

## Unemployment Benefits: Disincentives to Work?

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*The aim of this paper is to analyze the effect that unemployment benefits – an instrument of social policy – have on incentives to work. It will start by discussing arguments that portray unemployment benefits as disincentives. It will continue by analyzing more profoundly how benefits can serve as an instrument to increase employment and mitigate disincentives to work. Finally, it will be shown that when taking into consideration the heterogeneity of elements shaping the unemployment benefit system and structure, substantial replacement rates may contribute to increasing efficiency of labor market.*

*The disincentive effects of unemployment benefits.*

Unemployment is a risk that is faced by any individual in a capitalist society. Unemployment is not a natural phenomenon; it is a man-made dependency created by capitalism (Cleaver, 2007). So, unemployment is politically recognized as a social problem all over Europe and, as part of this recognition, unemployment benefits constitute citizens' social right. But, from the 1970s neo-liberal economists started arguing that benefits had negative impact on the incentives to work, encouraging people to stay unemployed for longer periods of time.

The main reason for the development of this kind of thinking about benefits is considered the mass unemployment that swept Europe in the 1970s as well as the neo-liberal hostility towards social security programs in the 1980s (Clasen, 1999). According to neo-liberals, the persistence of unemployment in a number of countries is partially attributed to more generous levels of benefit payments (Atkinson, 1991, p. 1679).

While unemployment was sweeping over Europe, United States employment was increasing (too?). The US-style flexibility and unregulated market was seen as a panacea for European unemployment problems. Neo-liberal economists thought that the removal of labor market regulations, including unemployment benefits, would end the European unemployment. (Bradley & Stephens, 2007, p. 1486). Classical economists have seen unemployment compensation as having a negative impact on the labor market operation, with high benefits causing the unemployed to

reject job offers and inducing those in employment to quit and become unemployed (Atkinson, 1991, p. 1679).

Johnson and Layard (1986, p. 923) argue that in a simple market clearing demand and supply model of the labor market, benefits increase the level of unemployment. This effect, they note, is observed in every model constructed by them. "Viewed in simplest terms, benefits and taxes reduce the efficiency of the economy' (1986, p. 924).

According to Snower (1995), the two major problems of unemployment benefits are that they boost unemployment and impose a considerable burden on the taxpayer (p. 625). As the Institute for Fiscal Studies found out, people on low incomes face the weakest work incentives as their means-tested benefits or tax credits are withdrawn when they increase their income. Over two million workers in Britain lose more than half of any increase in earnings because of taxes and reduced benefits (IFS, 2006). The fear of an "unemployment trap" – the withdrawal of benefits and imposition of taxes – discourages unemployed people from job search. This "trap" is especially harsh for people who can only find temporary and part-time jobs particularly unskilled workers, since they get comparatively low wages while the opportunity cost of giving up unemployment and related benefits is much higher (Snower, 1995).

Common arguments against unemployment benefits are as follows: (a) benefits discourage job search; (b) lengthen the duration of search; (c) put upward pressure on wages; (d) induce workers to take greater risks of dismissal; and (e) induce firms to increase number of temporary layoffs.

Generous benefits may lengthen the time unemployed people spend on searching for new jobs. The greater the benefits, the longer the unemployed wait before accepting a job offer. This is especially true for long-term unemployed, who constitute the large portion of the European unemployment problem. These workers may have to undergo retraining and change their life styles in order to find a job; unemployment benefits help to avoid such adjustments through satisfying the financial needs.

Unemployment benefits put upward pressure on wages. People refuse to work for less compensation than they would receive if they remained jobless. This factor increases wages and leads to an increase in labor costs, which stimulates further unemployment.

Unemployment benefits permit employees to take greater risks of job loss. This means that, they may engage in industrial disputes more frequently as they have some kind of backup in the form of benefits and are not completely reliant on their jobs for their material well-being (Snower 1994, p. 626-627).

Besides this, in the absence of benefits, firms might be unwilling to lay off workers in response to random demand fluctuations, for fear of losing these workers to other firms. By contrast, in the presence of benefits,

firms will lay off employees for long spells during low demand. So, unemployment insurance increases the number of spells of temporary layoff unemployment (Feldstein, 1978).

Probably the most popular argument about the disincentive effects of unemployment benefits among economists is the behavioral impact of benefits on people's choice between work and leisure. The classical economic model of the individual decision about the working life sees a person as choosing to undertake work on the basis of an income/leisure trade-off. There is a choice between the utility derived from an additional hour of leisure against the extra utility derived from the disposable income which could be earned by devoting that hour to paid work.

The provision of benefits may induce people to withdraw from the labour force and choose leisure instead of work, as the additional return from working might be insufficient to justify effort involved (McClements, 1978, p. 29).

OECD reports on country-specific examples illustrate that those countries which had low replacement rates experienced low levels of unemployment. In Japan and the United States benefit entitlements have remained low for the last thirty years; both countries have avoided rises in their unemployment rates compared to other OECD countries. Norway, Sweden' and Switzerland had low benefit entitlements until the early 1970s, and unemployment in these countries also rose relatively later. France and Ireland increased entitlements substantially between 1973-75 and 1983-85, and unemployment rates in these countries doubled between the late 1980s. In Belgium, Germany, the Netherlands, and the United Kingdom, where benefit entitlements did not increase much after 1973-75, increases in unemployment rates between these periods were smaller (OECD, 1994, p. 177).

In line with these developments, opponents of unemployment benefits suggest that in order to limit the disincentive effects countries should legislate for only moderate levels of benefit, maintain effective checks on eligibility, and guarantee places on active programmes (OECD, 1994, p. 48).

### *"Real World" Benefits*

These are the arguments that portray unemployment benefits as a clear disincentive and an impediment to a flexible labour market operation. But, in order to argue about benefits' disincentive effect, it is very important to consider various factors involved in the unemployment benefit provision such as the benefits structure, different governing principles of unemployment compensation, the welfare system in which the benefits operate, consider households rather than individuals alone, evaluate eli-

gibility requirements as well as the conditionality principle. Considering these and other factors that structure benefits will give a more realistic picture of the effects that benefits can have on the incentives to work. Neo-liberals criticise benefits discussing them as a simple phenomenon without considering the heterogeneity of all aspects involved in the benefit system.

In order to define and clarify the role of benefits in employment creation we should consider the following aspects: (a) Unemployment/inactivity dichotomy, (b) the structure of benefits, (c) eligibility criteria (d) effects on skill formation (e) strength of disincentives in different welfare systems, (f) dissemination of disincentives among different groups, (g) individual/household relationship.

When neo-liberals discuss unemployment benefits and their impact, they only consider the employment/unemployment dichotomy. They omit one very important labor market state - inactivity. This condition is important as large numbers of transitions to inactivity occur among unemployed people. Thus, the relaxation of eligibility criteria for unemployment benefits, may lead people out of the labor market to join the labor force, while disqualification of benefit entitlement may lead to removal from the labor force rather than employment (Atkinson & Micklewright, 1999, p. 1681).

Arguing that benefits constitute disincentives is ignoring their structure and the conditionality principle. Atkinson and Micklewright (1991, p. 1687) argue that when neo-liberals test and provide arguments against benefits they simply use non-real world benefits in their models. According to their models, benefits are of the following "hypothetical" form: the benefits do not depend on the reasons for entry into unemployment, they are unlimited in time and duration, they do not set requirements for an active job search, the unemployed are not penalised because of refusals of job offers, there are no contribution conditions related to employment history, the benefit is paid at a flat rate, eligibility for benefits is not affected by the level of income of other household members.

In reality, in order to become eligible a person should satisfy a set of conditions, which really makes benefits not so much a disincentive to work as a disincentive to apply sometimes. When such features as the qualifying conditions for unemployment insurance are taken into account, it becomes apparent that the benefits do not produce that many incentives to stay unemployed, as a person needs to satisfy certain conditions in order to acquire rights for benefits (Atkinson and Micklewright, 1991, p. 1680).

Social protection does not always mean "politics against markets" as it helps to overcome market failures in skill formation which is the lack of incentives for workers to invest in certain skills. People are risk averse so

they are less likely to invest in industry or firm-specific skills if the risk of losing jobs and wages is high (Estevez-Abe *et al*, 2001).

According to Estevez-Abe *et al* (2001), for industry-specific skills, unemployment protection is very important (p.152). In order to make workers invest in industry-specific skills their 'skilled wages' should be protected. That way workers can move between firms without loss of income and even turn down job offers outside their previous industry and conduct longer and more costly job searches to find employment in which their skills are fully used (Bradley & Stephens, 2007). A high replacement ratio is kind of reward given to workers for their specific skill investment.

Similarly, Sinfield argues that benefits not only maintain aggregate consumer demand, but also enable individuals to search for jobs which are close to their qualifications thus facilitating a better match between supply and demand of labour, reducing the chance of future unemployment and increasing productivity (Clasen, 1999, p. 160).

It can be argued that the absence of benefits may lead to "worsened commodification." According to Esping-Andersen (1990), labour power becomes a commodity when a person can not survive outside the labour market. In case of absent unemployment benefits workers become commodified but, in addition, they have to take on jobs which do not match their skills and qualifications. This contributes to increasing dissatisfaction with work and may cause depletion of human resources as well as emotional exhaustion, instability and even rage.

Adequate replacement rates result in upskilling, the effect of which is reduced structural unemployment. They reduce the scar effects of unemployment bouts and result in longer term employment. They provide an incentive for private risk-taking so that individuals are more likely to conduct appropriate job searches. In information-age economy, this constant upskilling of workers is very important (Bradley & Stephens, 2007).

If there is any disincentive linked to unemployment benefits it is dealt with activation element attached to it. According to Clasen (2005, p. 53), in modern welfare states unemployed people besides income transfers are subject to active labor market policies which aim at returning the unemployed to paid work. The benefits receipt is conditional not only on eligibility criteria such as having paid sufficient contributions or need, but also requires a willingness and capacity to enter employment. Attached to benefits there are services that help people to actively search for jobs and provide trainings for them during the unemployment period in order to increase their employability.

According to Bradley and Stephens (2007, p. 1493), active labor market policies (ALMP) may lessen the potentially negative impact of generous benefits by retraining and reintegrating unemployed into the labor force. Greater spending on ALMP will have a positive impact on employment by increasing the employability of the working-age population.

According to the report of the Commission on Social Justice (1994) in the longer term, the unemployment period should be used for investing time in education and training; “eventually every member should be able to draw on social insurance to help finance a ‘sabbatical’ during his or her working life” (p. 234). These policies, attached to the benefit structure indicate that the ultimate goal of benefits is labor market integration.

Besides that, there is an important distinction between protection against loss of income and loss of job. Together they may cause an exhaustion of financial resources and market rigidities, but welfare states can support the flexibility of the labour market by loosening employment protection legislation and providing relatively generous benefits for the unemployed. Relaxed employment protection legislation enables firms to adjust quickly to new market conditions by laying off staff, during this period social security helps dismissed workers to avoid economic difficulties whilst looking for a new job. People are more likely to search for jobs which best suite their qualifications when they are without work and are less likely to stay with the same employer for security reasons. The combined result is a high degree of labour turnover, which is an indicator for a flexible labour market and an economy (Kvist, 2001).

There is also a very important aspect involved in the debate about benefit disincentive effects. When uninsured people lose jobs the loss of income may impose costs on others, like spouses and children (Bar, 1993, p. 195). This is an important issue as unemployed people are not living in a social vacuum: they have family members who may be dependant on them. So, when considering households unemployment is seen as a risky choice.

In any case, work incentives are affected by many other factors, amongst which the most important are non-economic ones. People work not only for financial motives but for the sense of social integration and self-esteem which jobs provide, so the cost of unemployment is much more than the loss of earnings. Conversely people may give up their jobs and leave the labour force for non-economic reasons. (Atkinson, 1993, p. 20)

There are many more reasons of why people might not participate in the labour market.

Returning to work creates uncertainty for people as income received from various work related benefits is uncertain. The future income risk can be seen as a disincentive for people to participate in the labour market, as there is a possible ‘employment lottery’ not just ‘an unemployment trap’ (Jenkins & Millar, 1989).

Clasen (1999) argues that the country specific roles of benefit programs show positive effects on certain groups of unemployed. In Denmark, benefits replace employment regulations which contribute to labor market mobility. In Britain, they strengthen work incentives and make

wages to fall particularly for younger workers. In Germany, they are used as an instrument for restructuring the workforce.

There are different insurance principles that govern unemployment compensation so disincentive effects can vary according to different welfare systems. Schmid and Reissert (1996, p. 236) identify two basic principles governing unemployment compensation: the insurance principle and the welfare principle. In the former benefits are determined by insurance contributions and by previous earnings. In the latter, the unemployed are provided with a guaranteed minimum income.

In the insurance principle system there is less incentive to be unemployed because the amount of the benefit depends on contributions and previous earnings. For certain groups such as young workers and women employees with low wages, there will be less incentive to quit jobs as they have a weak work history and low contributions: so their benefits will be less generous. In the insurance based system previous contributions and earnings also play a role in pension right accrual. As Clasen (1999) argues, especially in corporatist-conservative welfare states where access to pensions is largely determined by labour market participation, this will stimulate the search for regular paid work. In addition insurance contributions provide incentive for people to take "regular" jobs instead of "marginal" employment (Atkinson & Micklewright, 1989).

As for the welfare principle, the amount of the guaranteed minimum is so low that it can be an incentive only for the minority of workers to quite their jobs. In addition they are means tested which also discourages people who have saved or whose family members are working to apply. In addition to this, there are a lot more benefits derived from working life. Many fringe benefits plus family or child support are connected with work as well as occupational pensions this may lead to less disincentives (Schmid & Reissert, 1996).

### *Conclusion*

The intellectual hegemony of orthodox economists led to blaming benefits for increasing unemployment levels in Europe during the 1980s. These neo-liberal economists tend to see individuals as making choices about their working life based on monetary incentives, so unemployment benefits are seen as a disincentive to work. But, there are very important non economic aspects involved in this kind of decision making as people are not only looking for monetary gains but also for high self esteem and sense of social inclusion that jobs provide.

Claiming that unemployment is caused by the generous benefit systems means ignoring problems connected with identification of unemployment itself. Starting from definition the elements that constitute un-

employment vary across countries, systems and organizations which makes it difficult to argue that unemployment problems are caused by benefits.

Besides neo-liberal economists fail to see that unemployment benefits have productive functions above providing income replacement as elements attached to benefits system such as activation, skill formation, constant up skilling, better match between labour supply and demand and etc. make them economically effective as well as socially justifiable. And if effectively constructed, benefits can serve as an instrument for increasing employment and flexibility of labour market.



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