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Policies Against Unemployment Through Behavioral Economics

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ABSTRACT

Unemployment is an issue that continues to persist around the world. It has many negative consequences on an individual, such as lower self-esteem, and this paper looks at how these effects could be mitigated, by ensuring the reemployment of these individuals, through a behavioral economics approach. Understanding and examining the heuristics of anchoring effect, status quo bias, and framing, allows us to shape new policies and amend existing ones that mitigate these negative effects. This happens as these new policies nudge both policymakers, and recently unemployed individuals to make decisions that would benefit them in situations regarding unemployment.

Introduction

In the last decades, the United States has seen many economic and financial crises, with the Global Recession of 2008 and the 2020 Covid-19 related crisis being the most prominent examples. One of the main effects of these crises was unemployment. According to the National

Conference of State Legislatures (NCSL), during the 2008 crisis the unemployment rate in the U.S. was as high as 10 percent and during the 2020 crisis it rose to 14.8 percent (NCSL). Unemployment affects "millions of Americans residing in the United States daily," (Schliebner and Peregoy 368).

These effects are the main reason why we must combat unemployment. "[T]he loss of a job can thus have devastating effects as the unemployed person begins to question his or her purpose in life," (Waters and Moore 171). These stresses that result from unemployment can lead to depression, substance abuse, physical ilness and even domestic abuse and suicide. A 1982 research at Johns Hopkins University found that when unemployment rate rose merely 1%, suicides, homocides and deaths from heart disease rose noticably (Schliebner and Peregoy 368). Furthermore, unemployment is "an experience that leads to self-doubt and internal struggle with confidence," (Waters and Moore 171).

The easiest way to mitigate these consequences is to ensure unemployed individuals are quickly reemployed. This paper aims to look at how this could be achieved through a behavioral economics perspective. According to the theory of behavioral economics, there are biases, or heuristics, that activate while making decisions. These biases act as shortcuts that our brain takes while making decisions, even sometimes subconsciously. Due to these biases, however, sometimes people might make choices that could be considered economically irrational.

The following paper will look at situations regarding unemployment, through three main biases: anchoring effect, status quo bias, and framing.

The first section will first explain what the anchoring bias is, how it could be applied in situations regarding unemployment, and how it could be used to make new policies to mitigate the bad consequences of unemployment.

The second section will explain the status-quo bias, the role it serves in unemployment and reemployment policies, and the ways it could be used to improve the process of policy implementation regarding unemployment.

The third section of this paper will focus on framing. While it is not a bias on its own, its effects are still detrimental as framing works by activating other heuristics and biases. The section will explain framing in more detail, its role in reemployment policies and further policy recommendations that implement framing.

Anchoring Effect

The anchoring bias is one of the most common biases. Daniel Kahneman, in his book *Thinking Fast and Slow* defines the anchoring bias as an effect that "occurs when people consider a particular value for an unknown quantity before estimating that quantity," (Kahneman 118). Here the particular value that is considered is called the "anchor". While estimating the value we tend to adjust the value by moving farther away from the anchor. However, "the adjustment typically ends prematurely, because people stop when they are no longer certain that they should move farther," (Kahneman 119). Hence the value we estimate is close to the given particular value or the anchor. While adjustment is a deliberate conscious activity, " in most cases of anchoring there is no corresponding subjective experience," (Kahneman 120). This effect is best understood by the real life examples that are prevalent almost everywhere. The following scenario, which was explained in Kahneman's book, is a clear example of the anchoring effect.

Some visitors at the San Francisco Exploratorium were asked the following two questions:

Is the height of the tallest redwood more or less than 1,200 feet?
What is your best guess about the height of the tallest redwood?

The "high anchor" in this experiment was 1,200 feet. For other participants, the first question referred to a "low anchor" of 180 feet. The difference between the two anchors was 1,020 feet," The answer that the two different groups gave differed on the anchor they had received. While the average of the group that got the high anchor was 844 feet, the average for the other group was 282 feet (Kahneman 122). This shows that the groups adjusted their guesses based on the anchor they got.

Another real world example is seen with real estates. A group of real estate agents were shown a house. After they were shown the house, they were shown the listing price; then they were asked to give an estimated price for the house. The listing price varied between two groups, one price being high and the other being low. The group that got the lower listing price gave a lower price estimate for the house, while the group that got the higher listing price gave a higher price estimate for it. This occurred despite the fact that the real estate agents claimed the listing price had no effect on their estimates (Kahneman 122 - 123).

It is evident that "anchoring effects—sometimes due to priming, sometimes to insufficient adjustment—are everywhere," (Kahneman 124). This is why they are so important. From bargaining to important property decisions, we are affected by anchors constantly. This is why they are readily used, and even abused by, companies and corporations to sell products. Since, the anchoring effect could be used in many different ways, it could also be easily applied to the bad consequences of unemployment.

Lawrence F. Katz *et al.* explain that when individuals are unemployed they are paid a reservation wage, and "[i]ndividuals return to work when they get a job offer paying above their reservation wage. In standard theory, individuals are assumed to form reservation wages in a rational manner incorporating unbiased expectations of market wage and an accurate assessment of the market value of their skills," (Katz *et al. 6*). However, this is not the case. Unemployed individuals tend to anchor their wage expectations based on their previous wages. As a result "unemployed individuals may be reluctant to entertain and slow to accept even objectively reasonable wage offers," (Katz *et al. 6*). This prolongs the time period when they stay unemployed hence suffer more severely from unemployment. Furthermore, wage expectations are not the only thing an unemployed person might anchor their expectations on. Commuting and travel time to the workplace is also a common anchor that might lead to a prolonged period of unemployment.

The current policies fail to address the anchoring bias as Katz *et al.* claim "[t]he current structure of unemployment insurance and related programs does not address this tendency, but the efficiency of these programs may suffer because of it," (Katz *et al.* 6). However, there are ideas emerging to account for this bias in different policies. For instance, Katz *et al.* explains that providing wage-loss insurance (temporary money given to an unemployed

person if their new wage is lower compared to their old job) to recently reemployed people could nudge them into accepting job offers much sooner (Katz *et al. 7*).

Furthermore, the effects of the anchoring bias could be combated by making unemployed people aware of them. "Evidence from other contexts suggests that debiasing of such beliefs is possible through carefully designed interventions … having people question their own judgment by explicitly considering counterarguments to their own thinking can be effective," (Katz *et al.* 14 - 15). This intervention can be in the form of direct seminars held at various reemployment agencies, flyers, texts and emails sent to unemployed individuals and PSA's all regarding the right steps to take while setting wage expectations during unemployment. These seminars and announcements should stress the role anchoring bias plays in decision making and inform individuals about this bias (The World Bank 8,9).

In short, anchoring bias tends to prolong the period of unemployment because people tend to anchor their wage and commute time expectations based on their previous job. However, if policies are redesigned to include wage-loss insurance (to accept job offers sooner) and careful interventions regarding this bias are adopted, this period of unemployment will shorten, and unemployed people will feel the negative consequences of unemployment less effectively.

Status Quo Bias

Another bias that is effective in this situation is the status-quo bias. We come across this bias everywhere, as it is a really simple one. It is basically "doing nothing" when faced with a decision (Samuelson and Zeckhauser 8). In traditional economics " maintaining one's current or previous decision is almost always a possibility"; however, one tends to maintain the current decision, or the status-quo, much more often than predicted by the traditional model (Samuelson and Zeckhauser 8).

One example of this was seen in the book *Nudge* by Cass R. Sunstein and Richard Thaler. While examining the ways of increasing organ donations, they came across this bias. There are three main ways in which organ donations work: explicit consent, presumed consent, and mandated choice. Explicit consent is when citizens of a state or a country explicitly have to give permission for their body to be used in organ donations. Presumed consent is when the state assumes that the person wants their body to be used in organ donations; ones who do not want to do this have to explicitly opt out. In mandated choice, citizens have to make the decision for themselves, not the state. These three options display the effects of the status quo bias really well. In states with explicit consent, only 42% opted in to do so. However, in states with presumed consent 82% agreed to be donors. In states with mandated choice, those who agreed to be donors was significantly higher than those in explicit consent but less compared to presumed consent. This displays the fact that people tend to stick with the current decision, in this case the decision made for them by the state regarding their donor situation (Sunstein and Thaler Chapter 11).

Examples of the status-quo bias could also be simpler. "[D]ecision makers often stick with the status quo alternative, for example, to follow customary company policy, to elect an incumbent to still another term in office, to purchase the same product brands, or to stay in the same job," (Samuelson and Zeckhauser 8). In *Nudge* Thaler explains that this bias is basically the " 'yeah whatever' heuristic" (Sunstein and Thaler 34). For example, a person watching a show tends to stay on the channel: "when one show ends and the next one comes on, a surprisingly high number of viewers (implicitly) say, 'yeah, whatever' and keep watching,"
(Sunstein and Thaler 35)

This bias, of course, could be exploited. Companies exploit people's tendency to procrastinate and say "yeah, whatever" constantly to profit off of them. Thaler explains that "[m]any years ago American Express wrote Sunstein a cheerful letter telling him that he could receive, for free, three-month subscriptions to five magazines of his choice … For about a decade, he has continued to subscribe to magazines that he hardly ever reads," (Sunstein and Thaler 35).

The more options there are, the more people tend to stick with the status quo. Since the bias is a shortcut that makes the brain say "yeah, whatever", if there are multiple options, the brain tends to maintain the current decision rather than weighing out all of the options
(Samuelson and Zeckhauser 8).

When we look at how the status quo applies to the situations regarding unemployment, we see that both policymakers and unemployed individuals are affected by it. Policymakers tend to stick with the status quo. "Once made, policies frequently persist and become codified implicitly or explicitly in the form of decision-making rules of thumb, company policy, standard operating procedures, and the like," (Samuelson and Zeckhauser 45). Looking at program performance reviews is a case to this point. "Far less than 1% of the funds allocated to public programs is devoted to program review or performance evaluations," (Samuelson and Zeckhauser 45). Since there are many different proposed policies to mitigate the bad consequences of unemployment, policymakers tend to just go with the status quo instead of trying out new policies (Samuelson and Zeckhauser 46).

To combat this, policymakers could be encouraged to try out new policies that will mitigate the bad consequences of unemployment, such as a raise if a different solution is implemented or no drawbacks if the implemented policy fails. Policymakers could also be made aware of their tendencies to do so, and through careful intervention, they could make rational choices in policy implementation.

Unemployed individuals tend to procrastinate or even unintentionally avoid signing up to reemployment agencies. A policy that automatically assigns an individual to a reemployment agency would avoid this tendency greatly. Similar to the organ donor example, presuming that an individual wants to enroll in a reemployment agency would greatly increase that individual's likelihood of staying in the reemployment agency. This in turn would help them find a job more easily, and mitigate the negative consequences of unemployment they face.

Framing

Before beginning to explain framing in more detail, loss aversion has to be explained. According to *Nudge*, "losing something makes [a person] twice as miserable as gaining the same thing makes [that person] happy," (Sunstein and Thaler 33). This is called loss aversion and as a result people experience "a strong desire to stick with [their] current holdings," (Sunstein and Thaler 34).

Framing is, in simple terms, how a situation is presented; "every simple choice formulated in terms of gains and losses can be deconstructed in innumerable ways into a combination of choices, yielding preferences that are likely to be inconsistent," (Kahneman 327).

This is because our brains construct decisions in two different frames:

- Narrow Framing: Sequence of simple decisions that are considered separately
- Broad Framing: A single comprehensive decision that includes the consequences of the options in narrow framing (Kahneman 327)

The difference between narrow and broad framing could be seen in the following table, though in a simplified way:

Narrow Frame	Broad Frame
1. Lose $5 or Take $10 2. Lose $25 or Take $7	1. Gain $17 2. Gain $2 3. Lose $15 4. Lose $30

Our minds tend to think in narrow frames. Because of this, we might make decisions that wouldn't be considered economically rational (Kahneman 328). For instance, when selling shares investors tend to sell the share that is profiting instead of the one that's costing money – even if the shares are at the same price. As people think in narrow frames, they tend to choose the satisfaction of gaining money, by selling the successful share, to losing money. However, in the broad frame, selling the unsuccessful share and buying more shares in the successful company would be considered the rational choice. The following experiment, explained in *Thinking Fast and Slow* shows the effects of framing clearly.

Decision (i): Choose between

A. sure gain of $240
B. 25% chance to gain $1,000 and 75% chance to gain nothing

Decision (ii): Choose between

C. sure loss of $750
D. 75% chance to lose $1,000 and 25% chance to lose nothing"

Most people prefer A to B and D to C, resulting in a 25% chance of winning $240 and 75% chance of losing $760. However, if they had picked B to A and C to D, they would have had a 25% chance of winning 250 and 75% chance of losing $760. Many people "did not compute the possible results of the four combinations of choices" which caused 73% of the respondents to pick the path that is not rational according to the standard economic theory (Kahneman 326 327). However, since the situation was presented in narrow frames, the different decisions invoked different loss aversion feelings and tendencies to avoid risk. This in turn made them make irrational decisions in the broad frame.

While we do tend to think in narrow frames, the feelings that different frames could evoke, especially regret, are also crucial to understanding the effects of framing. An example of this could be seen with consumers and their product choice. "Consumers who are reminded that they may feel regret as a result of their choices show an increased preference for conventional options, favoring brand names over generics," (Kahneman 340). So while narrow and broad frames might influence the choices we make, our choices are also influenced by the feelings that the particular frame makes us feel.

Frames work by invoking loss aversion as well as feelings such as regret: they work by invoking other biases. And framing, which could be seen everywhere in our daily lives also has an effect on unemployment policy – especially during the process of reemployment. "[T]here are behavioral barriers to job search that arise simply due to the fact that it is an intrinsically difficult problem … individuals are limited in the attention and the computational capacity they can bring to multifaceted and complex problems," (Katz *et al.* 11 - 12). The way reemployment opportunities and policies are framed confuse unemployed individuals and encourage them to procrastinate reemployment.

Job search requires a lot of effort; workers need to understand the market conditions, have information regarding openings and application processes, understand their own skill level, and have the willpower to search for a job. However, there are proposals to combat this situation. The first one is expanding the access unemployed individuals have to employment services and job search assistance. " individuals are bad at knowing that job search is effective … which may result in individuals choosing a lower than optimal level of search," (Katz *et al.* 12) Another way could be to just change the wording and the way the information is presented. "For example, it is one thing to say that a certain sector is expanding or contracting but probably a different level of information transmission to convey what it means to be in that sector and incorporate this information into labor exchange systems," (Katz *et al.* 13). Furthermore "framing can also affect the willingness of participants to take risks, such as the risk of interviewing for or starting a new job. Framing might also be used to attempt to influence the reference points around which individuals judge alternatives and thereby impact attitudes toward job opportunities," (Katz *et al.* 16).

Another way frames help us mitigate the negative consequences of unemployment is that they might reduce procrastination. A study found that sending regular reminders and notifications (in the form of text messages) about job openings increased the employment rate in the first month of unemployment by 17%. Hence, frames in the form of regular reminders could also prove useful.

Frames can easily influence our decisions on a daily basis and they are everywhere. They make us feel certain emotions and induce us to take particular risks. Due to this, if new reemployment policies focus on simplifying the way the reemployment policies work and making reemployment opportunities more accessible and easier to understand (by simplifying the jargon used to describe the process, posing the whole process through a broad frame so that individuals would make the most rational choices, explaining the process in a more detailed manner etc), framing can help mitigate bad consequences of unemployment by ensuring that individuals are reemployed quickly. Lastly, reemployment agencies could also use framing to help recently unemployed individuals find a job more easily, by methods such as constant reminders for them to take action.

Conclusion

As humans, our brains tend to take shortcuts to make decisions more easily and efficiently. While these shortcuts, or biases and heuristics, tend to lead us to make economic decisions that would be considered “irrational”, by better understanding and using them, they could be used to resolve certain economic issues. Unemployment, which affects millions of people in the US and in the world by causing them both financial and mental issues, is one of these issues that could be resolved.

The anchoring effect is the first bias that this paper had looked at. It occurs when people anchor their estimation of expectation of a value to a value previously displayed to them. For instance when guessing the height of a tree, being asked whether we think the tree is longer or shorter than 5 meters will result in us giving answers closer to 5 meters. In unemployment, recently unemployed individuals tend to anchor their expectations to the situation they had in their previous job. They could expect a similar salary or a similar commute time which deters them from accepting job offers, even once that would be considered a rational choice. This, in turn, elongates the process of unemployment for that individual. A policy that could mitigate the effects of this bias could be offering wage-loss insurance for these individuals so they are more inclined to take the offer. Furthermore, careful intervention regarding this bias could also prove useful.

The status quo bias is another bias that is important in mitigating bad consequences of unemployment. When faced with a decision, people tend to maintain the current decision they have, much more than what the traditional economic model would predict. Furthermore, the intensity of this bias increases the more decisions a person is presented with. For example, if you are given a list of companies and some money to invest in, status-quo bias would make it more likely that you would invest in a company you already have shares in, and you would be more likely to do this the more company opportunities you have. In situations regarding unemployment, we see that the status quo bias comes to play in policy implementation and enrollment to reemployment agencies. Many policymakers hesitate to implement new unemployment policies as a result of the status quo bias. This, however, could be overcome by offering rewards for implementing a new policy or reducing the punishment and drawback received if the new policy fails. Many unemployed individuals tend not to join a reemployment agency. However, through a process similar to presumed consent, if individuals are assigned a reemployment agency they can find a suitable occupation more quickly.

The last effect is the framing. Framing is how a decision is presented to people and it can invoke other feelings and biases such as regret, risk aversion, and loss aversion. This comes to play, especially in reemployment policies and agencies. Reemployment is a complicated process that requires hard work from the recently unemployed individual. However, if reemployment policies and agencies are framed to make the process more accessible, more people are able to find a new job more easily. While there are policies that could be implemented and amended according to behavioral economics theory, more research on certain aspects of this situation is required. There is

minimal research on how the status quo bias affects recently unemployed individuals. Furthermore, there is not enough research on data on the ways of intervening with the status quo bias and the anchoring effect so respective individuals would be less affected by them in their decision making process.

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