

# Self-Inflicted Unemployment Scarring and Stigma\*

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August 15, 2019

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\*We have benefited from very useful discussions with and comments from Rob Alessie, Marnix Amand, Tony Berrada, David Card, Rafael Lalive, Lars Ljungqvist, Fabien Postel-Vinay, Jean-Marc Robin, Bruce Shearer and Nicolas Werquin, as well as from participants at the IZA World Labor 2018 Conference and the Society of Labor Economists 2017 Annual Meeting. Financial support from the Swiss Finance Institute is gratefully acknowledged. The usual disclaimer applies.

## Abstract

Long-term scars of unemployment include higher ex-post displacement and lower re-employment likelihoods, as well as income losses that increase in occurrence and duration of previous unemployment spells. Human capital explanations assume that its accumulation is valued by the market, but is impaired by non-employment. We retain the former assumption, yet relax the latter by considering continuous investment decisions made by workers across employment statuses, where wages, as well as likelihood and duration of unemployment spells are capital-dependent. We calculate analytically the joint optimal investment by the employed and the unemployed. We structurally estimate the model using NLSY79 data and identify two dynamically stable steady-state values with a lower one for the unemployed. Circular dynamics follow whereby human capital optimally falls during unemployment spells and increases again upon re-employment. Scarring and stigma are thus *self-inflicted*, i.e. endogenously induced through decisions made by agents only. A counter-factual exercise allows to gauge and confirm the importance of employment risks hedging in total demand for human capital and that of moral hazard issues in the design of UIB programs. We also show that status-dependent accumulation technology and capital specificity complement, but are not required for scarring and stigma.

**Keywords**— Human capital; Unemployment; Duration dependence; unemployment stigma and scarring; Displacement; Re-employment probability; Simulated Moments Estimation.

**JEL classification**— J24, J64, J65

# 1 Introduction

## 1.1 Motivation and overview

In addition to contemporaneous income losses associated with incomplete and temporary replacement,<sup>1</sup> unemployment ( $u$ ) imposes long-term costs to workers. On the one hand, scarring refers to persistent detrimental labor market outcomes, such as earnings decline,<sup>2</sup> as well as lower employment ( $e$ ), re-employment ( $u \rightarrow e$ ) and higher displacement ( $e \rightarrow u$ ) probabilities of workers with previous unemployment spells.<sup>3</sup> On the other hand, negative duration dependence (stigma) implies more unfavorable ex-post outcomes the longer agents are not working.<sup>4</sup> Despite being persistent, unemployment scars and stigma are not permanent, with more distant spells having weaker effects than recent ones.<sup>5</sup>

Human capital is often invoked as an explanation for unemployment scarring and stigma. This conjecture relies on two postulates: (i) human capital is valued by employers

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<sup>1</sup>The U.S. weighted average UI replacement rate in 2010-2011 was 0.41 and varied between 0.30 (AK, LA) and more than 0.49 (AZ, HI, RI) with median maximal duration of 26 weeks. Source: U.S. Department of Labor.

<sup>2</sup>Jacobson et al. (2005, Fig. 1) report that pre- vs post-displacement earnings losses are 10% for short-tenured, 23% for medium-tenured and 30% for long-tenured workers. See Kletzer (1998); Arulampalam et al. (2001); Abbott (2008); Quintini and Venn (2013); Carrington and Fallick (2014) for reviews of US and international evidence on post-unemployment income losses. Additional discussion of income scars is presented in Jacobson et al. (1993); Neal (1995); von Wachter et al. (2009); Farber (2011); Davis and von Wachter (2011); Fang and Silos (2012); Huckfeldt (2016). Corresponding welfare costs are found to be substantial by Rogerson and Schindler (2002); Krebs (2007).

<sup>3</sup>Ruhm (1991a) finds that displacement entails a three times higher risk of future unemployment. Stevens (1997) shows that displacement induces multiple additional displacement, resulting in long-term earnings losses. Krueger et al. (2014, Fig. 3) show that the long-term unemployed ( $> 26$  weeks) have an exit rate to employment less than half that of the very short-term ( $< 5$  weeks). Guvenen et al. (2017) emphasize the persistence of (voluntary and involuntary) non-employment statuses in explaining earnings losses. Fujita and Moscarini (2017) distinguish between recalled and new hires in analyzing  $e \rightarrow u \rightarrow e$  transitions, showing that recalled workers had more tenure, received offers faster and stayed longer with their employer, while experiencing more duration dependence than new hires. See also Nilsen and Reiso (2011); Eliason and Storrie (2006) for Scandinavian and Arulampalam (2001) for British evidence on employment scarring. Seniority rules determining Last-in-First-Out termination policies are discussed in Kletzer (1998); Medoff and Abraham (1981); Carmichael (1983).

<sup>4</sup>Kroft et al. (2013) rely on fictitious CV's sent to prospective employers advertising openings and find that call-backs were 45% lower for 8-month unemployment spells, compared to 1-month. Similar effects through low call-backs are identified in Eriksson and Rooth (2014) for Swedish data. See also Eubanks and Wiczer (2016); Alvarez et al. (2016); Nekoei and Weber (2015); Huttunen et al. (2011); van den Berg and van Ours (1996); Ruhm (1991b) for discussions of the role of sample composition effects and unobserved heterogeneity in explaining duration dependence.

<sup>5</sup>See Jacobson et al. (2005); Davis and von Wachter (2011); Carrington and Fallick (2014) for discussions.

and (ii) its accumulation is impaired by non-employment. Evidence for capital valuation include higher wages, lower displacement risk and faster re-employment transitions for skilled workers.<sup>6</sup> Reasons for slower capital accumulation for the unemployed include not learning-by-doing, faster skills depreciation and less efficient learning technologies in non-employment, as well as human capital specificity, technological obsolescence, and unemployment insurance (UI) incentives distortions. The relative depreciation of the unemployed workers' capital is sanctioned by employers who rely on observable spell occurrence and duration as a screening mechanism to identify existence and magnitude of imperfectly observed human capital losses. Firms are consequently less willing to hire and pay high wages to, as well as are more inclined to lay off previously unemployed workers, especially the long-duration ones.

Our main research question is whether these long-term unemployment costs are still relevant when we retain assumption (i) of valuable capital, but when we abstract from assumption (ii) of exogenous accumulation wedges across employment statuses. In particular, we ask whether unemployment scarring and stigma can persist in an environment where measurable human capital (i) is associated with both a lower likelihood and expected duration of unemployment spells, in addition to higher wages and (ii) can be continuously adjusted by agents in both employment and unemployment states. Whereas the first assumption is well justified empirically and in the literature, the second postulate can be rationalized by invoking workers' decisions at the extensive (i.e. participation) and intensive (i.e. effort) margins with respect to on-the-job training, continuing education and active UI programs.<sup>7</sup> To the extent that capital positively affects wages, as well as reduces unfavorable employment risks and that its accumulation is decided by the agent, exposure to unemployment scarring and stigma should be minimized by investing more

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<sup>6</sup>See Mincer (1974) for education, tenure and experience gradients of wages. See Neal (1995); Kletzer (1998); Farber (2005, 2011); Riddell and Song (2011); Gomes (2012); Fang and Silos (2012); Quintini and Venn (2013) for evidence on role of human capital in mitigating exposure to labor market risks,

<sup>7</sup>Evidence and theoretical rationalization for human capital decision- and cost-sharing in employment are provided by Becker (1962, 1993); Acemoglu and Pischke (1999); Fu (2011); Marotzke (2014); Kräkel (2016) whereas unemployed agents' participation in active UI policies is reviewed by Heckman et al. (1999); Jacobson et al. (2005).

when employed (to prevent displacement), as well as when unemployed (to accelerate re-employment and counter duration dependence). If the optimal strategy nonetheless admits long-term unemployment costs, then any residual scarring and stigma must be optimally *self-inflicted* by the agent.

To answer this question, we address unemployment scarring and stigma through the lens of classical Human Capital (HK) investment theory, to which we append endogenous exposure to employment risks. We rely on four modeling choices. First, we take as primitive the assumption that human capital induces better wages, as well as lower displacement risk and faster re-employment transitions for the better-skilled agents. Second, we internalize both the income and employment risks motives in a HK setup with Ben-Porath (1967) accumulation featuring stochastic employment states and endogenous transition densities. Third, a realistic specification of unemployment insurance benefits provides both the resources and the incentives for investing during unemployment spells. Finally, we allow for (but do not impose) differences in human capital technology across employment statuses, as well as for firm- or sector-specific capital losses incurred upon occurrence of displacement. Abstracting from both in our baseline setup lets us emphasize scarring dynamics resulting from *optimal* investment policies, instead of from arbitrary parametric restrictions, such as less efficient capital accumulation, or faster depreciation rates for the unemployed. We later reinstate status-dependent technology and capital specificity to gauge their respective contributions.

We compute interior investment rules for this problem and characterize the wages and employment dynamics resulting from the optimal choices. Solving this dynamic model is particularly challenging for two reasons. First, as is the case for Diamond (1982); Mortensen and Pissarides (1994) (DMP) Search and Matching models – and unlike standard HK models –, the employment and unemployment value functions are non-separably intertwined with one another, as the returns to investing when employed depend on what is selected when unemployed and vice versa. Second and more importantly, both the displacement and re-employment arrival rates are endogenous functions of

the human capital decided by the agent, which enriches the motives for investing, but significantly complicates the model's solution. We circumvent this problem through two-step expansion methods developed in Hugonnier, Pelgrin and St-Amour (2013). We start by solving analytically a restricted version (referred to as order-0) where the arrival rates governing displacement and re-employment are exogenously set. We then do an expansion on this solution (order-1) where the perturbation concerns the key parameter governing the endogeneity of the arrival rates.

We first show that the order-0 solution yields two separate and constant human capital growth, such that no steady-state exists. Consequently, the exogenous employment risks case captures only a subset of the stylized facts on scarring and stigma. To illustrate its shortcomings, we abstract from ad-hoc depreciation and productivity differences across employment statuses, as well as from capital specificity in our baseline scenario. A high capital gradient of income is then sufficient to yield lower investment and growth for the unemployed than for the employed. Since capital positively affects employment revenues, the gap in constant growth rates generates positive income wedges that are increasing in unemployment occurrence and duration, consistent with *income* scarring and stigma. However, constant growth rates levels and differentials entail permanent effects of unemployment, at odds with the persistent, but temporary nature of observed scarring and stigma. Moreover, because displacement and re-employment intensities are exogenously set and cannot be adjusted, slower capital growth during unemployment spells is inconsequential for future employment risks exposure. The restricted model is thus unable to reproduce *employment* scarring and stigma observed in the data.

We next reinstate endogenous displacement and re-employment intensities in calculating the order-1 solutions to assess whether these shortcomings can be addressed. The associated human capital, employment and income dynamics are significantly more complex to investigate analytically and we resort to numerical analysis instead. For that purpose, we structurally estimate the order-1 model using a Simulated Moments Estimation (SME) to match predicted and observed employment and income dynamics from NLSY79 data.

Again abstracting from technological differences and capital specificity, our baseline results confirm that the optimal human capital dynamics are now fully consistent with *both* income and employment scarring and stigma, as well as with their non-permanent features. This finding rests on two main results. First, investment by the unemployed is positive, but lower than for the employed. Second, two distinct employed and unemployed steady-state levels of human capital exist, are both dynamically stable, and with a lower steady state for the unemployed. Combining the two results entails circular optimal wages and risks dynamics. Upon unemployment, human capital optimally falls towards the lower unemployed steady state and increases towards the higher employed steady state upon re-employment. Since re-employment (resp. displacement) and wages are increasing (resp. decreasing) functions, unemployment spells thus internally induce lower recall rates and lower wages and higher displacement upon re-employment (scarring). Moreover, since human capital falls continuously until either re-employment occurs or the steady state is reached, duration dependence (stigma) obtains internally. Because scarring and stigma depend on displacement and re-employment events whose joint likelihood is human capital-dependent and since the investment in the capital is decided by workers exclusively, scarring and stigma are self-inflicted in the sense that both arise through an optimal dynamic strategy of workers, with minimal and realistic assumption on market valuation of skills, and abstracting from heterogeneous technology across statuses.

We next rely on a counter-factual exercise to assess the various mechanisms at play. First, since our model innovates from standard human capital theory in that particular dimension, we gauge the importance of displacement and re-employment risks control in total demand for human capital. By removing endogenous exposure and adjusting the parameters to maintain the mean displacement/reemployment rates constant, we show that the marginal effects of risk exposure adjustment strongly complements any wage considerations in investment decisions. Second, we also measure the policy effects of UI generosity and of base income on total investment. Standard search models associate more generous programs with reduced search efforts and longer unemployment spells

(e.g. Chetty, 2008; Daly et al., 2012). We offer an alternative moral hazard explanation whereby less generous UIB increases the motives for investing, decreasing unemployment through lower displacement and higher re-employment. Finally, our baseline results assume employment status independent technologies and no capital specificity. We assess the importance of these restrictions by re-introducing both in turn. Our results show that unemployment disadvantages are complementary, but not necessary for self-imposed scarring and stigma to occur.

This paper contributes to discussions of human capital in labor market dynamics. We highlight the importance of endogenous employment risks exposure as additional motivation for investing in one's own human capital as a complement to the traditional higher wages argument. These employment risks are widely assumed to be the result of systemic macro shocks and cannot be insured against through market instruments, thereby justifying both active macro stabilization and UIB policies. We show instead that displacement and re-employment risks *can* be adjusted through agents' decisions and that long-term scars can nonetheless obtain optimally through investment choices made by workers only. Finally, we highlight the strong moral hazard risks in making the UIB programs more generous. This results in lowering the incentives for investing, with ensuing higher displacement and lower wages and re-employment.

## 1.2 Related literature

**HK models** Our paper is most directly related to the HK literature where agents make continuous decisions on their human capital accumulation subject to Ben-Porath (1967) technology. A first strand emphasizes the role of specificity, of capital complementarities and of market frictions in optimal cost- and decision-sharing by workers and firms (Becker, 1962, 1993; Acemoglu and Pischke, 1999; Fu, 2011; Marotzke, 2014; Kräkel, 2016). A second strand focuses on heterogeneity in human capital production, both in terms of abilities and in types of acquired capital (Ingram and Neumann, 2006; Cunha and Heckman, 2007; Heckman, 1976, 2008; Hu and Taber, 2011; Yamaguchi, 2012; Polachek



et al., 2015; Jones, 2014; Stantcheva, 2017; Guvenen et al., 2018). A third subset of HK contributions is primarily concerned with the life cycle of wages and earnings, notably how pre-employment education, finite employment and life horizons reduces human capital investment late in life and yields hump-shaped earnings profiles (Heckman, 1976, 2008; Keane and Wolpin, 1997; Huggett et al., 2006, 2011; Cervellati and Sunde, 2013; Hendricks, 2013; Kredler, 2014; Fan et al., 2015). A fourth strand of the HK literature measures the impact of non-diversifiable depreciation and income shocks to the accumulation process (Rogerson and Schindler, 2002; Krebs, 2003; Pavoni, 2009; Huggett et al., 2011).

We follow the classical HK approach in letting capital investment decisions be made and costs be incurred by agents exclusively. In addition, the model is flexible enough to allow for differences in abilities or technology, as well as between general and specific capital. However, we do not emphasize heterogeneity in the primitives as the main driving force. Rather heterogeneous income and employment outcomes stem exclusively from optimal investment and idiosyncratic shocks whose distributions are endogenously determined through the agents' choices. Moreover, although the HK framework we resort to is by definition a life cycle model, we do not emphasize its life cycle properties. In particular, we neither focus on education decisions made prior to labor market entry, nor do we rely on the earnings profile by age to identify the properties of the human capital dynamics. Finally, the distribution of human capital shocks found in the literature is exogenously set and cannot be altered by the agent's decisions. One exception is Keane and Wolpin (1997) where agents select between finite alternative distributions on human capital returns. However, our choices are continuous, rather than among a fixed set of alternatives (e.g. working, not working) and the shocks we consider are exclusively driven by changes in employment status whose transition matrix is human capital-dependent.

**DMP models** Our paper is more indirectly related to the strand of the DMP Search and Matching models either explicitly or implicitly emphasizing human capital (DMP-

HK). Explicit DMP-HK literature<sup>8</sup> primarily adopts a learning-by-doing perspective whereby skills reflect work experience that improve match quality and wages and that accumulate if employed and stagnate or decline during non-employment spells (either voluntary or not). Human capital accumulation in DMP-HK models is best characterized as a by-product of workers’ job acceptance decisions and on- and off-the-job search efforts, rather than as a consequence of explicit investment choices by agents.<sup>9</sup> Exposure to employment risk is also indirectly affected by workers decisions, such as in the case of endogenous separation, where matches are not consumed in light of insufficient *ex-post* quality (Esteban-Pretel and Fujimoto, 2014; Fujita and Moscarini, 2017) or in unemployment search efforts that are combined with market tightness conditions (Mukoyama et al., 2018), as well as human capital specificity (Fujita and Moscarini, 2017; Fujita, 2018) to determine the job arrival rate.

We also draw from the DMP literature with implicit references to human capital. For example, the match quality in Pissarides (1992) depends on past employment status and is higher for previously employed workers, thereby mimicking additional skills depreciation during unemployment. Recall models such as Fujita and Moscarini (2017) emphasize dynamics for match productivity that persist as long as a worker does not find employment outside a given firm, thereby capturing firm-specific human capital that can be drawn upon when recalled. Kroft et al. (2016) implicitly mimic unemployment depreciation by directly appending negative duration dependence to model UE transitions in a search framework. Finally, Job Ladders models (Lise, 2013; Pinheiro and Visschers,

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<sup>8</sup>Examples of DMP settings with explicit human capital considerations include Ljungqvist and Sargent (1998); Shimer and Werning (2006); Pavoni (2009); Yamaguchi (2010); Burdett et al. (2011); Esteban-Pretel and Fujimoto (2014); Bagger et al. (2014); Ortego-Marti (2017); Fujita (2018); Guvenen et al. (2018). Capital depreciation can further be accelerated in “micro-turbulent” periods where workers suffer from specific skills obsolescence (Ljungqvist and Sargent, 1998; Kitao et al., 2017).

<sup>9</sup>Exceptions in DMP-HK setups with explicit investment decisions include Flinn and Mullins (2015) who consider binary schooling choices made prior to market entry and Kitao et al. (2017) who allow for direct investment at the mid-life (Experienced) phase. Flinn et al. (2017); Fu (2011) analyse joint training decisions by workers/employers, whereas agents decide on job offers that include training opportunities, as well as wages, whereas Lentz and Roys (2015) consider training decisions made by firms exclusively. Guvenen et al. (2018) let workers select accumulation through directional search for firms with different skills requirements that augment human capital. This literature considers income motives only for accumulation, with no effects on the distribution of employment risks internalized in workers decisions.

2015; Moscarini and Postel-Vinay, 2016; Krolikowski, 2017) emphasize slow resolution of mismatches between demanded and offered skills to explain wages and employment risks dynamics. These papers have implicit references to human capital where displaced workers suffer from jumps to less favorable employment ladders and slowly climb back up when their capital is replenished following re-employment.

We indirectly borrow from the DMP paradigm in letting agents' decisions affect their employment outcomes and from the DMP-HK segment by channeling this influence through their human capital. We also implicitly assume that match quality is improved by the latter, resulting in better employment opportunities (wages/risks) for high-capital agents. Moreover, the circular optimal wage and employment dynamics we uncover share strong similarities with those obtained under the Job Ladders approaches.

However, several differences with DMP are worth mentioning. First, we abandon the learning-by-doing perspective by making capital accumulation a product of deliberate and continuous decisions by agents across both the employment and the unemployment statuses. Equivalently, whereas DMP models focus on extensive margin adjustments associated with changes in statuses, we emphasize intensive adjustments where agents can continuously fine-tune their human capital throughout the employment or unemployment spells. Second, we depart from DMP in taking a partial-equilibrium and agents-focused perspective. Unlike the latter, firms act mechanically in our setup, supplying the wage, displacement and re-employment functions that are taken as primitives and are not stemming from general equilibrium. Finally, we put forward an idiosyncratic, rather than systemic stochastic environment where the capital-induced distributions are agent-specific and do not encompass equilibrium variables such as the market tightness rate.

## **2 NLSY79 evidence on scarring and stigma**

We resort to National Longitudinal Survey of Youth (NLSY79) data to provide *prima facie* evidence of scarring and stigma, as well as to compute empirical moments that

are relied upon in the Simulated Moments Estimation below. NLSY79 is a widely-used<sup>10</sup> panel of 9,964 respondents aged between 14-22 in 1979, and followed up to 2014, providing longitudinal information on employment statuses and income, as well on socio-economic variables (see Appendix A for details). Summary statistics in Table 1 shows that our sample is evenly balanced on gender, composed mainly of white, US citizens, of average age 32, and living in urban areas. Human capital measures include close to 13 years of highest completed grade, with 14% of respondents indicating vocational or professional training. Labor market experience shows that 91% were employed with mean income less than 17 K\$ in real terms.

Table 2 identifies employment scarring and stigma by reporting current employment probabilities by past statuses (panel a) and by human capital (panels b and c). First,  $t - 1$  unemployment lowers current employment by 26.4% (95.13%-68.73%), whereas  $t - 2$  unemployment reduces it by 17.2% (78.25%-95.44%). Duration dependence (stigma) is apparent as being continuously unemployed in the last two periods reduces current employment by 38.7% (96.31%-57.58%).

Second, panels b and c show the mitigating effects of human capital on unemployment level and persistence. Agents with less than high school had 14.3% (97.70%-83.39%) lower employment rates in general compared with those having college degree. They also faced a 30.9% (89.36%-58.43%) lower employment if previously unemployed, compared with only a 8.9% (97.96%-89.07%) gap for those with college degrees. Vocational and professional training also provides some attenuating effects, although of lower magnitude compared to education. Trained agents had higher employment by 2.7% (95.15%-92.46%), and faced a past unemployment gap of 24.0% (96.75%-72.77%), compared with 28.1% (94.82%-66.72%) for untrained respondents.

Table 3 reveals similar scarring and stigma when measured in terms of income. Declining persistence is visible with  $t - 1$  unemployment resulting in 64.7% lower income, while  $t - 2$  spells lower income by 52.2%. Income stigma is also apparent with continuous

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<sup>10</sup>See Guvenen et al. (2018); Lise (2013) and references therein for recent applications.

unemployment in the last two periods leading to a 74.2% drop in current revenues. The mitigating human capital effect on income is less striking compared to that on employment. Although college graduates earn 61.8% more than those without high school, the effects of education on the income gap associated with  $t - 1$  unemployment is relatively constant, ranging between 57.3% and 61.6%. Again, the effect of training appears more limited.

These statistical findings are confirmed by longitudinal regression analysis. Table 4 shows the marginal effects from panel Probit regressions of current employment statuses, controlling for socio-demographic characteristics and year fixed effects. The dependent variables are (1) the unconditional, i.e.  $\Pr(e_t)$ , (2) re-employment, i.e.  $\Pr(e_t | u_{t-1})$  and (3) continuing employment, i.e. non-displacement  $\Pr(e_t | e_{t-1})$ . First, in panel a, past employment statuses improve current employment, re-employment and continuing employment. The temporary nature of scarring is apparent with weaker effects associated with time  $t - 2$  statuses, compared to  $t - 1$ . Second, in panel b, human capital measured either through lagged work experience (i.e. cumulated past statuses up to  $t - 1$ ), education or training significantly augment current employment, re-employment, and continuing employment probabilities. Table 5 makes similar findings for current income via panel GLS, random-effects regressions. Positive gradients are also found for being employed in the last two periods, with stronger effects for more recent statuses. Again, human capital proxied by work experience, education, or training improve current, re-employment, and continuing employment incomes.

Overall, we conclude that the employment and income scarring costs associated with previous unemployment are significant, as well as compounded by duration (stigma), and are more important for recent than for distant spells. Human capital augments both employment and income and is a significant hedge against these scarring and stigma costs. The next section describes a theoretical model incorporating these elements. Consistent with Tables 4, and 5, we assume that labor demand values human capital with higher re-employment, lower displacement probabilities, as well as higher wages. Taking these labor

market characteristics as given, we let agents select their investment in human capital and verify whether the resulting dynamics are consistent with scarring and stigma costs identified with NLSY79 data.

### 3 HK Model with Endogenous Employment Risks

#### Exposure

**Overview** Consider an economy where agents are characterized by two sources of heterogeneity: Human capital  $H_t \in \mathbb{R}_+$  and labor market status  $i_t \in \{e, u\}$  (i.e. employed, unemployed). The former is defined as the publicly measurable set of skills accumulated by workers over their lifetime. We assume that investment in human capital is decided by agents and takes place both within (e.g. through experience or voluntary training) and outside (e.g. through formal and informal education) employment. The pecuniary (e.g. tuition fees, books, software, ...) and indirect (e.g. opportunity cost of time and effort spent acquiring skills) investment costs are borne by individuals. Human capital provides no direct utility flows to the agent, but is valued by employers, as reflected in more favorable conditions with respect to wages, firing and hiring for highly-skilled agents. Although our perspective is on general human capital, we allow for part of that capital to be immediately depreciated upon a displacement event in order to reflect firm- or industry-specific components that have limited value to outside employers.

Labor market statuses are stochastic and the transition matrix between employment and unemployment spells is agent-specific, in that it depends on the accumulated level of human capital. Employed agents receive an income that is continuously adjusted to reflect changes in human capital. Conversely, unemployed agents receive unemployment benefits that are set at a fraction of the last employment revenue; the benefits are constant for the duration of the unemployment spell. Risk-neutral agents thus select optimal investment paths taking into account its joint benefits in terms of income premia and employment risk adjustments.

**Employment statuses** A person's time- $t$  labor market status  $i_t$  follows a Poisson stochastic process. Importantly, the arrival intensity is assumed to be dependent of the observable human capital level  $H_t$ . More specifically, let  $T^i$ , be the random time of job displacement from current employment ( $e \rightarrow u = i$ ), or re-employment from current unemployment ( $u \rightarrow e = i$ ), with Poisson arrival intensities  $\lambda^i : \mathbb{R}_+ \rightarrow \mathbb{R}_{++}$  defined as:

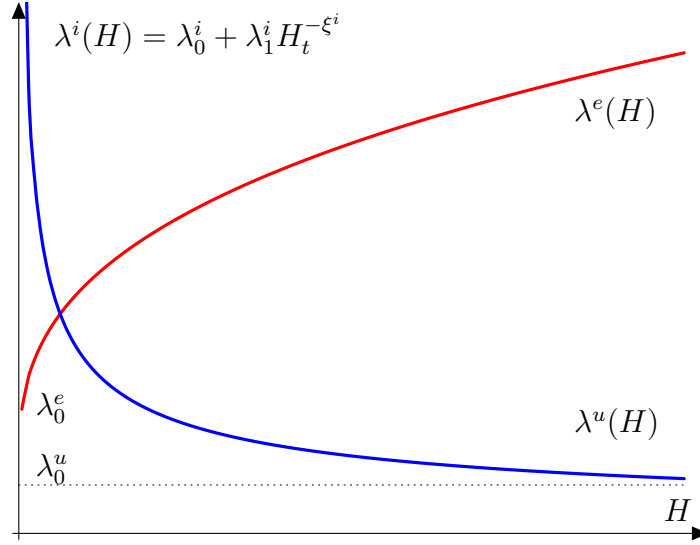
$$\begin{aligned} \lambda^i(H_t) &= \lim_{\tau \rightarrow 0} \frac{1}{\tau} \Pr [t < T^i < t + \tau \mid H_t], \quad i \in \{e, u\} \\ &= \lambda_0^i + \lambda_1^i H_t^{-\xi^i}, \quad \lambda_0^i, \lambda_1^i \geq 0; \quad \xi^i > -1. \end{aligned} \tag{1}$$

Equivalently, the time  $t$  probability of remaining employed ( $e \not\rightarrow u = i$ ) or remaining unemployed ( $u \not\rightarrow e = i$ ) up to  $t + s$  is therefore:

$$P_t [T^i > t + s] = \exp \left[ - \int_t^{t+s} \lambda^i(H_\tau) d\tau \right], \quad i \in \{e, u\}.$$

Imposing  $\xi^u > 0$  in (1) entails decreasing and convex work displacement intensities, whereas  $\xi^e \in (-1, 0)$  yields increasing concave re-employment intensities displayed in Figure 1. An agent can thus reduce his exposure to conditional employment risks by investing in his human capital which decreases his displacement intensity  $\lambda^u(H)$ , as well as increases his re-employment intensity  $\lambda^e(H)$ . On the one hand, the parameters  $\lambda_0^i$  represent unadjustable exposure to displacement and re-employment hazard. On the other hand, the parameters  $\lambda_1^i$  capture the endogeneity of the employment risks exposure and play a key role in the solution method discussed below, with  $\xi^i$  governing the extent of diminishing returns to investment against employment shocks.

Figure 1: Re-employment and Displacement Intensities



Notes:  $\lambda^e(H)$ : re-employment intensity.  $\lambda^u(H)$ : displacement intensity.  $H$ : human capital

**Income process** The income process  $Y_t = Y(H_t, \bar{H}, i_t) \in \mathbb{R}^+$  is status- and human-capital-dependent:

$$Y(H_t, \bar{H}, e) = Y^e(H_t) = y_0 + y_1 H_t, \quad (2a)$$

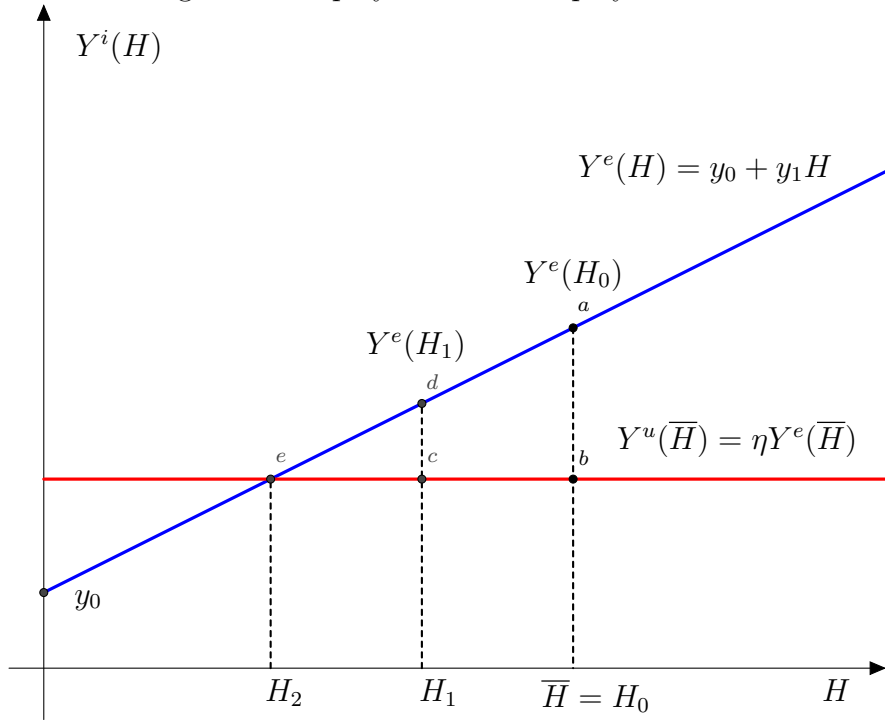
$$Y(H_t, \bar{H}, u) = Y^u(\bar{H}) = \eta Y^e(\bar{H}), \quad (2b)$$

where  $\eta \in (0, 1)$  is the UI replacement rate and where  $\bar{H}$  is the last measurable human capital level at the beginning of the unemployment spell (i.e. *lock-in* capital).

Figure 2 shows that employment income  $Y^e(H)$  increases in human capital which can be continuously altered through the agent's investment decisions. Upon job loss at human capital level  $H_0$ , unemployment income at point  $b$  is a fraction  $\eta$  of the last employment income  $Y^u(\bar{H}) = \eta Y^e(H_0)$  and remains fixed throughout the duration of the unemployment spell. For example, if human capital declines to  $H_1$  during unemployment, UI income remains constant, whereas the income upon re-employment income at point  $d$  is lower than previously,  $Y^e(H_1) < Y^e(H_0)$ . Consistent with passive UI policies, investment



Figure 2: Employed and Unemployed Income



Notes:  $Y^e(H)$ : Employed income.  $Y^u(\bar{H})$ : Unemployed income at replacement rate  $\eta$ , evaluated at last measurable capital  $\bar{H}$ .

decisions during the unemployment spell thus affect the displacement and re-employment probabilities, as well as the re-employment wage, but not the UI benefits.<sup>11</sup>

Note further that the income loss (resp. gain) associated with displacement (resp. re-employment):

$$\begin{aligned} \Delta Y(H, \bar{H}) &= Y^e(H) - Y^u(\bar{H}) \\ &= (1 - \eta)y_0 + y_1(H - \eta\bar{H}) \end{aligned} \quad (3)$$

is an increasing function of  $H$  and can become negative if human capital depreciates sufficiently during the unemployment spell, i.e. for  $H < H_2$  in Figure 2. Indeed, beyond point  $e$ , UIB benefits are more generous than what would be earned upon re-employment, thereby lowering incentives to invest in order to augment re-employment probability.

<sup>11</sup>See St-Amour (2015) for an alternative UIB policy with continuous adjustments in  $Y^u(H) = \eta Y^e(H)$ , instead of lock-in capital. The results for this specification are qualitatively similar.

**Human capital dynamics** The law of motion for the agent's human capitals,  $dH_t = dH_t(I_t, H_t, i_t)$ , is status-dependent and is given by:

$$dH_t = -\delta^i H_t dt + P^i I_t^\alpha H_t^{1-\alpha} dt, \quad \alpha, \delta^i \in (0, 1) \quad (4)$$

The accumulation process (4) is in the spirit of the HK literature, (e.g. Ben-Porath, 1967; Heckman, 1976; Huggett et al., 2006; Kredler, 2014) and captures continuous, as opposed to period-specific (e.g. pre-employment education) investment  $I_t$  decided by the agent. The Cobb-Douglas gross investment function  $P^i I_t^\alpha H_t^{1-\alpha} dt$  is monotone increasing and concave in its arguments. The productivity term  $P^i$  can be equivalently interpreted as an ability or as the inverse of an investment price, whereas depreciation  $\delta^i$  can be interpreted as technological obsolescence of acquired skills.

Unlike most models who assume on-the-job training only (i.e.  $I_t(i_t = u) \equiv 0$ ), or active unemployment training decided by UI planners (e.g. Spinnewijn, 2013), the agent's investment decisions span across employment statuses. Differences in productivity and depreciation capture status-dependent returns to investment. For example, faster depreciation, and/or lower productivity when unemployed<sup>12</sup> can be attained by imposing  $\delta^u > \delta^e$  and  $P^u < P^e$ . Conversely, a lower opportunity cost of time spent on  $I_t$  for the unemployed obtains through  $P^u > P^e$ . We remain agnostic by not imposing such restrictions and instead solving the model for any  $\delta^i, P^i$  combinations.

The literature also puts forward distinctions between general and firm- or industry-specific human capital, where the latter has a lower outside value (Hamermesh, 1987; Becker, 1993; Neal, 1995; Ljungqvist and Sargent, 1998; Wasmer, 2006; Decreuse and Granier, 2013). We can incorporate this feature by defining a transferability share  $\phi \in (0, 1]$  representing the general capita. In the spirit of Ljungqvist and Sargent (1998), a newly displaced agent's capital is thus only valued  $\phi H_t < H_t$  to prospective employers for income and reemployment intensity purposes. This non-stochastic jump can capture

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<sup>12</sup>See Pissarides (1992); Acemoglu (1995); Ljungqvist and Sargent (1998); Pavoni and Violante (2007); Pavoni (2009); Spinnewijn (2013) for discussions of unemployment disadvantages in capital accumulation.

firm- or industry-specific capital that is foregone when employment is terminated. Alternatively, the loss  $(1 - \phi)H_t$  can also be interpreted as discrimination or branding against unemployed workers whereby the actual capital is under-estimated by prospective employers following an unemployment spell. Both the effects on displacement/re-employment and on firm-specific capital loss are fully internalized in the agent's investment decisions, as will be seen below.

**Preferences** All agents are infinitely-lived<sup>13</sup> and select dynamic investment in human capital  $I_t$  to maximize the expected discounted (at rate  $\rho$ ) value of net income flow, taking as given the dynamics for human capital, the distributional assumptions and income function. More specifically, the value function can be written as:

$$V(H_0, \bar{H}, i_0) = \sup_I \mathbb{E}_0 \int_0^\infty e^{-\rho t} [Y(H_t, \bar{H}, i_t) - I_t] dt \geq 0, \quad (5)$$

subject to the intensities (1), the income rate (2) and the human capital law of motion (4).

We remain in the HK tradition in assuming risk-neutral preferences in (5), with two important implications. First, observe that negative net income  $Y_t - I_t < 0$  always remains feasible and can be achieved by implicit borrowing (at rate  $r = \rho$ ), as long as the expected net present value  $V(H_0, \bar{H}, i_0)$  remains non-negative.<sup>14</sup> Second, risk neutrality implies that any incremental demand for human capital (above that related to higher income) induced by endogenous displacement and re-employment risks cannot strictly be justified by self-insurance motives. Rather, this demand stems from a duration service whereby human capital augments the expected time spent in the employed state (with associated high income  $Y^e(H)$ ), and reduces that spent in unemployment (with associated low income  $Y^u(\bar{H})$ ). Observe that this duration service comes at no extra cost (aside from

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<sup>13</sup>In the spirit of the Perpetual Youth literature, the model is easily adaptable to finite lives is easily by assuming Poisson death intensity  $\lambda^m$  and augmenting discounting at rate  $\rho + \lambda^m$  over an infinite horizon (e.g. Blanchard, 1985).

<sup>14</sup>St-Amour (2015) considers the case where risk-averse agents have no access to borrowing for human capital investment. The main findings obtained through numerical solutions remain qualitatively similar to the ones of this paper.

the increase in marginal price due to convex adjustment costs) and can thus be interpreted as positive side benefit of investment over and above income considerations.

Letting  $V^e(H), V^u(H, \bar{H})$  denote the pair of value functions and invoking the Law of Iterated Expectations with Poisson distributions allows the agent's problem (5) to be written as a joint optimization system:

$$V^e(H_0) = \sup_I \int_0^\infty e^{-\int_0^t (\rho + \lambda^u(H_s)) ds} [Y^e(H_t) - I_t + \lambda^u(H_t) V^u(\phi H_t, H_t)] dt, \quad (6a)$$

$$V^u(H_0, \bar{H}) = \sup_I \int_0^\infty e^{-\int_0^t (\rho + \lambda^e(H_s)) ds} [Y^u(\bar{H}) - I_t + \lambda^e(H_t) V^e(H_t)] dt. \quad (6b)$$

The presence of  $V^u(\phi H, H)$  in the employed agent's problem (6a) highlights the additional depreciation that is associated with employment-specific capital  $(1 - \phi)H$  that is foregone upon the displacement event occurring with intensity  $\lambda^u(H_t)$ . The UI income in (6b) is calculated at locked-in capital  $\bar{H}$  until re-employment occurs with intensity  $\lambda^e(H_t)$ , after which the agent returns to  $V^e(H)$ . The program (6) features endogenous discounting at augmented rates  $\rho + \lambda^i(H)$  induced by the Poisson distributional assumption.

The corresponding Hamilton-Jacobi-Bellman (HJB) representation of (6) is:

$$\begin{aligned} 0 &= \sup_I -\rho V^e(H) - \lambda^u(H) [V^e(H) - V^u(\phi H, H)] + Y^e(H) - I \\ &\quad + V_H^e(H) [-\delta^e H + P^e I^\alpha H^{1-\alpha}], \\ 0 &= \sup_I -\rho V^u(H, \bar{H}) - \lambda^e(H) [V^u(H, \bar{H}) - V^e(H)] + Y^u(\bar{H}) - I \\ &\quad + V_H^u(H, \bar{H}) [-\delta^u H + P^u I^\alpha H^{1-\alpha}]. \end{aligned}$$

Calculating the first-order conditions and substituting back into the objective function reveals that the joint HJB system simplifies to:

$$0 = -\rho V^e(H) - \lambda^u(H) [V^e(H) - V^u(\phi H, H)] + Y^e(H) \quad (7a)$$

$$- \delta^e H V_H^e(H) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} H [P^e V_H^e(H)]^{\frac{1}{1-\alpha}},$$

$$0 = -\rho V^u(H, \bar{H}) - \lambda^e(H) [V^u(H, \bar{H}) - V^e(H)] + Y^u(\bar{H}) \quad (7b)$$

$$- \delta^u H V_H^u(H, \bar{H}) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} H [P^u V_H^u(H, \bar{H})]^{\frac{1}{1-\alpha}}.$$

The bi-variate system of first-order differential equations (7) has no analytical solution due to the endogeneity and nonlinear functional forms used for the intensity functions (1). St-Amour (2015) relies on Chebyshev polynomials to calculate numerical solutions to a similar program. We resort instead to a two-step approximate closed-form solution method developed in Hugonnier, Pelgrin and St-Amour (2013). First we remove the endogeneity in the employment intensities by imposing  $\lambda_1^i = 0$  in (1). This exogenous employment risks case yields a closed-form solution (referred to as order-0 solution) for  $V_0^i(H, \bar{H}), I_0^i(H, \bar{H})$ . Second, we rewrite the endogenous intensity component as  $\lambda_1^i = \epsilon \bar{\lambda}_1^i, i = e, u$  for some constants  $\bar{\lambda}_1^i$  and perturbation  $\epsilon$  and perform a first-order expansion of the value functions around the  $\epsilon = 0$  solution:

$$V^e(H, \epsilon) \approx V^e(H, 0) + \epsilon V_\epsilon^e(H, 0), \quad (8a)$$

$$V^u(H, \bar{H}, \epsilon) \approx V^u(H, \bar{H}, 0) + \epsilon V_\epsilon^u(H, \bar{H}, 0). \quad (8b)$$

Once the approximate solution (referred to as order-1) for the value functions is obtained, any relevant associated variable such as investment and human capital growth is thus recovered through a similar expansion (see Hugonnier et al., 2013, for details).

**Remark 1 (baseline scenario)** In order to emphasize capital dynamics resulting from optimal investment, rather than from technological differences, it will also be useful to define a baseline scenario of status-independent technologies, and no capital specificity:

$$\delta^i = \delta, P^i = P, \quad i \in \{e, u\} \quad (9a)$$

$$\phi = 1. \quad (9b)$$

Our theoretical results of Section 4 will be obtained for the general case of status-dependent  $(\delta^i, P^i)$  and specificity  $\phi \in (0, 1]$ , while our simulated results of Sections 5 and 6 will focus on the baseline scenario (9), before reintroducing technological differences and specificity in Section 7.

## 4 Optimal human capital investment and growth

We now calculate the optimal investment, starting first with the exogenous displacement and re-employment (order-0), followed by the more general case where both are endogenous (order-1).

### 4.1 Exogenous displacement and re-employment (order-0)

**Theorem 1 (exogenous employment risks)** *Let  $\lambda_1^e = \lambda_1^u = 0$  and assume that the order-0 transversality and regularity conditions conditions (16) in Appendix C hold. Then:*

1. *The indirect utility functions of employed and unemployed agents are given as:*

$$V_0^e(H) = A_0^e + A_h^e H \quad (10a)$$

$$V_0^u(H, \bar{H}) = A_0^u + A_h^u H + A_b^u \bar{H} \quad (10b)$$

2. *The optimal investment functions are given as:*

$$I_0^e(H) = H (P^e \alpha A_h^e)^{\frac{1}{1-\alpha}} \quad (11a)$$

$$I_0^u(H) = H (P^u \alpha A_h^u)^{\frac{1}{1-\alpha}} \quad (11b)$$

3. *The optimal human capital growth functions are given as:*

$$g_0^e = -\delta^e + P^e \frac{1}{1-\alpha} (\alpha A_h^e)^{\frac{\alpha}{1-\alpha}} \quad (12a)$$

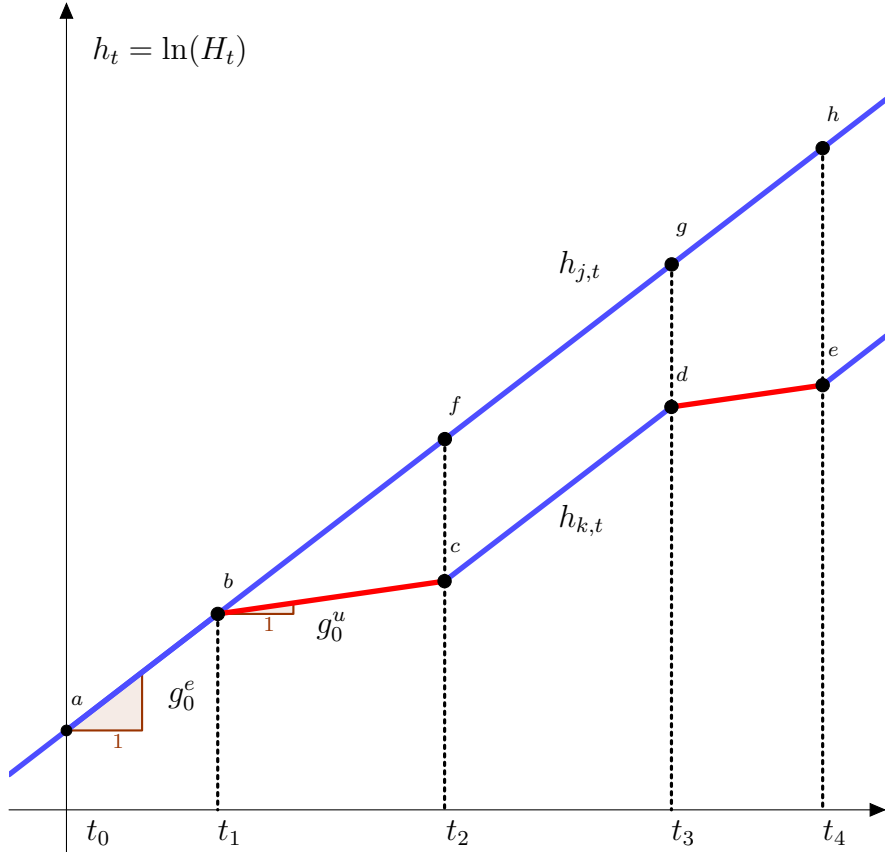
$$g_0^u = -\delta^u + P^u \frac{1}{1-\alpha} (\alpha A_h^u)^{\frac{\alpha}{1-\alpha}} \quad (12b)$$

where the parameters  $(A^e, A^u)$  are given in closed form in Appendix D.

First, the last measurable human capital level before the unemployment spell begins  $\bar{H}$  is valued under unemployment in (10b), but not for employed agents in (10a). Indeed, the UIB program sets  $\bar{H} = H$  when unemployment begins, such that the value function simplifies to a function of  $H$  only from the employed agent's perspective. Second, the optimal investment in (11) shows that the investment-to-capital ratio is constant. Consequently, so are the growth rates (12) such that no steady-state exists at the order zero. The expressions  $A_h^i$  in the indirect utility (10), investment (11), and growth (12) functions capture the status-dependent shadow prices, i.e. the Tobin's marginal- $q$ 's of human capital, that jointly solve (20). Corollary 1 in Appendix D shows that a sufficiently high income gradient  $y_1$  in (2) results in a lower Tobin's- $q$  for the unemployed,  $A_h^u < A_h^e$ . For the baseline scenario in (9), it follows from (12) that the growth rate of human capital is then always lower for the unemployed, i.e.  $g_0^u < g_0^e$ . This special case is useful to illustrate the shortcomings of the exogenous exposure to employment risks solved in Theorem 1.

Indeed, Figure 3 plots the corresponding optimal evolution of  $h_t = \ln(H_t)$  for agents  $j, k$  with identical initial level at  $t_0$ , and with both employed up to  $t_1$ . Whereas agent  $j$  is continuously employed at all periods, agent  $k$  becomes unemployed at  $t_1$  and has his human capital grow at lower rate (in red)  $g_0^u < g_0^e$ . If re-employed at  $t_2$ , his human capital grows at the same rate  $g_0^e$  as agent  $j$  (in blue), but its level is permanently lower by distance  $f-c$ . A second unemployment spell at  $t_3$  results in the same lower unemployed growth rate as at  $t_1$ , and permanently lower human capital by amount  $h-e$  following re-employment at  $t_4$ .

Figure 3: Permanent scarring and stigma with exogenous employment risks



Notes: Optimal log human capital dynamics (employed: blue; unemployed: red), exogenous displacement and re-employment case  $\lambda_1^e = \lambda_1^u = 0$ , assuming condition (21) in Corollary 1 and for baseline scenario (9).

Permanent human capital wedges translate into permanent income wedges in (2), that are increasing in both occurrence and duration of unemployment spells (see Figure 3). Constant growth rates differentials predicted by the exogenous employment risks model thus imply permanent, duration-dependent, income scarring of unemployment, contrary to observed patterns of persistent, but temporary, and duration-dependent income wedges (e.g. Jacobson et al., 2005; Davis and von Wachter, 2011; Carrington and Fallick, 2014). Relaxing the baseline scenario (9) to allow for status-dependent technologies and specificity will have quantitative, but not qualitative effects; except in the unlikely case where parameters are such that  $g_0^u = g_0^e$ , income scars increase in spell duration and are not mean-reverting. Moreover, because the order-zero case imposes  $\lambda_1^i = 0$  in (1), the human



capital wedges in Figure 3 are inconsequential for post-unemployment displacement and re-employment risks exposure. A second shortcoming of the restricted case is therefore that unemployment episodes have no impact on the likelihood and duration of future unemployment spells. To summarize, the exogenous employment risks model case can generate *income* scarring and stigma, but fails to account for the non-permanent nature of these costs, and is unable to generate *employment* scarring and stigma.

## 4.2 Endogenous displacement and re-employment (order-1)

We now consider the more general case of endogenous exposure to gauge whether the shortcomings of the exogenous employment risks exposure model can be addressed.

**Theorem 2 (endogenous employment risks)** *Assume that the order-0 transversality and regularity conditions conditions (16) in Appendix C hold. Then, up to a first-order approximation,*

1. *The indirect utility functions of employed and unemployed agents are given as:*

$$\begin{aligned} V^e(H) = & V_0^e(H) + B_u^e \lambda_1^u H^{-\xi^u} + B_{1u}^e \lambda_1^u H^{1-\xi^u} + B_e^e \lambda_1^e H^{-\xi^e} \\ & + B_{1e}^e \lambda_1^e H^{1-\xi^e}, \end{aligned} \quad (13a)$$

$$\begin{aligned} V^u(H, \bar{H}) = & V_0^u(H, \bar{H}) + B_u^u \lambda_1^u H^{-\xi^u} + B_{1u}^u \lambda_1^u H^{1-\xi^u} + B_e^u \lambda_1^e H^{-\xi^e} \\ & + B_{1e}^u \lambda_1^e H^{1-\xi^e} + B_b^u \bar{H} \lambda_1^e H^{-\xi^e}, \end{aligned} \quad (13b)$$

2. *The optimal investment functions are given as:*

$$\begin{aligned} I^e(H) = & I_0^e(H) + C_u^e \lambda_1^u H^{-\xi^u} + C_{1u}^e \lambda_1^u H^{1-\xi^u} + C_e^e \lambda_1^e H^{-\xi^e} \\ & + C_{1e}^e \lambda_1^e H^{1-\xi^e}, \end{aligned} \quad (14a)$$

$$\begin{aligned} I^u(H, \bar{H}) = & I_0^u(H) + C_u^u \lambda_1^u H^{-\xi^u} + C_{1u}^u \lambda_1^u H^{1-\xi^u} + C_e^u \lambda_1^e H^{-\xi^e} \\ & + C_{1e}^u \lambda_1^e H^{1-\xi^e} + C_b^u \bar{H} \lambda_1^e H^{-\xi^e}. \end{aligned} \quad (14b)$$

3. The optimal human capital growth functions are given as:

$$g^e(H) = g_0^e + D_u^e \lambda_1^u H^{-1-\xi^u} + D_{1u}^e \lambda_1^u H^{-\xi^u} + D_e^e \lambda_1^e H^{-1-\xi^e} + D_{1e}^e \lambda_1^e H^{-\xi^e}, \quad (15a)$$

$$g^u(H, \bar{H}) = g_0^u + D_u^u \lambda_1^u H^{-1-\xi^u} + D_{1u}^u \lambda_1^u H^{-\xi^u} + D_e^u \lambda_1^e H^{-1-\xi^e} + D_{1e}^u \lambda_1^e H^{-\xi^e} + D_b^u \bar{H} \lambda_1^e H^{-1-\xi^e}. \quad (15b)$$

where the order-0 values  $V_0^e(H), V_0^u(H, \bar{H}), I_0^e(H), I_0^u(H, \bar{H})$  and  $g_0^e(H), g_0^u(H, \bar{H})$  are given in Theorem 1 and where the parameters  $(B^e, B^u), (C^e, C^u)$  and  $(D^e, D^u)$  are given in closed form in Appendix E.

When contrasted with Theorem 1, the order-1 results of Theorem 2 show that the investment shares of human capital  $I^i(H, \bar{H})/H$  are no longer constant. It follows that neither are the optimal growth functions  $g^i(H, \bar{H})$ , such that steady state values  $H_{SS}^i(\bar{H})$  may exist, contrary to the exogenous employment risks case. Importantly, generalizing  $\lambda_1^i \neq 0$  permits feedback effects of changes in  $H$  for employment risks exposure. In addition to income wedges identified for the order-0 case, any gaps in the optimal dynamics  $g^e(H) - g^u(H, \bar{H})$  will be penalized in both displacement and re-employment intensities, thereby reinstating potential employment scarring and stigma.

## 5 Simulated human capital dynamics

The investment and growth functions revealed by the order-1 optimal rules in Theorem 2 are much more challenging to describe analytically than their order-0 analogs. We therefore resort to numerical analysis to identify the dynamics of employment statuses and income induced by those of the human capital. Again to emphasize optimal evolution of  $H_t$ , rather than parametric choices, we first evaluate the model for the baseline scenario (9). We will reinstate both status-dependent technology and firm-specific capital loss in the comparative statics exercise in Section 7.

## 5.1 Simulated Moments Estimation

**SME procedure** We rely on Simulated Moments Estimation<sup>15</sup> to structurally estimate a large subset of the model’s main parameters corresponding to the displacement and re-employment intensities parameters  $(\lambda^i, \xi^i)$  in (1), the income process  $(y_0, y_1)$  in (2), as well as the human capital dynamics parameters  $(\delta, \alpha)$  in (4). The other parameters such as the UI replacement rate  $(\eta)$  and the discount rate  $(\rho)$  are set at standard value. The productivity parameter  $(P^i)$  is calibrated relying on thorough search procedure, while the capital specificity  $(\phi)$  is set at one in our baseline setup and is varied in the sensitivity analysis below.

The estimation is implemented so as to match the theoretical moments calculated from the simulated histories of employment statuses and incomes  $(i_j, Y_j^i) = \{i_{j,t}, Y_{j,t}^i\}_{t=1}^T$  to their NLSY79 counterparts. The moments to be matched are the unconditional, conditional and joint (i.e. continuation) moments for employment and income. We minimize the optimally-weighted square distance between observed and predicted moments, where the estimation is undertaken subject to the three order-0 transversality and regularity conditions conditions (16) in Appendix C.

**Simulation** Our model simulation follows the Monte Carlo procedure outlined in Appendix F. For a given set of structural parameters, conditional on status  $i_t = e, u$ , current  $H_t$  and locked-in capital  $\bar{H}_t$ , the optimal investment  $I^i(H_t, \bar{H}_t)$  from Theorem 2 are selected, and the Poisson intensities  $\lambda^i(H_t)$  are determined. The agent’s status and capital are then updated to  $(i_{t+1}, H_{t+1})$ , with special provision – when applicable – for a share  $(1 - \phi)$  of employment-specific capital being lost upon new displacement events, and the Poisson intensities are updated as well to  $\lambda^i(H_{t+1})$ . The procedure is iterated upon over  $j = 1, 2, \dots, 5'000$  individuals and for  $T = 100$  periods, with the initial (burn-in) draws  $t \in [1, 50]$  discarded for moments calculations.

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<sup>15</sup>See McFadden (1989); Duffie and Singleton (1993); Newey (2001) for theoretical SME considerations and French (2005); French and Jones (2011); Boyd et al. (2013); Pelgrin and St-Amour (2016) for applications.

## 5.2 Results

**Moments matching and parameters** Table 6 reports the observed and theoretical moments. The unconditional, conditional and joint employment moments in panel (a) are very well reproduced, whereas those associated with income in panel (b) are less so. In particular, the employed and unemployed income levels are correctly fitted, but the effects of past employment histories on income tend to be understated, suggesting other income factors not accounted for by the model. Notwithstanding these caveats, the overall SME fit for the joint employment and income moments can be considered as adequate, which is remarkable considering the spartan assumptions of the model, especially with the baseline restrictions (9) imposed.

Table 7 presents the estimated SME (standard errors in parentheses) and calibrated (no std. err.) parameters. The former are all estimated precisely. Importantly, both the  $\lambda_1^i$  and  $\xi^i$  parameters in panel a are significantly different from zero at the 1% level, thereby rejecting the null of the exogenous risks model in Section 4.1 in favor of the endogenous displacement and re-employment model of Section 4.2. Similarly,  $y_1$  is significant in panel b, consistent with a valuation of human capital in the income function. Finally, the estimated law of motion (4) parameters are in the habitual range of estimates for Ben-Porath (1967) technology and indicative of diminishing returns in investment.<sup>16</sup>

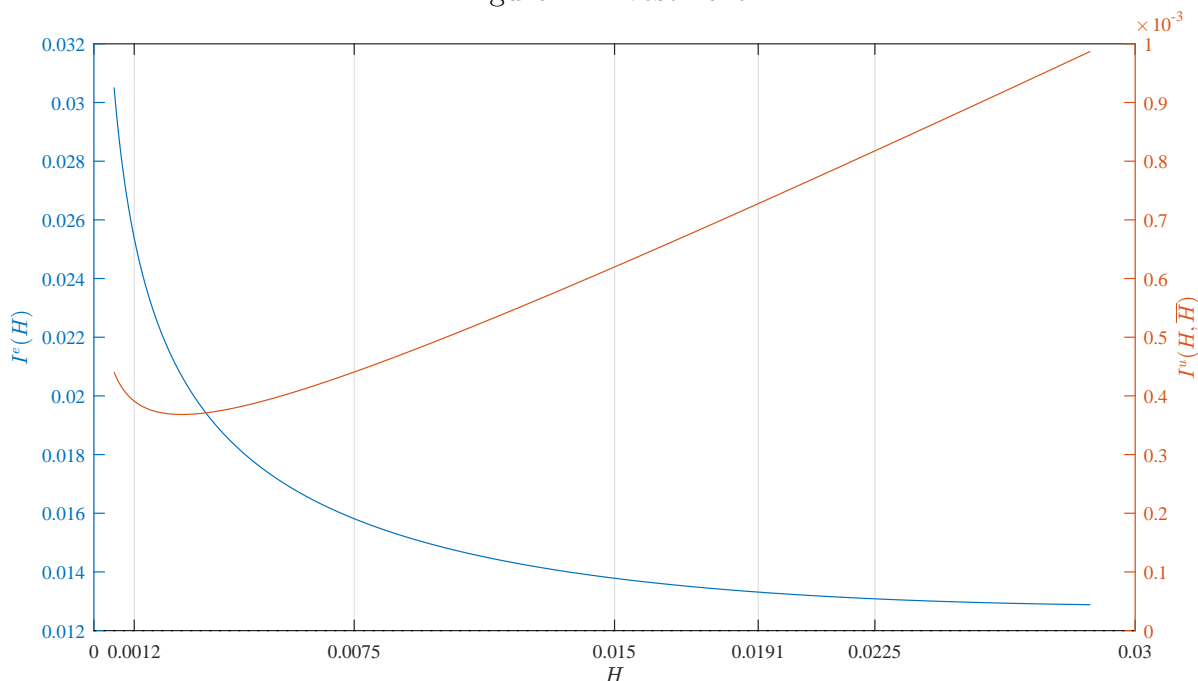
**Optimal investment** Figure 4 plots the SME-consistent estimates of the optimal investment in human capital for the employed (in blue, LHS scale) and unemployed (in red, RHS scale) agents, in function of  $H$  and for mid-level  $\bar{H}$  lock-in capital level. First, we find that investment for unemployed agents is lower for all  $H$  and  $\bar{H}$  compared to employed workers. Second, investment is falling in human capital for the employed, but is U-shaped for the unemployed due to conflicting income and employment risks effects. Indeed, on the one hand, increasing  $H$  reduces the likelihood of displacement, while increasing the re-employment probability, thereby reducing the incentives for investment.

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<sup>16</sup>Estimates for  $\alpha$  vary between 0.35 and 0.80, whereas  $\delta$  estimates range between 0.027 and 0.07 (see the references cited in Polachek et al., 2015, p. 1425).

Diminishing returns in adjusting the arrival intensities  $\lambda^i(H)$  entail that the marginal effect on employment risk is stronger at low  $H$ . On the other hand, an increase in  $H$  raises the employed agent's revenues  $Y^e(H)$  – and thus available resources for investing for the employed – without affecting UI income fixed at lock-in level  $Y^u(\bar{H})$ . Moreover, equation (3) shows that it also raises the income wedge  $\Delta Y(H, \bar{H})$ , i.e. the value at risk in case of unemployment, and potential income gain if re-employed. The income level and gain both concur to increase investment. Our calibration reveals that the employment risk effect dominates the income effect for the employed, as well as for the unemployed with low human capital. At high  $H$  however, diminishing returns entail that the income effect is stronger for the unemployed and investment increases in human capital.

Figure 4: Investment

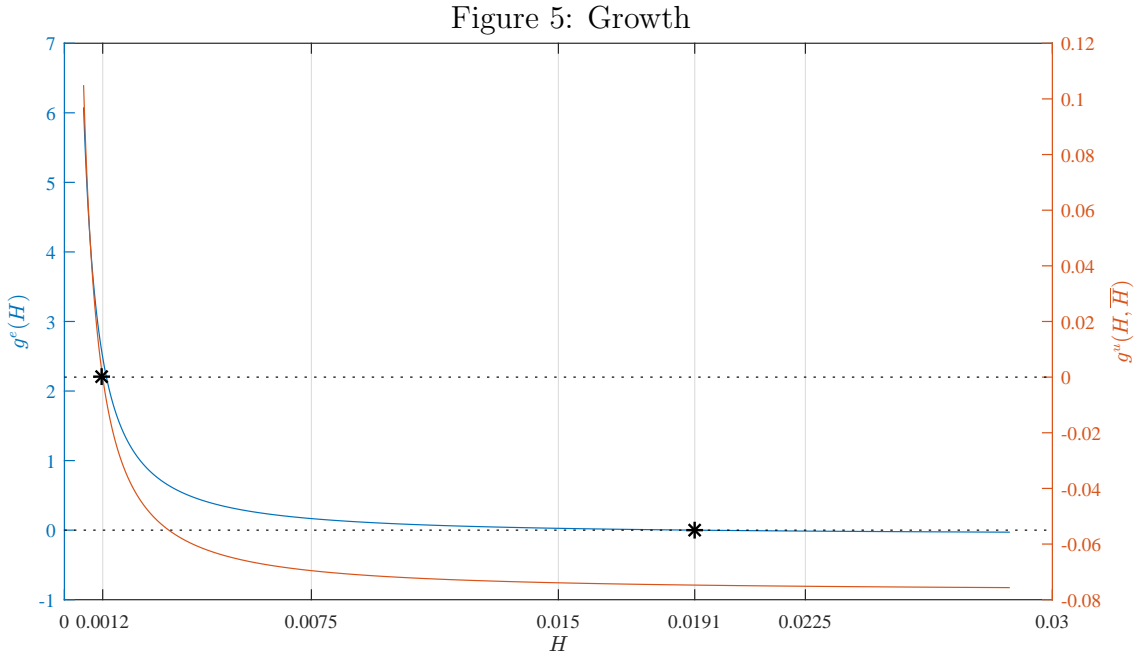


Notes: Optimal investment functions for the unemployed ( $I^u(H, \bar{H})$  in red, RHS scale) and for the employed ( $I^e(H)$  in blue, LHS scale).

Third, our calibration entails that  $C_b^u, D_b^u < 0$ , indicating that the investment and growth are both lower for unemployed agents with high lock-in capital, although the net effect is weak due to two opposing forces. On the one hand, a high lock-in capital raises UI revenues available for investing. On the other hand, the discussion of (3) revealed

that the attractiveness of investing in order to raise the likelihood of re-employment is reduced due to more generous UIB income for high  $\bar{H}$ . Our results indicate that the two effects more or less offset one another.

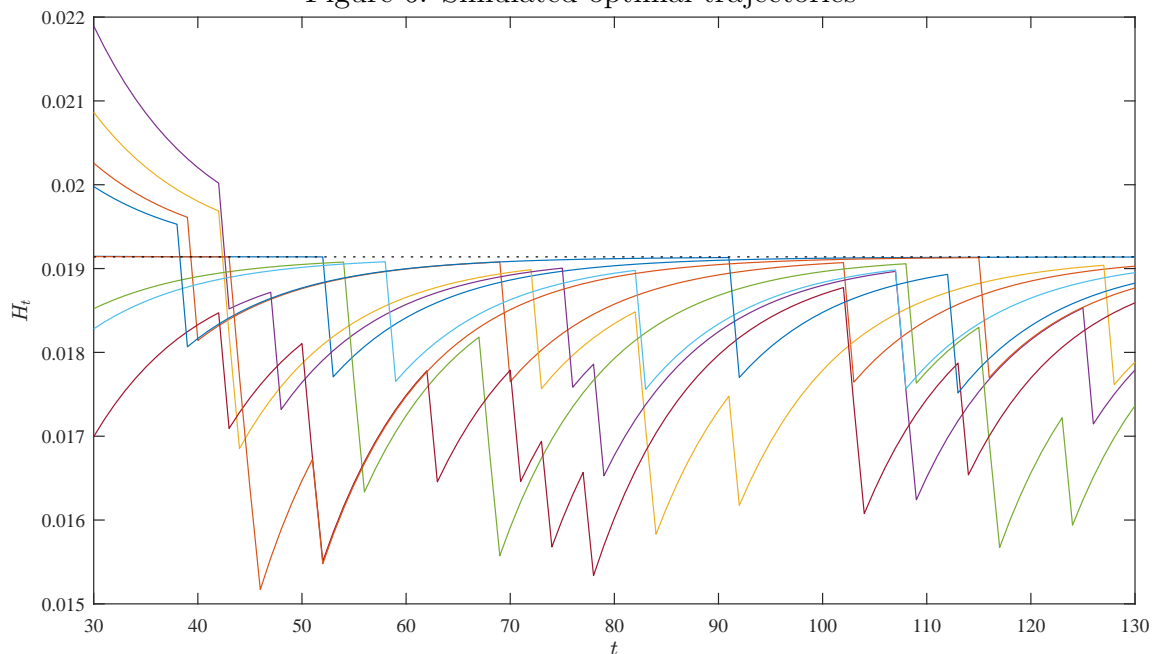
**Optimal growth** Figure 5 plots the SME-consistent estimates for optimal human capital dynamics for the employed (blue line, LHS scale) and the unemployed (red line, RHS scale), where the latter are evaluated at mid-level lock-in capital levels. These results show that two distinct steady-state levels (i) exist, (ii) are unique given status and  $\bar{H}$ , (iii) are dynamically stable since the growth functions cross the zero axis with negative slopes, and (iv) are lower for the unemployed, with  $H_{SS}^u(\bar{H}) = 0.0012 < 0.0191 = H_{SS}^e$ . Importantly, a displaced worker in the vicinity of  $H_{SS}^e$  will optimally choose  $g^u < 0$ , i.e. a depletion of his human capital until either the lower steady state  $H_{SS}^u$  obtains, or he is re-employed. A re-employed worker in the vicinity of  $H_{SS}^u$  will optimally choose  $g^e > 0$ , i.e. to replenish his human capital until either he reaches the higher steady state  $H_{SS}^e$ , or he is displaced again.



Notes: Optimal growth functions for the unemployed ( $g^u(H, \bar{H})$  in red, RHS scale) and for the employed ( $g^e(H)$  in blue, LHS scale).

**Simulated trajectories** These dynamics are illustrated in Figure 6 which plots a representative sample of the simulated optimal trajectories for human capital  $\{H_{j,t}\}$ , where each color corresponds to a different agent  $j$ . Consistent with Figure 5, dynamic paths converge rapidly towards the dynamically stable steady-state level associated with employment  $H_{SS}^e = 0.0191$  (dotted line). Each dip in  $H_{j,t}$  is caused by a job displacement; once re-employed, the paths converge again towards  $H_{SS}^e$ . A prolonged unemployment spell is associated with a constant fall in capital towards the unemployment steady state  $H_{SS}^u = 0.0012$ . Since the predicted employment probability  $\Pr(e_t) = 91.03\%$  is high, most of the dynamic paths cluster in the vicinity of the employed steady-state value  $H_{SS}^e$ .

Figure 6: Simulated optimal trajectories



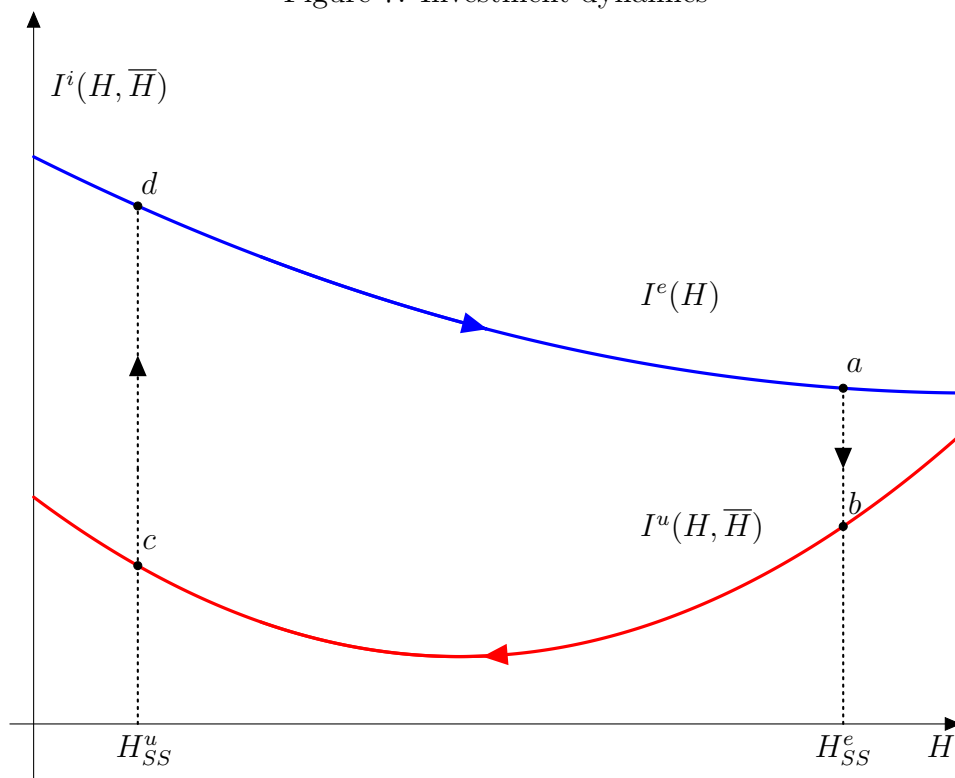
Notes: Sample of simulated  $\{H_{jt}\}$  optimal paths for Monte-Carlo procedure in Appendix F.

## 6 Self-inflicted unemployment scars and stigma

**Investment** The optimal investment dynamics consistent with Figure 4 are plotted in Figure 7. Consider a long-tenured agent with human capital  $H_{SS}^e$ . Upon displacement,

the agent reduces investment from  $a$  to  $b$ . Because that level is insufficient to cover depreciation, capital falls generating leftward movements along the red  $I^u(H, \bar{H})$  line. Since investment  $I^u(H, \bar{H})$  is an increasing of human capital in the vicinity of  $H_{SS}^e$ , the fall in  $H$  induces further cuts in investment, accelerating to decline in capital. As the agent approaches the lower steady-state  $H_{SS}^u$ , the investment function is decreasing in  $H$  and the fall in capital leads to increases in investment, generating rightward movements long the blue  $I^e(H)$  line. Upon re-employment, investment increases to  $I^e(H)$  from  $c$  to  $d$ , initiating the gradual recovery in capital towards  $d$  and steady-state  $H_{SS}^e$ .

Figure 7: Investment dynamics

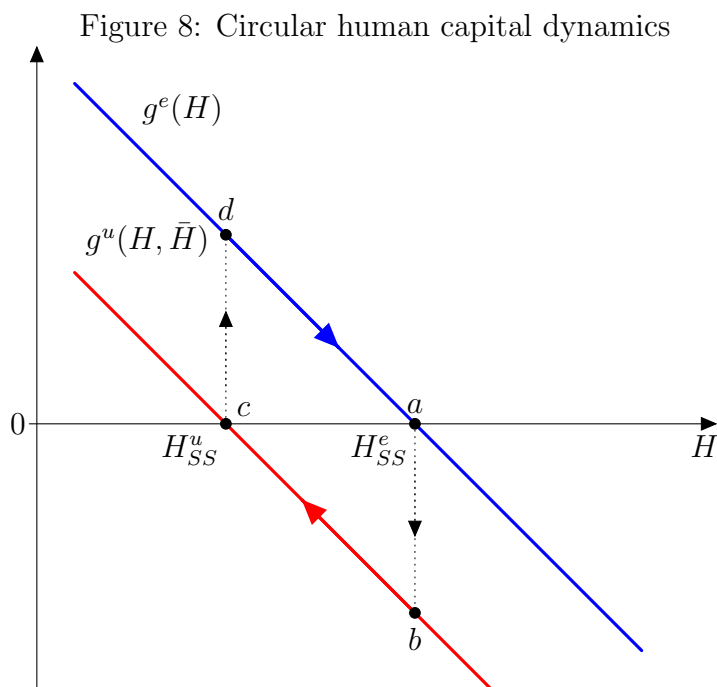


Notes:  $I^e(H)$ : Optimal human capital investment conditional on employment in (11a).  
 $I^u(H, \bar{H})$ : Optimal human capital investment conditional on unemployment in (14b),  
for capital  $H$  and UIB lock-in capital  $\bar{H}$ .

**Human capital** Figure 8 plots the optimal phase diagrams of human capital stemming from Figure 5. These paths are consistent with circular dynamics that are reminiscent of Carnot cycles in thermo-dynamics. First, our displaced long-tenured worker with steady-



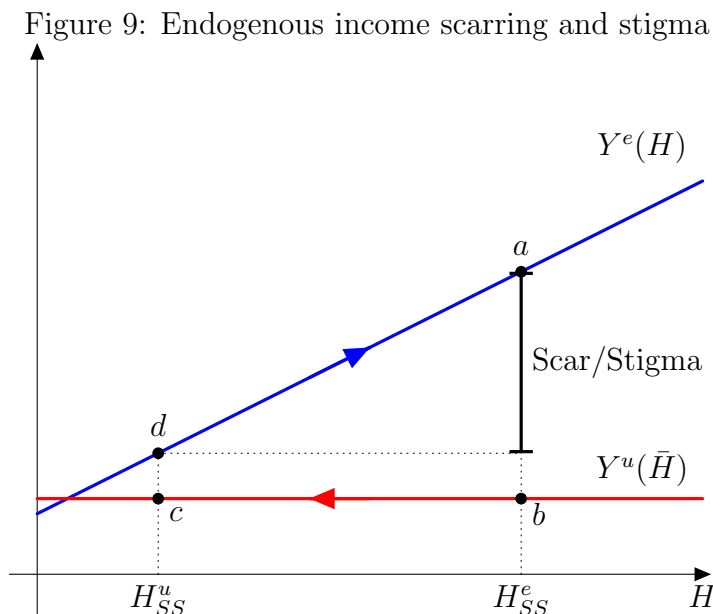
state capital  $H_{SS}^e$  moves from  $a$  to  $b$  on the optimal human capital growth path. From the previous analysis, human capital then optimally depletes for the entire duration of the unemployment spell and moves towards the new lower steady state in  $c$ . Once attained, the capital remains at steady-state  $H_{SS}^u$  for the duration of the unemployment event. Upon re-employment, the agent's capital moves to point  $d$  after which capital increases again back to the former steady-state  $H_{SS}^e$ .



Notes:  $g^e(H)$ : Optimal human capital growth conditional on employment in (15a).  
 $g^u(H, \bar{H})$ : Optimal human capital growth conditional on unemployment in (15b), for capital  $H$  and UIB lock-in capital  $\bar{H}$ .

**Income** These circular dynamics generate endogenous income scarring and stigma effects of unemployment, as evidenced in Figure 9. The displaced long-tenured worker suffers a drop in income from  $a$  to  $b$ . As human capital is optimally depleted towards  $c$ , the UIB revenues remain unaffected due to the lock-in feature. However, upon re-employment, the agent's labor income is now lower at  $d$ , with the longer the unemployment spell, the more important the drop in wages upon re-employment. However, re-employed wages are only temporarily depressed at  $d$  and pick back to their former

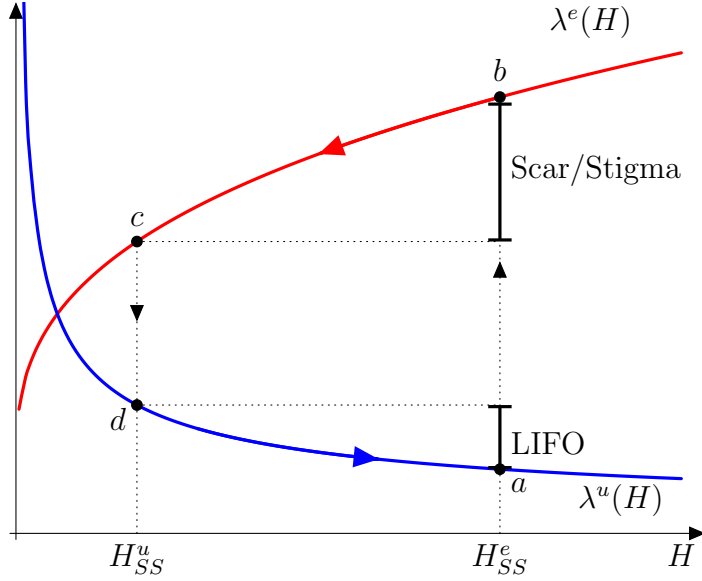
level as human capital increases towards  $H_{SS}^e$ . The model thus endogenously generates wage dynamics that are consistent with duration-dependent, but non-permanent income scarring and stigma effects of unemployment.



Notes:  $Y^e(H)$ : employment income.  $Y^u(\bar{H})$ : unemployment income, under dynamics described in Figure 8.

**Employment** Unlike the exogenous employment risks of Section 4.1, Figure 10 shows how the circular human capital dynamics also translate into employment scarring and stigma. Our long-tenured displaced worker moves from  $a$  to  $b$  on the re-employment intensity function  $\lambda^e(H)$ . As human capital optimally falls, so does the recall probability with intensity moving towards  $c$ . Duration dependence endogenously obtains as the longer the duration spell, the more important is the associated unemployment stigma, i.e. the fall in  $\lambda^e(H)$ . Upon re-employment, the agent moves to point  $d$  on the  $\lambda^u(H)$  intensity and is subject to a higher displacement probability due to the optimal fall in human capital. This last-in-first-out (LIFO) effect persists up to the period where the former steady state  $H_{SS}^e$  is attained in point  $a$ .

Figure 10: Endogenous employment scarring and stigma



Notes:  $\lambda^e(H)$ : re-employment intensity;  $\lambda^u(H)$ : displacement intensity, under dynamics described in Figure 8.

## 7 Understanding the mechanisms

Our results emphasize the key role of endogenous displacement and re-employment risks exposure in replicating observed income and employment scarring and stigma patterns. Indeed, the exogenous risks case ( $\lambda_1^i = 0$ ) in Section 4.1 yields constant, status-dependent growth rates for human capital. Income scarring is duration-dependent, but permanent rather than temporary, and employment scarring is abstracted from. Conversely, the endogenous risks case ( $\lambda_1^i \neq 0$ ) in Section 4.2 generates more complex dynamics whereby two distinct human capital steady states exist, are dynamically stable and with a lower one for the unemployed. Circular dynamics follow with capital optimally falling upon displacement, and being replenished upon re-employment. This mechanism ensures that the stylized facts of both income and employment scarring are all correctly replicated, consistent with our SME findings in Table 7 rejecting the null hypotheses of  $\lambda_1^i = 0$  and  $\xi^i = 0$ .

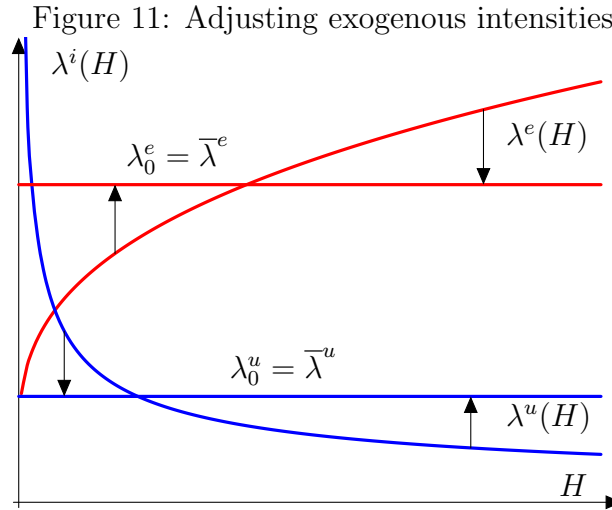
The predicted unemployment scars and stigma can be characterized as *self-inflicted*, to the extent that they stem exclusively from optimal human capital dynamics decided by agents. This key result, as well as the favorable empirical performance are far from trivial. Indeed, both the likelihood and duration of unemployment spells can be controlled by the agent and both affect the magnitude of the associated scarring and stigma costs borne by workers. A reasonable prior could have been that the incidence of these costs would have been minimized by the agent, yet our results show that this is not the case. Moreover, the observed patterns are reproduced relying only on simple and empirically motivated characterization whereby observable human capital is associated with higher wages, lower displacement and higher re-employment probabilities. Alternative explanations in the HK literature based on screening practices by employers, or parametric hypotheses, such as (i) more important depreciation rates, (ii) capital specificity, (iii) less efficient production technology of human capital, or (iv) learning-by-doing are therefore not essential to generate scarring and stigma. We now look at some of the model's key assumptions to gain further insights on the underlying mechanisms.

**Preferences** Risk neutrality could well be invoked to justify why remaining exposed to unemployment scars and stigma is optimal. Indeed, our linear preferences in (5) entail no utilitarian costs associated with exposure to employment shocks. Moreover, the effects of risk neutrality could well be compounded by our reliance on first-order approximate solutions in Theorem 2, and abstracting from more complex risk hedging strategies.

However, several reasons suggest that neutrality is not at stake. First, the approximation method outlined in (8) concerns the parameters  $\lambda_1^i$ , and not the shape of the  $V^i(H, \bar{H})$  functions. Indeed, despite linear preferences, the diminishing returns in intensities (1) and in the Cobb-Douglas technology (4) are sufficient to induce strong curvature of the indirect utility (13). Moreover, allowing for risk aversion and more flexible numerical solutions based on high-order Chebyshev polynomials by St-Amour (2015) yields qualitatively

similar results. Self-inflicted scarring and stigma are therefore not a by-product of insufficient utilitarian costs associated with employment risks exposure.

**Endogenous employment intensities** The health-dependent intensities (1) are a main innovation to the Human Capital literature and play a key role in our results. We can assess their marginal contributions to investment, human capital, unemployment, displacement and re-employment. This exercise is performed by sequentially removing the re-employment ( $\lambda_1^e = 0$ ) and the displacement ( $\lambda_1^u = 0$ ) endogeneities in (1). Since the intensities are mechanically lowered, we re-adjust the base intensity so as to maintain the mean theoretical displacement  $\bar{\lambda}^u$  and re-employment  $\bar{\lambda}^e$  rates. This adjustment is however not neutral and tends to benefit low human capital agents by providing them with higher re-employment and lower displacement rates; high human capital agents are disadvantaged for the opposite reasons (see Figure 11).



The first two columns of Table 8 reports how the variables of interest are affected by exogenous employment risks, relative to baseline levels. First, removing the capacity to accelerate re-employment in column 1 lowers the attractiveness of investing in human capital and results in a narrowing of the steady-state gaps, as well as a 78% drop in both investment and capital levels. By construction, the re-employment  $\Pr(e|u)$  is unaffected, while displacement  $\Pr(u|e)$  is increased by 2.74 bps due to the sharp drop in

human capital, resulting in a 3.3 bps increase in unemployment  $\Pr(u)$ . Second, exogenous displacement in column 2 also lowers the incentives to invest with  $I, H$  falling by 88%. By construction the displacement risk  $\Pr(u|e)$  is unaffected, but re-employment  $\Pr(e|u)$  falls by 1.68 bps, leading to a modest increase in unemployment rate. For both cases, the fall in investment under exogenous employment risks is caused by lower returns, as evidenced in Figure 11. We conclude that allowing adjustment in exposure to employment risks is a key driver to human capital investment.

**Policy** Unemployment benefits and base income affect both the incentives and the disposable resources for investing in human capital. In Table 8, column 3, we investigate the effect of less generous unemployment insurance by decreasing the UI replacement rate  $\eta$  from 0.50 to 0.33 in (2b). The outcome is a 21% increase in investment and capital, inducing lower displacement and improvements in re-employment and unemployment. In column 4, we next analyze changes in the base income  $y_0$  in (2a) by allowing an increase in the latter from 0.10 to 0.15. The increase in disposable income leads to 39% increases in investment and human capital leading to improvements in labor market outcomes.

The reason for these similar effects of less (more) generous UI (base income) policies on investment and capital can be deduced from (3) which shows that the income loss associated with unemployment  $\Delta Y(H, \bar{H})$  is a decreasing function of  $\eta$  and is increasing in base income  $y_0$ . Less generous UIB and/or higher base income thus both increase the income gap of unemployment and gains from re-employment, thereby raising the incentives for investing. Our results are thus consistent with strong moral hazard responses to UIB generosity, whereby both employed and unemployed agents invest less in their human capital and face higher displacement and lower re-employment probabilities in more generous regimes. These effects are similar in spirit to Davidson and Woodbury (1993); Belzil (1995); Ljungqvist and Sargent (1998); Chetty (2008); Daly et al. (2012); Spinnewijn (2013) who argue that more generous UI benefits (e.g. in Europe) distort

incentives away from job search and favor remaining long-term unemployed where skills are mechanically depreciated.

**Status-dependent technology and specificity** Our baseline results obtained under restrictions (9) have thus far abstracted from additional disadvantages of being unemployed, such as lower returns to investment and loss of firm-specific human capital. Recalling that Theorems 1 and 2 are derived for the general case allows us to explicitly calculate the effects of such costs.

First, in column 5 we augment the depreciation rate of human capital when unemployed to  $\delta^u = 0.2108 > \delta^e = 0.0843$ . Second, in column 6, we introduce depletion of firm-specific human capital by imposing a  $1 - \phi = 75\%$  loss on the capital stock upon displacement. Both comparative statics convey the same message. A faster capital depreciation rate once unemployed or an immediate cut in capital upon the displacement event both reduce the incentives for investing, lowering both  $I$  and  $H$ , inducing a deterioration in labor market outcomes, with increased displacement and reduced re-employment leading to higher unemployment. We conclude that appending additional disadvantages on employment amplifies the self-inflicted scarring and stigma.

## 8 Conclusion

In addition to the contemporaneous drop in income due to incomplete and temporary UI replacement, unemployment imposes significant long-term scarring and stigma costs on agents; displacement (re-employment) probabilities are higher (lower), whereas wages upon re-employment are lower following unemployment spells. Moreover, the duration of unemployment spells significantly compounds the magnitude of these costs.

Relative human capital loss during non-employment spells has long been suspected as potential rationale for these costs. Accelerated depreciation during unemployment associated with screening by employers for imperfectly observed human capital levels have been invoked as the main drivers for scarring and stigma. This explanation has notably

been advocated in DMP models with human capital appended, where a learning-by-doing perspective minimizes accumulation outside of employment. Traditional HK models allow for explicit investment by agents, but fail to account for effects on employment risks exposure.

This paper has taken the alternative approach or endogenizing human capital decisions by employed and unemployed workers alike and by internalizing their exposure to displacement and re-employment risks. Contrary to others, our model can integrate or abstract from status-dependent human capital accumulation technology and from firm- or sector-specific capital depletion upon displacement. For our baseline scenario, these additional tolls of unemployment are bypassed. It follows that any acquisition and depletion of human capital and resulting unemployment scarring and stigma are entirely endogenous, rather than mechanic. The solution of this model is complicated by the fact that the two value functions (employed and unemployed) are intertwined with one another and because the model with human capital-dependent arrival rates can be re-written as one with endogenous discounting across the two statuses. We resorted to expansion methods to circumvent this problem and obtain, and structurally estimate analytical approximations of the optimal investing strategies

We first investigated whether and confirmed that the general framework with endogenous intensities is capable of generating unemployment scarring and stigma at the optima. The two key theoretical elements behind this result are that investment is positive, but lower when unemployed than when employed and that the model generates two status-dependent and dynamically stable steady-states for human capital, with the one for the unemployed always being lower. Changes in employment statuses thus trigger circular dynamics characterized by endogenous depletion of acquired human capital when unemployed and accumulation upon re-employment. Since re-employment (displacement), as well as wages intensities are increasing (decreasing) functions of human capital, scarification and stigmatisation are internally generated. Because they depend



entirely on optimal decisions made by workers instead of by employers, scarring and stigma are therefore self-inflicted.

To the extent that scarring and stigma both impose substantial costs to workers, that they depend on accumulated human capital and that the latter can be adjusted by agents, the optimal strategy could have been to minimize exposure to these risks by investing more to prevent displacement if employed and in favor of re-employment if unemployed. However, our results show that this is not the case. The cushioning against downward income risks offered by UI programs, as well as imperfect replacement rates entails that moral hazard and low income prevent the unemployed from investing more to avoid long-term costs. Incorporating incremental tolls of displacement, such as added depreciation and/or depletion of firm-specific capital for the unemployed is complementary, but not essential for self-inflicted costs.

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## A Data

We rely on the National Longitudinal Survey of Youth (NLSY79), a panel of 9,964 respondents aged 15-22 in 1979 (Round 1), followed up to year 2014 (Round 26), annual from 1979-1994, biennial afterwards. The principal variables are constructed as follows:

**s** Employment status (binary), from `ESR_COL_` employment status recode (collapsed) equal to 1 if employed (`ESR_COL_==1`), 0 if unemployed (`ESR_COL_==2`). One- and two-period lagged statuses (`s_lag_1`, `s_lag_2`), as well as lagged cumulated statuses (`exper_lag_1`) are used in the panel regressions.

**y** Income, scaled by  $1.0e-05$ , in real terms, from:

- `Q13_5_` total income wages and salary, years 1979-1981,
- `Q13_5_TRUNC_REVISED_` (truncated, revised), years 1982-2000,
- `Q13_5_TRUNC_` amount of respondent's salary wages and tips, years 2002-2014.

**male** Gender (binary), from `SAMPLE_SEX_1979==1`

**white** Race (binary), from `SAMPLE_RACE_78SCRN==3`

**citizen** US citizen (binary), from `CITIZEN_1990==1`, is respondent of US citizenship.

**educ** Education level, from `HGC_`, highest grade completed by 05.01 of survey year. Less than high school ( $HGC < 12$ ); High school ( $HGC = 12$ ); Some college/associate degree ( $12 < HGC < 16$ ); College ( $16 \leq HGC$ ).

**weight** Sampling weight, from `SAMPWEIGHT_`

**training** Training (binary) from `Q8_18_`, any vocational/technical training for more than one month.

**urban** Urban (binary), from `URBAN_RURAL_==1` current residence urban/rural.

**age** Age, from `AGEATINT_`, age of respondent at interview date.

## B Tables

Table 1: Summary statistics

Variable	Year-pers. obs.	Mean	Std. Dev.	Min	Max
a. Socio-demographics					
Age	250 709	32.62	10.74	14	58
Male	329 836	0.5086	0.4999	0	1
White	329 836	0.7941	0.4044	0	1
US citizen	329 836	0.9119	0.2835	0	1
Urban	234 958	0.7588	0.4278	0	1
b. Human capital measures					
HGC	249 936	12.95	2.4596	0	20
Training	181 333	0.1367	0.3435	0	1
c. Employment and income					
Employment	149 242	0.9103	0.2858	0	1
Income	184 317	16 970	18 596	0	156 449

Notes: See Appendix A for NLSY79 data details. Balanced panel of 9 964 individuals over period 1979-2014 (biennial after 1994). Sample moments are weighted with frequency weights.

Table 2: Current employment probability by previous statuses and by human capital

	$i_{t-1}$ status:		All
	Unemployed	Employed	
All	0.6873	0.9513	0.9298
a. By $i_{t-2}$ status			
- Unemployed	0.5758	0.8669	0.7825
- Employed	0.7716	0.9631	0.9544
b. By education			
- Less than high school	0.5843	0.8936	0.8339
- High school	0.6925	0.9464	0.9251
- Some college	0.7836	0.9642	0.9539
- College	0.8907	0.9796	0.9770
c. By training			
- No	0.6672	0.9482	0.9249
- Yes	0.7277	0.9675	0.9515

Notes: Current employment probability by previous employment status  $i_{t-1} \in \{u, e\}$ . Panel a: by  $i_{t-2} \in \{u, e\}$  status. Panel b: by education level from highest grade completed (*HGC*). Panel c: By professional/vocational and on-the-job training.

Table 3: Current real annual income by previous statuses and by human capital

	$i_{t-1}$ status:		All
	Unemployed	Employed	
All	5 724	16 220	15 519
a. By $i_{t-2}$ status			
- Unemployed	4 372	9 037	7 924
- Employed	7 086	16 969	16 560
b. By education			
- Less than high school	3 976	10 329	9 416
- High school	5 697	13 883	13 279
- Some college	5 808	15 118	14 614
- College	10 670	24 997	24 622
c. By training			
- No	6 590	14 690	14 114
- Yes	7 565	17 733	17 248

Notes: Average current real annual income by previous employment status  $i_{t-1} \in \{u, e\}$ . Panel a: by  $i_{t-2} \in \{u, e\}$  status. Panel b: by education level from highest grade completed (*HGC*). Panel c: By professional/vocational and on-the-job training.

Table 4: Current employment: Marginal effects

	(1) All $\Pr(e_t)$	(2) Re-employment $\Pr(e_t u_{t-1})$	(3) Cont. employment $\Pr(e_t e_{t-1})$
a. Past employment statuses			
s_lag_1	0.0928*** (34.79)		
s_lag_2	0.0420*** (15.38)	0.0582*** (4.25)	0.0362*** (13.04)
b. Human capital			
exper_lag_1	0.0103*** (19.74)	0.0310*** (8.49)	0.00824*** (17.13)
educ_	0.00890*** (17.72)	0.0292*** (8.97)	0.00698*** (15.11)
training_	0.0173*** (5.22)	0.0323 (1.53)	0.0156*** (5.10)
Observations	67 629	5 930	61 699

Notes: Marginal effects calculated from panel Probit with year fixed effects and population-averaged effects. Additional controls for age, age squared, race, gender, citizen and urban included. Variables s\_lag-j are  $t - j$  employment statuses, while exper\_lag\_1 are cumulated lagged statuses up to time  $t - 1$ .  $t$ -statistics in parentheses.

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ .

Table 5: Current income

	(1) Employed $Y(e_t)$	(2) Re-employed $Y(e_t u_{t-1})$	(3) Cont. employed $Y(e_t e_{t-1})$
a. Past employment statuses			
s_lag_1	0.0323*** (27.76)		
s_lag_2	0.00814*** (8.06)	0.00844*** (3.77)	0.00985*** (8.80)
b. Human capital			
exper_lag_1	0.00903*** (35.03)	0.00429*** (7.54)	0.00881*** (32.47)
educ_	0.0126*** (47.17)	0.00427*** (8.89)	0.0129*** (46.63)
training_	0.00472*** (6.22)	0.00414 (1.37)	0.00482*** (6.19)
Observations	59 086	3 285	55 801

Notes: Estimates from panel GLS with year fixed-effects and population-averaged effects. Additional controls for age, age squared, race, gender, citizen and urban included.  $t$ -statistics in parentheses. Variables s\_lag\_1 are  $t - j$  employment statuses, while exper\_lag\_1 are cumulated lagged statuses up to time  $t - 1$ . \*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ .



Table 6: Moments matching

(a) Employment			(b) Income		
	Data	Model		Data	Model
1. Uncond. and transition			1. All income and condi.		
$\Pr(e_t)$	0.9103	0.9209	$E(Y_t)$	0.1593	0.1068
$\Pr(e_t u_{t-1}, u_{t-2})$	0.5758	0.6693	$E(Y_t u_{t-1}, u_{t-2})$	0.0437	0.0905
$\Pr(e_t e_{t-1}, e_{t-2})$	0.9631	0.9402	$E(Y_t e_{t-1}, e_{t-2})$	0.1697	0.1081
2. Empl. continuation			2. Unempl. income and cond.		
$\Pr(e_t, e_{t-1})$	0.8657	0.8654	$E(Y_t^u)$	0.0812	0.0556
$\Pr(e_t, e_{t-1}, e_{t-2})$	0.8268	0.8182	$E(Y_t^u u_{t-1}, u_{t-2})$	0.0321	0.0557
$\Pr(e_t, e_{t-1}, e_{t-2}, e_{t-3})$	0.7924	0.7711	$E(Y_t^u e_{t-1}, e_{t-2})$	0.1011	0.0557
3. Unempl. continuation			3. Empl. income and cond.		
$\Pr(u_t, u_{t-1})$	0.0542	0.0238	$E(Y_t^e)$	0.1624	0.1112
$\Pr(u_t, u_{t-1}, u_{t-2})$	0.0430	0.0083	$E(Y_t^e u_{t-1}, u_{t-2})$	0.0527	0.1078
$\Pr(u_t, u_{t-1}, u_{t-2}, u_{t-3})$	0.0379	0.0024	$E(Y_t^e e_{t-1}, e_{t-2})$	0.1704	0.1114

Notes: Moments used for SME estimation. Simulated moments relying on simulated human capital trajectories for  $t = 50, \dots, 100$  periods, with  $n = 5000$  agents.

Table 7: Estimated and calibrated parameters

(a) Intensities (1)							
$\lambda_0^e$	$\lambda_1^e$	$\xi^e$	$\lambda_0^u$	$\lambda_1^u$	$\xi^u$		
0.1190	1.1835	-0.0227	0.0017	0.0203	0.2693		
(0.0089)	(0.3538)	(0.0092)	(0.0003)	(0.0026)	(0.0033)		
(b) Income (2), Dynamics (4) and HJB (7)							
$y_0$	$y_1$	$\eta$	$\delta^e, \delta^u$	$\alpha$	$P^e, P^u$	$\rho$	$\phi$
0.0908	1.1228	0.5000	0.0843	0.8465	0.1000	0.0500	1.0000
(0.0036)	(0.2158)	—	(0.0010)	(0.1665)	—	—	—

Notes: Structural Simulated Moments Estimates (SME) of model parameters (standard errors), and calibrated parameters (no std.err.). Optimal weighting matrix used. Transversality conditions (16) imposed for estimation.

Table 8: Hedging motives and comparative statics

Variable	Base	Risks		Policy		Unempl. costs	
		(1)	(2)	(3)	(4)	(5)	(6)
(a) Human capital							
$I$	0.0124	-77.70	-88.31	20.83	39.15	-4.26	-2.71
$H$	0.0179	-77.64	-87.71	21.01	39.11	-14.53	-36.45
(b) Labor market risks							
$\Pr(u)$	0.0789	3.31	0.23	-0.42	-0.62	0.25	1.02
$\Pr(e u)$	0.6976	-0.68	-1.68	0.33	0.45	-0.12	-1.37
$\Pr(u e)$	0.0597	2.74	0.04	-0.31	-0.47	0.19	0.72

Notes: (a) Percentage and (b) basis points changes from base scenario. (1) Exogenous re-employment,  $(\lambda_0^e, \lambda_1^e) = (1.1800, 0)$  instead of  $(0.1190, 1.1835)$ . (2) Exogenous displacement,  $(\lambda_0^u, \lambda_1^u) = (0.0620, 0)$  instead of  $(0.0017, 0.0203)$ . (3) UIB low,  $\eta = 0.33$  instead of 0.50. (4) Base income high,  $y_0 = 0.15$  instead of 0.10. (5) High unemployment depreciation,  $\delta^u = 0.2108$  instead of 0.0843. (6) General human capital share  $\phi = 0.25$  instead of 1.0.

## C Order-0 transversality and regularity conditions

The required transversality and regularity conditions for the order-0 solutions are:

$$0 < \rho + \lambda_0^e + \delta^u - \left( \alpha P^{u\frac{1}{\alpha}} A_h^u \right)^{\frac{\alpha}{1-\alpha}}, \quad (16a)$$

$$0 < \rho + \lambda_0^u + \delta^e - \left( \alpha P^{e\frac{1}{\alpha}} A_h^e \right)^{\frac{\alpha}{1-\alpha}}, \quad (16b)$$

$$\phi \lambda_0^e \lambda_0^u < \left( \rho + \lambda_0^e + \delta^u - \left( \alpha P^{u\frac{1}{\alpha}} A_h^u \right)^{\frac{\alpha}{1-\alpha}} \right) \left( \rho + \lambda_0^u + \delta^e - \left( \alpha P^{e\frac{1}{\alpha}} A_h^e \right)^{\frac{\alpha}{1-\alpha}} \right), \quad (16c)$$

## D Order-0 parameters

**Proof.** At the optimum, the order-0 HJB (7) corresponding to  $\lambda_1^e, \lambda_1^u = 0$  can be written as:

$$0 = -\rho V^e(H) - \lambda_0^u [V^e(H) - V^u(\phi H, H)] + Y^e(H) \quad (17a)$$

$$- \delta^e H V_H^e(H) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} H [P^e V_H^e(H)]^{\frac{1}{1-\alpha}},$$

$$0 = -\rho V^u(H, \bar{H}) - \lambda_0^e [V^u(H, \bar{H}) - V^e(H)] + Y^u(H) \quad (17b)$$

$$- \delta^u H V_H^u(H, \bar{H}) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} H [P^u V_H^u(H, \bar{H})]^{\frac{1}{1-\alpha}}.$$

Consider candidate solution:

$$V_0^e(H) = A_0^e + A_h^e H \quad (18a)$$

$$V_0^u(H, \bar{H}) = A_0^u + A_h^u H + A_b^u \bar{H} \quad (18b)$$

Substituting the candidate solutions (18) in (17) yields:

$$0 = \tilde{A}_0^e + \tilde{A}_h^e H \quad (19a)$$

$$0 = \tilde{A}_0^u + \tilde{A}_h^u H + \tilde{A}_b^u \bar{H} \quad (19b)$$

Assuming the transversality and regularity conditions (16) hold, we can individually set the implicit parameters  $\tilde{A}^e, \tilde{A}^u$  to zero in (19) and obtain that the parameters in Theorem 1 are:

$$A_0^u = \frac{y_0 (\lambda_0^e + \eta (\rho + \lambda_0^u))}{\rho (\lambda_0^e + \rho + \lambda_0^u)}; \quad A_b^u = \frac{\eta y_1}{\lambda_0^e + \rho}; \quad A_0^e = \frac{y_0 (\lambda_0^e + \rho + \eta \lambda_0^u)}{\rho (\lambda_0^e + \rho + \lambda_0^u)}$$

and where  $A_h^e, A_h^u$  jointly solve:

$$0 = A_h^e \lambda_0^e - A_h^u (\delta^u + \lambda_0^e + \rho) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} (P^u A_h^u)^{\frac{1}{1-\alpha}} \quad (20a)$$

$$0 = \lambda_0^u \left( \phi A_h^u + \frac{\eta y_1}{\lambda_0^e + \rho} \right) + (1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} (P^e A_h^e)^{\frac{1}{1-\alpha}} - A_h^e (\delta^e + \rho + \lambda_0^u) + y_1 \quad (20b)$$

The optimal investment and growth functions follow directly by substituting  $(A_h^e, A_h^u)$  in (11) and (12). The following result shows that a large income sensitivity  $y_1$  is sufficient to generate a lower Tobin's- $q$  when unemployed.

**Corollary 1** *Define:*

$$b_0^u = \frac{(\lambda_0^e + \rho + \lambda_0^u \eta) y_1}{(\lambda_0^e + \rho) \phi \lambda_0^u}, \quad b_1^u = \frac{\delta^e + \lambda_0^u + \rho}{\phi \lambda_0^u}, \quad b_2^u = \frac{(1 - \alpha) \alpha^{\frac{\alpha}{1-\alpha}} P^e \frac{1}{1-\alpha}}{\phi \lambda_0^u}.$$

*If the following condition holds:*

$$\alpha (1 - \alpha)^{\frac{1-\alpha}{\alpha}} (b_1^u - 1)^{\frac{1}{\alpha}} b_2^u \frac{\alpha-1}{\alpha} < b_0^u \quad (21)$$

*then the solutions  $A_h^e, A_h^u$  to (20) satisfy*

$$A_h^u < A_h^e.$$

The proof is obtained by rewriting (20) as:

$$\begin{aligned} A_h^e &= b_1^e A_h^u - b_2^e A_h^u \frac{1}{1-\alpha} \\ A_h^u &= b_1^u A_h^e - b_2^u A_h^e \frac{1}{1-\alpha} - b_0^u \end{aligned}$$

The two functions  $A_h^e = A_h^e(A_h^u)$  and  $A_h^u = A_h^u(A_h^e)$  are increasing at the solution, by transversality conditions (16) and are concave. They intersect at the solution to (20) in the  $(A_h^e, A_h^u)$  space. A sufficient condition for the intersection to lie below the 45 degree line is for the function  $A_h^u(A_h^e) < A_h^e$  everywhere, or:

$$\max_{A_h^e} (b_1^u - 1) A_h^e - b_2^u A_h^e \frac{1}{1-\alpha} - b_0^u < 0.$$

Taking derivatives, setting to zero and substituting back yields sufficient condition (21).

Observe from the closed-form solution to  $b_0^u$  that the latter can also be rewritten as

$$\alpha(1-\alpha)^{\frac{1-\alpha}{\alpha}} \left( \frac{\delta^e + (1-\phi)\lambda_0^u + \rho}{\phi\lambda_0^u} \right)^{\frac{1}{\alpha}} \left[ \frac{(1-\alpha)\alpha^{\frac{\alpha}{1-\alpha}} P^e \frac{1}{1-\alpha}}{\phi\lambda_0^u} \right]^{\frac{\alpha-1}{\alpha}} \frac{(\lambda_0^e + \rho)\phi\lambda_0^u}{(\lambda_0^e + \rho + \lambda_0^u\eta)} < y_1$$

i.e. a large capital gradient of income  $y_1$  is a sufficient condition for  $A_h^u < A_h^e$  and therefore lower capital growth when unemployed than employed  $g_0^u < g_0^e$ . ■

## E Order-1 parameters

**Proof.** Without loss of generality, rewrite the endogenous component in intensities (1) as  $\lambda_1^i = \epsilon \bar{\lambda}_1^i$ ,  $i = e, u$  for some constants  $\bar{\lambda}_1^i$  and perturbation  $\epsilon$ . The order-1 solution proceed as a first-order Taylor expansion around the order-0 solution corresponding to  $\epsilon = 0$ . First, the corresponding order-1 HJB can be written as:

$$\begin{aligned} 0 = \sup_I & -\rho V^e(H) - \left( \lambda_0^u + \epsilon \bar{\lambda}_1^u H^{-\epsilon^u} \right) [V^e(H) - V^u(\phi H, H)] + Y^e(H) - I \\ & + V_H^e(H) [-\delta^e H + P^e I^\alpha H^{1-\alpha}], \end{aligned} \tag{22a}$$

and

$$0 = \sup_I -\rho V^u(H, \bar{H}) - \left( \lambda_0^e + \epsilon \bar{\lambda}_1^e H^{-\xi^e} \right) [V^u(H, \bar{H}) - V^e(H)] + Y^u(\bar{H}) - I + V_H^u(H, \bar{H}) [-\delta^u H + P^u I^\alpha H^{1-\alpha}]. \quad (22b)$$

Second, consider candidate solutions given by:

$$V^e(H) = V_0^e(H) + \epsilon \left( B^e H + B_u^e \bar{\lambda}_1^u H^{-\xi^u} + B_{1u}^e \bar{\lambda}_1^u H^{1-\xi^u} + B_e^e \bar{\lambda}_1^e H^{-\xi^e} + B_{1e}^e \bar{\lambda}_1^e H^{1-\xi^e} \right), \quad (23a)$$

and

$$V^u(H, \bar{H}) = V_0^u(H, \bar{H}) + \epsilon \left( B^u H + B_u^u \bar{\lambda}_1^u H^{-\xi^u} + B_{1u}^u \bar{\lambda}_1^u H^{1-\xi^u} + B_e^u \bar{\lambda}_1^e H^{-\xi^e} + B_{1e}^u \bar{\lambda}_1^e H^{1-\xi^e} + B_b^u \bar{H} \bar{\lambda}_1^e H^{-\xi^e} \right). \quad (23b)$$

Third, we solve for  $I^e, I^u$  using guess (23) in HJB (22) and express optimal investment as a first-order expansion around  $\epsilon = 0$ . Fourth, we substitute this first-order solution back in the HJB, again do a first-order expansion around  $\epsilon = 0$  and individually solve the implicit parameters  $B$  as follows:

where the  $(A^i, g_0^i)$  parameters are given in Appendix D and Theorem 1. Substituting back for  $\lambda_1^i = \epsilon \bar{\lambda}_1^i$  yields the optimal solution in Theorem 2.

**Investment and growth** Given the parameters  $(B^e, B^u)$ , the parameters  $(C^e, C^u)$  for the investment functions are obtained as:

$$C^e = \begin{pmatrix} C_u^e \\ C_{1u}^e \\ C_e^e \\ C_{1e}^e \end{pmatrix} = \kappa^e \begin{pmatrix} -\xi^u B_u^e \\ (1 - \xi^u) B_{1u}^e \\ -\xi^e B_e^e \\ (1 - \xi^e) B_{1e}^e \end{pmatrix}, \quad C^u = \begin{pmatrix} C_u^u \\ C_{1u}^u \\ C_e^u \\ C_{1e}^u \\ C_b^u \end{pmatrix} = \kappa^u \begin{pmatrix} -\xi^u B_u^u \\ (1 - \xi^u) B_{1u}^u \\ -\xi^e B_e^u \\ (1 - \xi^e) B_{1e}^u \\ -\xi^e B_b^e \end{pmatrix}$$

$B^e$	0
$B_u^e$	$\frac{(\eta-1)y_0\phi^{\xi^u}(\lambda_0^e+g_0^u\xi^u+\rho)}{(\lambda_0^e+\rho+\lambda_0^u)(\phi^{\xi^u}(g_0^e\xi^u+\rho+\lambda_0^u)(\lambda_0^e+g_0^u\xi^u+\rho)-\lambda_0^e\lambda_0^u)}$
$B_{1u}^e$	$-\frac{\phi^{\xi^u}(\lambda_0^e+g_0^u(\xi^u-1)+\rho)((\lambda_0^e+\rho)(A_h^e-\phi A_h^u)-\eta y_1)}{(\lambda_0^e+\rho)(\phi^{\xi^u}(g_0^e(\xi^u-1)+\rho+\lambda_0^u)(\lambda_0^e+g_0^u(\xi^u-1)+\rho)-\phi\lambda_0^e\lambda_0^u)}$
$B_e^e$	$-\frac{(\eta-1)y_0\lambda_0^u}{(\lambda_0^e+\rho+\lambda_0^u)(\phi^{\xi^e}(\xi^e g_0^e+\rho+\lambda_0^u)(\xi^e g_0^u+\lambda_0^e+\rho)-\lambda_0^e\lambda_0^u)}$
$B_{1e}^e$	$\frac{\lambda_0^u(\phi A_h^e(\lambda_0^e+\rho)(\xi^e g_0^u+\lambda_0^e+\rho)-\phi A_h^u(\lambda_0^e+\rho)(\xi^e g_0^u+\lambda_0^e+\rho)-\eta y_1((\xi^e-1)g_0^u+\lambda_0^e+\rho))}{(\lambda_0^e+\rho)(\xi^e g_0^u+\lambda_0^e+\rho)(\phi^{\xi^e}((\xi^e-1)g_0^e+\rho+\lambda_0^u)((\xi^e-1)g_0^u+\lambda_0^e+\rho)-\phi\lambda_0^e\lambda_0^u)}$
$B^u$	0,
$B_u^u$	$\frac{(\eta-1)y_0\lambda_0^e\phi^{\xi^u}}{(\lambda_0^e+\rho+\lambda_0^u)(\phi^{\xi^u}(g_0^e\xi^u+\rho+\lambda_0^u)(\lambda_0^e+g_0^u\xi^u+\rho)-\lambda_0^e\lambda_0^u)}$
$B_{1u}^u$	$-\frac{\lambda_0^e\phi^{\xi^u}((\lambda_0^e+\rho)(A_h^e-\phi A_h^u)-\eta y_1)}{(\lambda_0^e+\rho)(\phi^{\xi^u}(g_0^e(\xi^u-1)+\rho+\lambda_0^u)(\lambda_0^e+g_0^u(\xi^u-1)+\rho)-\phi\lambda_0^e\lambda_0^u)}$
$B_b^u$	$-\frac{\eta y_1}{(\lambda_0^e+\rho)(\xi^e g_0^u+\lambda_0^e+\rho)}$
$B_e^u$	$-\frac{(\eta-1)y_0\phi^{\xi^e}(\xi^e g_0^e+\rho+\lambda_0^u)}{(\lambda_0^e+\rho+\lambda_0^u)(\phi^{\xi^e}(\xi^e g_0^e+\rho+\lambda_0^u)(\xi^e g_0^u+\lambda_0^e+\rho)-\lambda_0^e\lambda_0^u)}$
$B_{1e}^u$	$\frac{\phi^{\xi^e}((A_h^e-A_h^u)(\lambda_0^e+\rho)((\xi^e-1)g_0^e+\rho+\lambda_0^u)(\xi^e g_0^u+\lambda_0^e+\rho)-\eta y_1\lambda_0^e\lambda_0^u\phi^{-\xi^e})}{(\lambda_0^e+\rho)(\xi^e g_0^u+\lambda_0^e+\rho)(\phi^{\xi^e}((\xi^e-1)g_0^e+\rho+\lambda_0^u)((\xi^e-1)g_0^u+\lambda_0^e+\rho)-\phi\lambda_0^e\lambda_0^u)}$

where we have set:

$$\kappa^i \equiv \frac{[P^i \alpha (A_h^i)^\alpha]^{\frac{1}{1-\alpha}}}{1-\alpha}, \quad i = e, u$$

Given the parameters  $(C^e, C^u)$ , the parameters  $(D^e, D^u)$  for the growth functions are obtained as:

$$D^i = \frac{C^i}{A_h^i}, \quad i = e, u.$$

■

## F Simulation

We begin initializing the employment status and human capital for a population of agents  $j = 1, 2, \dots, n$ :

- The employment status is drawn from the unconditional population rates:  $i_{j,0} \sim \{e, u\}$ .
- Both the initial capital  $H_{j,0}$  and the initial lock-in capital  $\bar{H}_{j,0}$  are independently drawn from a uniform distribution over interval  $[a, b]$ .

Next, the recursive phase is obtained for  $\forall j$  and  $\forall t = 0, 1, 2, \dots, T$  as follows:

1. Set the employment status  $i = i_{j,t}$ , in order to compute the optimal investment (14) and welfare (13), as well as the displacement/re-employment exposures and income as:

$$\begin{aligned} I_{j,t} &= I^i(H_{j,t}, \bar{H}_{j,t}), & V_{j,t} &= V^i(H_{j,t}, \bar{H}_{j,t}), \\ \lambda_{j,t} &= \lambda^i(H_{j,t}), & Y_{j,t} &= Y^i(H_{j,t}, \bar{H}_{j,t}). \end{aligned}$$

2. Use the law of motion (4) to update human capital and the Poisson distribution to update employment status as:

$$\begin{aligned} H_{j,t+1} &= H_{t+1}(I_{j,t}, H_{j,t}), & \bar{H}_{j,t+1} &= \mathbb{1}_t^e H_{j,t+1} + \mathbb{1}_t^u \bar{H}_{j,t}, \\ i_{j,t+1} &\sim \text{Poisson}(\lambda_{j,t}). \end{aligned}$$

Note that each new displacement event ( $e \rightarrow u$ ) adds an additional loss of  $(1 - \phi)H$  associated with capital specificity. These losses are abstracted from when the agent remains unemployed ( $u \rightarrow u$ ).