Abstract:

I document a small spousal earnings response to the job displacement of the family head. The response is even smaller in recessions, when earnings losses are larger and additional insurance is most valuable. I investigate whether the small response is an outcome of the crowding-out effects of government transfers. To accomplish this, I use an incomplete markets model with family labor supply and aggregate fluctuations where predicted spousal labor supply elasticities with respect to transfers are in line with microeconomic estimates both in aggregate and across subpopulations. Counterfactual experiments indeed reveal that generous transfers in recessions discourage the spousal labor supply significantly. I then show that the optimal policy features procyclical means-tested and countercyclical employment-tested transfers, unlike the existing policy that maintains generous transfers of both types in recessions. Abstracting from the incentive costs of transfers on the spousal labor supply changes both the level and cyclicality of optimal transfers.