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**Knut Røed**

*The Ragnar Frisch Centre for Economic Research  
and IZA*

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IZA

P.O. Box 7240  
53072 Bonn  
Germany

Phone: +49-228-3894-0  
Fax: +49-228-3894-180  
E-mail: [iza@iza.org](mailto:iza@iza.org)

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## ABSTRACT

### Active Unemployment Insurance<sup>\*</sup>

The paper argues that a comprehensive *activation strategy* is called for – in both unemployment and disability insurance – to minimize the conflict between income insurance and work incentives and to prevent the economic crisis from causing a long-lasting decline in labor force participation. A review of recent empirical evidence, particularly from the Scandinavian countries indicates that “mild” activation requirements effectively counteract moral hazard problems in social insurance. The paper also argues that the distinction between unemployment and disability is blurred, and that both temporary and permanent disability insurance programs should be designed to encourage and support the use of remaining (partial) work capacity.

JEL Classification: H55, J65

Keywords: activation, moral hazard, disability insurance, unemployment insurance, ALMP

Corresponding author:

Knut Røed  
The Ragnar Frisch Centre for Economic Research  
Gaustadalléen 21  
0349 Oslo  
Norway  
E-mail: [knut.roed@frisch.uio.no](mailto:knut.roed@frisch.uio.no)

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## Introduction

At some level, there is probably an inescapable tradeoff between the aims of equality and social security, on the one hand, and active job search and entrepreneurship, on the other. Although the quantitative results differ across different empirical studies, there is by now a broad agreement among researchers that more generous unemployment insurance (UI), *ceteris paribus*, yields less effort to prevent and escape from unemployment. This means that policy makers need to strike a balance between two highly legitimate, but conflicting, aims. At the end of the day, this is intrinsically a political choice, which must be made on the basis of values. But scientific knowledge can be used to design institutions that *minimize* the tradeoff. The present paper discusses how a strategy of *activation* can be applied to reduce the conflict between generous insurance and appropriate incentives for being self-sufficient. It also discusses how the optimal strategy is likely to be affected by cyclical fluctuations. The paper mainly builds on empirical evidence from the Scandinavian countries.

An important element of virtually all unemployment insurance systems is that they encompass procedures for benefit termination, both in the form of maximum duration limits and in the form of sanctions when claimants reject (suitable) job offers, or when job search effort is deemed inappropriate. The prospect of losing benefit entitlements can be viewed as a sort of “threat”, designed to ensure a minimum of compliance with job search requirements. However, there might be an element of time-inconsistency involved in the benefit termination strategy, since, when the threat turns out to be ineffective in its aim of pushing claimants into jobs, it sometimes requires that still-unemployed job seekers are thrown into poverty. In comprehensive welfare states – like Norway, Denmark, and Sweden – this dilemma may be twisted in a slightly different direction, however, since the end of unemployment insurance often involves the start of some other income transfer. The prevalence of multiple layers in the social security safety net, e.g., in the form of sickness insurance, disability benefits, rehabilitation benefits, housing subsidies, family allowances, and means-tested welfare assistance, often render threats of UI benefit termination non-credible in the first place. Given a political obligation of poverty prevention, a more thrifty UI system may simply shift insurance costs over to other social security programs – and well-informed economic agents may realize this.

From a more general perspective, the existence of a comprehensive welfare state requires that the different components of the social insurance systems – such as unemployment insurance, social assistance, and disability insurance – are not designed in isolation, and that a strategy for minimizing the conflict between equity and efficiency thus has to take the design of the whole social insurance

system into account. I will argue that the distinction between different social programs is typically anything but clear-cut in modern welfare state economies, and that the classification of a given non-employment spell as being caused by, e.g., “unemployment” or “disability” is often determined more by the design of the insurance institutions than by the nature of the problem at hand.

Economies with low unemployment rates often have high disability rates. This pattern is particularly striking in the North-European welfare states. According to recent OECD statistics, the 2007 disability rates of Denmark, Finland, Norway, Sweden, and the Netherlands ranked among the top six out of the 28 industrialized nations for which comparable statistics are available (OECD, 2009, p. 14). These five countries are also well known for their low unemployment rates; e.g., in 2007 – well before the financial crisis – their average unemployment rate was 4.5 percent compared to 7.1 for OECD Europe as a whole (OECD, 2008, p. 335). Existing empirical evidence points to substitution between unemployment- and disability insurance program utilization; see Black *et al.* (2002), Autor and Duggan (2003), Rege *et al.* (2009), and Bratsberg *et al.* (2010). A natural question to ask is whether low unemployment and high disability rates are two sides of the same coin, and whether disability sometimes is unemployment in disguise and vice versa.

## **Activation and moral hazard**

While there is a broad agreement among researchers that the generosity of UI insurance does affect job search behavior and choosiness, the sizes of the estimated effects vary widely across different studies – within as well as across countries; see, e.g., Krueger and Meyer (2002) for a recent overview. The lack of consensus estimates across studies from different countries is not really a mystery, given the substantial variation in UI-systems and other institutional features, e.g., related to disability insurance programs. Causal impacts of particular features of a UI institution have to be evaluated within the context of the broader institutional set-up to which they belong. For example, one would expect UI generosity to be more important for search behavior, the less substitutability there is between UI and other social insurance programs.

There are basically four parameters that policy makers play around with in order to contain moral hazard problems in their unemployment insurance systems: i) the replacement ratio, ii) the maximum duration of benefit claims, iii) monitoring and sanction practices, and iv) activation strategies. We know that reduced replacement ratios, shorter maximum UI durations, tighter monitoring and more frequent sanctions (in terms of benefit cuts) will encourage/force some job seekers to move faster into employment; see, e.g., Fredriksson and Holmlund (2006) for a review of the literature and Abbring *et al.* (2005), Boone *et al.* (2009), and Svarer (2011) for recent evidence on

the impacts of monitoring and sanctions. However, we also know that these policies potentially have some undesirable side-effects, such as pushing some job seekers – and their families – into poverty. The risk of causing poverty rather than employment obviously increases in times of economic crisis. Consequently, some countries tend to make their unemployment insurance systems more generous in bad times than in good times, particularly by extending the maximum duration; see OECD (2011).

Now, an alternative to benefit cuts and sanctions is to make unemployment insurance more strongly oriented towards activation, this way eliminating (or at least reducing) the “leisure component” of unemployment insurance. Since Black *et al.* (2003) published their paper on the “threat effects” of reemployment services, researchers have worked hard to identify the “ex ante effects” of active labor market programs (ALMP), i.e., the effects on the current job search behavior of the *risk* of soon having to participate in ALMP in order to maintain unemployment benefits. The consensus view now seems to be that the prospect of imminent activation has some of the same moral-hazard-containing effects as the prospect of imminent benefit loss: It stimulates search effort and discourages pickiness, and it virtually eliminates claims that were illegitimate in the first place (in the sense that the claimants had no intention of accepting a job, or had already got one, but wanted to exploit their unemployment insurance first). It is interesting to note that the economics literature in some sense has made a U-turn at this point. In the 1980’s and early 1990’s, the typical view was that the ALMP’s would be seen by agents as more attractive than open unemployment, making them *less eager* to avoid and escape from unemployment; see, e.g., Calmfors and Lang (1995). Since UI claimants constitute a highly heterogeneous group, both views could of course contain elements of truths: For some claimants, activation makes unemployment more attractive, while for others it makes unemployment less attractive. It seems reasonable, however, that moral hazard problems are more acute in the latter than in the former case. Hence, activation may be viewed as a strategy to encourage persons who are not sufficiently motivated for work to *self-select* out of the UI system. That some workers are also encouraged to “overinvest” in publically provided skills-upgrading may in this context be viewed as a problem of secondary importance.

While it is well documented that transition rates out of unemployment rise sharply around the time of UI termination (whether it is due to exhaustion or a sanction) – both to employment and to non-employment – it is less clear how the sizes and natures of these effects depend on “what comes after UI”. Røed and Westlie (2012) use a major reform of the Norwegian UI system in 1997 to investigate this issue. The authors identify four different *regimes* in their data with respect to the what-comes-after-UI-question:

- i) The possibility of applying for a new UI period, but with a small (10 per cent) reduction in the benefit level.
- ii) The possibility of applying for a new UI period with a 10 percent reduction in the benefit level, but only after a quarantine period with no benefits (13 weeks).
- iii) Immediate transition to indefinite follow-on benefits at a significantly lower level, i.e., approximately 30-40 percent below original UI entitlements.
- iv) No benefit entitlements at all.

Intuitively, one would expect the prospect of meeting constraint number iv), with no more benefits available, to have much larger effects on the transition rates out of unemployment than the other three constraints. As it turns out, however, all four constraints seem to have similar effects: They cause the employment hazard to rise by around 50 percent during the last months prior to exhaustion. Hence, for the threat effect, the “harshness” of the constraint seems to be of secondary importance relative to the fact that there indeed *is* a constraint. This result may of course be directly related to the existence of a multiple-layer welfare state in Norway. Job seekers in danger of losing all benefit entitlements would typically be offered alternative assistance if needed, e.g., in the form of disability programs (vocational rehabilitation) or social assistance. However, it is interesting to note that the predicted fall in average unemployment duration associated with a reduction in the length of the UI period through the imposition of a soft constraint is sizeable, i.e., around half a day for every week’s reduction. This effect is of the same magnitude as that reported by Card and Levine (2000) on the basis of an extended benefit program in New Jersey, USA. This similarity is intriguing, given that for most job-seekers, the soft constraint imposed in Norway does not really affect the absolute duration limit of UI benefits at all; it only reduces the time until some form of activity is demanded.

Røed and Westlie (2012) also evaluate the overall impact of the 1997-reform, which essentially replaced a UI system with “soft” constraints (of type i) and ii) above) after 80 weeks, often combined with various forms of activation requirements, with a system with no constraints at all until 3 years (and then of type iii) or iv) above). The authors estimate that the transition from the “soft-constraint-activation”-regime to the “no-constraint-no-activation”-regime caused unemployment duration to rise by approximately 25 percent on average, with only minor changes in the distribution of destination states after unemployment.

The Danish UI system is specifically designed in terms of relatively short “passive” income insurance periods, after which “activation” is the rule of the game. This is sometimes referred to as the “right-and-duty-principle” (or the “mutual obligation principle”). The idea is that an unemployed job seeker

has the *right* to assistance in the form of income insurance, placement services, and (if necessary) skills upgrading, but at the same time a *duty* to participate in ALMP's and other activities when offered. If the claimant is below 30 years, the "passive" period is limited to 6 months; for older job seekers it is 12 months. Existing evidence indicates that many job seekers find work as they approach the end of the "passive" period. Geerdsen (2006), for example, who takes advantage of legislative changes in the lengths of the passive and active periods to identify their causal effects, shows that the "threat effect" of activation is strong. And, again, an important conclusion is that the magnitude of the effect is comparable to those found in studies of UI systems where individuals are at risk of losing their entitlement to benefits altogether. Rosholm and Svarer (2008) investigate the threat effect of activation in Denmark based on a different empirical approach, where they use the estimated time-varying "risk" of activation directly as an explanatory variable in the job hazard rate. Their findings confirm the existence of a considerable threat effect.

Further evidence on the "power of soft constraints" is provided by Røed *et al.* (2008), presenting results from a comparative unemployment duration analysis based on Norwegian and Swedish administrative register data from 1999 and 2000. In these years, the maximum UI benefit period in Norway was three years, and there was little focus on activation (this was the "no-constraint-no-activation"-regime referred to above). In Sweden, by contrast, the maximum UI benefit period was only 60 weeks, and activation was used extensively as a work-test, and also applied as a paid alternative for job seekers with exhausted benefit entitlements. Hence, the Swedish 60 week limitation was clearly a soft one, in the sense that alternative income options were made available for job seekers whose benefit entitlements had been exhausted. Figure 1 shows how these differences were estimated to affect the so-called structural duration dependence pattern in the employment hazards during the first two years of unemployment.<sup>1</sup> While there was strong and monotone negative duration dependence in the employment hazard for Norwegian job seekers, there tended to be elements of both positive and negative duration dependence for Swedish job seekers, with a significant rise in transition rates around the time of passive benefit exhaustion. And the magnitude of the latter rise was similar in size to the corresponding rises identified on the basis of the various soft constraints that have been in place in Norway as well (see above).

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<sup>1</sup> The term "structural" refers to duration dependence present at the individual level, i.e., it is not caused by sorting.



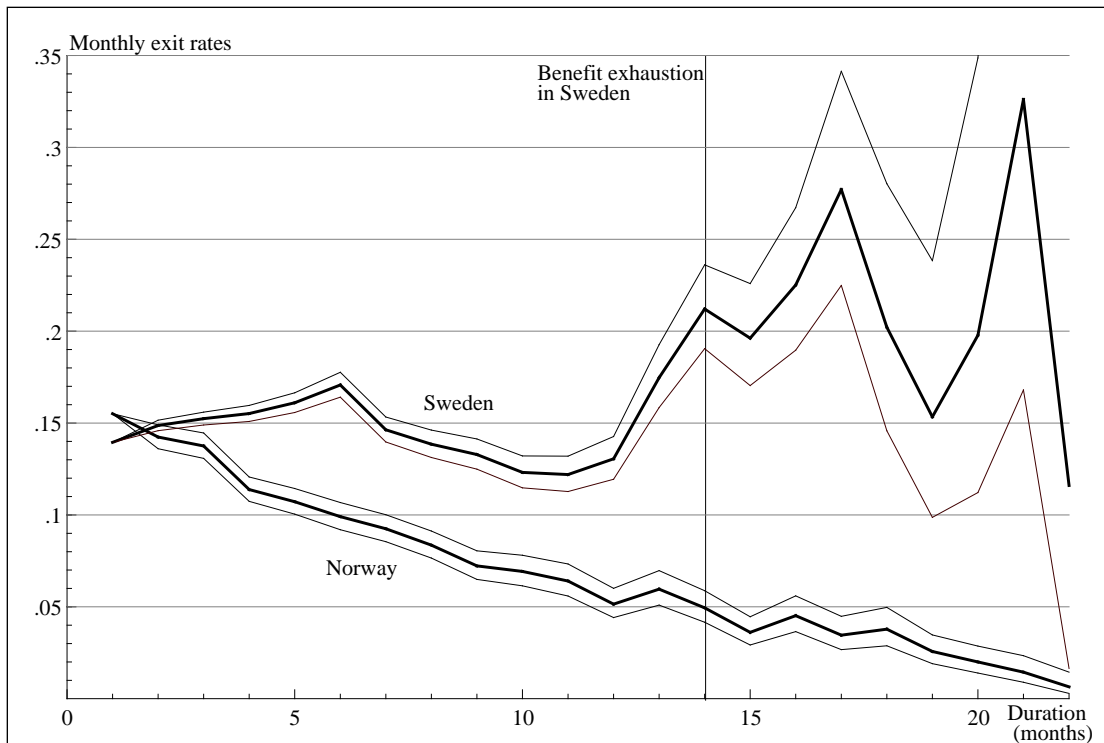


Figure 1. Estimated structural duration dependence in Norway and Sweden (with 95 % point-wise confidence intervals).

Note: The curves are normalised to the observed average exit rate in the first duration month in each country.  
Source: Røed *et al.* (2008)

## The impacts of actually being activated

Basing the social insurance system on the idea of offering *paid activity* rather than *paid leisure* obviously has the consequence that a significant fraction of the workforce is actually “activated” from time to time. That may (or may not) be costly, depending, of course, on the type of activity offered and the output it generates. There is by now a large – and still rapidly expanding – literature on the impacts of participation in active labor market programs (ALMP); see Kluge *et al.* (2007) and Card *et al.* (2010) for recent reviews. The evidence is mixed. Traditional training programs tend to perform quite poorly, in the sense that it is hard to provide convincing evidence for a significant positive impact on subsequent employment or earnings. Programs aiming at subsidized placement in regular jobs perform somewhat better. However, there are few experimental studies in this area – and hardly any with results that can be generalized very far beyond the particular context from which they were generated. And although many of the non-experimental studies are based on state-of-the-art methodologies, it is typically hard to convince oneself that the published results really capture the causal effects of interest, and not the unobserved sorting into the various types of programs. In any

case, program effects need to be evaluated relative to some alternative – and the alternative to activation is highly dependent on the setup of a country's social insurance institutions in general.

Sweden has been a sort of pioneer in the use of active labor market programs; hence it may be of particular interest to examine the experiences generated from that country. Evaluation studies based on data from the late 1980's and the 1990's – summarized by, e.g., Calmfors *et al* (2001) – tended to convey a rather dismaying message; ALMP apparently did little to help unemployed job seekers back to work. Later studies have, however, provided a more encouraging picture (Forslund and Vikström, 2011). Possible explanations are, inter alia, that the overall "activity stance" (the fraction of job seekers that are activated) has been scaled a bit down, making it possible to substitute quality for quantity, and that an improved economic situation has ensured the existence of a demand for labor that the programs can aim at satisfying. Denmark has now taken over the role as the country with the strongest emphasis on activation in its UI system. But, while there is quite unanimous evidence in support of a strong "threat effect" of the activation strategy in Denmark, the evidence on the impacts of actual participation are mixed. Evaluation of private sector employment programs tend to come out with favorable effects, whereas training programs and public sector employment programs mainly have no effects; see, e.g., Kluve *et al.* (2007, Chapter 6).

Norwegian evidence also indicates that there are some favorable effects of ALMP, in terms of shorter unemployment durations and higher subsequent employment propensity; see, e.g. Røed and Raaum (2005) and Røed and Westlie (2012). A recent paper by Gaure *et al.* (2012) evaluates effects of Norwegian ALMP on a number of outcomes simultaneously – including the quality of a subsequent job match – and compares the estimated impacts with reported administrative costs. Since the authors use a multivariate hazard rate model to study all transitions (with nonparametric modeling of unobserved heterogeneity), they are also in a position to characterize the sorting into ALMP. The results indicate that there is strong negative selection into ALMP. Abstracting from any effects of actual participation, the likelihood that an unemployed job seeker actually ends up in employment is on average 8.4 percentage points higher for non-participants than for participants, and their earnings are around 11 percent higher, given that they do find a job. The estimated *causal* effects of participation are generally small. ALMP participation implies a higher likelihood of around 2 percentage points (from 47 % to 49 % on average) that an unemployment spell eventually ends with a transition to a job. Moreover, it raises the quality of the job slightly, as captured by a 2.5 % increase in expected earnings. On the other hand, it also implies that it takes approximately one month longer to find the job. Thus, there are pros and cons, but the gain in expected earnings caused by the small rises in employment propensity and earnings are too small to compensate for the slower transition. Moreover, there are administrative costs associated with arranging the programs. Hence, unless the

period of actual participation is of some value in itself, a cost-benefit analysis is bound to come out with a negative result. Since many of the programs involve fulltime employment, it is indeed reasonable to assume that the period of participation is of some value. And the authors calculate that the condition for a five-year cost-benefit analysis to come up with a positive result is that these employment programs generate a net positive value equal to at least 35 % of the participants expected market earnings. If programs are properly designed, this does not seem unrealistic.

The most important caveat to a “narrow” cost-benefit analysis of actual program participation is that one has to take into account impacts of *not offering the program* that goes well beyond the fact that each participant would have been a non-participant. It would also remove activation as a tool for containing moral hazard. An important feature of Scandinavian welfare state economies is that the use of sanctions and duration limits in UI insurance, on the one hand, and the use of ALMPs, on the other, are intimately related, in the sense that the former would be politically unfeasible without the latter. One simply cannot take families’ basis of existence away without offering alternative income options.

## **Cyclical institutions?**

Should unemployment insurance institutions be designed such that important policy parameters – like the UI generosity and the overall scale of activation – are adjusted according to the state of the economy? In order to contain public deficits – which for obvious reasons has become a major priority in many countries – it may be tempting to reduce UI generosity and cut down on labor market programs in bad times. However, the value of social insurance clearly rises in a recession, and its role as an automatic macroeconomic stabilizer also becomes more important. Hence, to the extent that public sector budget constraints can (still) be viewed as inter-temporal, the optimal policy responses to cyclical fluctuations may very well be to upgrade UI during recessions. Many countries also do so, most often on a discretionary basis. In response to the current “Great Recession”, for example, the maximum UI duration has in some US states been extended from 26 to 99 weeks; see OECD (2011).

Cyclical fluctuations not only imply that the value of income insurance and activation changes, the associated costs – in terms of disincentive and lock-in effects – may also change. At this point, the literature is relatively sparse. Intuitively, one may perhaps argue that the costs of both insurance and activation are likely to be low during recessions, since there are no regular jobs to be had anyway, and thus small costs associated with distorted search incentives and ALMP lock-in. If this is true, there is no inherent conflict between insurance and disincentives with respect to cycle-contingencies in UI institutions; both concerns suggest that UI generosity should be stepped up in bad times.

Andersen and Svarer (2011) examine the cyclical nature of UI distortions within the framework of standard search theory. A key finding is that job search efforts are pro-cyclical, and that this causes the UI-generated distortion to be pro-cyclical as well. As a consequence, UI generosity should be countercyclical. Existing empirical evidence on the cyclical nature of UI distortions is sparse, although research in this area has been boosted by the Great Recession. Findings for the US and the UK indicate that disincentive effects are indeed pro-cyclical; see Moffitt (1985) and Arulampalam and Stewart (1995), and, more recently, Kroft and Notowidigdo (2011). Findings for Norway, based on the relatively limited labor market fluctuations experienced in this country, indicate that the disincentive effect of the UI *level* on the transition rate to employment is close to non-cyclical (Røed and Zhang, 2003; 2005). Recent findings for Germany also indicate that the disincentive effect of UI *duration* is close to being non-cyclical, perhaps with a small (but not statistically significant) indication of pro-cyclicality (Schmieder *et al.*, 2012).

A potential danger with counter-cyclical UI is that it also stifles entrepreneurship, which is of particular value to society during recessions. Evidence from both Sweden and Norway indicates that joblessness is actually among the key drivers of entrepreneurial behavior in these countries; see Von Greiff (2009) and Røed and Skogstrøm (2010). The latter of these studies finds that more than half of the transitions from regular employment to entrepreneurship in Norway are directly caused by involuntary job loss. Hence, there is a potential for transforming the job losses emanating from a recession into the establishment of new firms and new jobs.

Since the value of job search is lower in a recession than in a boom, a recession also reduces the opportunity cost of activation. If, on the other hand, the disincentive effects of UI are smaller in a recession, the need for activation as a tool to combat moral hazard problems may also be less acute. Moreover, there is evidence that the favorable effects of actual participation – on the exit rate from unemployment as well as on long-term employment outcomes – are pro-cyclical; see Røed and Raaum (2006) and Lechner and Wunsch (2009).

There are also two other arguments that point towards maintaining a significant level of activation even in good times. The first is that the *composition* of unemployed job seekers become significantly more negatively selected – in terms of their individual employment prospects – in good times; see Gaure and Røed (2007) and Forslund *et al.* (2011). Thus, relative to the total number of unemployed, there are more job seekers in need of skills-upgrading in good than in bad times. In addition, existing empirical evidence shows that persons with poor individual employment prospects also have more to gain from actually participating in activation; i.e., they have larger positive effects (Røed and Raaum, 2006). The second argument is that it is administratively costly to scale the level of activation quickly

up and down according to cyclical fluctuations. If there is a significant level of activation in place even in good times, employment services will be better prepared to take care of the influx of new job seekers that typically accompany a recession. This does of course not imply that the contents of ALMPs should be the same regardless of the cyclical situation; employment services should probably focus more strongly on search-oriented programs in good times, when there are many available jobs to be had. During recession, on the other hand, programs should probably focus more strongly on skills-upgrading (since lock-in costs are lower) and on the establishment of new firms.

Based on these considerations, I will argue that there are good reasons to make UI generosity counter-cyclical – particularly in countries with very low maximum UI duration under normal business cyclical conditions – but that stance of active labor market policies should be *less* cyclical than employment prospects are, implying that the *fraction* of job seekers in activation should be pro-cyclical.

### **Activation in sickness and disability insurance**

There has recently been a drive towards making social insurance more activity-oriented in many countries, both for unemployed job seekers and for welfare assistance claimants. However, abstracting from the current recession, it is the trend-wise rise in health-related benefit claims that has posed the most worrying challenge for policy makers; see, e.g., Duggan and Imberman (2006), Bratsberg *et al.* (2010), and Burkhauser and Daly (2011). In Norway, the permanent disability insurance rolls already outnumber registered unemployment by four to one.

Is the activations strategy also applicable for disability insurance programs? The empirical observation that there is a strong element of substitutability between unemployment and disability insurance programs, with job loss figuring as one of the most important explanations for disability program entry (Bratsberg *et al.*, 2010) may suggest that the answer to this question is yes. Moreover, if governments choose to make unemployment insurance even more oriented towards activation, it is probable that some of the moral hazard problems associated with today's unemployment insurance will be shifted over to the disability insurance programs.

Should we design sickness/disability insurance programs such that they facilitate adapted work rather than inactivity? After all, individuals' work-capacity can rarely be characterized as either 0 % or 100 %. Work-capacity is more a question of *degree* than of *kind*. Sickness/disability normally reduces an individual's work-capacity, but it rarely eliminates it. Many countries – particularly the Nordic ones; see Kausto *et al.* (2008) – have in recent years made efforts to promote “partial” rather than “full” absence from work during workers' spells of sickness and temporary disability. The idea is that

physicians, who have the task of certifying absence spells in these countries, instead of simply declaring whether an absent worker is really sick or not, also stipulates the *degree* of reduced work-capacity caused by the sickness/disability and, if relevant, prescribes the work-adaptations required to exploit the remaining work-capacity.<sup>2</sup> Such “graded” absence certificates have over time become more common, and now account for around a third of long-term physician-certified absence spells in both Norway and Sweden. In Norway, the use of graded absence certificates was significantly stepped up in 2004, in response to a reform of the sickness certification guidelines, defining graded absence certificates as the norm after 8 weeks of absence. And, as can be seen from Figure 2, the increased use of graded absence certificates coincided with a significant drop in overall absenteeism. Similar developments were seen in Sweden when the use of graded absence certificates was stepped up there during the period from 2002 to 2005.

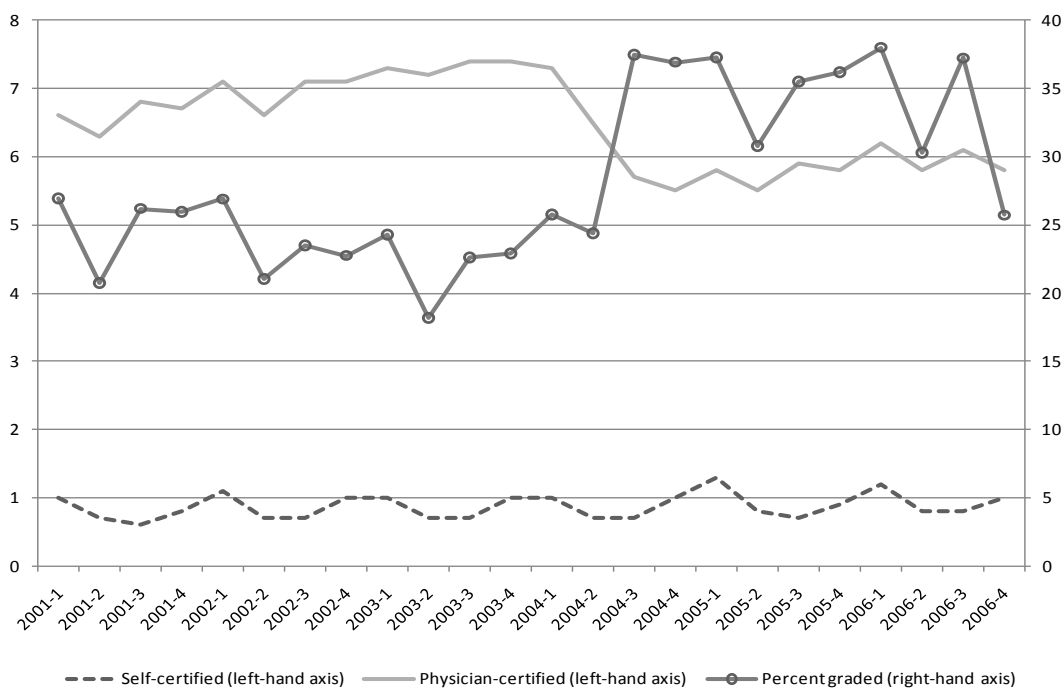


Figure 2. Percent of agreed work-hours lost due to self-certified and physician-certified sickness absence and percent of long-term absence spells (more than 8 weeks) graded. Norway 2001.1-2006.4.

<sup>2</sup> A similar arrangement is now in place in the UK, in the form of the so-called *fit note*. In the fit note, physicians are requested to certify whether a sick worker is unfit or (potentially) fit for work. In the latter case doctors may recommend reduced hours or duties, and provide recommendation to employers on how they can help the worker back to ordinary work.

Can we be sure that more intensive use of graded absence certificates really has a negative *causal* effect on overall absenteeism? And – perhaps even more important – will this also lead to lower social insurance dependency in the longer run? These questions are addressed by Markussen *et al.* (2010), who investigate the causal impacts of issuing graded rather than full-time sick leave certificates for workers in Norway who had been temporary disabled for at least 8 weeks. Since the use of graded (as opposed to full-time) absence certificates is anything but randomly assigned, the authors face an obvious endogeneity problem. This is handled by exploiting the variation in grading-propensity *across family physicians*, generating a significant source of random-assignment-like (from the employee's point of view) variation in the probability of being subject to activity requirements during spells of sickness. Based on an instrumental variables model, Markussen *et al.* (2010) conclude that the use of graded rather than non-graded sickness absence certificates reduces the length of absence spells, and significantly improves the likelihood that the absentees are employed in subsequent years. The effects are large, both from an economic and a clinical perspective. Their most conservative instrumental variables estimates indicate that substituting a graded for a full-time absence certificate reduces the length of the absence spell by as much as 80-90 fulltime-equivalent days and also reduces social insurance claims the next two years – in terms of, e.g., new sickness or disability benefits – by around 80-85 days. Even more importantly, it raises employment propensity two years after by 16-18 percentage points.

Høgelund *et al.* (2010) study the impact of graded absence certificate in Denmark by means of a proportional hazard rate model, and use the timing-of-events approach (Abbring and Van den Berg, 2003) to identify the effect on absence duration. The results indicate that when a patient is given a graded instead of a non-graded absence certificate, it raises the weekly probability of returning to regular work hours by as much as 50 percent. Similar effects are found in a small randomized controlled trial in Finland (Viikari-Juntura *et al.*, 2012). The experiment was conducted in six Finnish enterprises and encompassed 63 workers who were unable to perform their regular duties due to musculoskeletal disorders, and randomly allocated to either full-time or graded absence. The findings indicate that grading caused a 60 percent rise in the hazard rate to regular work activities, and also a 20 percent reduction in subsequent absenteeism during a one-year follow-up period. There have also been attempts to evaluate the use of graded absence certificates in Sweden. Andrén and Andrén (2008; 2009) examine how graded certificates affect the speed of recovery to regular work, using the workers' occupation as instrument for the grading decision. They argue that while occupation heavily influences the potential for working reduced hours, it is unlikely to influence the recovery prospects directly. Based on this – perhaps somewhat controversial identifying assumption – they find that graded sick leave speed up recovery after around four months of absence.

Activation thus seems to be a hugely successful strategy for temporary disabled workers. This can be understood in terms of the moral hazard problems discussed above; i.e., that the participation requirement reduces the leisure component of disability insurance. But there is also an increasing stock of empirical evidence showing that work is actually a *healthy* activity for workers with the illnesses and symptoms responsible for the vast majority of disability cases in industrialized countries (musculoskeletal diseases, back pain, and light mental disorders); see, e.g., Waddel and Burton (2006) for a recent review of the literature.

A possible reason for the apparent success of graded absence certificates in Norway is also that it contributes to containing some rather strong incentives for employers to refrain from reintegrating long-term sick employees in their active workforce. Like most OECD-countries, the Norwegian sick leave insurance system embodies a limited initial period of pay liability for the firms, after which the public insurance system covers the costs. This has the very unfortunate side-effect that once a worker's sickness absence spell has exceeded the pay liability period, it is potentially costly for the firm to allow that employee to take up work again, since, if a relapse occurs, the firm once again becomes financially responsible. Based on a reform in Norway which removed the pay liability for pregnancy-related absences, Fevang *et al.* (2011) show that this side-effect is empirically important. Physicians' use of graded absence certificates may in this context be viewed as a way of "forcing" firms to accept to take workers back before they are fully recovered and before the risk of a relapse has become negligible.

It is noteworthy that in the Netherlands – where employers now bear the full costs of a generous sick-leave insurance for as long as two years of absence – gradual take-up of work after sick-leave episodes, is very common. A recent survey indicates that after 10 months of absence, more than 60 percent of sick-listed employees have taken up work partially (Everhardt and de Jong, 2011).<sup>3</sup> Hence, in the absence of incentive distortions, gradual re-integration into the workplace seems to be the rule rather than the exception in connection to long-term sickness.

## **Concluding remarks**

Balancing the objectives of appropriate social insurance and sufficient work-incentives is a difficult task. For unemployment insurance and social assistance programs, policy makers in many countries have to an increasing extent resorted to various *activation strategies*, essentially requiring benefit claimants to participate in temporary employment or training programs. The key idea behind this strategy – with potential appeal to the political right as well as to the left – is that by pairing

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<sup>3</sup> This number is not reported directly in their article, but has been provided to me by the authors.



insurance with activity requirements it becomes possible to partly escape the unpleasant tradeoff between equality and work incentives; i.e., it facilitates a reduction of the moral hazard problem, given the level of insurance, or, alternatively, to improve the insurance coverage, given the level of moral hazard. Experiences from the Scandinavian countries – which from time to time have combined relatively generous social insurance payment levels with strict activation requirements – indicate that activation is an efficient tool for containing moral hazard problems. For claimants who do not really need the benefit, “threatening” with activation seems to have basically the same effect on their behavior as threatening to take away their benefits altogether. Actual participation in labor market programs has more ambiguous effects on the participants’ future labor market outcomes; some studies indicate positive effects – others indicate negative or no effects. However, properly designed, it should be possible to ensure that program participation represent a net value added even during the participation period. Job search is very much about “waiting” – it is difficult to fill the task of job search with meaningful activities 8 hours a day.<sup>4</sup> Activation not only aims at shortening the waiting period, but also to ensure that a given waiting period is put to better use.

There may be good reasons to adjust parameters of unemployment insurance systems in response to cyclical fluctuations. In particular, countries with relatively short maximum durations in their UI benefit system should probably extend them during recessions, both to ensure their ability to play the intended roles as automatic stabilizers and as consumption smoothing devices, and (possibly) to take advantage of pro-cyclical disincentive effects of UI. Given high general ambitions regarding the degree of activation in UI systems, it is obviously necessary to step up the use of active labor market programs in times of recession. I have argued, though, that cyclical fluctuations should probably not be fully accommodated by changes in the activity level, implying that the fraction of unemployed job seekers who participate in activation should be (slightly) pro-cyclical, at least conditional on unemployment duration. There are at least four reasons for this: i) Programs tend to have larger positive effects in good times; ii) the group of unemployed job seekers is more negatively selected in good times (and persons with poor employment prospects tend to have more to gain from ALMP participation); iii) the moral hazard problems in UI are, at least according to some studies, larger in good times; and iv) there are significant administrative costs associated with scaling ALMPs up and down according to cyclical fluctuations.

The activation strategy that has permeated many countries’ strategy towards unemployment and poverty may fruitfully be carried over to disability insurance. Recent evidence from the Scandinavian countries suggest that requiring sick/disabled individuals to exploit their remaining (reduced) work

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<sup>4</sup> Based on time use studies, Krueger and Mueller (2010) show that the average U.S. unemployed worker devotes about 41 minutes to job search on weekdays.

capacity significantly reduces moral hazard problems in temporary disability (sick leave) insurance. And, since work is normally a healthy activity – even for individuals with musculoskeletal diseases, back pain, or mental disorders – it also has the potential of improving health. I have argued that there is a large “grey area” between unemployment and disability. With less than full work capacity it is obviously difficult to find a job without at the same time being willing to accept less than a full wage. What is missing in most industrialized countries are disability insurances that are designed to deal with partial disabilities – and an accompanying strategy to ensure that the labor market is open to persons with such disabilities. Existing empirical evidence shows that disabilities are often triggered by job loss; hence, when the Great Recession (hopefully) comes to its close, we may expect to find that it has left behind a challenging disability problem.

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