A general equilibrium analysis of the consumption response to active labor market policy

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Abstract

There has been a growing interest in the active labor market policies (ALMPs) in the U.S. in order to combat the unemployment. We develop a structural dynamic general equilibrium model with heterogeneous agents to quantify the general equilibrium effect of ALMPs, focusing on the consumption response. In addition to the classical general equilibrium effects which previous literature have discussed, we find a new general equilibrium effect, named the unemployment risk effect. ALMPs affect aggregate consumption in three ways. First, the program participants become employed and hence the different consumption level between the employed and the unemployed generates a positive response of aggregate consumption upon a fall in unemployment level. Second, an improved job-finding rate increases the expected wealth of unemployed nonparticipants and third, a reduced firing rate raises the expected wealth of the employed nonparticipants. Numerical experiments show that ALMPs have a positive general equilibrium effect on aggregate consumption level even if the partial equilibrium treatment effect is canceled by negative general equilibrium effects such as tax effect.

Keywords: Time-varying idiosyncratic risk, unemployment risk, precautionary saving, regime-switching fiscal policy, transfers

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