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Incentive effects of unemployment insurance savings accounts: Evidence from Chile ☆

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ABSTRACT

The paper, the first one to empirically examine whether individual accounts internalize the cost of unemployment, estimates the determinants of job finding rates of unemployment benefit recipients under the Chilean program. This is a unique, innovative program that combines social insurance, provided via solidarity funding, with self-insurance in the form of unemployment insurance savings accounts (UISAs). The paper shows that beneficiaries who use solidarity funding are less likely to exit unemployment in early months than those relying on UISAs only. Moreover, job finding rates are found to be positively correlated with pre-separation UISA balances among those that use solidarity funding, but are found to be uncorrelated with balances for those relying on UISAs only. While the findings are consistent with the effects expected under the internalization of unemployment costs via UISAs, they do not pinpoint unambiguously the causal link, as alternative mechanisms may be responsible for the observed correlations, particularly selection into the use of UISAs.

1. Introduction

Unemployment insurance (UI) offers financial compensation to qualifying workers for income loss due to unemployment. By providing protection against unemployment risk, the program seeks to bring welfare gains: it increases the sense of security among employed workers and, thanks to its large coverage and wide-base pooling of risk, it typically enables strong smoothening of consumption patterns. For example, studies on the U.S. find that the welfare of benefit recipient households is on average only 3 to 8% lower than the welfare of otherwise identical households Hamermesh and Slesnick (1995), and that in the absence of unemployment insurance, average consumption expenditures would fall by about 20% (Gruber, 1997).

While UI programs provide protection against the hardship of job loss, the evidence shows that such protection is typically produced at the cost of increased work disincentives and wage pressures, and, consequently, of increased unemployment. The problem of moral hazard in UI programs has been extensively studied and documented (see reviews of Holmlund, 1998 and Vodopivec, 2004). Spurred by adverse incentives created by UI programs, policymakers have often redesigned such programs, trying to reduce the moral hazard and striking a balance between the protection and disincentive effects.

There are several mechanisms that help reduce work disincentives in UI benefit programs: monitoring and benefit sanctions, work requirements, and financial incentives.[1] First, recipients can be subject to monitoring of their job-search activities and labor market status, and if they do not meet certain performance criteria, they can be exposed to sanctions (such as benefit reductions). Second, work or other requirements can be imposed on benefit recipients, forcing them

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[1] Compare Fredriksson and Holmlund (2006a, 2006b). For evaluation of various mechanisms that help reduce work disincentives in UI programs, see overviews, for example, in Abbring et al. (2005), Lalive et al. (2006) and Van Ours and Vodopivec (2006).

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to participate in public works or training, for example, in order to retain benefits. And third, financial incentives can be introduced to make reemployment more attractive. Options include reducing benefit levels over time, introducing bonuses for speedy reemployment, lowering income tax rates or introducing employment subsidies (such as earned income tax credit), and basing benefits on unemployment insurance savings accounts (UISAs).

Among new approaches used to reduce work disincentives, a UISA system is the most radical and perhaps promising one. Under the UISA system, each worker is required to save a fraction of earnings in his or her account, and draw unemployment benefits from it; the remaining balance can be accessed upon retirement. By internalizing the costs of unemployment benefits, a UISA system is expected to reinforce worker incentives and thus to avoid or reduce the moral hazard inherent in traditional UI programs while, under some variants of the program, providing the same protection as the traditional UI system. The system is thus credited with a potential to substantially decrease overall unemployment and, by lowering payroll taxes, increase wages.

In contrast to the other mechanisms used to address work disincentives in UI programs (or other cash benefit systems), studies on UISAs are rare and mostly limited to theoretical contributions. In particular, so far there has been no empirical evidence whether UISAs can reduce moral hazard problems plaguing traditional UI schemes, mainly because only a few countries in Latin America and Austria have introduced such a system, and non-availability of experimental approaches and heavy informational requirements have prevented such studies (for an overview of existing UISAs in Latin America, see Ferrer and Riddell, 2009). Taking advantage of the recently introduced, innovative Chilean unemployment benefit system, this paper is the first attempt to test empirically the theoretical prediction that UISAs reduce the moral hazard problems inherent in traditional UI schemes.

In 2002, Chile introduced a new UI program which combines social insurance with self-insurance. Unemployment contributions, paid by both workers and employers, are split between individual-level UISAs and a common, solidarity fund (SF), the latter being cofinanced by the government. To stimulate reemployment, benefit recipients first draw resources from their UISAs and, upon depletion, from the solidarity fund (to reach target replacement rates, solidarity funding may top resources drawn from UISAs also during initial withdrawals). Withdrawals from individual accounts are triggered by separation from the employer, regardless of the reason. Withdrawals from the common fund are triggered by non-fault dismissals after the individual account is depleted, if the claimant satisfies the usual conditions of continuing eligibility under UI. Only those who prior to unemployment worked under permanent contracts and were laid off for reasons attributable to the employer can access solidarity funding, but even if they qualify, workers may opt not to choose the option of using SF (presumably, if they want to avoid additional conditions for continuing benefit eligibility imposed under SF option, see below). In August 2008, the program had 2.9 million active contributors, representing 77%of private sector wage and salary workers—the target population, and distributed benefits to 105,000 members, approximately one per every four unemployed workers.[2]

A natural, so far unanswered question thus arises: is the Chilean system – by partly relying on savings accumulated on UISAs – an effective tool to combat the moral hazard plaguing the traditional UI programs? That is, by drawing on UISAs (in a particular combination with solidarity funding), does the program improve job search incentives and/or reduce reservation wages, and thus increase the exit rate from insured unemployment—as theoretical models predict? After all, individuals may be myopic and may discount heavily resources which the access to can only be gained after a long time, often a decade or more. Moreover, if people distrust the government, they may also distrust the scheme that postpones the access to resources into the distant future, as they may see little guarantee for the present rules to be retained.

We exploit the design of the program and compare the transition behavior observed for UISA and SF recipients, taking into account the potential self-selection that may affect the composition of both groups. By analyzing transitions to work of the benefit recipients of the Chilean program, our paper is the first one empirically examining the above question. We find that beneficiaries who use solidarity funding are less likely to exit unemployment in early months than those relying on UISAs only. Moreover, job finding rates are found to be positively correlated with pre-separation UISA balances among those that use solidarity funding, but are found to be uncorrelated with balances for those relying on UISAs only. While these findings are consistent with the effects expected under the internalization of unemployment costs and thus support the idea of UISAs, our evidence stops short of confirming a definitive causal link. As discussed below, other mechanisms – above all, selection of beneficiaries into groups receiving different types of benefits – may provide an alternative explanation for the observed correlations.

The organization of the paper is as follows. Section 2 provides a background by summarizing the literature on UISAs and describing the Chilean unemployment benefit program. Section 3 describes the data, formulates the empirical strategy to identify incentive effects of the Chilean program. Section 4 analyses the determinants of opting for the actual use of the SF among those that are entitled to do so. Section 5 presents the results of the estimation of hazard rate models of job finding rates that identify work incentives under the Chilean program. Section 6 concludes.

2. Previous studies on UISAs and institutional background

2.1. Overview of studies on UISAs

According to theoretical modeling, the main rationale and key advantage of the UISA system as an alternative to the traditional UI system is its potential for improving the incentives of employed workers and job seekers while conceivably providing the same protection as traditional UI. As shown by several theoretical papers, UISAs would radically change workers' incentives (Orszag and Snower, 2002; Orszag et al., 1999). By internalizing the costs of unemployment benefits, the UISA system avoids the moral hazard inherent in traditional UI. Orszag et al. (1999) also recommend a comprehensive vs. a piecemeal approach when introducing savings accounts. They warn that a potential complementarity problem exists if the savings account is not set up for multiple uses: under the traditional unemployment system, workers who have built up substantial resources in their pension accounts have the incentive to withdraw from the labor force and claim unemployment benefits until they retire. Setting up an integrated savings account reduces such incentives. There are also other advantages of the “Integrated Unemployment Insurance System." By combining several risks under one program, the system can offer not only superior provision of insurance and thus consumption smoothing, but also to significantly reduce disincentives as compared to the traditional UI system. For example, Stiglitz and Yun (2005) analyze a system in which a personal unemployment savings account is combined with a pension program, allowing workers to borrow against their future wage income to finance unemployment benefits. They argue that integration of several social insurance programs with a pension program through an individual account is desirable unless the risks are perfectly correlated.

Empirically, UISAs are still largely uncharted territory, and – to the best of our knowledge, except for the current study – UISAs' potential

[2] The coverage rate seems high because although there are a total of 6.6 million occupied workers in the same period, the target population of the program is limited to private sector salaried workers under formal contracts. Self employed, domestic service and public sector employees are excluded from the program and these categories account for 35% of total employment in the period.