Optional Assignment

1. Unemployment insurance premiums add to the cost of labor and therefore lower the demand for labor. If, instead, workers purchased their own unemployment insurance, firms would hire more workers and pay higher wages. In addition, private insurance contracts could be tailored more closely to individuals' willingness to sacrifice earnings for security. Finally, the current system penalizes firms whose employment levels rise and fall with the business cycle. Fear of firing makes a firm less willing to hire in the first place. By removing the burden of unemployment insurance from the employer, the labor market would become more flexible and again the average level of employment would rise.

2. Venture-capital firms develop expertise in assessing the likelihood that an entrepreneur will succeed. If an entrepreneur can convince a venture capitalist that she is a promising candidate, the venture capitalist will provide cash in exchange for influence, oversight, and a share in future earnings. A private contractor who backs an individual's pursuit of a new career ahs incentive to make sure the career is viable and the training effective. Government bureaucrats do not put their own resources on the line, and therefore lack a compelling interest in the success of their clients.

These were very difficult questions, especially at the beginning of the course. They were intended to be difficult and no one received full credit. To receive even one point on a given question, it was necessary that there be at least one genuine insight beyond what was provided in the discussion on the worksheet. The main point of the bonus exercise is to give you a chance to "think like an economist". If you received four points or more on the assignment, then you are well on your way to receiving your Ph.D. If you did not, don't worry. Thinking like an economist is something that is learned, not something that is innate.

In terms of the first question, many of the answers that I read suggested that private insurance is likely to be less costly than public insurance. While this would no doubt be the case for some workers, it would not necessarily be the case for all workers. There are many examples of public insurance being less expensive than private counterparts. Having lived in jurisdictions where automobile insurance is private and where it is public, I can report that the public insurance was generally less expensive than private insurance. One reason is that the public insurer can achieve the largest possible pooling of risk. Also, the public insurer has monopsony power in purchases of repair services, keeping costs down.

The main benefit to workers is probably not the overall cost of insurance, but the ability to choose the level of insurance that is appropriate to their personal circumstances. The primary income earner in a family would likely want a higher level of insurance than other members of the family. Also, the ability of insurance companies to evaluate risks based on personal histories of clients would provide incentives for workers to participate in ongoing education programs and other activities that would make them less prone to long spells of unemployment and, therefore, reduce their premiums. Finally, if firms are able to employ more workers at less cost in activities for which there is volatile demand (for example, due to sensitivity to the business cycle), they will likely pay workers higher wages. (We will get to economic models of wage determination in Chapter 8.)

Here are excerpts from some of the best answers to the first question:

"If we assume that the money saved by the company on no longer paying proportional unemployment taxes would trickle down or directly transfer to the employees salary or benefits than [sic] it is safe to say employees would benefit. They would receive an increase in … their income and can now decide on an individual basis…how much money to allot to insurance for their own unemployment. Some people are at a higher risk than others and would want to spend more money on unemployment insurance…"

"…[B]ecause the government is not interested in accruing any profit, and the money paid to the unemployed is from taxes on companies for this purpose, it has less incentive to alleviate the actual problem of unemployment than a private insurance company would…"

"One … benefit is that the government will no longer have to devote resources to policing employment, and those freed resources could be devoted to programs that are ore socially beneficial."

"Requiring business to pay more money because of a larger payroll discourages businesses from hiring workers…"

"…Under the current system, people can receive unemployment money for a select amount of time following their being fired. During this time, those people have substantially less incentive to find a new job. If insurance rates were to rise during that period, people would try to find a new job much faster."

In terms of the second question, the key issue is the possibility for private contracts to create incentives that lead to mutually beneficial outcomes. It is interesting to note, however, that such contracts have not flourished in the current system. The closest thing may be student loans for professional schools. But these have tended to go to higher skilled workers, not to the workers mentioned in the question. It may be that the current system prevents this outcome by reducing workers incentives to seek out such contracts and reducing the amount of future earnings workers would be willing to sacrifice due to the higher taxes. However, this is an empirical question that is unresolved given the lack of experience with the other system.

One source of possible information on this empirical question could come from international comparisons. Most industrial countries have unemployment insurance programs, but the extent of the insurance varies greatly across countries. An enterprising researcher could pursue this issue for an Honours thesis.

Also, there was an interesting article in the January 27th edition of the Economist on the use in India of a guaranteed employment program rather than unemployment insurance to reduce the risks associated with losing a job. The link is

http://www.economist.com/finance/displayStory.cfm?story_id=3598933

Here are excerpts from some of the best answers to the second question:

"Venture capital firms do a great deal of investigation before investing. This will lead them to make contracts with capable people in areas of business that have potential to make money…"

"With private contracts, the [companies] creating the contracts are invested in their "students". Because they get a percent of the profits, they are going to work harder to make good classes. Something else to remember is that private venture firms can choose who[m] to invest in. The people with the best potential to benefit from the contract will be included."

"With government run programs their [sic] is no protection against the risk that the worker's new skill will be useless in the work place. Thus the worker has low incentive to devote resources such as time, money and human capital to improving or learning new abilities. With a private contract the worker has a higher incentive to invest resources in a new skill. The risk of the skill becoming useless is not as much as an obstacle to new training because the private insurance companies offer financial support should the worker's new skill not be useful in the work-place. There is also low choice with government companies. With a private contract the worker can choose among numerous existing and more experienced training institutions as opposed to the limited government run programs. Thus private contracts give the worker a high incentive and greater choice to be able to increase their value as an employee and increase productive efficiency within the company."

"The first reason that private contracts 'analogous to those drawn up by venture-capital firms' would be better is that such contracts would not require the low-wage worker to fork over a huge sum of money. This would permit poor workers to have a chance to improve themselves and reach a higher rate of pay. The company would be taking a risk in the worker, in hopes of the worker succeeding then and owing the company a percentage. The rest of the answer lies, again, with incentives. Government-run training programs are better than no training program at all, but the government does not have a s strong an incentive to produce quality workers as a private firm would. The monetary incentive created by a contract between the potentially employed and the private firm would prompt the firm to invest in and help in the development process of as many workers as possible…"

"… If we can assume that better jobs are the result of more experience, better education, and better job performance, than [sic] we can build an incentive system to reward length of experience at a company or in an industry, continuing education, and rated job

performance. By encouraging consumers to improve their own ‘labor capital’ these contract[s] would also reduce the risk of an unemployment contract actually taking effect.”