main reason for the gap.

Further, the classical view could not explain why in Canada, just after the generous UI Act of 1971 was introduced, its unemployment did not rise. Indeed, the unemployment gap between the two countries emerged only in 1981, after Canada tightened its UI laws in the late 1970s. How come? Ashenfelter and Card examined various data pertaining to this puzzle , and conducted a detailed econometric investigation, that controlled for demand factors via GDP growth. They could not find any explanation and concluded that UI was not to blame.

US and Canadian unemployment rates, 1954-1984

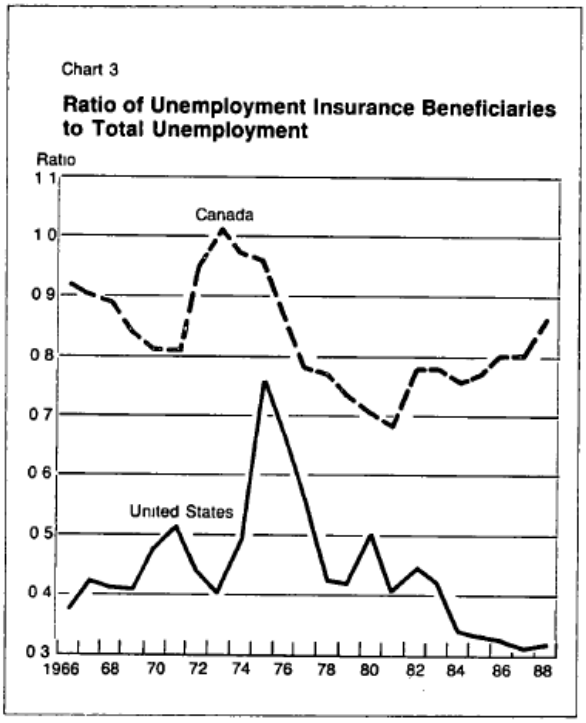


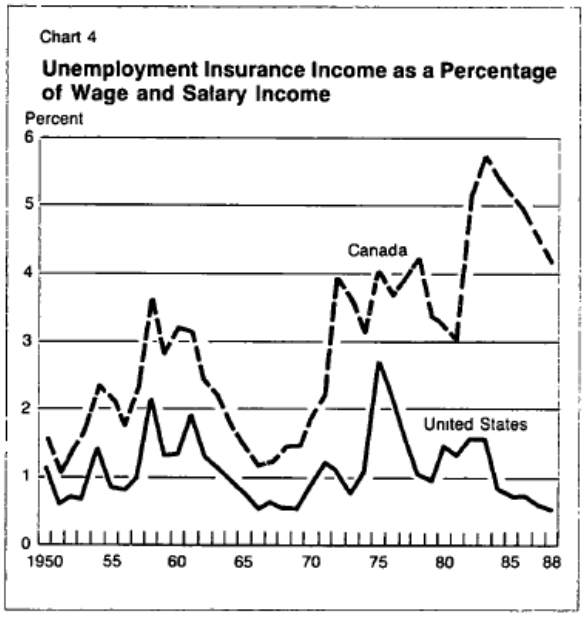
Source: Pg S172, New Series Vol. 53 Supplement: Unemployment S171-S195.
Why have Unemployment rates in the Canada and U.S. Diverged?" Economica, 1986

Resolving this puzzle, which my paper does, requires breaking unemployment into its different subgroups: for some groups demand conditions matter more, while for others UI easily induces unemployment. To begin with an Unemployment Insurance system comprises different aspects and features that need to be first categorized. I have listed five features below:

(a) The replacement rate – ratio of benefits to wages, as in pension payments.
(b) The duration of benefits (Typically 26 weeks in USA of regular benefits, provided by States).
(c) Qualifying or vesting period, as in pensions, based on years of work.
(d) Coverage - percentage of labour force who come under UI schemes (unorganized sector workers such as illegal migrant workers in USA are not covered).
(e) Eligibility criteria – when the unemployed are broken down by reason for unemployment, whether unemployed other than job losers get benefits.

Most studies typically focus on (a) while my analysis focused on the neglected criteria (e). Canada was always more generous than the USA, judged by duration of benefits, vesting period and the effective replacement rate. But in 1971, it greatly liberalized its UI scheme to provide benefits to, "all Canadians experiencing temporary earnings interruptions" (official wording) . **In** effect, Canada started giving benefits to unemployed other than job losers i.e. job leavers and reentrants to the labour force i.e. criteria (e) listed above. The broadest indicator at a macro level, of the generosity of UI, the ratio of UI payments to wage and salary income, which was higher for Canada to begin with, jumped from about 2% to 4% in 1972 (see Chart below).





The differential effect of this policy on unemployment rates of the two main demographic subgroups (male and female) in Canada can be seen in the Table below:

	Total U Rate	Male Rate	Female Rate
1971	6.2	4.3	5.0
1972	6.2	4.1	5.7
1979	7.4	4.5	7.0
1980	7.5	4.8	6.5

Since the world economy was booming in 1972, male unemployment which was relatively more demand determined (or Keynesian) fell from 4.3% to 4.1%. At the same time, female unemployment which was more supply determined (or classical) rose from 5.0% to 5.7% in 1972. Conversely, when Canada tightened its UI rules in 1980, a recession year, male unemployment rose from 4.5% to 4.8% while female unemployment fell from 7.0% to 6.5%.

Data on unemployment by reason also indicate that Canada's higher unemployment was due to job leavers getting benefits easily, as implied by criteria (e) of the UI system. The job leaver rate for Canada was 1.7% versus 0.8% for USA. (This classification of the data should actually be called "unemployment by reason for entry into unemployment". Once a person becomes unemployed, how long that person stays unemployed depends on the generosity of UI. Hence Canada's higher job loser rate in the Table below reflects job losers remaining unemployed longer. Longitudinal studies that track individuals have estimated a sharp jump in the probability of leaving unemployed in USA after 26 weeks, when benefits run out.)

Unemployment By Reason (data available only from 1975 onwards for Canada)

			Average		
1975-1988	Job Loser	Job Leaver	New Entrant	ReEntrant	Total
USA	3.7	0.8	0.9	1.9	7.3
Canada	4.7	1.7	0.5	2.1	8.8

Source: Vivek Moorthy, Federal Reserve Bank of New York Quarterly Review, April 1990, pp.

The Beveridge curve, a scatter plot of vacancies against unemployment, also shows the UI induced rise in Canada's natural rate in 1972. Typically, unemployment and vacancies move in opposite directions along the curve, reflecting demand fluctuations. But if both vacancies and unemployment rise, and the curve shifts up, it is due to a rise in the natural rate. In 1972, the vacancy rate rose below from 1.1% to 1.3% while unemployment stayed at 6.2%. (Chart from R.Archambault & M. Fortin, Canadian Journal of Economics, 2001) i.e. the natural rate rose.

Postscript

Had we not taken Fort Duquesne
My dear the French would still remain
Entrenched in a Confederation
From Louisiana to Quebec
I tell you Pittsburgh saved our neck!
From The Golden Gate by Vikram Seth

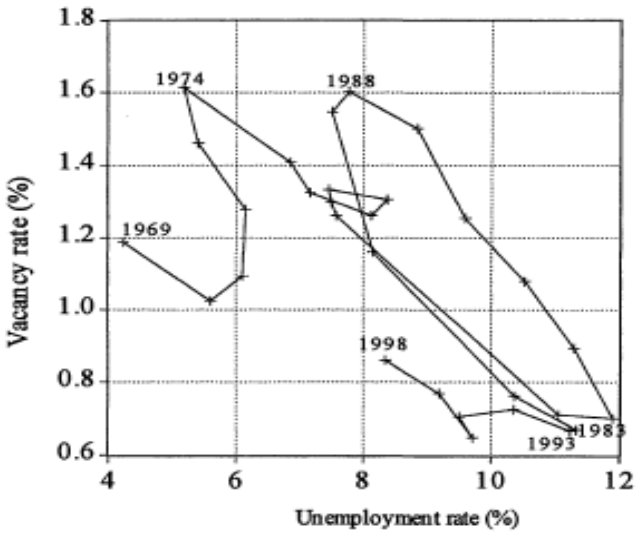


FIGURE 1 The Beveridge curve
Source: Statistics Canada and author's calculations