

Improving Incentives in Unemployment Insurance: A Review of Recent Research

Peter Fredriksson and Bertil Holmlund

Department of Economics

Uppsala University

copyright with the author

A review of the effects three policies to improve incentives in unemployment insurance

- The duration (time sequencing) of benefit payments
- Monitoring and sanctions
- Work tests and workfare

Time limits in UI: theory

Mortensen (1977):

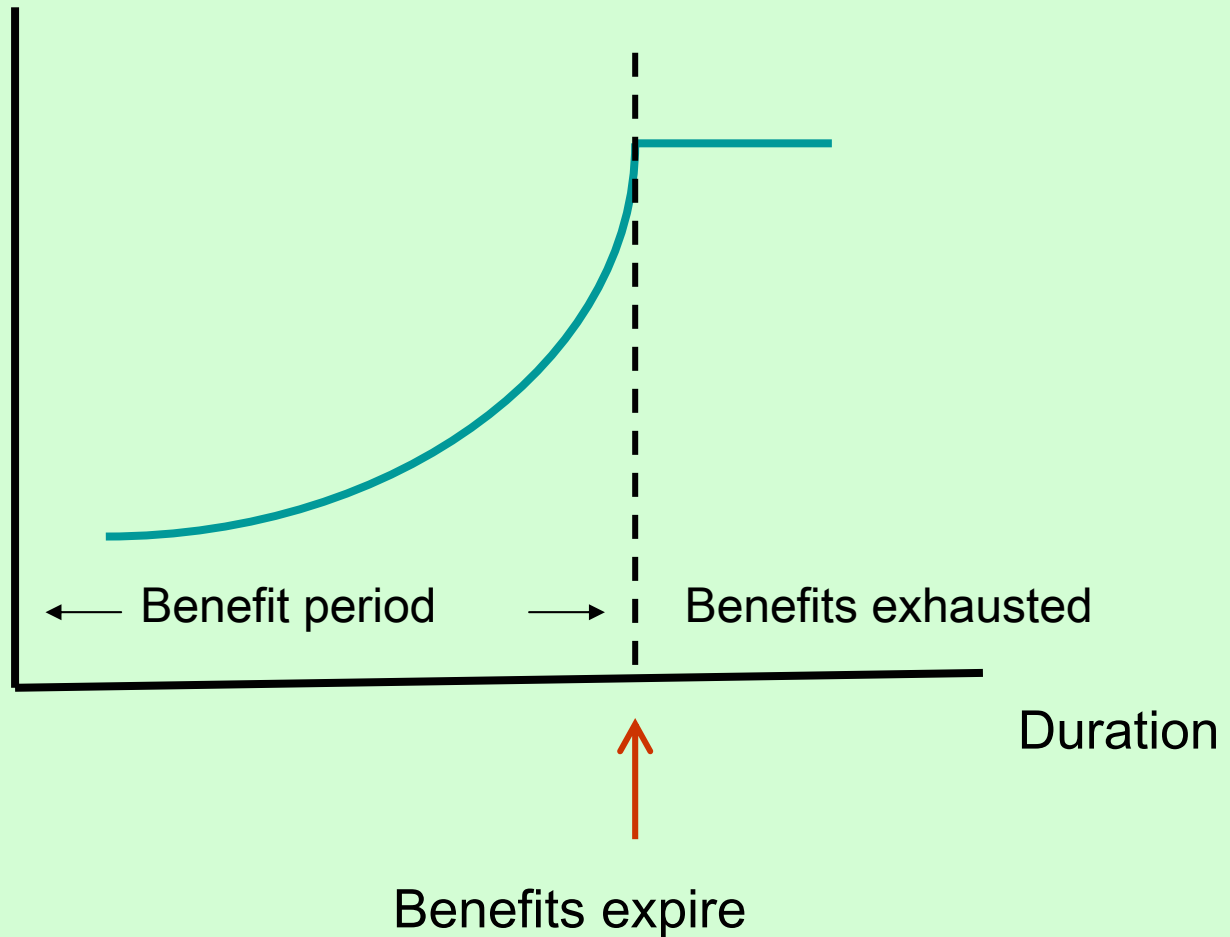
- Sequential search, maximization of lifetime utility
- Fixed duration of benefit payments, stochastic duration of employment spells
- Eligibility condition: work must precede benefit receipt

Implications

- The reservation wage declines as the insured worker gets closer to the date at which benefits expire
- The exit rate increases with elapsed duration

Job finding over the spell of unemployment

Exit rate

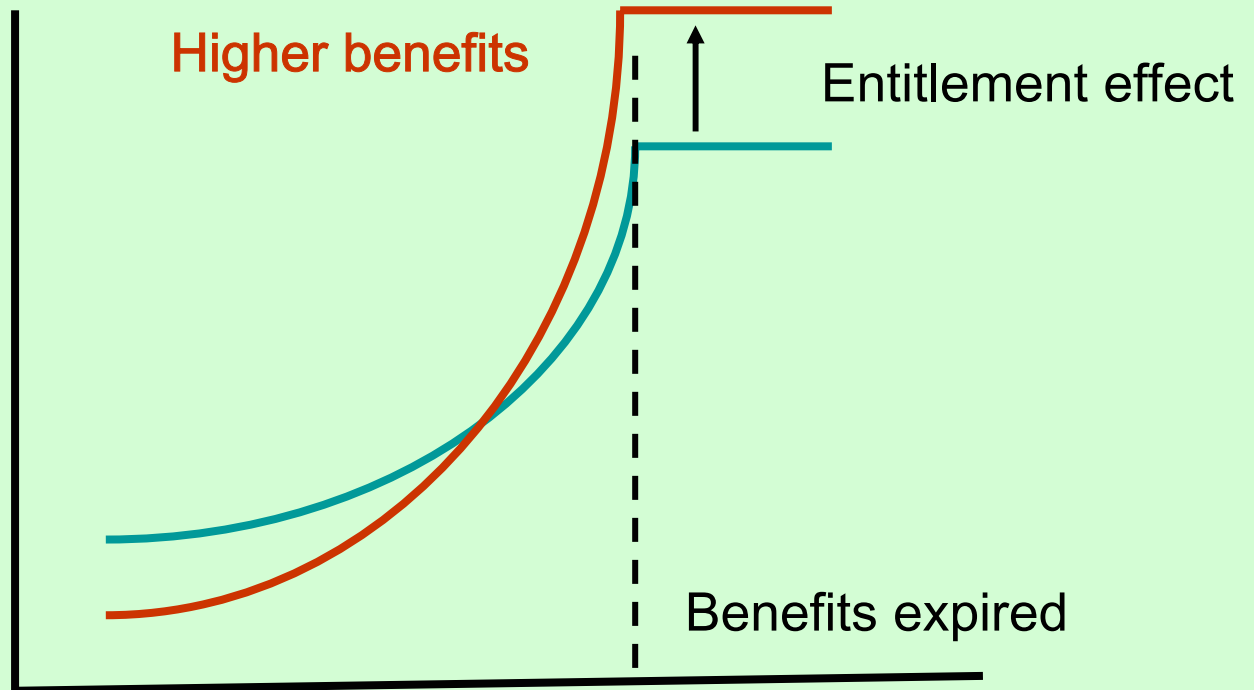


The theory implies that a rise in the benefit level

- increases exit rates to employment among workers not eligible for UI (entitlement effect)
- causes a newly unemployed worker to increase the reservation wage
- but induces an insured worker close to benefit expiration to *reduce* the reservation wage

Effects of a rise in the benefit level

Exit rate



Duration

- Strong empirical evidence on the impact of the potential duration of benefits
- Not much evidence on whether benefit hikes will increase job finding among insured workers close to benefit expiration

Optimal time profile of benefits

Shavell and Weiss (1979): a case for declining time profile

Hopenhayn and Nicolini (1997):

- Two instruments: Benefits + wage tax after reemployment.

Results

- Benefits should decrease over the elapsed duration of unemployment.
- The wage tax should increase with the length of the previous unemployment spell.
- Numerical examples: large welfare gains, high replacement rates

Wang and Williamson (1996): endogenous work effort

- Endogenous *inflow* into unemployment: the probability of remaining employed is increasing in work effort.
- Endogenous *outflow* from unemployment depends on search effort.

Implications for optimal UI:

- A large drop in consumption in the first period of unemployment (discourages shirking).
- A large reemployment bonus (encourages search).
- Optimal UI: compensation increases initially and then falls throughout the spell.

General equilibrium with collective bargaining

Cahuc and Lehmann (1997, 2000)

Union bargaining model.

- The fall-back position of the union is the welfare of the short term unemployed.
- A declining time profile may increase wage pressure by increasing welfare of the short-term unemployed relative to the long-term unemployed.

Search equilibrium

Fredriksson and Holmlund (2001)

- Equilibrium search, endogenous wages and search effort.
- Is a two-tiered benefit system better than a uniform one?
 - Yes, in general.
 - Entitlement effect.

Summary: time profile

- A reasonably strong case for a declining time profile
- Caveats:
 - Work effort, inflow into unemployment
 - A case for a waiting period
 - Private savings

Monitoring and sanctions

- In practice: UI systems condition benefits on performance criteria:
 - availability for work
 - actively searching for work
- Monitoring through benefit administration (public employment service).
- Benefit sanctions if search criteria are not met.

- The economics of law enforcement (Becker)
 - Individuals compare the benefits and costs of violating the law
 - Higher punishment as well as higher probability of detection reduces crime
- How should the government optimally choose punishment (fines) and detection probabilities?
 - Result under risk neutrality: the optimal fine is the maximum fine

Fines are costless whereas detection requires costly monitoring

The result is modified under less restrictive assumptions

Monitoring and sanctions in UI: theory

- Ljungqvist, Sargent (1995)
- Abbring, van den Berg, van Ours (1998)
- Van den Berg, van der Klaauw (2001)
- Boone, van Ours (2000)
- Boone, Fredriksson, Holmlund, van Ours (2002)
 - monitoring and sanctions represent a welfare improvement for reasonable values of monitoring costs

Evidence on monitoring and sanctions in UI

- Social experiments in the United States:
- Random assignments of unemployed benefit claimants into groups exposed to different search requirements
 - Washington state, 1986-87.
 - Maryland, 1994.

The Washington study

- Four treatments:
 - elimination of work-search requirement
 - standard requirement
 - individualized requirements
 - intensive services
- Results
 - Workers in the first category (no search requirements) had 3 weeks longer duration of benefit receipt than those with standard requirements.
 - No search requirement increased the risk of benefit exhaustion.
 - Workers in the first category had slightly higher reemployment wages in the short term.
 - No evidence of any longer-term effects on wages.

The Maryland study

- Benefit claimants randomly assigned to four treatment groups and two control groups.
- The control groups were required to follow the standard requirements (at least two employer contacts per week)
- The treatments:
 1. increased work-search requirements (workers should make at least four employer contacts per week)
 2. two employer contacts per week without any requirement of documentation
 3. workers should attend a job search workshop early during the unemployment spell
 4. information to the claimants that their reported employer contacts would be verified

Results from the Maryland study

- Increasing the number of required employer contacts from two to four reduced the duration of benefit receipt by 6 %.
- Informing claimants that their employer contacts would be monitored reduced the duration of benefit receipt by 7.5 %.
- Participation in the job search workshop reduced the number of benefit weeks by 5 %.
The effect is driven by a sharp increase in exit rates from unemployment *prior* to the scheduled workshop.

Other evidence

- Ashenfelter, Ashmore, Deschenes (1999)
 - Randomized US experiments of stricter job search requirements
 - At most very small effect on benefit payments
- Dolton, O'Neill (1996)
 - Restart experiments in the UK (job search interview and risk of losing benefit if not showing up)
 - Result: fairly strong increase in the exit rate (30 %)
- Van den Berg, van der Klaauw (2001)
 - Experiments in the Netherlands (counseling and monitoring)
 - No effect on the transition rate from unemployment to employment

Non-experimental evidence on sanctions

- Abbring, van den Berg, van Ours (1998)
- Van den Berg, van der Klaauw, van Ours (2004)
 - Increase in the transition rate to employment by 80-100 %
 - The estimated elasticity of the exit rate with respect to the benefit level is very high (=3)
- Lalive, van Ours, Zweimuller (2002)
 - Swiss evidence on the impact of warnings and actual benefit sanctions
 - Both warnings and enforcements raised the outflow from unemployment

Workfare: work required in exchange for benefits

Three arguments:

1. Benefits for the unemployed more politically acceptable
2. Workfare as a screening device
3. Workfare as deterrent (tax on leisure)

Workfare and UI

- Informal argument: ALMP as workfare
 - Workfare puts a price on workers' time
 - Workers with a high value of leisure self-select out of the benefit system
- Formal argument: Hansen and Tranaes (1999)
 - Two types of individuals, different preferences for leisure
 - The government doesn't know individual preferences, only the distribution

Can workfare be Pareto improving?

Yes!

- Absent workfare, searching as well as non-searching individuals may claim benefits
- Workfare induces non-searching workers to self-select out of UI (strong preference for leisure)
- Makes it possible to raise benefits without making it worse for non-searching individuals

Evidence on workfare

- Black, Smith, Berger, Noel(2003)
 - Random assignment of unemployed individuals into mandatory employment and training services
 - Participation required in order to receive benefits

Results

- The treatment reduced the mean UI duration by about 2 weeks
- The effect is mainly driven by a marked rise in reemployment before the scheduled program participation

Conclusions

- The case for penalizing less active search is solid
 - Indirect penalty: a declining time profile
 - More direct penalty via monitoring of search
 - Workfare can be a useful screening device
- Caveats
 - Low benefits during the first week(s) would discourage unemployment entry
 - Precautionary savings