Labour market policies at different benefit replacement rates
Thematic Paper
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1. Outline

- Benefits without active measures tend to increase unemployment, especially if replacement rates are high. But “activation” measures reduce unemployment.
- There are two main classes of “activation” measure:
  - “Interventions in the unemployment spell” by the Public Employment Service (PES), such as intensive interviews, job-search monitoring and individual action plans.
  - Compulsory participation in active labour market programmes (ALMPs) (“workfare/trainingfare”)
- Countries with net replacement rates of up to 65% seem able to keep unemployment low with strategies of relatively cheap “interventions in the unemployment spell”. Countries with higher replacement rates seem to spend much more on ALMPs, although they use both approaches.
- This perspective suggests some recommendations for benefit levels and for active policies in high-replacement-rate countries.

2. The impact of benefits

Simple hazard rate graphs show that limits on unemployment insurance (UI) benefit duration considerably affect behaviour (Figure 1). When the UI duration is 14 months, the monthly rate of entry to employment increases through months 10 to 16. This implies that search frictions are significant, but that they do not justify long-term (more than 12 months) unemployment. Although people who are employable - within the current structure of incentives, assistance measures and state of the labour market - cannot usually find a reasonable match to start in a exact month, they can usually find a reasonable match within a 6-month time-window.

Similar “spikes” are found in studies from other countries.

Better-quality studies of the impact of replacement rates suggest a fairly large elasticity of job entry rates with respect to replacement rates, e.g. -0.7. But such a number is only part of the story, because:

- Benefits influence rates of entry to unemployment, as well as rates of exit
- Microeconomic studies estimate short-run impacts, holding institutions and social attitudes to unemployment near-constant
Figure 1. Monthly rate of entry to employment when the duration of UI benefit was 14 months, France

For four levels of earnings prior to unemployment

Source: Dormont et al., as cited by OECD (2005)

Caseload growth for new (i.e. much more generous) assistance benefits has typically continued for 15 to 20 years. Thus their long-run impact has often been around 3 times the short-run impact, as judged by caseloads after 20 years vs. the first few years (e.g. see OECD, 2003).

In general, the long-run incentive effects of relatively generous benefits are large in the absence of active measures, so that active policies have “a lot of work to do” to offset them.
3. Some history of UI systems and active measures

Finland (1971), Luxembourg (1976), Sweden (1974) and Switzerland (1976) introduced their current (much more generous) unemployment insurance (UI) benefit entitlements in the 1970s - later than other countries of North and Western (though not Southern) Europe. They then suffered “late” increases in unemployment, in the 1990s (into the 2000s for Luxembourg and Switzerland), in contrast to the experiences of neighbouring countries where unemployment increased mainly in the 1970s and 1980s (Figure 2). Their caseload growth continued for 20 years or more after the introduction of generous UI benefits, in line with international experiences with assistance benefits (although trends in assistance benefit caseloads are often less cyclical).

Thus although some smaller countries were able to reconcile generous benefit levels with low unemployment rates in the 1970s and 1980s, this experience does not necessarily prove that benefit disincentive effects are limited or can be offset easily and cheaply, because the low unemployment rates that at first limited the cost of the benefit system proved to be temporary in nature.

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1 In July 1971 Finland increased maximum benefit from 2/3 to 3/4 of the individual’s normal daily wage, increased the ceiling level of benefit by more than 50% and reduced the waiting period: also around this time the payment of benefits by UI funds for more than the legal maximum of 150 days began to be tolerated (NOSOSCO, 1973; 1976). In 1974, Sweden increased the maximum duration of benefit for individuals under 55 from 150 to 300 days, and introduced a complementary system of KAS benefits for uninsured individuals (Björklund and Holmlund, 1991; Strand, 1999). Luxembourg’s unemployment benefit system (which resembles unemployment insurance although it is not financed by contributions) is governed by the law of 30 June 1976 (downloadable at www.legilux.public.lu). In Switzerland before 1976 unemployment insurance contributions were optional, and less than 20% of workers were contributing: following the approval by referendum of a constitutional amendment, universal compulsory coverage was implemented by federal decree as from 8 October (e.g. see Dictionnaire Historique de la Suisse, www.hls-dhs-dss.ch/textes/f/F16813.php). The OECD “summary measure of benefit entitlements” (which provides except for Luxembourg data for 1961 onwards: e.g. see OECD, 2004, Figure 3.2) illustrates the lateness of the introduction of generous benefits in these countries as compared to others of Northern and Western Europe. Benefit rates also became progressively more generous after 1975 in Norway, but the literature does not appear to identify a specific date of reform and the net replacement rate (according to the summary measures presented here) remains somewhat lower than in the other four countries.

2 Canada’s experience has been similar to that of the four European countries highlighted here, in that more generous UI was introduced in 1971 and the difference between Canadian and US unemployment rates which historically had been minimal reached a first peak only in 1983 and a second (higher) peak (4.4 percentage points) in 1993, i.e. 22 years later. Riddell and Sharpe (1998) provide a broad discussion of this development. Lemieux and Macleod (2000) analyse in some depth a “supply-side hysteresis” mechanism which may explain the length of the lag.
Figure 2. Unemployment rates in four countries which introduced generous unemployment benefits after 1970

![Unemployment rates graph](image)

* Austria, France, Germany (western until 1990), Ireland, Iceland, Norway, Netherlands, United Kingdom. Source: OECD Economic Outlook, Annex Table "Commonly used definitions".

The direct impact of ALMPs

These and other countries faced with a tendency for unemployment to rise\(^3\) at first used active labour market programmes (ALMPs), but that did not stop the upward trend for long. For example, Finland in 1987 (1984 for youth) introduced a job guarantee for the long-term unemployed\(^4\) and Sweden in the late 1980s allowed participation in ALMPs to renew individual entitlement to UI - arrangements which involved high levels of ALMP spending – but open unemployment levels exploded only a few years later. They now focus more on an “activation” approach, which has helped to reverse the trend.

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\(^3\) In the statistics it is not clear that Finland and Sweden did face a tendency for unemployment to rise in the 1980s. However, they already were making exceptional efforts to keep unemployment low. Finland’s job guarantee (see below) remains unparalleled in its ambition. Sweden in the 1980s had very high levels of government employment and spending on labour market programmes, and heavily restrained wages in the competitive sector of the economy so as to maintain aggregate demand (e.g. see Angresano, 2007). As late as 1980, less than half the unemployed had UI coverage (Björklund and Holmlund, 1991).

\(^4\) Under Finland’s job guarantee, as from 1987, the long-term unemployed were automatically offered a subsidized job (in some cases in the private sector; otherwise in municipal government or various national government agencies) lasting 6 months, which requalified them for UI benefit.
4. The direct impact of ALMPs

Evaluations have identified modest direct impacts (impacts on employment-related outcomes of participants) from ALMPs. Impacts are perhaps slightly positive for training programmes, none or even negative for job creation. Impacts tend to be more positive for adult women than for youth or adult men (Martin and Grubb, 2001).

- Training programmes have given some more positive evaluation findings when outcomes are tracked over a longer period, although some findings concern specialised training programmes that would be hard to expand.
- Hiring subsidies are often found effective in recent evaluations using non-experimental (matching) estimators, but other studies continue to show large deadweight effects (Boockmann et al., 2007).
- Job-search assistance programmes are often found to be effective, especially given their low cost.

The direct effects of the full-time ALMPs do not seem large enough, by themselves, to tackle high unemployment.

5. Indirect impacts of ALMPs

ALMPs can have a large impact through their interaction with the benefit system:

- When ALMPs re-qualify participants for unemployment benefits, their "carousel effects" increase unemployment, after a short lag, as in Finland and Sweden in the late 1980s/early 1990s.
- "Motivation" effects, which arise when participation in ALMPs is compulsory for long-term benefit recipients, reduce unemployment (their impact is similar to that of benefit exhaustion, as shown in Figure 1).

Some channels of impact from ALMPs are rarely identified in microeconomic evaluations:

- A general change in expectations, associated with more intense activation, affects most labour market groups and unemployment durations so that its impact is relatively difficult to identify.
- Impact on rates of (re)entry to unemployment
- Social interaction effects, i.e. impacts of programmes on the behaviour of non-participants in the programme.

A few microeconomic studies that have studied these channels of impact suggest that they can be important, so the impact of ALMPs at the macroeconomic level need not correspond closely with what is reported by studies of direct impact alone.

In the early-mid 1990s, US political scientist Lawrence Mead visited individual counties within Wisconsin that were implementing “work first” strategies and saw how their caseloads fell by more than 50% (often 70% or more). Local experience tended to show a larger total impact than was captured even in good microeconomic evaluations of individual labour market reforms. By the early 2000s it was clear that this pattern had been repeated in aggregate caseload data (see OECD, 2003; 2005, for additional discussion of US Welfare Reform).
6. Activation through regular interventions in the unemployment spell

In some countries activation strategies have relied mainly on “regular interventions” in the unemployment spell, such as:

- personal contact with jobseekers
- intensive interviews and individual action plans
- job-search requirements and monitoring
- job-search training sessions
- direct referrals to job vacancies
- sanctions

(A chapter for the forthcoming OECD Employment Outlook 2007 documents what countries do in several of these areas). In countries such as Australia, New Zealand, the UK and the US (Welfare Reform), these types of activation measure arguably reduce benefit caseloads sharply, within an overall strategy where only a small proportion of the unemployed participate in expensive (full-time) programmes (although in-work benefits are important in some cases).

7. Activation through compulsory participation in labour market programmes

In Denmark, Finland and Sweden, activation more often involves referral to a full-time ALMP. For example, in Denmark’s “active period of benefits” (in the strategy as of about 2000), after a year the unemployed person had to participate in an ALMP 75% of the time for the next 3 years. Significant numbers do actually participate in ALMPs. Luxembourg and Switzerland have also at certain times systematically referred beneficiaries (in Luxembourg, RMG beneficiaries) to full-time ALMPs. Germany and the Netherlands spend heavily on ALMPs which can be compulsory (e.g. the “Melkert” jobs of the 1990s).

Why do these countries rely so much on full-time programmes? The high-replacement-rate environment is probably a factor.

8. The impact of unemployment-benefit replacement rates in international comparison

In international comparison, net replacement rates (theoretical entitlements defined by legislation, as summarised using typical-case calculations) have no clear correlation with unemployment rates. But high net replacement rates do correlate strongly with high spending on labour market programmes.
The exact ordering of OECD countries by theoretical net replacement rate\(^5\) varies depending on how a summary indicator for the net replacement rate is defined. For the present analysis, two different summary measures are presented (Figure 3, Figure 4). The summary measure in Figure 3 assumes that social assistance is always received where relevant, and does not include two-earner couple cases. The summary measure in Figure 4 assumes that in countries that have regional or local financing of social assistance (except France where the principle of regional financing is recent and unclear) only 75% of (otherwise-eligible) cases take up social assistance (these countries administer social assistance more restrictively, although the degree of strictness varies widely). It also includes some two-earner couple cases.

In both versions, for net replacement rates of 60 to 65% the total cost of labour market programmes remains moderate (about 1.2% of GDP), but above 65% costs accelerate fast, even averaging over 3% of GDP for the top 6 countries in Figure 4. This suggests that even fairly small differences in replacement rates (within the upper part of the range, i.e. 65-85%) may be strongly influencing labour market environments and the appropriate activation strategy.

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\(^5\) Note that net replacement rates are defined here in terms of the net income of household units, including family and housing benefits and after tax and social security contributions, comparing cases where the earner is in work vs. unemployed. Commonly income taxes are progressive, housing benefits increase as other income falls, and family benefits are unrelated to other income. For couples with two earners, the net replacement rate includes in the numerator the continuing earnings of the partner who remains in work. The summary measures presented here relate to cases where the job-loser was earning 67% or 100% of average production worker (APW) earnings, since the unemployed typically have relatively low skills. These definitional choices tend to generate relatively high reported replacement rates, but seem reasonable in terms of taking into account factors that are relevant for international comparisons.
Figure 3. Relationship between net replacement rates (ver.1), unemployment rates, and LMP spending

Net replacement rate summary indicator (version 1, 2002 data) is defined as: average of (a) initial net replacement rate, for four family types and two earnings levels and (b) net replacement rates over 60 months of unemployment, for four family types and two earnings levels, case “with social assistance”. The family types are single, couple with one earner, with not children or with two children. The two earnings levels are 67% and 100% of APW (average production worker) earnings. See source for details. This indicator takes values of 57.5% to 62.5% in the group of countries above “60”, and similarly for other groups.

Figure 4. Relationship between net replacement rates (ver.2), unemployment rates, and LMP spending

On either basis (Figure 3 or Figure 4) the ratio of passive LMP spending (as % of GDP) to the unemployment rate more than doubles when the replacement rate increases from 65% to 75-80%, which is too small a change to account directly for the increase. The reasons for this are not entirely clear. The data for passive spending include early retirement benefits “for labour market reasons” (i.e. when entry to the retirement benefit is linked to unemployment status), and these account for a small share (about one eighth) of total passive LMP spending, on average, among the highest-replacement-rate countries (countries in the highest two groups in Figure 4). But the main factor may be that these countries have higher ratios of the number of unemployment benefit recipients to the number of unemployed as measured in the labour force survey. At the same time, policy-makers increase active spending roughly in proportion with the higher passive spending, plausibly because this is an optimal strategy in terms of limiting total costs.
9. Problems in managing high-replacement-rate systems

- In high-benefit countries, high spending on ALMPs (e.g. in Finland and Sweden before 1990 and Germany in the early 1990s) did not historically prevent unemployment from rising further to post-war peak levels.
- Labour market programmes remain expensive even when unemployment is low (3.0-4.5% of GDP in 2004 not only in Finland and Germany, but also in Denmark and the Netherlands which had unemployment rates well below the EU or OECD average at the time).
- A large immigrant-native differential in unemployment and employment rates is proving hard to tackle in several countries (Figure 5).
- Strict or artificial “workfare/trainingfare” schemes can be needed for the management of social assistance (e.g. Kildal, 2000; Thøren, 2005, describes some Swedish schemes).
- Controversy and experimentation continues, e.g. privatisation of employment services in Denmark, the “Activity Guarantee” in Sweden, and in some countries benefit cuts.

Figure 5. Unemployment rates of non-EU immigrants vs. natives

10. Better outcomes where replacement rates are slightly lower?

Austria and Norway are two rare Western European countries that have since the 1960s avoided a major peak in the unemployment rate. Their LMP spending levels are only moderately high (about 2% of GDP). Active policies might explain these positive outcomes, but the fact that net replacement rates (as shown in Figures 3 and 4) are only slightly above the 60 to 65% level may also be helping.

11. Potential advantages of high replacement rates

Although the highest net replacement rates (75 to 80%) seem to make labour market policy expensive and difficult to manage successfully, if they can be managed successfully, some broader economic benefits arise:

- High replacement rates compress the bottom of the earnings distribution, improving the situation for low-paid workers in general, while high ALMP spending (in the form of training) may have a positive impact on their productivity.
- High replacement rates combined with effective activation measures can in principle increase labour force participation and reduce the unemployment rate. For this to happen, benefits need to function as a "wage" paid to the unemployed in return for engaging in higher levels of job search and participation in placement assistance measures than would otherwise be the case.

12. Guidelines for active policy in countries with high replacement rates

Countries with high replacement rates need to carefully optimise their active policies. Some issues which are not usually relevant at lower replacement rates but become relevant at high replacement rates are:

Minimise “programme dependency”

Where replacement rates are high, activation through referrals to ALMPs tends to create a new problem of “programme dependency”, e.g. some people prefer ALMP participation (rather than passive benefits) to market work:

- Recruitment incentive programmes should be targeted on individual unemployed by the PES, not driven by the employer demand for subsidies.
- Training and job creation programmes should pay less than market work, *i.e.* not significantly more than unemployment benefits.
- Except perhaps for small groups with severe employability barriers, to combat inertia (or "lock-in" effects) potential “programme careers” should be repeatedly interrupted by short intervals in open unemployment, with a review of the individual action plan and a focus on searching for market jobs.

Keep open unemployment low
When the unemployment is low the vacancy/unemployment ratio is high. This allows some relatively cheap activation measures (job-search monitoring and direct referrals to vacancies) to be more effective. And when the expected duration of individual benefit spells is being kept below about six months, the disincentive effects of high replacement rates are attenuated. These factors arguably imply that high-benefit countries need to keep open unemployment relatively low so as to minimise disincentive effects, at least among relatively employable people. This in turn implies that they need to adjust their activation strategy in line with the labour market situation:

- If open unemployment is or has become high, it is necessary to expand ALMPs and perhaps transfer some unemployed groups to an inactive status, in order to reduce open unemployment.
- Conversely if open unemployment has been reduced to moderate levels, activation through ALMPs can be scaled back in favour of a strategy of activation through interventions in the unemployment spell (job-search monitoring, direct referrals to vacancies) (Denmark's activation strategy partly refocused on regular interventions after 2000: Graversen and van Ours, 2006, show their potential impact). Also, some client groups on non-employment benefits (lone parents, disabled) can be transferred to the PES and a more active regime (see Carcillo and Grubb, 2006: although this policy approach is also relevant for countries with lower replacement rates).

References


NOSOSCO (1976), as above 1972.


