The Wage Effect of UI Reform: The Role of Eligibility for the New Policy Rule

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Abstract :

The macroeconomic effects of unemployment insurance (UI) reforms have received increased attention since the implementation of UI extensions during the Great Recession. At first glance, standard models of the labor market predict that a policy which makes UI more generous leads to an increase in jobseekers' reservation wages, which through the assumed wage formation mechanism (e.g. wage bargaining, wage posting) translates into an increase in actual wages. The expected rise in wages in turn negatively affects job creation, leading to higher levels of unemployment in equilibrium. Several arguments have been proposed to nuance this negative conclusion about the labor market impact of UI through wages.

In this paper, I look at how eligibility for the new policy rule may alter the predicted wage effect of a reform that makes UI more generous in the context of a standard Mortensen-Pissarides model. If the reform applies to new UI claims only, then a significant proportion of unemployed individuals are ineligible for the new policy rule some short period of time after the policy change, and since the new UI policy rule is more generous, employment becomes more valuable for these ineligible jobseekers, leading to a decrease in their reservation and hiring wages. This eligibility effect dominates in the immediate aftermath of the policy change and then progressively takes on its attenuating role in the long-run equilibrium impact.

The theoretical argument implies a discontinuity in the average reemployment wage as a function of the UI claim starting date of otherwise similar jobseekers around the date on which the policy change takes effect. I fail to find any significant discontinuity predicted by the theory in the context of the 2001 Austrian UI reform, despite it being an ideal case for testing the theoretical prediction.