

THE PRIVATE AND SOCIAL COSTS OF UNEMPLOYMENT

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ABSTRACT

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This short note emphasizes and illustrates two basic points:

(1) The private costs of unemployment, i.e., the costs borne by the unemployed themselves, vary substantially and are often extremely low. This low private cost is an important cause of the permanently high unemployment rate in the United States.

(2) The social costs of unemployment, i.e., the costs of unemployment to the nation as a whole regardless of how they are distributed, must be judged by considering the specific policy by which a worker would be reemployed. It is wrong to regard unemployment as either without cost (because the unemployed enjoy the opportunity for job search and leisure) or as having a cost equal to lost output. Examples are given to show that output may overstate or understate true social cost, depending on the options available for reemployment.

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Martin Feldstein*

We do not need a careful quantitative analysis to establish that the unemployment of seven million workers involves very substantial private and social costs. Why then should we bother to think about measuring the cost of unemployment? There are two quite different reasons. First, by measuring the private costs of unemployment that are borne by the unemployed themselves, we can better understand why our unemployment rate is so high. Second, by examining the social costs of unemployment (i.e., the costs of unemployment to the nation as a whole regardless of how they are distributed), we can better decide when the benefits of a reduction in unemployment outweigh the costs of achieving it. The present paper considers both of these problems, emphasizing the conceptual issues rather than presenting specific estimates.

Because unemployment is so often thought of in aggregate terms, it is worth emphasizing at the outset that a proper analysis of the costs of unemployment must begin by disaggregating. The private cost of unemployment is very large for some of the unemployed but is quite small for many others. The average private cost of unemployment is therefore much less relevant than the distribution of such costs. Similarly, in considering the social costs of unemployment, it is important to distinguish several kinds of unemployment since the cost of each type of unemployment and the costs of reducing that unemployment differ significantly.

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I. Private Costs

The cost of unemployment that is borne by the unemployed person himself varies from the overwhelming to the trivial. At one extreme is the very substantial loss by those who experience a long period of unemployment with little or no help from transfer payments. At the other extreme, is the minimal loss of those who are out of work very briefly and whose lost net income is fully replaced by unemployment compensation. Although there is a wide range of experience, the typical spell of unemployment is closer to the "low cost" extreme than to the high cost extreme. Even now, more than half of the unemployment spells last four weeks or less. Moreover, more than half of the unemployed received unemployment compensation. I believe that the relatively low cost of unemployment in these circumstances is a substantial cause of our high permanent rate of unemployment.

The principal reason for the low private cost of unemployment is the interaction of our tax system and our system of unemployment compensation. It is particularly important to consider these two together. The income and social security taxes now imply a marginal tax rate in the neighborhood of 30 percent for a worker in a median income family. It is therefore very significant that unemployment compensation is not subject to tax. The combination of a relatively high marginal tax on earnings and no tax on unemployment compensation implies that unemployment benefits replace a very high fraction of lost net income, typically about two-thirds.

An example will illustrate how this occurs. Consider a worker in Massachusetts in 1977 with a wife and two children. His gross earnings are \$140 per week while hers are \$100 per week. If he is unemployed for 10 weeks, he loses \$1400 in gross earnings but only \$279 in net income. Why does this occur? A fall in gross earnings of \$1400 reduces his federal income tax by \$226, his social security tax by \$82, and his Massachusetts income tax by \$75. Thus, total taxes fall by \$383, implying that net wages are reduced by \$1017.

Unemployment benefits are 50 percent of his wage plus a dependents' allowance of \$6 per child per week. The benefit is thus \$82 a week. Since there is an annual one-week "waiting period" before benefits begin, nine weeks of benefits are paid for the ten week unemployment spell. Total benefits are thus \$738. The loss in net income is only the \$279 difference between these benefits and the fall in after-tax wages. The \$279 private net income loss is less than 20 percent of the loss in output as measured by the gross wage.

Because of the one-week waiting period, the private cost of unemployment is even lower for an additional week of unemployment. If he stays unemployed for 11 weeks instead of 10, he loses an additional \$140 in gross earnings but only \$16 in net income. The private net income loss is less than 12 percent of the loss in output as measured by the gross wage. If the individual values his leisure and non-market work activities at even 50 cents an hour, there is no net private cost of unemployment!

The great reduction in the private cost of unemployment that results from this interaction of high taxes on earnings and the untaxed

unemployment benefits produce substantial adverse incentives that magnify the cyclical volatility of unemployment and raise the non-cyclical "baseline level" of unemployment. The most obvious effect is to increase the average duration of unemployment spells. With little or no personal cost of a longer period of unemployment, it is rational for the individual to look for a new job until the potential gain from additional search is extremely small or to use the low cost time to do chores at home or just to enjoy a period of vacation. In addition to increasing the average duration of existing unemployment spells, the low private cost of unemployment also causes an increase in the number of unemployment spells. Since workers who quit their jobs are eligible for benefits in a number of states, the low private cost of unemployment is responsible for many of the one million unemployed who quit their last job.

More significant, however, is the incentive for temporary layoffs. Approximately half of the unemployment spells that are officially classified as "job losses" are actually temporary layoffs in which the unemployed worker expects to return to his original job. In manufacturing, approximately 80 percent of those who are laid off do return to their original jobs. Our system of unemployment compensation lowers the cost of such temporary layoffs to both firms and workers, making unemployment more attractive than accumulating inventories or cutting prices.

I have concentrated these comments on unemployment compensation because this is the most significant program for reducing the private costs of unemployment. Those who are not eligible for unemployment

compensation often receive other forms of income replacement such as food stamps, social security and welfare. It is also important to remember that a very large fraction of the unemployed who do not receive unemployment compensation are young people who are supported by their families.

It is easy to see how our system of taxes and transfers drastically lowers the relative private cost of unemployment and thereby induces a higher unemployment rate. The real puzzle is why the low private cost of unemployment does not result in a higher rate of unemployment. What are the forces of self-restraint that limit the public's willingness to exploit the full opportunities for subsidized unemployment? And will they continue to be effective in the future? Public attitudes about accepting transfer payments appear to have been changing rapidly during the past decade, resulting in the rapid growth of such things as disability insurance benefits, food stamps and health insurance payments. The contagiousness of social attitudes suggests that this trend may accelerate in the future. It carries with it an ominous prospect for unemployment.

II. Social Costs

The social cost of an unemployment spell depends of the social opportunity cost of the unemployed person's time. In measuring the social cost of unemployment, it is therefore crucial to ask "Unemployment as compared to what?" As economists, we tend to define the opportunity cost of any resource as its value in the best possible use to which it

might be put. But the relevant opportunity cost in the current context is not this "best allocation" of full employment general equilibrium theory. We are interested in the social costs of unemployment in order to assess the desirability of particular unemployment policies. Different policies imply different opportunity costs for the unemployed workers. In each case, we should compare the particular net social cost of unemployment -- i.e., the potential benefit of returning the unemployed person to work -- with the cost of the policy itself.

The format of this session suggests that all policies to reduce unemployment entail increasing inflation, implying that the relevant comparison is between the social costs of unemployment and the social costs of inflation. If this were true, the implication would be quite dismal since most economists now agree that a permanent increase in inflation cannot achieve more than a temporary reduction in unemployment.¹ Fortunately, there are policies for reducing unemployment permanently that do not involve increases in inflation. These policies may involve such costs as a reallocation of some workers from more productive to less productive activities, as a reduction in unemployment insurance protection, or a redistribution of income with losses by some groups and gains by others. A proper evaluation of available policies requires quantifying the costs and benefits of each.

Before looking at some examples of the social costs associated with different types of unemployment, it is useful to comment on two extreme but common views of the social cost of unemployment. According

¹In a growing economy, the present value of the social cost of a permanent increase in inflation can be extremely large relative to the gain from a temporary reduction in unemployment; see Feldstein (1977).

to one view, unemployment has no social or private cost. The individual's loss of wage income is at least offset by the value of his leisure and of the information that he acquires by his job search activity. This conclusion is false even if we accept its premise that all unemployment is voluntary. The taxes and unemployment insurance described above imply a substantial gap between the individual's gross wage and the value of his time when unemployed. The existence of the rigidities that cause involuntary unemployment only strengthens the reason to reject this view.

At the other extreme is the view that the loss in wage income is equal to the social cost of unemployment. This ignores the value of the individual's leisure and of the information gained by searching for a new job. Moreover, even if both of these were zero, it would be wrong to regard the individual's normal or potential wage as a measure of the gain that would result from his reemployment without specifying the policy that would be used to achieve his reemployment.

Consider, for example, the case of workers on temporary layoff. As I noted above, some 80 percent of workers who are laid off by manufacturing firms soon return to their original jobs at those firms. Such temporary layoffs are almost completely unknown in Europe and Japan. This important source of unemployment could be significantly reduced if the employer tax that is used to finance unemployment compensation were changed to eliminate the current subsidy of excessive layoffs. While I believe that this would be a worthwhile reform, the benefit of such a change should not be overstated. The social cost of the unemployment that would thereby be eliminated is not the normal

wage of these workers or even that wage reduced by the value of their leisure. A reduction in temporary layoffs would mean more production for inventory and more spells of below average productivity.

This example also illustrates the familiar principle of welfare economics that it may be possible to identify a good policy in terms of the marginal conditions without explicitly evaluating the gains from the policy. In this case, it seems clear that eliminating the subsidy that increases temporary layoff unemployment would be a move in the right direction even though the value of the gain is unknown. Although the theory of the second best cautions against this general line of reasoning, an explicit partial equilibrium calculation of the gain from reducing unemployment is unlikely to be an improvement in this regard. An explicit calculation of the social cost of temporary layoff unemployment would be of value primarily in deciding whether the economic gains of the reform outweighed the political costs of achieving it.

Although the potential wage will generally overstate the social cost of unemployment, there is an important case in which it is an understatement. For young workers, unemployment means not only the loss of output and earnings but, more important, the missed opportunity for on-the-job training and experience. The very high unemployment rates among low skilled youth is symptomatic of the more serious problem that the jobs available to them generally offer little opportunity for training or advancement. The social cost of youth unemployment thus depends very much on the contemplated alternative. If we judge the social cost of youth unemployment by the type of no-training jobs that

are currently available, the cost is relatively low. But if employment with useful on-the-job training is a feasible alternative, the social cost of youth unemployment is substantially greater than the immediate loss of output.

III. Conclusion

In this short note, I have emphasized two basic points. First, the private cost of unemployment varies substantially and is often extremely low. This low private cost is an important cause of the permanently high unemployment rate in the United States. Second, the social costs of unemployment must be judged by considering the specific policy by which a worker would be reemployed.

In selecting these points for emphasis, I have ignored many of the issues generally associated with measuring the costs of unemployment. That is inevitable in a note of this length. In conclusion, however, I want to call attention to two further costs of a chronically high unemployment rate that are likely to be of great long-run importance.

If we do not change the structural causes of our high unemployment rate, we will face growing pressure to adopt the strategy of some European countries that suppress unemployment by denying firms the right to lay off workers without government approval and by denying those workers who lose their jobs the right to decide where and when they will return to work. In addition, a chronically high unemployment rate will create strong pressures for expansionary macroeconomic policies that will serve only to exacerbate inflation. The loss of freedom in labor

markets and the increase in inflation throughout the economy would be an extremely high cost to bear for our failure to reform the incentives and eliminate the barriers that create our unemployment problems.

References

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