To search or not to search? The effects of UI benefit extension for the older unemployed

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A B S T R A C T

In Finland the older unemployed can collect unemployment insurance benefits until retirement, while the entitlement period for younger groups is two years. In 1997 the eligibility age of persons benefiting from extended benefits was raised from 53 to 55. This paper takes advantage of this quasi-experimental setting to identify the effect of extended benefits on transitions out of unemployment among the older unemployed. We apply a competing risks version of a split population duration model to account for multiple exit routes and the possibility that some of the older unemployed may not be active in the labour market due to pension rules. Our finding is that roughly half of the unemployed with extended benefits withdraw from job search.

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1. Introduction

Unemployment differences between the European countries and the United States have been the focus of much political and academic debate during the past couple of decades. In addition to higher levels of unemployment, the duration of unemployment spells is typically much longer in Europe than in the US (Machin and Manning, 1999). A high incidence of long-term unemployment among older workers and a tendency of workers to leave the labour force at ages several years below the official retirement age are common problems in Europe. The unemployment compensation system, with generous benefit levels and long entitlement periods, is often blamed for being responsible for much of the European unemployment problem (e.g. Ljungqvist and Sargent, 1998). In many European countries, including Finland, Belgium, France, Germany, the Netherlands, Portugal, Spain, and United Kingdom, the entitlement periods are further extended for older workers and/or particular early retirement schemes are tailored for the older unemployed (Duval, 2003). When unemployment-related benefits provide a particular pathway to early retirement, a large fraction of the older unemployed may be effectively withdrawn from the labour market. This is a serious concern given the current political goal to induce people to retire later. The purpose of this study is to quantify the extent of this problem using data from the Finnish labour market.

In Finland unemployment insurance (UI) benefits can be collected for a maximum of two years but an exception is made for the older unemployed: workers old enough can receive UI benefits until early retirement via a particular unemployment pension at age 60. Unemployment pension benefits can be received until old-age pension at age 65. The combination of extended UI period and unemployment pension is known as the unemployment tunnel (UT) scheme. Since the level of unemployment pension benefits is comparable to that of UI benefits, this scheme effectively provides an indefinite period of UI benefits for older workers. The age threshold for the extended UI period was raised from 53 to 55 in 1997. As a result, the entitlement period of UI benefits for workers aged 53–54 at the time of job loss was effectively reduced to two years, while the other groups remained unaffected by the reform.

We use a sample of workers aged 50–54 who became unemployed between 1995 and 1998, drawn from the Finnish Employment Statistics database. Unemployment experiences of the group aged 53–54 are compared under two schemes: the extended UI entitlement period (pre-reform scheme) and the conventional UI period of two years (post-reform scheme). The younger group (aged 50–52) serves as a control group to eliminate the business cycle effect. Since the unemployment spells can end through the taking of a job, withdrawal from the labour force, or participation in an active labour market programme, competing risks are inherent in our data.

We consider the effect of extended UI benefits on the flow out of unemployment among the older unemployed in a competing risks setting. A novel feature of our analysis is that we explicitly allow for some older workers, registered as unemployed job seekers, to effectively withdraw from job search and simply wait for access to early retirement. If this is the case, the standard duration models that assume all individuals are at risk of experiencing the event of interest are not applicable. Therefore, we apply a competing risks version of a split population duration model that is capable of accounting for this sort of heterogeneity, i.e. the possibility that some individuals do not consider all possible exit routes. The idea is to model simultaneously both the likelihood that the worker is still active in the labour market and the timing of exit to employment, non-participation, or labour market programmes conditional on being active. This approach allows us to distinguish the participation decision from labour market behaviour in the case of continued search among those entitled to extended benefits.[2]

We find that roughly half of the unemployed eligible for extended UI benefits choose to retire from job search altogether. For the workers with a fixed two-year-entitlement, there is evidence of some increases in the employment hazard around the time of benefit exhaustion but the hazard rates for labour market programmes and non-participation exhibit much larger increases. There are no large discrepancies in the employment hazards between workers with extended UI benefits who choose to engage in job search and those with the entitlement period of two years. However, active workers with extended UI benefits have much lower transition rates to labour market programmes and non-participation (prior to access to early retirement). As a consequence, compared with those who will lose their benefits after two years of unemployment, active workers entitled to extended UI benefits are more likely to enter employment but also more likely to still be unemployed 42 months after entry to unemployment.

The plan of the paper is as follows. In the next section we discuss evaluation issues and findings of the previous studies. Section 3 describes the Finnish unemployment compensation system. Section 4 gives details of the data. Section 5 reports our descriptive analyses. In Section 6 we discuss the econometric methods and our empirical findings are reported in Section 7. The final section concludes.

2. Previous evidence and evaluation issues

In this section we raise the following issues that require particular attention when the effects of the length of the entitlement period are investigated. First, a flexible model specification should be adopted, as no a priori parametric restrictions for the effects of the entitlement period on the hazard functions can be derived from theoretical models. Second, some older unemployed with generous UI benefits may no longer be actively searching for a new job. Third, competing risks analysis is potentially very useful, especially when active labour market policy plays an important role, as in the Nordic countries. Finally, reliable analysis requires independent variation in the entitlement periods across individuals.

2.1. Incentives of the older unemployed

Dynamic models of job search have shed light on the ways in which UI can affect unemployment duration through the reservation wage and search effort. Mortensen's (1977) model is the seminal contribution in this branch of the literature. In his model, workers are either employed or unemployed. Eligibility for UI requires some previous work experience and UI benefits can be received for a fixed period. As the unemployed worker approaches the time when UI benefits will expire, his search effort increases and the reservation wage decreases. After the exhaustion of UI benefits, the worker faces a stationary environment, and hence his search effort and reservation wage no longer change. The employment hazard therefore increases up to the point of benefit exhaustion and remains constant thereafter.

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[2] In a related study, Kyyrä and Wilke (2007) show that the 1997 reform had a strong effect on the layoff rate of older workers in the private sector. They also analysed exits from unemployment to employment, but did not consider exits to labour market programmes or non-participation. Nor did they identify the fraction of inactive unemployed applicants, which is the main contribution of our analysis.