Introduction

As stated earlier in the course, people “budget” their time in much the same way that people decide how to budget for different goods. An individual decides how much he or she “values” his or her leisure time versus work time. The more a person works, the more he or she will tend to value his or her remaining leisure time. Changes in income via non-wage income or via changes to an individual’s wage also affect labor market decisions. An increase in wage may lead a person to work more because the return to work has increased (substitution effect). Alternatively, a person may decide to work less, because his or her income has increased and he or she can afford more leisure time.

This question can be analyzed by using a utility function. To simplify, in this case, we will assume that the person modeled faces a constant hourly wage, regardless of the number of hours worked. (We could also do the model with a premium over-time wage, changing the slope of the line for all labor hours over 40 hours).

Effects of Unemployment Benefits on Labor Market Decisions
We can use this same model to examine the effect of unemployment transfers. If a person is unemployed, his or her time is fully devoted to leisure (not work). If the individual has no non-wage income (i.e. payment for rental properties), and there are no unemployment transfers, then the person's income is 0. Most people would not be able to continue in this situation for long.

If an individual receives an unemployment benefit, his or her incentives are shifted. He or she does not have access to a point outside his or her budget constraint curve. If a person receives a relatively low wage, or if he or she values leisure very highly, this new point may be on a higher indifference curve than any available on his or her budget constraint. This increases the transfer’s loss to society, because people who would otherwise work will drop out of the workforce in order to gain unemployment benefits.

Could you redraw this graph such that a person might choose to work rather than receive a benefit?

Empirical Evidence
The effect that unemployment insurance has on workers’ labor supply decisions has been studied widely. Literature on the subject has found that unemployment insurance has positive, statistically significant effects on the amount of time workers spend unemployed. These studies tend to find elasticities of lost work time near 1.0, which are quite a bit larger than the labor supply elasticities estimated in studies looking at the effects of wages or taxes on hours of work for male workers, indicating that the provision of these benefits creates a significant distortion in individual decision making. Others argue that the provision of these benefits is justified by improved “job-matching,” since individuals will invest this extra time to find a job that better matches their skills and experience levels, which in turn makes them more productive employees and increases their willingness to work for a longer period of time.

References:


