Evaluating the Welfare Effects of Alternative Monetary Arrangements (p. 3)

Ayşe İmrohoroğlu
Edward C. Prescott

The Labor Market Implications of Unemployment Insurance and Short-Time Compensation (p. 11)

Randall Wright
The Costs of Inflation...

Standard economic analyses of inflation start with the notion that it is a tax on money holdings. All taxes are costly: They distort the economic decisions that people would have made otherwise. Inflation is no exception. As a tax, it distorts the decision of how much money to hold. But like other taxes, inflation also has a benefit: the printing of money that causes inflation is a useful source of government revenue. Most analyses of the inflation tax try to weigh the costs from the distortions against the benefits from the revenues. Such analyses typically find that while the costs are pretty small, so are the benefits; and the annual inflation rate that best balances the two is typically below 5 percent. Most of these analyses also conclude, however, that the net costs to exceeding that best rate are fairly small.

Ayse Imrohoroglu and Edward C. Prescott take a slightly different approach—and come to a quite different conclusion. In “Evaluating the Welfare Effects of Alternative Monetary Arrangements” (p. 3), Imrohoroglu and Prescott find that the net costs of inflation can be substantial. This contrary conclusion comes from an unusual feature of their model: that printing money to raise revenue also reduces the real (adjusted for inflation) interest rate which people can earn on their savings. In fact, with this model, Imrohoroglu and Prescott find that the real interest rate is what matters most for economic welfare. More generally, Imrohoroglu and Prescott find that both monetary policy and the institutional features of monetary arrangements, such as reserve requirements, play a key role in determining the real interest rate and, therefore, the costs of inflation.

That the real interest rate depends on monetary policy in this model is controversial. The empirical evidence does suggest that higher rates of inflation are associated with lower rates of return to savings. But correlation does not imply causation, and much more work is needed. Still, Imrohoroglu and Prescott’s finding that the costs of inflation depend on institutional monetary arrangements will be a crucial ingredient of future studies of inflation.

An earlier version of the Imrohoroglu and Prescott paper was presented last year at a conference sponsored by the Federal Reserve Bank of Cleveland and was published recently in a special issue of the *Journal of Money, Credit, and Banking*. We thank the Cleveland Fed for allowing us to publish a revised version of that paper.
To qualify for unemployment insurance benefits in the United States and Canada, workers typically must lose their jobs. In Europe, however, workers can keep their jobs and still qualify for a portion of such benefits, referred to as *short-time compensation*, by working a reduced number of hours. Thus, the European system provides an incentive to share the available work rather than to lay off workers when times are bad or demand for a firm’s product is low.

In “The Labor Market Implications of Unemployment Insurance and Short-Time Compensation” (p. 11), Randall Wright shows that there are sound theoretical reasons, as well as empirical evidence, to support the view that short-time compensation promotes work-sharing. Most striking, however, is his conclusion that both the strict unemployment insurance system and the short-time compensation system lead to inefficient outcomes unless the revenue side is properly designed. In particular, Wright focuses on the extent to which the system is *experience-rated*, that is, the extent to which a firm’s unemployment taxes are based on the employment history of that firm. Typically, these taxes are incompletely experience-rated and thus provide incentives to reduce the number of workers rather than their hours during bad times. Wright argues that while it might be desirable to encourage work-sharing, it is much more important to increase the extent of experience-rating.

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