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Chapter 5

PERSISTENCE OF HIGH UNEMPLOYMENT: WHAT RISKS? WHAT POLICIES?

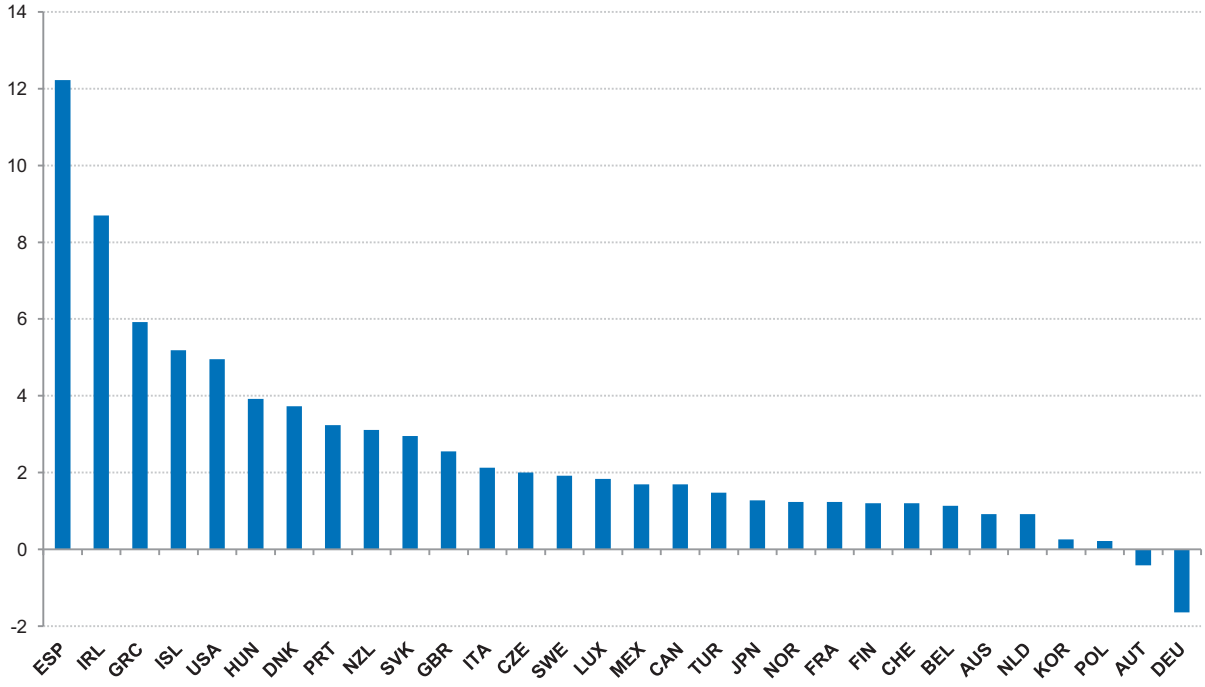
Introduction and main findings

The labour market has yet to recover from the crisis

Nearly two years after production began to recover from the worst recession to have hit OECD countries since the 1930s, the labour market situation remains a major preoccupation. At the end of 2010, the average OECD unemployment rate was still close to the historical peak reached during the crisis. In 12 OECD countries it remained two percentage points or more above the pre-crisis level, and even where the rise in joblessness was less severe, the recovery has been generally too weak so far to allow for a significant fall in unemployment (Figure 5.1). A main concern in countries most severely hit is that persistently high levels of unemployment – and a rising share of unemployed workers facing long spells without a job – will eventually result in widespread deterioration of human capital, discouragement and labour market withdrawal. The risk is strongest for youth and less skilled workers who have been disproportionately affected by the rise in unemployment.

Figure 5.1. **The increase in unemployment rates following the crisis**

2007Q3-2010Q4, change in percentage points[1]



1. Except Ireland, Italy, Mexico, Switzerland and Turkey: 2007Q3-2010Q3.

Source: OECD, *Economic Outlook 88 database*.

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The main short-term policy challenge is to accelerate the return to work

The main purpose of this chapter is to assess the role of policies in facilitating a swift return to work so as to minimise these risks. Given the slack remaining in economic activity and labour utilisation, together with still-anchored inflation expectations, aggregate demand policies have a role to play in supporting the economic recovery and stimulate jobs. Indeed, monetary policy remains strongly expansionary in most OECD countries whereas unsustainable public debt path in several of them has necessitated a turn towards fiscal consolidation. Recommendations in the area of macro policies are discussed at length in Chapter 1. This chapter focuses on the role of structural policies even if the budgetary implications of specific options are taken into account in the discussion regarding the appropriate policy mix.

The issues vary across countries

The risk of persistently high unemployment rates is less of a concern in countries where the fall in GDP triggered by the financial crisis was largely absorbed by labour hoarding or some form of time sharing among workers (*e.g.* Austria, Belgium, Finland, Germany, Japan, Korea, Luxembourg and the Netherlands). The ability of these countries to cushion the employment impact of the crisis may offer lessons that could help improve labour market resilience to future shocks. Concerns that average hours worked and productivity remain below pre-crisis levels well after the recovery are not addressed in this chapter and concerns that labour hoarding and time-sharing arrangements hamper the reallocation of resources across businesses and sectors (if maintained for too long) are also not extensively addressed, though the role of time-sharing policies is discussed.

The main risks and policy options are examined

The chapter briefly reviews how OECD labour markets have evolved during the recession and the early phase of the recovery, looks at how vulnerable countries are to risks of strong unemployment persistence and labour force withdrawal and examines policy settings that can facilitate the return to work. The main findings as regards the risks and the policy implications can be summarised as follows:

Some countries are more exposed to risks of unemployment persistence

- Countries with high unemployment levels and a high share of long-term unemployment face a higher risk of unemployment persistence during the recovery:
  - Before the crisis, relatively weak flows into and out of unemployment as well as high long-term unemployment continued to be observed in large continental EU countries, while pre-crisis turnover was stronger and long-term unemployment lower in North America, Australia and New Zealand.
  - However, a striking feature of the current situation is an unusually high share of long-term unemployment in the United States, occurring against the backdrop of a sharp rise in unemployment and a trend decline in outflows from unemployment. While the US outflow rate remains significantly higher than in continental EU countries, and although the US unemployment rate has begun to

decline, such developments raise concerns about future persistence of unemployment.

Labour force withdrawal has generally been limited overall

- At this stage there has been little evidence of widespread labour force withdrawals, but protracted slack in labour utilisation raises the risk that unemployed workers drift out of the labour force. Past evidence suggests that the peak effect of downturns on labour force participation could display a lag of up to 3 or 4 years.

Boosting labour demand remains a short-term priority in some countries

- Where job prospects remain bleak, the policy focus in the short term should be to continue to boost labour demand so as to increase unemployment outflows. Among the policies that can stimulate labour demand, measures to reduce labour costs through temporary and targeted tax wedge reductions are likely to be most effective. Indeed, such measures have already been put in place in several countries, though not always in a cost-efficient way.

Job-search assistance could be strengthened and access to training expanded

- In parallel to boosting labour demand, and to offset the risks that unemployed workers see their skills eroding to the point of losing attachment to the labour market (through so-called unemployment duration dependence or hysteresis effects), more could be done to improve the matching of workers and jobs, including through measures to strengthen public employment services and training programmes. As the risk of missing a job opportunity by suspending job search to enrol in training is lower in periods of labour market slack, there is a case for strengthening vocational training given the high rate of unemployment among youth and low skilled. Such training could also provide a surrogate test for participants' willingness to work. However, in countries where the financial space for manoeuvre is limited by severe budget constraints (*e.g.* Greece, Ireland, Portugal and Spain), stepping up training programmes may be difficult, and this could also be the case in countries that do not have the sufficient training infrastructure in place (*e.g.* the United States).

Some extensions of unemployment insurance should be permanent while others can lapse

- In the United States, Canada and other countries where unemployment benefit duration has been extended, the case can be made for maintaining the extension until labour market prospects have sufficiently improved to prevent individuals from falling into persistent poverty. Continued extension may also help avoid that the unemployed enter other benefit systems (such as disability pensions) from which exit may be less likely later on. In the meantime, benefits should be made conditional on recipients satisfying job-search requirements and, where benefits are relatively high, they could be made declining with duration. On the other hand, where the scope of unemployment insurance has been extended to workers previously not covered, as for instance in Finland, Japan and the Slovak Republic, the extensions should be made permanent both for social reasons and to maintain the

labour force attachments of groups newly covered, provided again that job-search requirement can be enforced on these new beneficiaries.

Short-time working schemes can be useful but subsidies should be phased out

- A large number of countries have encouraged short-time working during the crisis. The significant role played by these programmes in cushioning the crisis – especially in Belgium, Finland, Germany, Japan and Luxembourg – suggests that having such options in place and being able to activate them in severe downturns, can be useful. Such short-time working arrangements should include, as for instance in Germany and the Netherlands, built-in incentives for workers and firms to withdraw from them once they have outlived their conjunctural purpose. And, insofar as the schemes do not have sufficient auto-corrective incentives, a timeframe should be set for the phasing-out of public subsidies so as to avoid negative long-term effects on productivity and labour utilisation.

The gap in job protection between permanent and temporary contracts should be reduced

- In some countries, the impact of the crisis on unemployment has also been cushioned by restrictions on the dismissals of workers on permanent contracts. However, given that tight employment protection provisions – whose costs are often high and unpredictable for employers – reduce outflows from unemployment, there is now a case for streamlining such provisions, especially where substantial risks of unemployment persistence prevail. In particular, "two-tier" systems entailing large differences in protection across different types of contracts – which have contributed to labour market duality in countries like France, Italy and Spain – may have generated unemployment turnover for certain categories of workers (*e.g.* youth and women) with no permanent effects on the unemployment rate. Narrowing, or eliminating, differences in contract provisions across workers, for instance so that protection rises with seniority, could boost hiring during the recovery while at the same time improving labour market resilience to future shocks and lowering the unemployment rate in the longer term.

Labour market outcomes and the concerns moving forward

Labour markets adjusted differently across countries…

The crisis has had different impacts on labour market outcomes across countries. To some extent this reflected differences in the degree of exposure to specific features of the crisis, such as the aftermath of financial and housing market bubbles and the associated contractions in the construction and finance industries. However, the variations in outcomes also reflected differences in policy settings, resulting from both policies in place before the crisis and measures implemented in response to the crisis (see Box 5.1). These differences notwithstanding, considering the magnitude of the recession, the labour market fallout from the crisis has been relatively benign in the majority of countries, and this is due in large measure to past reforms.

Box 5.1. **Pre-crisis reforms and the policy response to the crisis**

In most countries, the crisis took place in a context of low or falling trend unemployment rates, especially relative to the levels prevailing in the mid-1990s. To some extent, this broad improvement in unemployment resulted from labour market reforms implemented in the late 1990s and early 2000s. A number of areas where governments have been particularly active during that period include:[1]

- In labour taxation, many countries have reduced the non-wage cost of labour, in particular for low-wage earners, mainly through a reduction in social security contributions.
- In income support for the unemployed, only a few countries have significantly reduced the overall level or duration of unemployment benefits. By contrast, a vast majority of them have tightened access to the system through more stringent eligibility or work availability conditions. In many countries, measures have been taken to reduce the disincentives to take up work, for instance by allowing the possibility to temporarily combine benefits and earnings and by lowering the benefit withdrawal rates.
- A majority of countries have also strengthened their "activation" programmes, in particular through increased job-search monitoring and individual action plans and profiling. In most cases this has been done without raising average active labour market policy expenditures per person unemployed.
- Several countries have eased employment protection legislation, but reform in this area since the early 1990s has generally focused on the conditions of temporary contracts or taken the form of new types of contracts with different characteristics and restrictions. In a few cases, this has made the labour market more adaptable to macroeconomic conditions, but these reforms have also added to segmentation between permanent employees enjoying stronger job protection, and a growing share of temporary workers bearing the brunt of workforce adjustment (OECD, 2006; Saint-Paul, 1996; Boeri, 2010).
- Reform activity has been more limited in the area of collective bargaining and wage setting, at least as far as legislative changes are concerned. While there were virtually no changes in provisions to extend administratively bargaining outcomes to non-covered parties, some countries have implemented reforms aimed at changing workers' representation mechanisms and allow firms to opt out of collective agreements in certain cases. As a result of this and, especially, of an increasingly competitive global and domestic environment, some movement towards decentralisation of wage bargaining has taken place in many countries. Indeed, the period of wage moderation observed in Germany during the 2000s is to some extent an illustration of the greater flexibility firms have had in adjusting collective wage agreements so as to better reflect local conditions.

Given the unusual severity of the crisis, a number of specific actions were taken to limit its impact. Hence, in addition to macroeconomic measures, all governments introduced different labour market measures aiming at three broad objectives: smooth the employment impact of the output shock (perceived as temporary) by subsidising jobs, encouraging the adjustment to occur in hours worked, and stimulating labour demand; facilitate the re-employment of unemployed workers (or those at strong risk of losing their job) *via* training and other re-deployment measures; and cushion the impact of the shock on the income of the unemployed through extended income-support measures:[2]

- Among the measures to limit the effect of the crisis on employment, the most widely used was the subsidisation of short-time working which took place in two-thirds of OECD countries. In several cases pre-existing schemes just expanded, while in others new schemes were established. In some countries these measures complemented spontaneous private-sector adjustment in average hours worked and their implementation was facilitated by collective bargaining arrangements (*e.g.* Germany). Overall, this led to an increase in the average stock of employees participating in such schemes by more than 2% of all employees in 5 countries (Belgium, Germany, Italy, Japan and Luxembourg). Other measures such as public-sector job creation or private-sector job subsidies and reductions in non-wage labour costs were implemented in at least half of OECD countries.

Box 5.1. **Pre-crisis reforms and the policy response to the crisis** *(cont.)*

- In order to facilitate re-employment and re-deployment, more than two-thirds of OECD countries raised resources for job-search assistance and training programmes. One-third of OECD countries provided additional resources to apprenticeship schemes.
- Measures to improve the access, level or duration of unemployment benefits, to raise other payments or in-kind support for the unemployed and to provide fiscal relief for low earners were implemented in half of OECD countries.

For the most part, governments avoided measures such as direct or indirect job support targeted to specific sectors that could have hampered a necessary restructuring and created international trade tensions (with the main exception of car manufacturing which benefited from demand support). But some of the policy interventions may nevertheless unduly contribute to delay adjustments in the workforce if maintained for too long. Indeed, many of the measures introduced in 2009 were meant to be temporary and a few countries have partially or fully withdrawn some of them, notably the reductions in non-wage labour costs and the subsidies for short-time work. However, the vast majority of countries kept the measures in place in 2010 and in some new ones were brought in, such as for instance a payroll tax cut implemented for 2011 in the United States.

1. A comprehensive review of labour market reforms over that period can be found in Chapter 3 of OECD (2006).
2. See OECD (2009, 2010a) for a review of measures taken in response to the crisis.

How have labour markets adjusted to the decline in output?

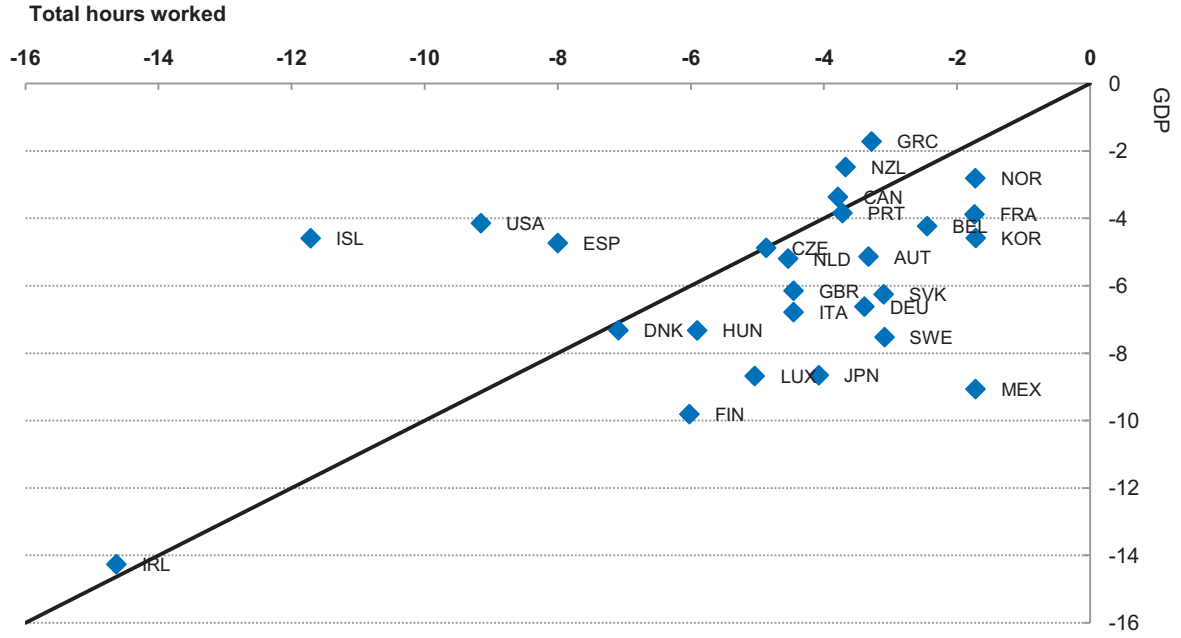
… in terms of productivity, average hours worked and employment

The profiles of hours worked, employment and labour productivity since the start of the crisis point to large cross-country differences in the way labour markets responded to the decline in output. In the majority of countries, total hours worked declined less than GDP as the output shock was partly absorbed through labour hoarding (Figure 5.2). In a few countries (Iceland, Spain and the United States), however, hourly productivity gains were substantial as a consequence of a decline in total hours.[1] These gains reflect to some extent composition effects since job losses were largely concentrated in low-productivity sectors such as construction (OECD, 2009). At the same time, those countries that recorded the largest decline in total hours have generally done so primarily *via* lower head-count employment (Denmark, Ireland, Iceland, Spain and the United States) (Figure 5.3). At the other end of the spectrum, the reduction in total hours has been almost entirely absorbed through adjustments in average hours per worker in Austria, Belgium, Germany, Korea and Luxembourg. A substantial contribution of average hours worked to total labour input adjustment has been a recurrent feature of past recessions in several countries (including Belgium and Germany), but the widespread use of short-time work arrangements on a scale as large as that observed during the recent crisis was unprecedented.

1. In both Spain and the United States, productivity growth over the period exceeded trend estimates. Even though hourly productivity gains have been frequently observed during previous recessions in the United States the extent of the increase in 2008-09 has been surprisingly strong (Wilson, 2010).

Figure 5.2. **GDP has generally fallen by more than hours worked during the crisis**

% decline in GDP and total hours worked from peak to trough[1]



1. The vertical axis shows the percentage decline in the GDP. In the case of countries where GDP has continued to decline, the trough corresponds to the latest data point available.

Source: OECD, *Economic Outlook 88 database*.

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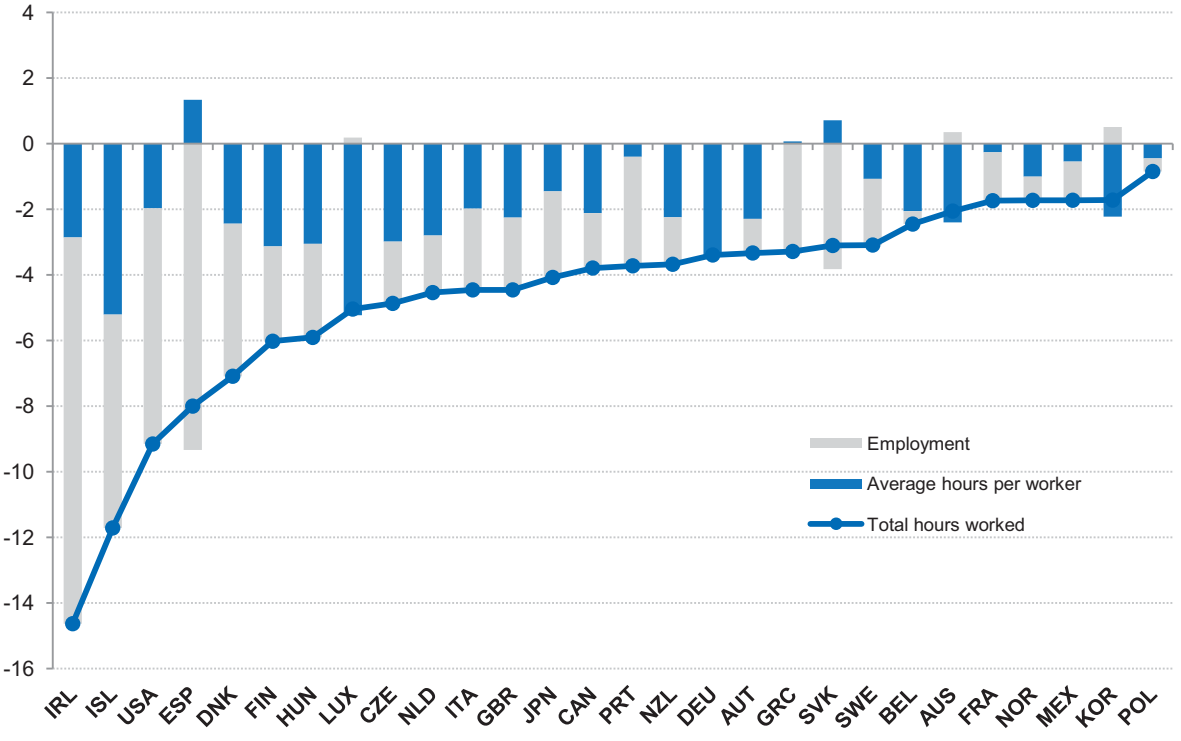
Figure 5.3. **The decline in total hours worked has been absorbed differently across countries**

Decomposition of the % change in total hours from peak to trough



Source: OECD (2011), *Quarterly Labour Market Indicators Database*; Directorate for Employment, Labour and Social Affairs; May, unpublished.

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In many countries, unemployment persistence remains the most pressing near-term concern…

Differences across countries in the size and nature of the labour market fallout from the crisis imply different policy challenges moving forward. Concerns about unemployment persistence are particularly pronounced in countries that have experienced large increases in long-term unemployment. The longer individuals remain unemployed, the more difficult it becomes for them to find a job and the less they may try, a phenomenon referred to as unemployment duration dependence or hysteresis.[2] In at least ten countries (*e.g.* Canada, Denmark, Hungary, Ireland, New Zealand, Norway, Portugal, Spain, the United Kingdom and the United States) the share of long-term unemployment has risen significantly during the crisis, pointing to a significant risk of hysteresis (Figure 5.4).

… reflecting in some cases persisting demand gaps

One reason for concern is that even though a recovery has been underway for some time in the majority of OECD countries, growth in aggregate demand has generally been too weak to begin making serious inroads into unemployment. Indeed, the substantial slack in labour productivity and average hours worked that has built up in the wake of the crisis has provided ample room in the majority of countries for accommodating GDP growth through more intense use of currently employed workers. Furthermore, even though GDP is generally expected to grow in 2011 and 2012 faster than productivity and the labour force combined, in several cases the slack may be absorbed too slowly to allow for a significant decline in unemployment over this horizon. Only when growth garners sufficient momentum, unemployment will begin to recede more rapidly and eventually returns to its longer-term or structural level.[3]

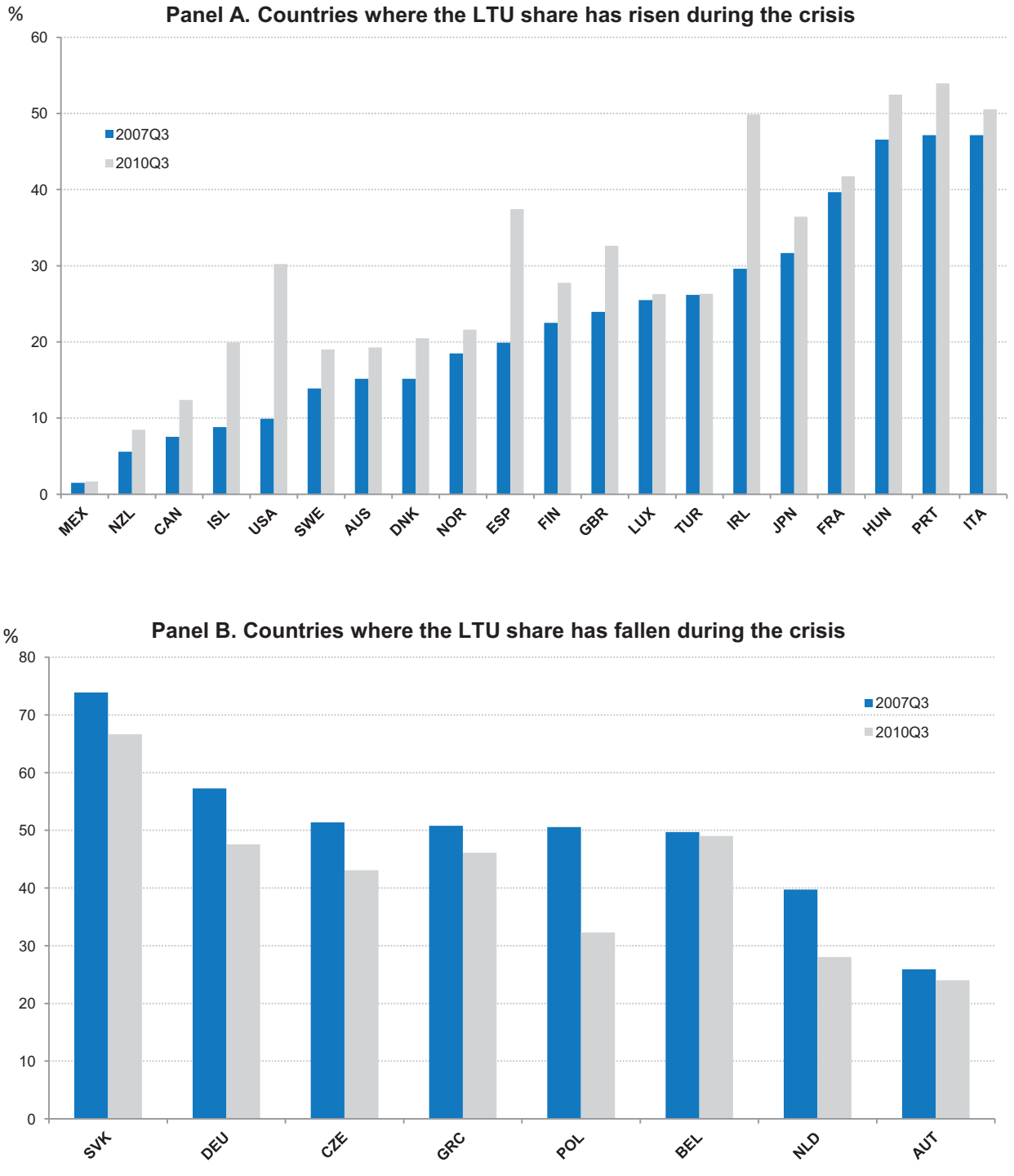
Wages have adjusted to help stem employment losses

Another factor that could influence the pace of decline in unemployment is the evolution of labour costs. In most countries, wages decelerated sharply, with the adjustment taking place one or two quarters after the recession began. Arguably, that wages reacted moderately to the severity of the output contraction was helpful to limit the risks of deflation at the trough of the recession, as this would have further complicated the task of demand policies. Still, the slowdown in wages in late 2009 and early 2010, combined with a rebound in productivity, was sufficient to bring about a deceleration in unit labour costs (and even a decline in several countries) which helped stem employment losses (Figure 5.5). In addition, measures were taken in several countries to reduce the non-wage component of labour costs, notably through targeted cuts in payroll taxes.

2. This phenomenon may be due to a variety of more or less related factors such as the erosion of skills (Pissarides, 1992), discrimination by employers (Lockwood, 1991) and the ranking of job applicants by employers on the basis of their time spent in unemployment (Blanchard and Diamond, 1994). Another factor potentially reinforcing these effects is the reluctance of unemployed workers to adjust downward their reservation wage even as their spells lengthen, which to some extent can reflect a rise in social tolerance *vis-à-vis* the status of long-term unemployment (Lindbeck, 1995).
3. Employment usually lags activity during recoveries as businesses tend to delay investment and hiring decisions until growth prospects look sufficiently robust and labour hoarding has been eliminated.

Figure 5.4. **The share of long-term unemployment (LTU) has risen sharply in some countries**

Share of people unemployed for more than 12 months in total unemployment[1]



1. Series smoothed using three-quarter centred moving average.

Source: OECD (2011).

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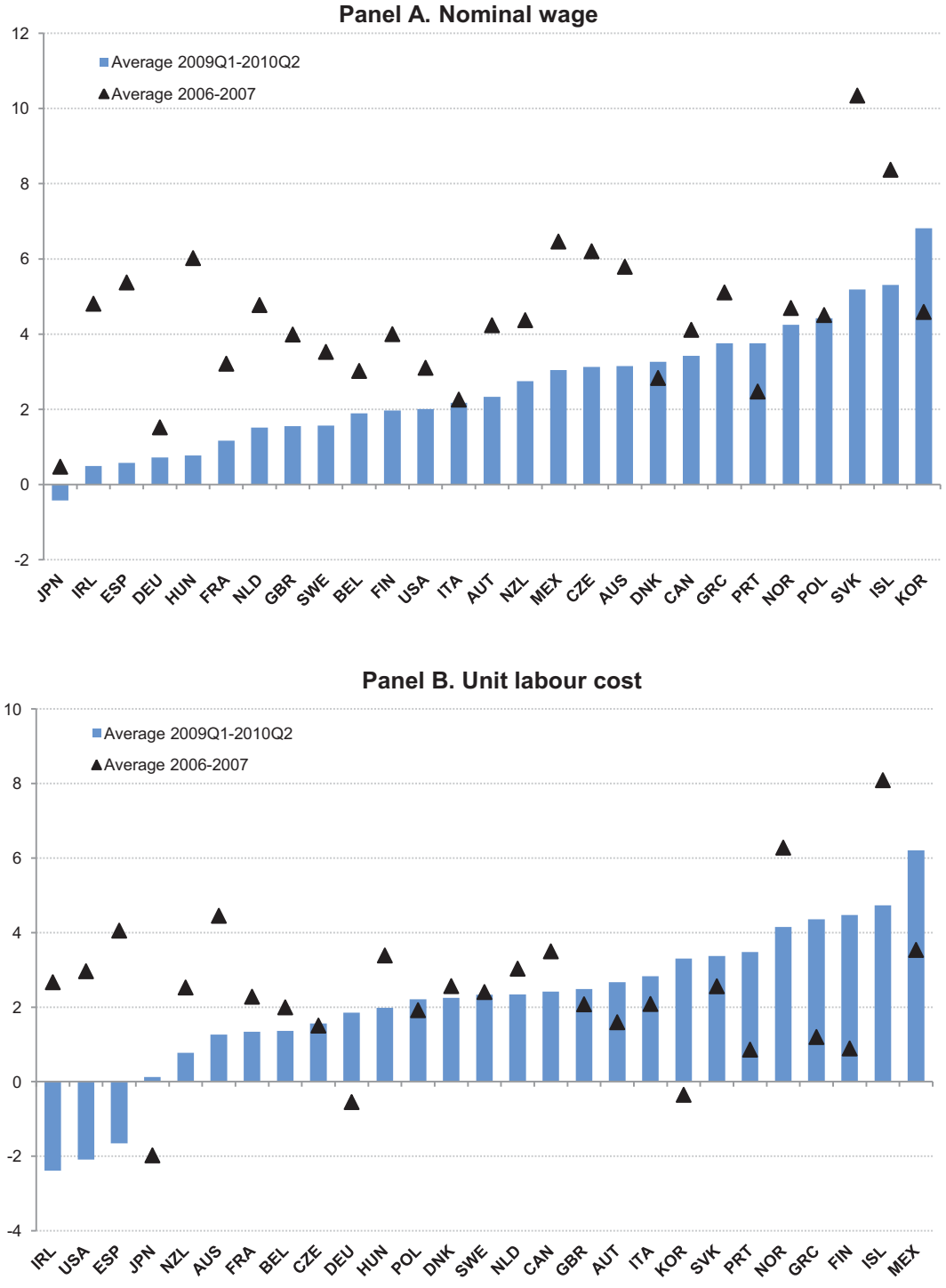
Figure 5.5. **Nominal wages and unit labour costs have decelerated**
Annualised average percentage changes before and after the crisis



Source: OECD, *Economic Outlook 88 database*.

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It remains unclear whether or not the resulting overall adjustment in labour costs has been sufficient to support sustained employment growth in the near term.

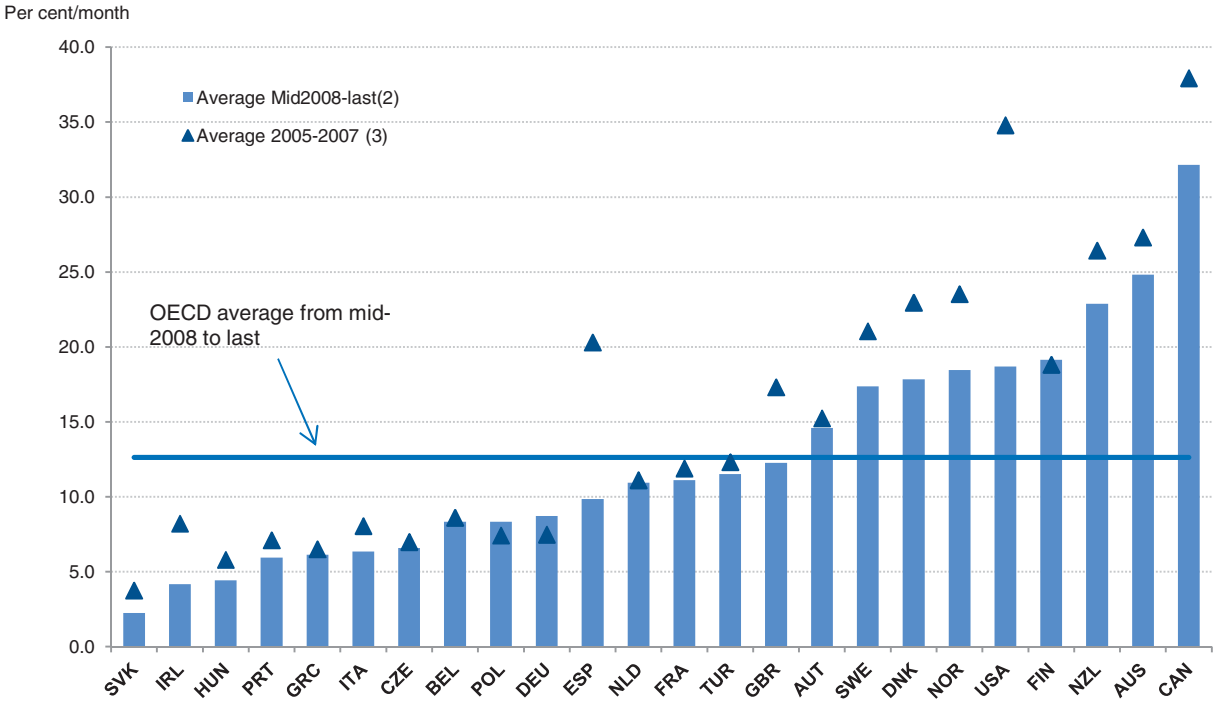
What factors boost the risks of unemployment persistence?

The persistence of unemployment is strongly linked to the outflow rate…

One of the key determinants of unemployment persistence is the degree of turnover in the unemployment pool, *i.e.* the pace at which workers flow in and out of unemployment over a given time period. While both higher inflow rates and lower outflow rates contributed to the rise in unemployment in the initial phase of the crisis, at this stage of the recovery the risk of persistence is largely determined by the evolution of the outflow rate. One reason is that after rising at the onset of the crisis, the inflow rate has since fallen back towards pre-crisis levels in a majority of countries (suggesting that there are no longer net job losses across the economy). In contrast, the outflow rate has generally remained depressed (Figure 5.6), in some cases at very low levels by historical standards, not least in the United States (see Box 5.2).[4]

Figure 5.6. **The probability of leaving unemployment has fallen following the crisis**

Outflow rates from unemployment[1]



1. Outflow rates are defined as the probabilities that an unemployed worker exits unemployment within the following month. The measured outflow rate includes both outflows to job and to inactivity.
2. Average from mid-2008 to the latest available observation.
3. Except Ireland and Turkey 2006-2007.

Source: OECD calculations based on Eurostat, New Cronos; US Current Population Survey; Australian Bureau of Statistics; Statistics Canada; Labour Force Survey.

StatLink http://dx.doi.org/10.1787/888932402071

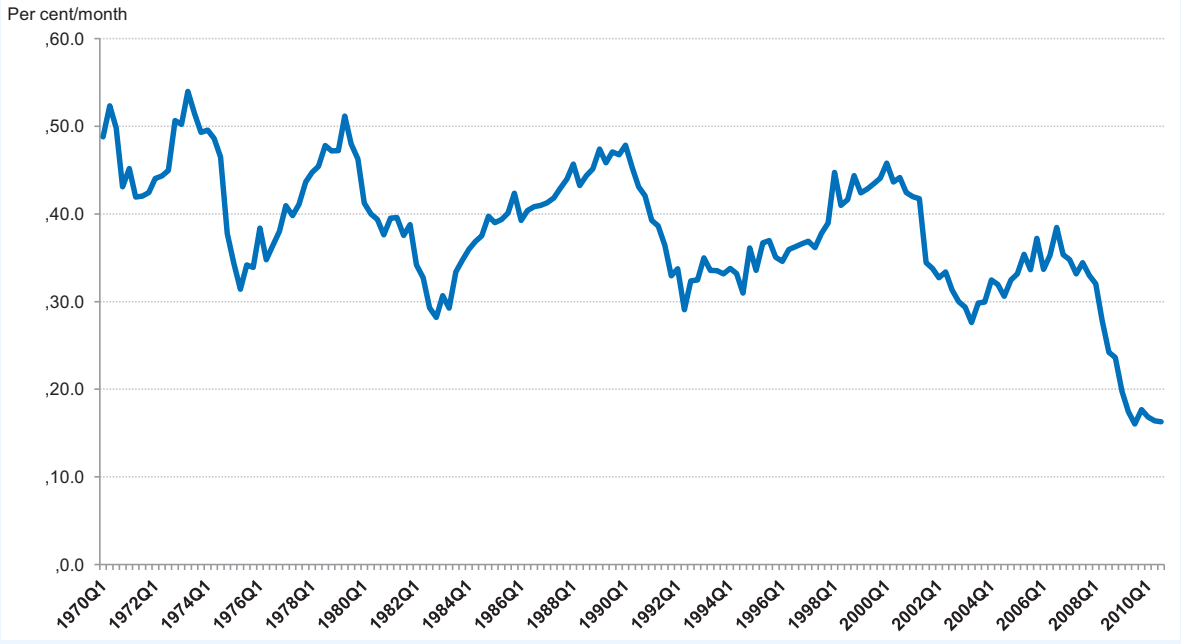
4. The measured outflow rates shown in Figure 5.6 do not distinguish between exits into jobs and withdrawals from the labour force.

Box 5.2. **The trend decline in the US unemployment outflow rate**

In the United States, the outflow rate from unemployment – defined as the probability that a worker exits unemployment within the following month – has fallen during the recent crisis to levels well below those observed during the previous major recession episodes even though it remains, at around 15%, above the level that has been the norm in many European countries. Since inflows into unemployment have also been falling in parallel, the trend decline in outflow rates had not led to an increase in the aggregate unemployment rate. Nevertheless, the fact that the US outflow rate had already been fluctuating around a clear downward trend over the past three decades suggests that an eventual return to pre-crisis levels may be hampered by structural forces working in the opposite direction.

A recent analysis of the long-term increase in the average duration of unemployment spells in the United States found that shifts in the age structure of the pool of the unemployed, as well as an increase in the unemployment duration spells of women both played major roles, while other factors such as changes in the industrial structure have had little impact (Aaronson *et al.*, 2010). The demographic factor largely reflects a falling share of youth (who tend to have shorter unemployment spells) in the unemployment pool. The rise in the share of long-term unemployment among women need not be worrying insofar as it results from a stronger participation to the labour force and that it has coincided with a trend decline in their overall unemployment rate (Abraham and Shimmer, 2002). However, these factors together only explain about half of the particularly large increase in average duration in the recent episode. The unexplained part could raise policy concerns.

Long-term evolution of the outflow rate in the United States[1]



1. Outflow rates are defined as the probabilities that an unemployed worker exits unemployment within the following month.

Source: OECD calculations based on US Current Population Survey.

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This has resulted in a steady lengthening of average unemployment duration. Workers exit unemployment either for a job, or because they withdraw from the labour force, which is a far less desirable outcome.

... which in turn depends on job creation and matching efficiency

Aside from the strength of aggregate demand and the responsiveness of wages to economic conditions, which affect the pace of job creation, one of the key structural determinants of outflows into jobs is the efficiency with which jobseekers (be they unemployed or already in a job) are matched with job openings (matching efficiency). Factors having an influence on matching efficiency include the degree of mismatch across regions or industrial sectors between job openings and workers looking for a job, as well as the overall intensity and effectiveness of the individual's job search, which may diminish as the average unemployment spell lengthens.

Has the matching of jobs and unemployed workers deteriorated?

Clear evidence on the efficiency of the matching process is hard to come by...

The efficiency of matching between job openings and unemployed workers is not directly observable, which makes it hard to say whether it has deteriorated as a result of the crisis. An oft-used gauge of matching efficiency is the relationship between open vacancies and unemployment (the so-called Beveridge curve) but it does not provide clear evidence concerning a shift during the crisis.[5]

... though possible sources of declines include occupational or geographical mismatch

One possible source of a decline in matching efficiency would be an increase in the mismatch between vacancies and jobseekers across types of occupations and geographical areas. This is a recurrent concern during cyclical downturns as they usually hit specific industries and regions harder than others. For instance, while the shock severely depressed manufacturing production across OECD countries, some have in addition been exposed to a large and potentially far more protracted collapse in specific non-manufacturing industries.

Manufacturing has broadly rebounded but not construction

Indeed, in a number of countries the losses in specific sectors have been particularly strong, even taking into account the historical business-cycle sensitivity of these sectors. As shown in Table 5.1 (bolded figures), for a large number of countries this has been the case in construction, which accounts on average for 7% of total employment in OECD area. Important losses have also been recorded for many countries in wholesale and retail trade and financial intermediation. Manufacturing has since largely rebounded but construction has remained depressed in most countries where the sector enjoyed a boom before the crisis. And countries where the latter sector has been hardest hit (*e.g.* Denmark, Ireland, Spain, the United Kingdom, the United States and, to a lesser extent, Portugal) are also the ones where the incidence of long-term

5. For instance, a recent analysis looking beyond the Beveridge curve has found that the outflow rate in the United States is significantly lower than what would be expected even taking into account the low availability of jobs relative to the number of unemployed, a development which could be interpreted as a decline in matching efficiency (Elsby *et al.*, 2010). However, such an interpretation is premature considering that it is not unusual for a pick-up in job openings following a period of steady decline to be fully reflected in lower unemployment only a few quarters later (Yellen, 2010).

Table 5.1. **Sectoral employment changes**
Employment growth between average in 2008 and 2010Q2

	Manufacturing	Construction	Wholesale and retail trade	Financial intermediation	Other services[1]	Total
Austria	**-3.9**	**-7.3**	**-4.9**	5.6	1.3	-2.4
Belgium	**-10.1**	0.9	4.8	**-6.0**	-1.7	-2.4
Canada	**-10.2**	**3.9**	2.4	6.2	3.0	2.3
Czech Republic	**-12.0**	-0.4	**-4.1**	-1.8	2.2	-5.0
Denmark	**-12.7**	**-24.9**	**-7.9**	3.7	0.5	-7.8
Finland	**-11.2**	**-7.5**	-0.5	-0.5	1.3	-3.1
France	**-8.4**	0.9	1.3	3.6	-0.6	-0.8
Germany	**-5.4**	-1.6	0.2	-0.7	2.7	-1.1
Greece	**-10.4**	**-16.5**	-3.3	-2.7	-3.3	-4.6
Hungary	**-8.1**	**-11.0**	**-7.0**	**-5.6**	1.1	-4.5
Ireland	-16.8	**-47.3**	-11.7	0.6	-7.4	-16.9
Italy	**-8.6**	-0.6	**-4.9**	**-2.9**	0.8	-3.1
Netherlands	**-9.6**	-11.7	**-5.7**	-4.1	**-6.2**	-7.0
Norway	**-8.3**	**-4.1**	**-2.6**	0.6	1.9	-1.3
Poland	**-8.7**	5.3	1.5	13.3	10.7	-0.3
Portugal	-5.8	**-13.9**	-3.2	**-11.5**	-2.3	-6.0
Slovak Republic	**-17.3**	-1.4	4.4	**-12.2**	-1.6	-7.5
Spain	**-19.4**	**-30.7**	-10.3	-5.7	-5.6	-13.3
Sweden	**-11.5**	0.8	-0.4	6.0	1.5	-1.4
United Kingdom	**-14.2**	**-16.1**	**-6.7**	**-8.5**	3.0	-5.6
United States	**-10.2**	**-13.4**	-4.2	**-8.4**	-3.5	-6.0

Note: The numbers in bold correspond to cases where the decline in employment exceeds what would be the expected drop based on average business-cycle sensitivity of employment in that sector, as reported in Figure 1.4, Chapter 1 of OECD Employment Outlook 2010.
1. Hotels and restaurants, Transport & communication, Real estate and business services.
Source: Eurostat, US Bureau of Labor Statistics and Statistics Canada.

StatLink http://dx.doi.org/10.1787/888932402128

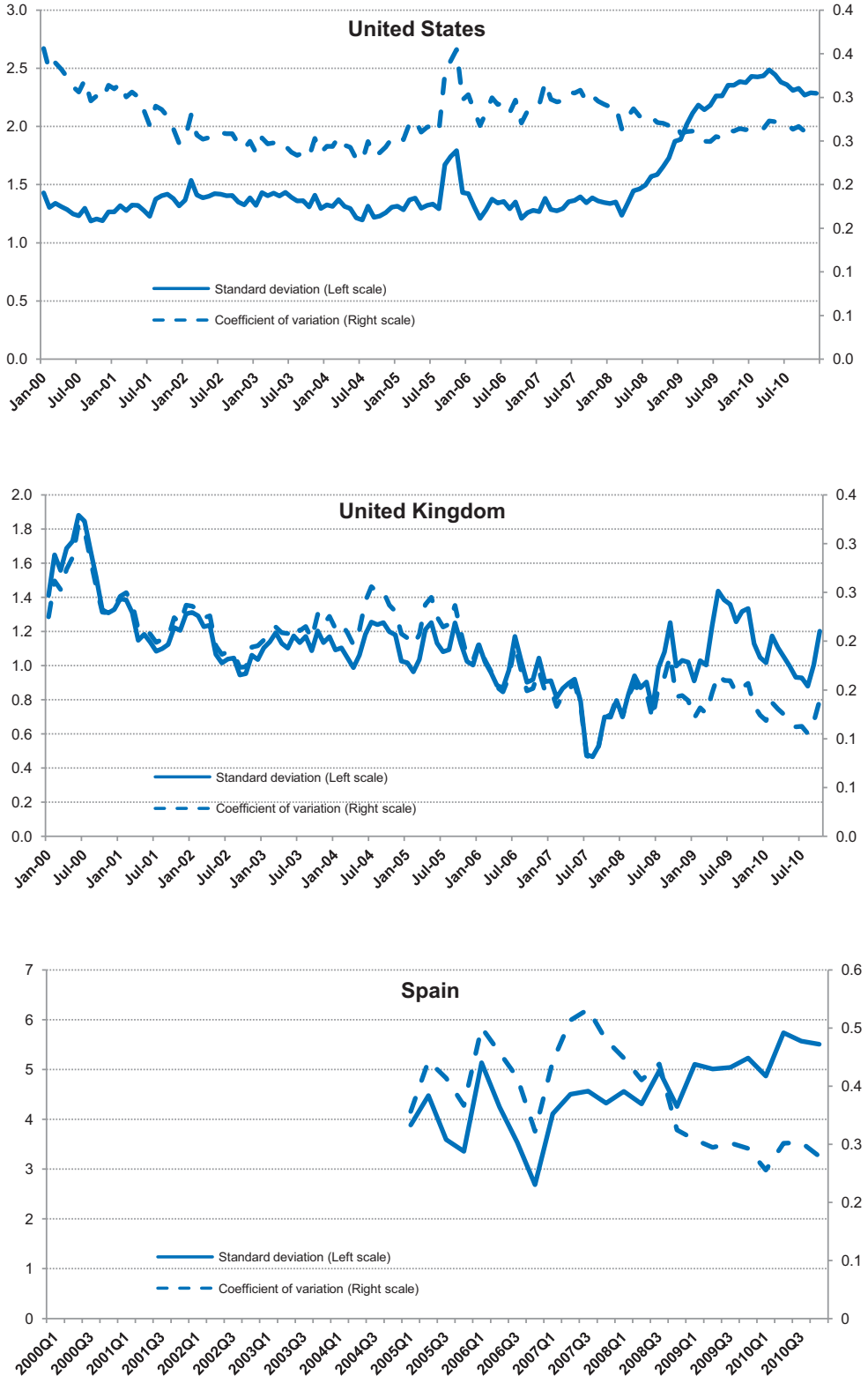
unemployment has risen most. Given the large share of low-skilled workers typically employed in this sector, matching problems could be exacerbated by this sectoral concentration of layoffs.[6]

There are no clear indications of geographical mismatch

As regards geographical mismatch, it is difficult to find strong evidence on the basis of indicators of regional unemployment dispersion, even in countries that have been particularly hard hit (*e.g.* Spain, the United Kingdom and the United States). While there are indications of a widening dispersion during the crisis, the rise in dispersion vanishes when the parallel increase in overall unemployment is taken into account (Figure 5.7), suggesting that the decline in the outflow rate bears little relationship with regional differences in unemployment. There have been concerns also that labour mobility may have decreased during the crisis. This could be the case if, for instance, geographical mobility is hampered

6. The percentage of low-skilled workers in construction is 1½ times larger than in the overall economy in the European Union and twice as large in the United States.

Figure 5.7. **Measures of dispersion of regional unemployment rates show no clear indication of mismatch**



Source: Spain, Instituto Nacional de Estadistica; United Kingdom, Office for National Statistics; and US Bureau of Labor Statistics.

StatLink http://dx.doi.org/10.1787/888932402090

by housing price developments that lead to negative home equity positions (Andrews *et al.*, 2011). However, recent evidence from the United States indicates, if anything, that homeowners with negative home equity positions have been moving slightly more than other homeowners (Schulhofer-Wohl, 2010).[7]

Unemployment duration dependence could bear on outflow rates

Matching efficiency may also deteriorate if long-term unemployment becomes a trap for the individual. In this regard, a key concern is that as time goes by and unemployment spells lengthen, duration dependence – that the probability of leaving unemployment declines as an unemployment spell becomes longer – may take hold. Empirical evidence on duration dependence is mixed. For instance, one study using aggregate unemployment duration data found evidence of duration dependence in Japan, English-speaking and Nordic countries, but not in Continental European countries (Elsby *et al.*, 2008).[8] Empirical studies based on micro data have also found mixed evidence of pure duration dependence or hysteresis effects.[9] However, more recent estimates based on individual level data point to more conclusive evidence of duration dependence effects in a sample covering a large number of OECD countries. And, these effects appear to be exacerbated by the duration of unemployment benefits (see Box 5.3 and related discussion in next section).

Could persistent unemployment lead to falling participation?

Strong persistence entails risks for labour force participation

Unemployment persistence and high long-term unemployment could in turn lead to labour force withdrawal, at least for some categories of workers, due to loss of human capital and discouragement effects. There is thus a risk that a pick-up in unemployment outflow occurs *via* lower participation rather than higher employment.

7. This result may be specific to the United States. First, the benefit of defaulting in the case of negative home equity position is generally higher than in most other countries, due to specific mortgage bankruptcy rules. Second, the incidence of strongly (as opposed to mildly) negative home equity position has been particularly high in the United States, which further increases the incentives to default.
8. One limitation of the methodology and data used in Elsby *et al.* (2008) is that no control is made for the influence of the composition of the unemployment pool on observed duration dependence. Individuals with different characteristics such as age, gender or education level will generally enter an unemployment spell with different probabilities of exit which is independent from the spell duration. Therefore, it is possible that findings of duration dependence effects reflect a growing share of workers with intrinsically low exit rates in the unemployment pool as average duration increases, rather than a gradual decline over time in the probability of exit faced by individuals due to skill erosion or other hysteresis effects.
9. See in particular Bover *et al.* (2002) and Garcia-Perez *et al.* (2010) in the case of Spain. Earlier studies reviewed in Machin and Manning (1999) generally found little evidence of positive duration dependence in the case of several European countries.

Box 5.3. **Duration dependence and the risk of unemployment hysteresis**

Hysteresis refers to a situation where unemployment shows little tendency to revert to its previous level following an increase, regardless of the source and nature (temporary or permanent) of the shock causing the rise. In such a case, the distinction between the cyclical and trend components of unemployment rates may lose practical relevance. The risk of hysteresis has become a major concern, not least because of the social consequences for the individuals directly affected. Both hysteresis and its corollary – a high incidence of long-term unemployment – have plagued several continental European countries, going as far back as the 1980s. They have also become a concern in the United States since the recent crisis, following the unusually strong increase in the incidence of long-term unemployment (Aaronson *et al*., 2010).

There are different explanations for hysteresis. According to one, once workers become unemployed, they struggle to get back into employment regardless of the time they have spent in unemployment. In such a case, for a given job-seeker, the exit probability may have fallen at all unemployment durations, *i.e.* even for short-term unemployed. This could reflect an insufficient adjustment of the going wage rate. Another explanation focuses instead on the gradual erosion of skills associated with unemployment spells. The longer a worker remains unemployed, the less attractive he/she appears to employers. As he/she loses attractiveness, the motivation for intensive job search diminishes and the worker becomes more detached from the labour market. Under this explanation, there is a clear negative relationship between the probability of moving from unemployment to employment on the one hand, and the duration of an unemployment spell on the other, a pattern referred to as unemployment duration dependence.

The empirical analysis discussed in the remainder of this box focuses on the latter phenomenon, *i.e.* duration dependence (for details see Dantan and Murtin, 2011). Observations on individual unemployment spells are exploited to assess the influence of unemployment duration on the probability of moving from unemployment into a job. The dataset used is composed of 17 national panels of individuals whose monthly status on the labour market has been observed over the period 2005-07. These data show that in countries where the unemployment outflow rate is relatively high on average, it also tends to exhibit a steeper decline as durations increase. This is the case in general for English-speaking countries, Nordic countries and the Netherlands. In other words, the exit probability is much higher for short-term than long-term unemployed in these countries. Conversely, in countries where the average outflow rate is relatively low (a majority of continental European countries) it is also more stable across unemployment durations.

In principle, this finding could reflect differences in the composition of the unemployment pool at different durations rather than pure duration dependence effects. However, when applying a statistical method to control for composition effects, using observations on individual characteristics, pure duration dependence effects are found to account for about one-third of the decline in the rate of exit from unemployment to employment as unemployment duration increases. This represents an average and the proportion is higher in Germany, Sweden, the United Kingdom and the United States than elsewhere.

The role of policies in mitigating or reinforcing the duration dependence effect can also be assessed in this framework. The influence of two types of policies has been examined more closely, namely the duration of unemployment benefits and spending on active labour market policies (ALMPs). As regards the former, several empirical studies have found a link between benefit duration and the average length of the unemployment spell (for a recent survey, see Krueger and Mueller, 2010). For example, recent estimates have suggested that the combined federal-state extension of benefit in the United States from 26 weeks to 99 weeks (or 90 weeks on a national average) in response to the crisis could, if maintained, raise the average length of the unemployment spell by between 1½ to 3 weeks corresponding to about ½ to 1 percentage point on the unemployment rate (Aaronson *et al*., 2010). In addition, the unemployment exit rate has been found to increase sharply at the time benefits are exhausted (Katz and Meyer, 1990). The empirical analysis conducted for this study partly corroborates this evidence. Longer benefit duration appears to reinforce duration dependence effects on average across the countries in the sample.

As regards spending on ALMPs, there is fairly robust evidence that it improves the probability of finding a job across all unemployment durations, but that the effect might be stronger for the short-term unemployed than for those who have been unemployed for a longer period.

There is no widespread labour force withdrawal yet but the risk remains

So far, the difficult labour market situation has not led to significant and general labour force withdrawal (Figure 5.8, panel A). Although contraction of the labour force was observed in about half of the countries for which data are available, by mid-2010, a decline of 1 percentage point or more in labour force participation rates had been observed in only six countries (Finland, Iceland, Ireland, Italy, Norway and the United States). In some countries, patterns of labour force participation may also have reflected reverse migration flows in the aftermath of the crisis (*e.g.* Ireland and Poland). Even so, recent empirical analysis looking at the impact of downturns on labour force participation has shown that severe recessions have in the past led to significant withdrawal that can occur with a significant lag (Duval *et al.*, 2010).

Withdrawal has been significant among youth

The withdrawals observed so far in the current episode have been largely concentrated among youth and the low-skilled (Figure 5.8, panels C and D), who may be harder to redeploy and more prone to discouragement effects than other categories of workers. At the same time, falling labour force participation may to some extent be less of a concern for youth when the alternative is prolonged schooling, especially if this leads to genuine skills acquisition through a completed programme and a diploma (OECD, 2010b, Chapter 1).[10] However, there is no clear indication that the significant decline in youth participation observed in recent years has been associated with youth staying longer in education (OECD, 2010b). This raises the concern that young people become detached from the labour market with a risk of lower labour supply and deep scarring effects.[11] In this context, some form of mandatory vocational training may be the best way to maintain attachment to labour market and improve human capital (OECD, 2010b, Chapter 4).

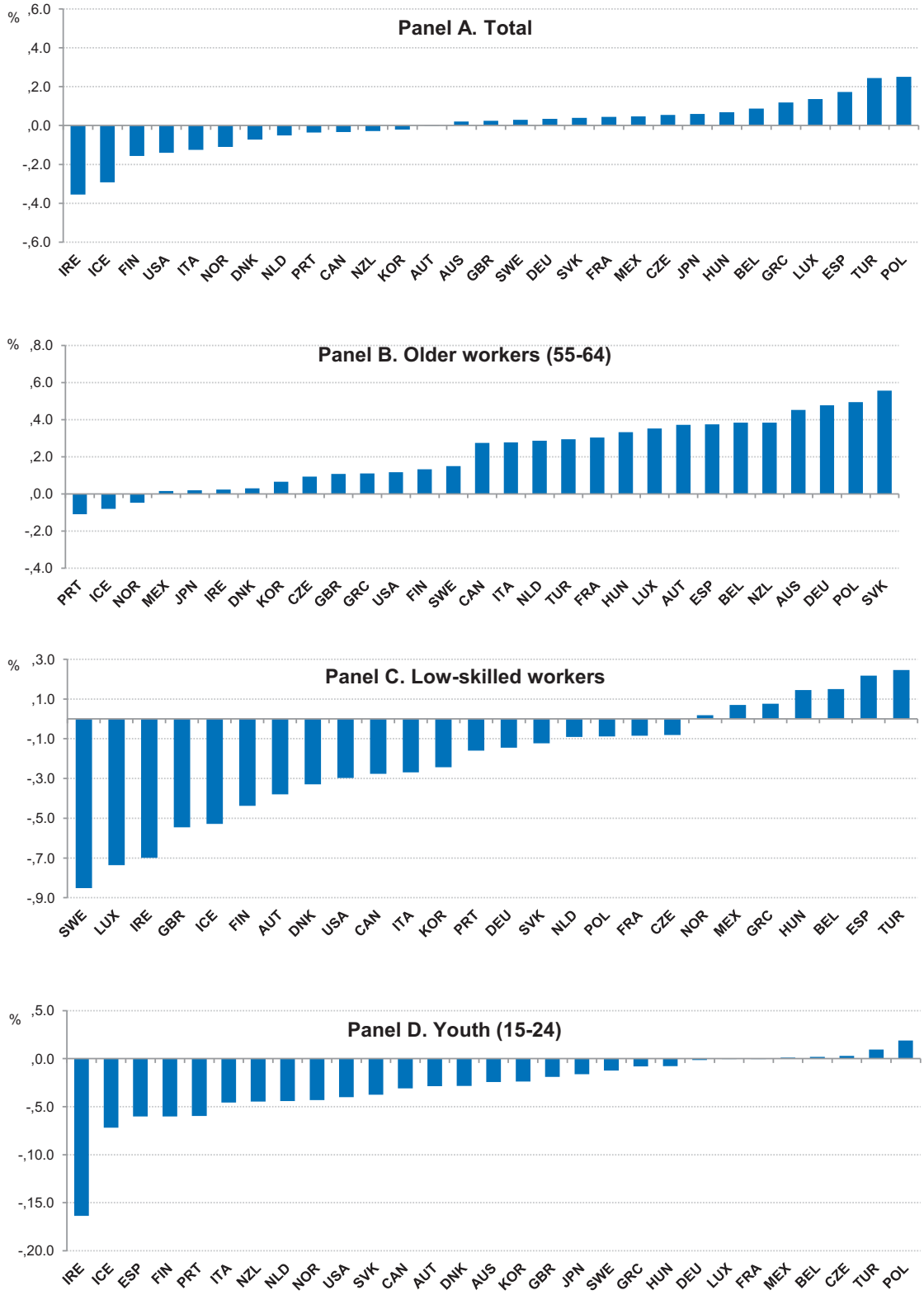
Earlier reforms may help explain that participation of older workers held up

In the case of older workers, the impact of recessions on participation has in the past been magnified by early retirement incentives, which have been sometimes embedded in pension systems (Duval, 2003). In this regard, the fact that older workers have remained in the labour market during the latest recession (Figure 5.8, panel B) could in part be explained by reforms implemented in many countries and which have led to the closing of many benefit routes to early retirement. And, in contrast to recession episodes of the 1980s and 1990s, governments have not encouraged premature withdrawal of older workers in the vain hope of reducing youth unemployment according to a "lump of labour" view of the market. In some countries, the severe capital losses incurred by many private pension funds or individual early retirement savings schemes may

10. Duval *et al.*, (2010) also find that the sensitivity of youth participation to downturns increases with the ease of access to post-secondary education and can be up to 1½ percentage points higher in countries with generally higher enrolment rates.
11. In this regard, any negative effects on youth attachment to the labour market may have implications for the economy over many years, whereas the long-term damage is lower when a cohort of older workers loses such attachment.

Figure 5.8. **Labour force withdrawal has so far been limited, except for youth and low-skilled**

Percentage points change in labour force participation rates from 2007Q3 to 2010Q3



Source: OECD (2011), *Quarterly Labour Market Indicators Database*; Directorate for Employment, Labour and Social Affairs; May, unpublished data.

StatLink http://dx.doi.org/10.1787/888932402109

have induced older workers to extend their active life in order to sustain prospective incomes (OECD, 2010c, Chapter 5). Relative to past recession episodes, all these factors point to diminished risks of labour force withdrawal among older workers despite the persistence of unemployment.

Disability benefits have in the past provided a route to labour force withdrawal

Besides early retirement programmes, long-term sickness and disability benefit schemes have in the past provided other routes to labour force withdrawal following increases in unemployment rates. Disability rates tend to increase in the wake of recessions, but then do not return to previous levels even after the economy has fully recovered (OECD, 2010d). Indeed, in a number of countries, unemployment peaks associated with recessions have tended to be followed by spikes in disability rates about two years later (Table 5.2). Such a pattern is particularly visible in the United States, but some evidence can also be seen in Denmark, New

Table 5.2. **Episodes of cyclical peaks in unemployment followed by spikes in disability rates**

		Cyclical peak in unemployment rate		Spike in disability rate[1]		
	Episode	Date	Deviation from trend	Date	Deviation from trend	Trend level
Australia	Late 70s	1978	1.1	1980	4.9	2.6
	Mid-80s	1983	2.8	1987	3.2	3.0
	Early 2000s	2001	0.7	2002	1.0	5.5
Denmark	Mid-80s	1983	1.9	1985	0.7	6.5
	Mid-2000s	2004	0.7	2007	0.7	7.5
Finland	Late 70s	1978	4.0	1980	3.1	9.3
	Mid-90s	1993	6.8	1995	1.2	9.9
	Mid-2000s	2003	0.9	2005	0.6	8.4
Ireland	Mid-80s	1984	2.1	1986	2.4	2.6
Netherlands	Mid-70s	1976	0.9	1977	7.1	7.1
New Zealand	Mid-80s	1983	1.2	1985	1.5	1.1
	Early 90s	1991	2.4	1993	1.1	1.7
	Late 90s	1998	1.1	2002	1.3	2.8
Norway	Mid-80s	1983	0.7	1984	1.8	7.1
	Mid-2000s	2005	0.7	2006	0.7	11.0
Sweden	Mid-80s	1983	0.9	1984	0.7	6.5
	Mid-90s	1997	3.8	1998	3.3	8.0
	Mid-2000s	2005	0.5	2005	3.1	10.1
Switzerland	Mid-90s	1993	1.3	1995	0.5	3.6
	Mid-2000s	2004	0.7	2006	2.2	5.4
United Kingdom	Mid-80s	1983	1.8	1985	3.1	3.2
	Mid-90s	1993	1.6	1995	2.8	6.7
United States	Mid-70s	1975	2.4	1977	2.3	3.6
	Early 80s	1982	3.0	1986	2.2	3.3
	Early 90s	1992	1.5	1994	1.7	4.5
	Mid-2000s	2003	0.8	2004	0.3	5.6

1. Disability beneficiaries as a % of working-age population.
Source: OECD Economic Outlook 88 database and OECD (2010*d*).

StatLink http://dx.doi.org/10.1787/888932402147

Zealand, Norway, Switzerland and, to a lesser extent, the Netherlands and the United Kingdom. The time lapse between high unemployment episodes and the subsequent hike in disability rates varies across countries and episodes but gaps of more than two years have often been seen in the past. Furthermore, in the majority of countries included in Table 5.2, disability rates have been on a trend rise over long periods, with, in some cases, accelerations in years following recessions.[12]

The rising proportion of long-term unemployed raises risks of increases in disability inflows…

There are indications that the impact of recessions on disability rates has been magnified by the tightening of access to other benefit programmes, such as unemployment insurance and social assistance, as well as by the elimination of various financial incentives to early retirement (Autor and Duggan, 2003; Koning and Van Vuuren, 2006), which left fewer options for workers facing the strongest difficulties in returning to work. Many of the countries now facing a significant increase in long-term unemployment have previously experienced high or steadily rising disability rates (*e.g.* Denmark, Ireland, the United States and to a lesser extent, the United Kingdom), which could suggest a risk of higher disability inflow going forward.

… though the risks are mitigated by earlier reforms

However, two factors could help mitigate this risk. One is the fact that older workers have not been as severely affected in the last recession as compared with earlier episodes. Since the probability of people aged between 50 and 64 years experiencing chronic health-related problems or disability is more than twice that of the total working-age population (OECD, 2010d), their relatively good employment performance during the recession should help lower the likelihood of a steep hike in disability enrolment in the near term.[13] Another mitigating factor is that many of the countries facing fast-rising disability rates following past recessions have taken measures to stem the "excess" flow of recipients and also, in some cases, to help existing recipients with work capacity to (re-)join the labour market.

Policy options to accelerate the return to work

Policies should mainly aim at fostering the return to work

This section focuses on the potential contribution of specific policies to boost the unemployment outflow rate in the near term, while at the same time contributing to lower trend unemployment in the medium term. Several combinations of policies can achieve both aims, as illustrated in Table 5.3. However, not all policy options may be equally desirable once other factors or policy objectives are considered. For instance, timing is clearly important in the current context, which would favour policies that can exert a more rapid influence on unemployment

12. The exceptions are Finland, where disability rates have been brought below their early 1980s levels, as well as the Netherlands and the United Kingdom where the trend has been partly reversed during the 2000s.
13. Older workers may be more vulnerable to stress-related factors associated with being unemployed in a period of weak labour market prospects.

Table 5.3. **The impact of policies on unemployment: summary of priors based on available evidence**

More robust findings are reported in bold

	Unemployment:			
	Level	**Flow into**	**Flow out of**	**Persistence of**
Reduction in:				
Unemployment benefit initial replacement rate	**Reduce**	No effect	**Increase**	Reduce
Unemployment benefit duration	No effect	No effect	Increase	Reduce
Higher spending in:				
Active Labour Market Policies	**Reduce**	**Reduce**	**Increase**	No effect
Public Employment Services	**Reduce**	**Reduce**	**Increase**	_
Job creation	Reduce	Reduce	Reduce	_
Training	No effect	Increase	Increase	_
Reduction in:				
Tax wedge	**Reduce**	No effect	**Increase**	**Reduce**
Tax wedge interacted with minimum wage	**Reduce**	No effect	**Increase**	_
Tax wedge interacted with nature of wage bargaining	**Reduce**	No effect	**Increase**	**Reduce**
Share of temporary contracts	No effect / Reduce	Reduce (prime-age women)	Reduce (prime-age women)	Increase
Easing of:				
Employment Protection Legislation (regular contracts)	Reduce (youth)	Increase	Increase (youth)	**Reduce**
Product Market Regulation	Reduce (youth and prime-age women)	Increase	Increase (youth and prime-age women)	Reduce
Increase in:				
Short-time work schemes participation	Reduce[1]	**Reduce**	Reduce	_

1. This favourable assessment relies on the premise that short-time work schemes are implemented on a *temporary* basis, in the context of a downturn.

Source: de Serres, Murtin and de la Maisonneuve (2011).

StatLink http://dx.doi.org/10.1787/888932402166

outflows. Furthermore, policies that can reduce unemployment persistence may to varying degrees conflict with other objectives such as budgetary consolidation, labour force participation or social protection (in particular ensuring that unemployed workers currently facing bleak jobs prospect do not fall into poverty or lose attachment to the labour market). This raises a number of potential trade-offs, some of which are highlighted in Table 5.4.

Table 5.4. **The impact of policies to reduce unemployment persistence on other economic objectives**

	Timing	Budgetary cost	Social protection / Labour force participation
Reduce initial replacement rate	Rapid	Negative	Reduce
Shorten benefit duration	Rapid	Negative	Reduce
Increase spending on PES	Fairly rapid	High	Improve
Create public sector jobs	Fairly rapid	High	Unclear (risk of strong displacement effect)
Expand training programmes	Fairly rapid	High	Improve
Reduce labour taxation	Rapid	Potentially high	Neutral
Ease EPL on regular contracts	Fairly Slow / Medium term	None unless accompanied by stronger UI benefits	Improve if help reduce duality
Reform wage bargaining	Slow / long-term	None	Improve if reduce insider-outsider divide
Phasing out subsidies to short-term working schemes	Rapid	Negative	Reduce if jobs prospects remain bleak

Source: de Serres, Murtin and de la Maisonneuve (2011).

StatLink http://dx.doi.org/10.1787/888932402185

Policies to provide income support

Poorly designed unemployment benefits may raise persistence

Designing unemployment benefits to minimise their unintentional side effects on unemployment flows is particularly relevant in the current context. Income support to the unemployed serves several purposes, including providing social protection for individuals, promoting continued labour market participation of job losers and, possibly, enabling better matches of job seekers to jobs, especially when benefits are flanked by effective activation measures.[14] However, the design of unemployment benefits can also exert an influence on persistence by raising the wage threshold below which unemployed will turn down job offers (the so-called reservation wage), reducing job-search intensity and making wages less sensitive to unemployment.

Benefit extension was necessary during the crisis…

Measures adopted in many countries in response to the crisis have raised the level, duration and coverage of benefits. While higher unemployment benefits may raise persistence of unemployment by

14. In normal economic conditions, the potential drawbacks of relatively high or durable benefits on unemployment outflows and persistence can, in principle, be partly offset by their potentially positive effects on the quality, and therefore the duration, of job matches (see OECD, 2010a, for a discussion).

lowering the outflow rate, some of the measures should nonetheless stay in place, either temporarily or permanently. For instance, the extension of *coverage* to additional categories of workers was implemented in response to the crisis but should in general be permanently kept for social reasons as well as to enhance the integration of certain groups in the labour market. Still, such extension needs to be coupled with conditionality and activation measures. Increases in benefit *duration* also were a necessary temporary response in a number of countries to ensure adequate social protection and may also have helped to support aggregate demand. The high level of unemployment prevailing in some countries combined with the weak pace of the output recovery suggests that extended duration should be maintained for some time in order to provide added protection and to minimise the risk of labour force withdrawal and dependence on other forms of benefits.

... but should be reconsidered as the recovery gathers momentum

Still, as the recovery gathers momentum in the majority of OECD countries and conditional on a clear pick-up in labour demand, the extension of benefit duration granted as an emergency measure should be reconsidered, as longer benefit duration weighs on the outflow rate and may exacerbate hysteresis effects (see Box 5.3). Indeed, many empirical studies – especially ones using micro data – have found that the average length of unemployment spells is significantly influenced by the duration of unemployment benefits. In any case, benefits should be conditional on job search and acceptance even from the early stages of the unemployment spells. Making the *level* of benefits decline with duration could also be envisaged as a further job search incentive when initial benefit *levels* are relatively high.

Facilitating the return to work of disability benefit recipients remains a challenge

In many countries, there is a risk of disability benefits becoming the *de facto* support of last resort following the tightening of access conditions to unemployment and social assistance benefits as well as the gradual phasing out of early pathways to retirement. This is particularly the case for people with tenuous attachment to the labour market, be they related to health problems, lack of skills or other disadvantages. Most countries where disability rates trended up over time have taken action to stem the inflow into such income support programme, notably through tighter gate-keeping and better control of sickness certificates. However, bringing benefit recipients with considerable work capacity back to the job market has remained a common challenge. A recent review of country experiences (OECD, 2010d) suggests that policies should aim at strengthening financial incentives for beneficiaries to work and for employers to hire them, including through wage subsidies. In this regard, there is a case for better integrating disability benefits with other working-age benefits as part of a broader reform of the tax and benefit system to make work pay. In parallel, public employment services may need to be tailored to better suit the specific needs of those with partial work incapacity.

Active labour market policies

Active labour market policies can reduce persistence

Different kinds of active labour market policies (ALMPs) can reduce persistence by improving matching efficiency, raising the wage sensitivity to unemployment or directly stimulating job creation. The desirability of different ALMP spending programmes can however differ along the business cycle, as the value of job search is higher during upturns (and conversely the costs of not searching for a job while participating in other programmes, such as training, may be lower during downturns).

Job-search assistance and training need adequate resources…

In the context of the recovery, there is a case for ensuring that resources devoted to job-search assistance are commensurate to the increased task. This holds in particular in countries where the average caseload per staff providing public employment services is likely to have risen substantially during the crisis given the sharp increase in registered jobseekers. Between 2007 and 2009, the number of jobseekers has increased by at least 50% in the Czech Republic, Greece, Ireland, Korea, Mexico, New Zealand, Turkey, the United Kingdom and the United States, and the average caseload per staff has increased in most countries (OECD, 2010a).[15] In addition, since reducing the incidence of long-term unemployment is at this juncture crucial, the intensification of training programmes implemented in most countries in response to the crisis should in most cases be maintained, especially where the unemployment outflow rate has remained depressed. Even though the overall effectiveness of such programmes in providing a sustained exit from unemployment remains unclear, they may be worth pursuing in the current context of difficult access to job opportunities so as to help unemployed to preserve work ethics and limit skills erosion.

… in particular for youth which can benefit most from vocational training

Given the high proportion of youth and low-skilled having joined the ranks of unemployment, an allocation of resources towards vocational training would seem particularly desirable. However, it should also be recognised that such programmes involve relatively large fixed costs and capacity constraints. Therefore, their scale cannot be easily and quickly adapted and their budgetary cost can be substantial, clearly a constraint for many countries, not least those confronted with high risk of unemployment persistence. Moreover, they should be carefully designed to limit the public financing of training that firms would have financed anyway (so-called deadweight losses).

Where budget constraints are most severe, resources should be well targeted

Deciding on which groups of unemployed to concentrate ALMP spending is not obvious as there are opposing arguments and trade-offs. For training the obvious candidates would be the low-skilled and long-term unemployed, especially in countries facing severe budget

15. Data on public employment service staff are not available for every country. Among those where it is, they indicate that the average caseload has increased by at least 50% in the Czech Republic, New Zealand, Turkey and United Kingdom.

constraints. But there is also a case for involving workers early in unemployment spells if the nature of the economic shock renders job-specific skills obsolete immediately after job loss, for instance because structural adjustment away from a particular sector or activity is needed. For job-search assistance, focusing on cases that stand better chances to find a match would make sense given that the aim is to accelerate the return to work. But it could also generate sizeable waste to the extent that these workers may find a job even without assistance. Indeed, an opposite argument could be made for focusing efforts on the long-term unemployed, but this could also involve waste due to the higher risk of failure. In many countries, the most difficult cases to match are often addressed through jobs subsidies or direct public-sector job creation targeted at specific groups.

Labour taxation

Taxes affect both the level and persistence of unemployment…

There is overwhelming evidence that higher tax wedges boost unemployment, with the size of the effect in individual countries depending, not least, on their wage-bargaining system. In countries where real wages are more rigid, the adverse effect of tax wedge increases are likely to be more substantial than elsewhere.[16] There is also some evidence suggesting that the effects of the tax wedge on unemployment comes primarily through a decline in the outflow rate, which reduces the turnover in the unemployment pool and raises persistence (de Serres, Hijzen and Murtin, 2011).

… and cuts in payroll taxes can be an effective way to boost employment

Hence, in the context of the recovery, cuts in payroll taxation might in principle represent an attractive option to provide a near-term boost to labour demand and reduce the risk of persistence. Several countries have indeed implemented cuts in social security contributions or payroll taxes in response to the crisis. The advantage of such measures is that their impact can be fairly rapid and, in principle, they can be put in place on a temporary basis – though knowledge that they are temporary may reduce their effectiveness. However, the measures that are easier to implement, such as for instance cuts to non-wage costs of all existing jobs below a certain wage level, are also the least cost-effective in the short term (OECD, 2009).

Tax cuts are costly and should therefore be targeted…

By comparison, cuts in payroll taxation targeted at new hires (so-called gross hiring subsidies) are less expensive and involve a smaller deadweight loss (OECD 2010a). For this reason they are to be preferred over across-the-board cuts, not least in a context of fiscal consolidation.

16. This is generally the case with bargaining systems that are neither highly decentralised (*i.e.* at the level of the firm) nor fully centralised (nation-wide), but where negotiations take place at the industry or sector level in an uncoordinated fashion, and where the outcomes of the bargaining are typically extended to all firms in the sector irrespective of whether their workers are represented by unions.

Targeting new hires that involve a net increase in jobs (so-called marginal job subsidies) constitutes in principle an even more effective policy, notably because it avoids "gaming" by firms through a mere increase in labour turnover. Indeed, a number of countries (*e.g.* Finland, France, Hungary, Ireland, Portugal, Spain and Turkey) have reduced social security contributions for new hires, in most cases with measures further targeted at specific groups, regions or firms. However, such marginal subsidies can be complex and lengthy to set up and difficult to monitor and administer. And, in the context of return to work strategies, the choice of instrument should also take into account the speed at which measures to stimulate labour demand can be effectively implemented.

... and could be introduced as part of a broader tax reform

On a longer time frame, in countries where tax wedges remain high, a reduction in social security contributions could be envisaged as part of a revenue-neutral tax reform package that could shift the burden towards tax bases that are less damaging for employment and growth. Based on recent empirical work, prime candidates among potential tax bases would be immovable property (see Arnold *et al.*, 2011) or consumption, but environmental taxation could also be considered since it would help achieve other objectives at the same time. Even if they are reflected to some extent in the tax wedge, shifts towards environmental and consumption taxation would help employment insofar as they are levied on broader bases than taxes on wages.[17]

Employment protection legislation

Stringent employment protection helps smooth the impact of shocks but raises persistence

Earlier empirical analysis (*e.g.* Bassanini and Duval, 2006; OECD, 2011, Chapter 3) reflected in Table 5.3 indicates that if stringent employment protection legislation on regular contracts can play a mitigating role in the event of adverse output shocks, it also raises unemployment persistence. Partly to minimise the impact on persistence, many countries (*e.g.* Belgium, France, Germany, Italy, Netherlands, Portugal, Spain and Sweden) have set up so-called two-tier regimes of employment protection, with different and asymmetric degrees of restrictions on open-ended and fixed-term contracts. In some cases, the use of fixed-term contracts has been facilitated with a view to improve access of the long-term unemployed (outsiders) to a parallel job market where wages may be set more flexibly.[18] However, while two-tier regimes may have contributed to raise the unemployment turnover, they are unlikely to

17. Even though the consumption tax can be seen as part of the labour tax wedge, its broader base would imply that a revenue-neutral shift from income taxes and social contributions towards consumption taxation would still reduce the wedge. However, it should be recognised that this could be difficult to achieve politically as it would involve a redistribution of the tax burden from workers towards pensioners.
18. A recent analysis based on the examination of earnings at the individual level has found that employees on fixed-term contracts earned on average substantially lower wages relative to those on permanent contracts, even in the case of individuals with similar education and experience (IMF, 2010, Chapter 3).

lower the long-term or structural rate unemployment (European Commission, 2010). If anything some evidence suggests that they may even be conducive to higher unemployment in the long run (Cahuc and Postel-Vinay, 2002) and can have the effect of amplifying the short-term response of unemployment to shocks (Bentolila *et al.*, 2010).[19]

Reforms of employment protection legislation may help to boost hiring…

In countries where employment protection legislation for regular contracts is very stringent, and where risks of strong unemployment persistence a concern, there is a case for reducing gaps in protection between regular and temporary contracts so as to facilitate hiring in the short term and eliminate the undesirable longer-run effects of two-tier regimes, such as labour market segmentation. Indeed, significant reforms are already underway in Greece and Spain and, given that most other countries are now into the recovery phase, the risk that such reform leads to an increase in unemployment inflow is diminished. Priority areas for reform would be *i*) to reduce the uncertainties related to the application of employment protection legislation for regular contracts so as to reduce the legal and other procedural costs, thereby allowing firms to better internalise the cost of the severance payment in their hiring and wage determination decisions; and *ii*) to better integrate legislation on temporary and regular contracts, for instance by introducing mechanisms for a smooth transition between trial and open-ended phases of a worker's career, with variable degrees of employment protection along this trajectory (*e.g. via* an open-ended contract where severance pay rises gradually with tenure).

… at little or no budgetary cost

An advantage of such reforms is that they entail little or no budgetary cost. However, it should be kept in mind that the favourable impact of such reforms on the outflow rate may take time to materialise and that they can be politically difficult to implement in a context of high unemployment. Furthermore, for many of the countries currently at risk of persistent unemployment, the stance of employment protection legislation is fairly liberal.

Lessons from the crisis

The crisis has brought new insights

Even though it would be premature to draw firm lessons from the crisis, it can be said that labour markets have done comparatively well in view of the magnitude of the recession. This relatively good outcome can in part be attributed to earlier reforms along the lines advocated in the long-standing OECD strategy to boost employment and labour force participation. Even so, the experience over the past few years has clearly put to test many of the policy recommendations conveyed in the OECD strategy and brought a number of insights which could lead to their reassessment.

19. In this regard, the increase in turnover can be viewed as artificial and to some extent counter-productive, especially that workers on fixed-term contracts are less likely to build as much human capital as workers on open-ended contracts given that firms have less incentives to provide training.

Demand conditions and policies are important

- Past experience has shown that recessions accompanied by severe financial and housing market turbulences are usually followed by weak and protracted recoveries, and that more time is needed in such case for the pick-up in activity to translate into lower unemployment. Hence, the role of macro policies and conditions in supporting the on-going recovery remains determinant. While monetary policy is still accommodative, fiscal policy is constrained in many countries by the need to reduce large public-sector deficit and contain rising debt levels. This serves as a reminder of the need for macroeconomic policies during the good times to create room for manoeuvre during bad times.

A flexible benefit system that combines protection and activation helps to cope with a downturn

- Pre-crisis reforms in benefit and activation systems, aimed at broadening coverage, tightening eligibility, increasing conditionality and making work pay, have made a number of countries better prepared to cope with the rapid increase in unemployment, notably by raising the effectiveness of the emergency measures taken in response to the crisis. In this regard, one lesson emerging from the recent episode is that during periods of bleak labour market prospects it may be possible to extend the duration of unemployment benefits without unduly undermining financial incentives to seek work – provided that such extension remains temporary (OECD, 2011, Chapter 1).

The contrasting performance of older workers and youth warrants further analysis

- One of the most striking features of the recent episode has been the good employment performance of older workers, both relative to earlier recessions and in comparison to other age groups. In this regard, the sharp contrast in the performance of older workers and youth may to some extent reflect the large difference in several countries in the degree of employment protection between the two groups. Also, pre-crisis reforms in pension systems, as well as the closing of early routes to retirement, have most likely contributed to the strong labour market participation of older workers during the recent episode. In any case, further analysis is required to better assess the relative contributions of the different possible explanations.

The benefits of partial reforms may be short-lived

- The crisis has exposed the vulnerabilities of partial reform strategies, such as policies that resulted in a high duality of the labour market, in spite of their immediate success in increasing turnover and temporarily bringing down unemployment during the years preceding the recession (Boeri and Garibaldi, 2007).

Work sharing arrangements can play a useful cushioning role

- The relatively benign labour market outcome in countries such as Belgium, Finland, Germany, Japan and Luxembourg has underscored the potential role of work sharing arrangements to cushion the impact of output shocks on employment, an issue which deserves to be further explored (see Box 5.4). Such schemes may work more effectively when implemented in the context of wage bargaining arrangements that provide individual firms more leeway (such as opt-out clauses) in the application of collective agreements.

Box 5.4. **The role of short-time working arrangements during the crisis and beyond**

In many countries, the reduction in average hours worked during the 2008-09 recession has limited the decline in employment given the observed drop in output. In part, hours adjustments rather than headcount adjustment have taken place due to work-sharing arrangements, partly operated *via* public short-time work (STW) schemes. These programmes intend to preserve jobs in firms that experience temporarily low demand by encouraging job sharing, while also providing income support to workers who experience reductions in hours worked. As such, STW schemes are a form of job subsidy. These subsidies can be justified economically insofar as they may avoid losses of specific human capital in the wake of major but temporary economic shocks.

The effectiveness and cost-efficiency of STW schemes have been discussed at length in OECD (2010a) and Hijzen and Venn (2011). Although an empirical assessment of their long-term effects is not yet possible, STW schemes have helped preserve permanent jobs during the economic downturn while promoting reductions in average hours among permanent workers. In Belgium, Finland, Germany, Italy and Japan, STW schemes are estimated to have substantially reduced the impact of the crisis on permanent employment. Hijzen and Venn (2011) estimate that about 234 000 and 416 000 jobs have been saved in Germany and Japan, respectively, thanks to these schemes.[1]

However, their contribution to preserve jobs differed substantially between countries that had already set up those schemes *before* the crisis and those who introduced those schemes *during* the crisis. This may indicate real difficulties in implementing an effective and timely STW scheme after a recession has begun, as the rate of layoffs tends to be higher in early phases of an economic downturn (OECD 2010a, Chapter 5). It also suggests that short-time work programmes could be set up and kept dormant in times of normal activity, and activated if necessary at the onset of future economic downturns.

As with any form of public wage subsidy, STW programmes also entail risks. Firstly, *deadweight losses* may be incurred if subsidies are paid for jobs that employers would have maintained even without public compensations. Secondly, *displacement effects* may occur if STW schemes help preserve jobs that are not viable in the long run, entailing a sub-optimal allocation of capital and workers in the economy. Thirdly, STW could also act to accommodate unwarranted wage increases which might have an adverse influence on wage-setting. To avoid those risks, certain features in the design of STW schemes look desirable:

- *Eligibility conditions,* such as proof of a minimum reduction in production or sales, as well as an explicit agreement between social partners, are likely to reduce deadweight losses. However, too strict eligibility requirements may deter some firms from participating in STW schemes, or might slow down their practical implementation due to excessive administrative costs.
- *Firms co-financing* the cost of STW schemes has two main advantages. First, it is an effective way of reducing deadweight losses. Second, it provides a built-in mechanism for encouraging firms to revert to statutory working hours as the pick-up in demand becomes clear. In practice, firms may either pay some fraction of the wage cost of hours not worked, or pay the full wage during an initial period. Of these two options, the former has an advantage in that it creates better incentives at the margin to withdraw from the scheme. In contrast, when firms pay up-front the full wage for a given period, they have less incentives to withdraw once the period is over. In any case, in several countries, such as Belgium, Canada, Denmark, Finland, Ireland and Spain, firms do not bear any part of the cost.
- Similarly, a *quick phasing out* of short-time work schemes is desirable to minimise the displacement effect. In practice, phasing out can be ensured by a regulatory maximum duration of STW schemes, which was on average equal to 14 months during the crisis (excluding Finland where there is no time limit). This duration limit was substantially increased in Austria, Germany and Switzerland in 2009. It is difficult to determine the optimal timing for scaling down STW programmes, but to avoid hysteresis effects in hours worked, it is important that working-time regulations return to normal within a reasonably short amount of time.

1. In both countries, this represents slightly less than 1% of total permanent employment.

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