Q. What are the pros and cons of unemployment benefits?

A. In short, the answer is insurance and incentives.

Unemployment insurance benefits help individuals who have lost their job to sustain a desirable consumption level. An MIT economist, Jonathan Gruber, argues that private insurance or savings are not enough to prevent a large drop in the consumption of the unemployed. In particular, he estimated that in the absence of unemployment insurance, the consumption of the unemployed would fall by 22 percent. This drop would be more than three times the average fall in the presence of this program.\(^1\)

Perhaps the most important disadvantage is that unemployed individuals may be discouraged from searching for a job (or taking certain jobs) if unemployment benefits are too generous. In a recent paper, Alan Krueger from Princeton University and Andreas Mueller from the Institute for International Economic Studies at Stockholm University found that across the 50 states and Distric of Columbia, job searches are inversely related to the generosity of unemployment benefits. In particular, the time devoted to job search drops by about 16 percent when unemployment benefits increase by 10 percent. The two economists also found that job search intensity increases prior to the exhaustion of benefits.\(^2\)

The current programs in the U.S. and in most of the developed countries involve two or three levels of benefits that often decrease over the unemployment spell; the benefits are provided for a restricted period of time. This design resembles prescriptions in the seminal work of the economists Hugo Hopenhayn from UCLA and Juan Pablo Nicolini from the Federal Reserve Bank of Minneapolis and Universidad Torcuato Di Tella in Buenos Aires. They found that the best way to design an unemployment insurance program involves payments that decrease throughout the unemployment spell. They also prescribe a tax on each individual after re-employment—a tax that increases with the length of the previous unemployment spell.\(^3\)

The entire program can be implemented with unemployment insurance accounts for each individual. Individuals who use their benefits for a longer period of time would have to contribute more after re-employment to balance their account.

