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Can workfare programs offset the negative effect of unemployment on subjective well-being?

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HIGHLIGHTS

- Estimates the effect of a workfare program on subjective well-being in Germany.
- Employment in workfare has a substantial positive effect on subjective well-being.
- The effect of workfare can offset most of the negative effects of unemployment.

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ABSTRACT

Previous research suggests that unemployment negatively affects indicators of mental health and well-being, but it remains unclear whether active labor market policy can offset this effect. This paper examines a workfare program that was a key part of Germany's active labor market policy for over 30 years. Fixed effects panel estimates suggest that participation in the workfare program offset most, though not all, of the negative effect of unemployment on subjective life satisfaction. Robustness tests find no evidence that this estimate is due to non-parallel time-trends, unobserved shocks in the pre-treatment period, adaptation to unemployment or differences in regional unemployment rates. These results suggest that active labor market policies can help reduce the negative psychological effect of unemployment.

1. Introduction

Previous research has documented a substantial negative psychological effect of unemployment. For instance, unemployment has been shown to reduce life satisfaction, increase psychological distress, and lead to cardiovascular disease, hospitalization for mental illness, and suicide (Clark and Oswald, 1994; Winkelmann and Winkelmann, 1998; Marks and Fleming, 1999; Clark, 2003; Carroll, 2007; Kassenboehmer and Haisken-DeNew, 2009; Kuhn et al., 2009; Browning and Heineken, 2012). A possible explanation for this effect is that jobs confer social status, social networks and a sense of purpose—all of which are thought to be important contributors to well-being (Izard, 1991; Ryan and Deci, 2000; Ellingsen and Johannesson, 2007; Ariely et al., 2008). Involuntary unemployment may therefore have a psychological cost—a negative effect on well-being and mental health that goes beyond its effects on income and consumption (Frey and Stutzer, 2002; Carroll, 2007). This would have important implications for labor market and welfare policy, suggesting that the welfare cost of unemployment is greater than the value of lost output and that active labor market policies like workfare programs may be a more efficient way of increasing the well-being of the unemployed than cash transfers. For instance, Edlin and Phelps (2009) cite the psychological benefits of employment as an argument for the introduction of tax credits for employers of low-wage workers.

It is, however, not clear whether jobs created through workfare programs or other active labor market policies can offset the negative psychological effect of unemployment. People may only receive psychological benefits from jobs with certain desirable characteristics like being perceived as meaningful or conferring social status (Ellingsen and Johannesson, 2007; Ariely et al., 2008). Since workfare jobs are often poorly paid and confer little social status, they may be poor substitutes for regular jobs when it comes to increasing life satisfaction.

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A previous study by Wulfgramm (2011) examined the effect of Germany's One-Euro-Jobs – a type of workfare program – on life satisfaction. The study found that participants in the program reported higher life satisfaction than unemployed non-participants but substantially lower life satisfaction than the employed. The positive effect of workfare was even smaller and not robustly statistically significant once time-invariant individual characteristics were controlled for by fixed effects. There is therefore little evidence that One-Euro-Jobs were able to substantially offset the negative effect of unemployment on life satisfaction.

The current paper examines the effect of a similar workfare program, Germany's *Arbeitsbeschaffungsmaßnahmen* (ABM). This program was an integral part of Germany's active labor market policy for over 30 years until the labor market reforms of 2004, after which it was phased out and replaced by One-Euro-Jobs. The main difference between the two programs is that ABM paid a wage to participants while One-Euro-Jobs only paid a small supplement to basic welfare payments. The previous evidence on the effects of the ABM program on subjective well-being and mental health is mixed. Using a random effects ordered probit model, Knabe and Rätzel (2011) find that the life satisfaction of people enrolled in ABM is slightly higher than that of the unemployed though still substantially lower than that of people employed in regular jobs. Huber et al. (2011), on the other hand, find that people who enter ABM and similar workfare programs experience a slightly higher prevalence of mental health problems than people who remain unemployed. I build on these two papers by using fixed effects regressions to estimate the effect of employment in the ABM program on life satisfaction, based on data from the German Socio-Economic Panel (SOEPv27) from the years 1992–2004. The main advantage of the fixed effects approach over the methods used in previous studies of the ABM program is that it controls for unobserved time-invariant differences between individuals with different employment status. Previous research has shown that not controlling for individual fixed effects can introduce substantial bias into estimates of the determinants of subjective well-being Ferrer-i-Carbonell and Frijters (2004). The detailed nature of the SOEP panel data further allows me to conduct robustness tests for unobserved shocks and to control for individual differences in unemployment duration and recent employment history.

My estimates suggest that workfare employment had a large positive effect that offset most of the negative effect of unemployment. The results are robust to controlling for individual specific linear time-trends. In an additional robustness test, I find no evidence that participants experienced systematic unobserved shocks to life satisfaction before entering the program. These results suggest that workfare programs can help reduce the negative psychological effects of unemployment, as postulated by Edlin and Phelps (2009).

2. Data and measurement issues

The empirical analysis in this paper uses data from the German Socio-Economic Panel (SOEPv27), from the years 1992 to 2004. The sample is restricted to working age individuals (ages 18–65). The outcome of interest is respondents' subjective life satisfaction measured by their answer to the question: "All things considered, on a scale from 0 to 10, how satisfied are you with your life?" This measure correlates strongly with more detailed measures of psychological distress (Koivumaa-Honkanen et al., 2004) and with objective indicators of well-being such as blood-pressure (Blanchflower and Oswald, 2008) and suicide risk (e.g. Koivumaa-Honkanen et al., 2001). Among other things, it has been used to evaluate the effect of income comparisons (Luttmer, 2005), environmental externalities (Luechinger, 2009) and infrastructure improvements (Cattaneo et al., 2009; Devoto et al., 2011).

Previous research has shown that while the unemployed report lower life satisfaction than the employed, they report equal levels of moment-by-moment satisfaction with their daily activities (Knabe et al., 2010). This suggests that not all measures of well-being are likely to be affected by workfare employment, a limitation that should be kept in mind when interpreting the results of this paper. However, Benjamin et al. (2012) found that, among the commonly used measures of happiness, life satisfaction is the best predictor of people's choices in hypothetical choice situations, which suggests that it is a better proxy for utility than the other measures.

3. Empirical strategy

The empirical strategy used in this paper is a fixed effects model based on repeated observations of the same individuals. In particular, I estimate the following equation:

$$Y_{it} = D'_{it}\beta + X'_{it}\gamma + \alpha_i + \lambda_t + \varepsilon_{it} \quad (1)$$

where Y_{it} is the life satisfaction reported by individual i at time t. D_{it} is a vector of indicators for the individual's employment status. It contains three mutually exclusive indicators for being employed in the ABM workfare program, being employed in a regular job, and being outside the labor force (defined as not working and not looking for work). The omitted category is being unemployed. X_{it} is a vector of household characteristics that serve as control variables. The model contains fixed effects at the individual and year level (α_i, λ_t).

Of course, enrollment into the workfare program is not random. It is therefore possible that the life satisfaction of individuals who were selected into the program was on an upward trend anyway, which would lead to endogeneity bias in the estimates of Eq. (1). As a robustness test, I estimate a model that includes individual-specific time trends.

$$Y_{it} = D'_{it}\beta + X'_{it}\gamma + \theta_i t + \alpha_i + \lambda_t + \varepsilon_{it}. \quad (2)$$

Since the data contains over 6000 individuals, it is computationally difficult to estimate the parameters θ_i. I therefore follow the method suggested by Wooldridge (2002), and estimate a fixed effects regression after taking first differences:

$$\Delta Y_{it} = \Delta D'_{it}\beta + \Delta X'_{it}\gamma + \theta_i + (\lambda_t - \lambda_{t-1}) + (\varepsilon_{it} - \varepsilon_{it-1}). \quad (3)$$

To further test whether workfare participants experienced unobserved shocks to their subjective well-being before enrolling in the program, I also estimate a specification that includes the "lead" (i.e. next period's value) of employment status.

4. Results

Table 1 presents summary statistics of the whole sample, and separately of participants and non-participants in the workfare program. The comparison in columns 2–4 shows that individuals who were ever employed in the workfare program are less happy, older and have more children and lower household incomes than the rest of the population. They are also substantially more likely to be unemployed, which is consistent with the fact that the policy targets the long-term unemployed.

Columns 1 and 2 of Table 2 present estimates of the fixed effects model described in Eq. (1). The parameter associated with employment in a regular job is 0.66–0.68, which suggests a large negative psychological effect of unemployment (which is the omitted category). The parameter associated with workfare employment is slightly smaller at 0.40–0.42 and the difference is statistically significant (see F-tests in the bottom row). However, the effect of workfare employment is still large and statistically significant. The results suggest that workfare employment can offset approximately 60% ($0.40/0.66 = 0.60$) of the negative effect of unemployment. The effect of workfare is also large in