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## ECONOMICS DEPARTMENT POLICY NOTE No. 5



# PERSISTENCE OF HIGH UNEMPLOYMENT: WHAT RISKS? WHAT POLICIES?



## Persistence of high unemployment: What risks? what policies?

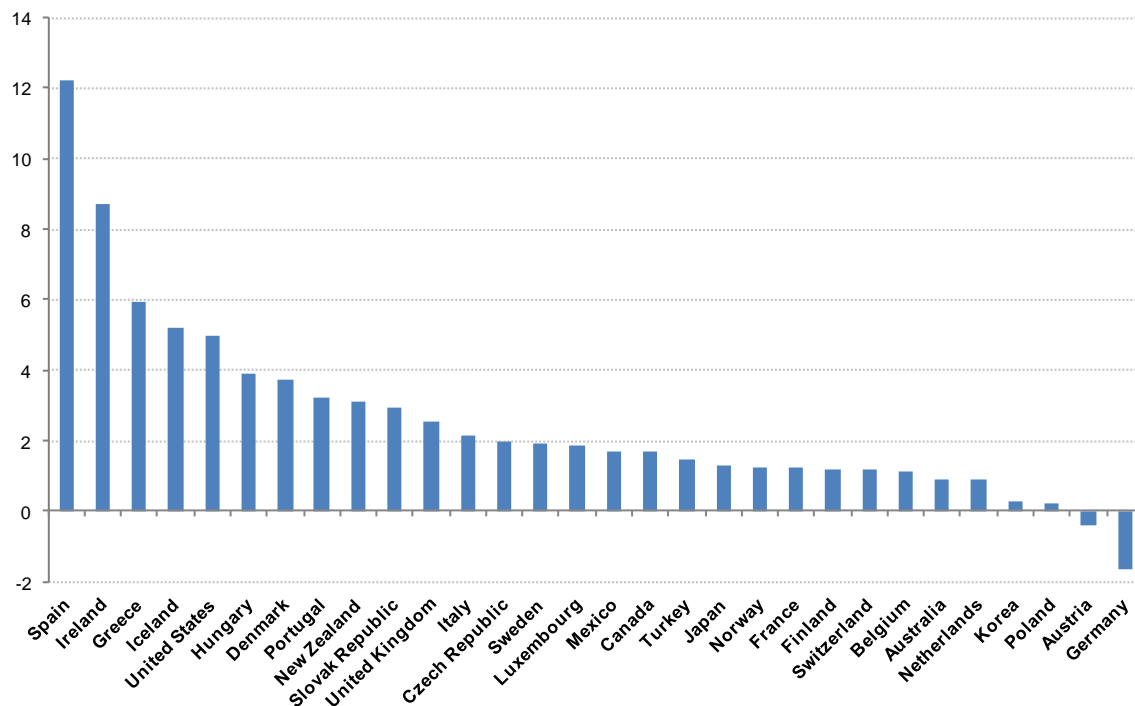
Nearly two years after the end of the deepest recession in decades, a large number of OECD countries still face high unemployment. A number of policy measures can be considered to facilitate the return work and to minimise the risk that unemployed workers stay unemployed or drift out of the labour force.

- Where the opportunities to find a job remain weak and the public finances allow, temporary and targeted cuts in payroll taxes can encourage firms to raise employment.
- Resources devoted to job-search assistance need to be made commensurate to the increased task.
- Given the high proportion of youth and low-skilled having joined the ranks of unemployment, enhancing vocational training is desirable, even if beefing-up such programmes may be difficult in countries facing large budget deficits or with limited training infrastructure.
- The extension in the coverage of unemployment benefits to additional categories of workers implemented in many countries in response to the crisis should in general be made permanent, provided benefits are conditioned on recipients agreeing to job-search availability and activation requirements.
- As the recovery gathers momentum and employment growth becomes more robust, the extension in the duration of unemployment benefits granted as an emergency measure in several countries should be reconsidered.
- Reducing gaps in employment protection between temporary and regular contracts, especially where protection of the latter are very stringent, would facilitate hiring in the short term, reduce labour market segmentation and improve conditions for people with weaker labour force attachment.

### The labour market has yet to recover from the crisis

1. 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, two percentage points or more above the pre-crisis level in 12 OECD countries (Figure 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.

Figure 1. **Unemployment remains well above the pre-crisis level in most countries**  
(Percentage points change in unemployment rate between 2007Q3 and 2010Q4)<sup>1</sup>



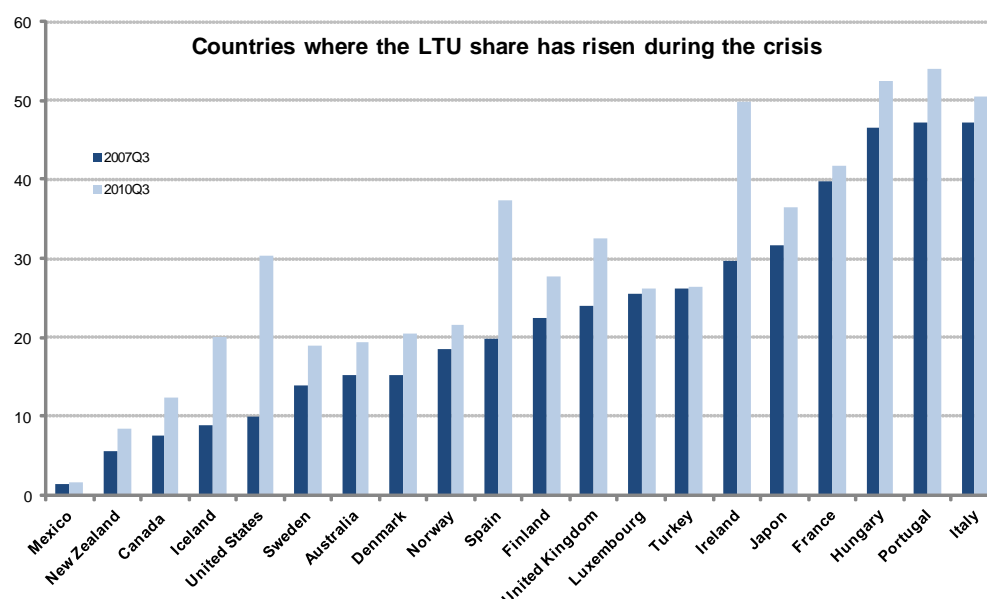
1. Except Ireland, Italy, Mexico, Switzerland and Turkey: 2007Q3-2010Q3

Source : .OECD, Analytical Data base.

## **Some countries are more exposed to risks of unemployment persistence and labour force withdrawal**

2. The crisis has had different impacts on labour market outcomes across countries. This reflected differences in the degree of exposure to specific features of the crisis (*e.g.* the aftermath of financial and housing market bubbles) as well as differences in pre-crisis policy settings and measures implemented in response to the crisis. 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. In many 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, albeit in some cases from a very low level (Figure 2). In other countries (*e.g.* Italy and France), the share of long-term unemployment was already high before the crisis, exposing them also to the risk of a persistent increase in unemployment into the recovery.

Figure 2. **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)<sup>1</sup>



1. Series smoothed using a three-quarter centred moving averages.

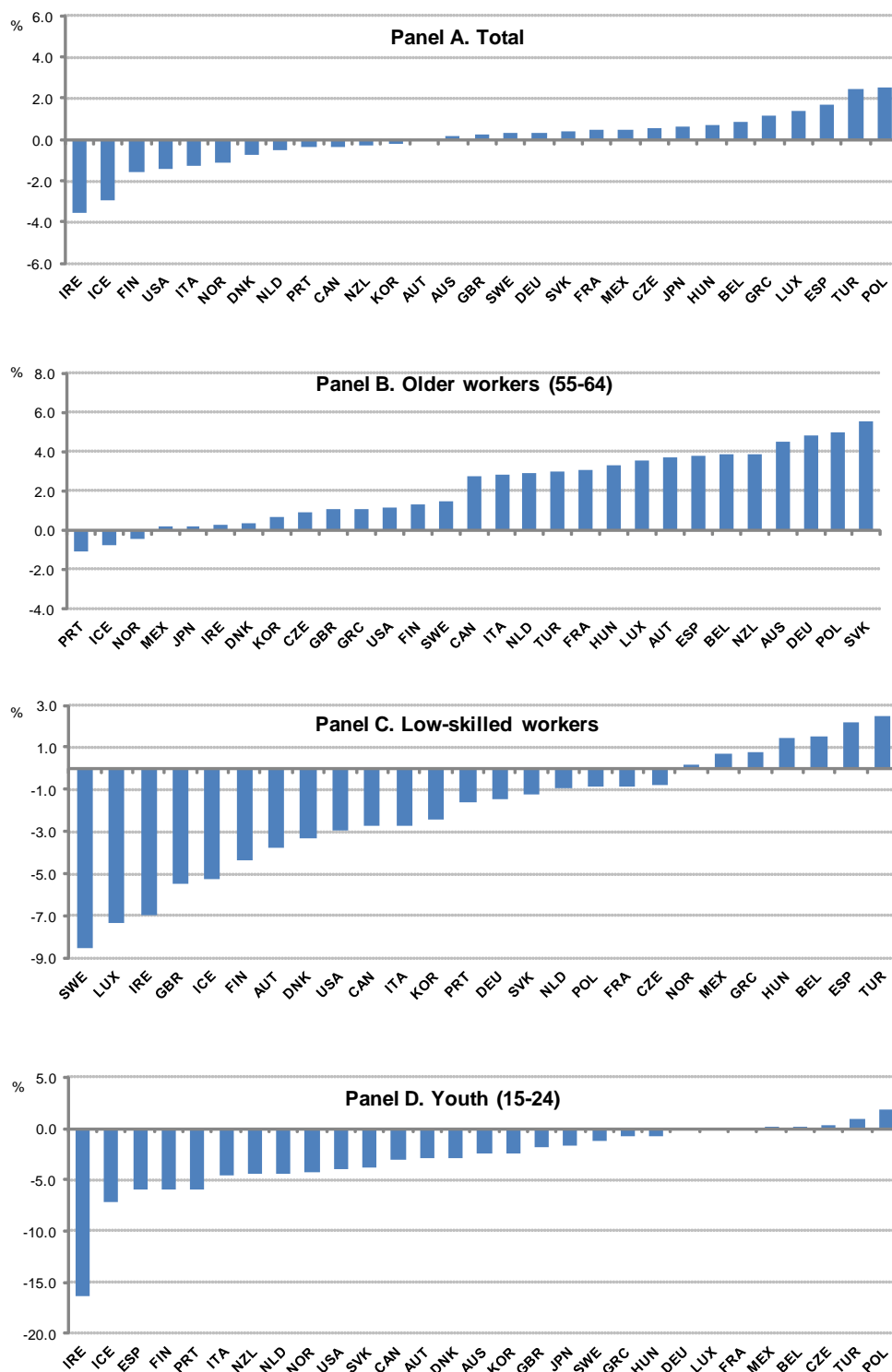
Source: OECD *Employment Outlook*, June 2011, OECD Publishing, Forthcoming.

## Labour force withdrawal has generally been limited, except for youth and low-skilled workers

3. At this stage there has been little evidence of widespread withdrawal from the labour force (Figure 3), but protracted slack in employment raises the risk that unemployed workers drift out of the labour market. In the past, negative effects on labour force participation have come with a considerable delay relative to the original economic downturn.

- Youth is the population group for which labour force withdrawal is most pronounced so far, but it may reflect to some extent longer time spent in formal education. However, for those who do not stay on longer in education and who fail to gain a firm foothold on the labour market, the initial stumble may cast a shadow on their long-term career prospects and future earnings (so-called scarring effects).
- Employment rates of older workers have shown remarkable resilience and have even increased during this crisis. Many of the factors and policies that led to premature exit of older workers via the early retirement route in the past are no longer present or are much weakened. At the same time, the loss of wealth associated with the crisis may also encourage continuing labour market participation.
- A particular concern in countries with high and persistent unemployment is that labour force withdrawal takes the form of an increased take-up of disability benefits. In the past, inflows into disability schemes have peaked after hikes in unemployment and have typically been very difficult to reverse. However, 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.

Figure 3. **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, ELS database.

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

4. Among the policies that can stimulate labour demand so as to boost the exit from unemployment, measures to reduce labour costs through temporary and targeted tax wedge reductions are likely to be most effective in the short run. Cuts in payroll taxation targeted at additional hires are to be preferred over across-the-board cuts, not least in a context of fiscal consolidation. A number of countries (*e.g.* Finland, France, Hungary, Ireland, Portugal, Spain and Turkey) target new hires that involve a net increase in jobs, and this may be the most cost-effective approach. But, such schemes can be both complex to monitor and administer and lengthy to set up. If maintained too long, however, such schemes risk becoming less effective as employers and workers gradually learn how to “game” the system.

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

5. In parallel, more could be done to help the unemployed find the right jobs and keep their skills up-to-date, including through measures to strengthen public employment services and training programmes. As the risk of missing a job opportunity during time spent 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 the low-skilled. However, in countries where budget constraints are particularly severe (*e.g.* Ireland, Greece, Portugal and Spain), stepping up training programmes may be difficult, as could also be the case in countries that do not have the sufficient training infrastructure already in place (*e.g.* the United States).

## **Some extensions of unemployment insurance should be made permanent, while others can lapse**

6. In the United States, Canada and other countries where unemployment benefit duration has been extended, the extension should be maintained until labour market prospects have sufficiently improved to prevent unemployed individuals and their families from falling into persistent poverty. Continued extension may also help avoid the unemployed entering into other benefit systems (such as disability pensions), from which exit may be less likely later on. In the meantime, benefits should be made conditional upon recipients satisfying job-search and availability requirements and, where benefits are relatively high, they could be made to decline 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 participation of newly-covered groups, provided again that job-search requirements can be enforced on these new beneficiaries.

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

7. In some countries, the impact of the crisis on unemployment has been cushioned by strong restrictions on the dismissal of workers on permanent contracts. However, employment protection provisions whose costs are high and unpredictable for employers hinder hiring during the recovery, and streamlining such provisions would reduce the risk of unemployment persistence. At the same time, narrowing, or eliminating, differences in contract provisions across workers, for instance so that employment protection rises with seniority, could boost hiring during the recovery and lower the unemployment rate in the longer term. “Two-tier” systems entailing large differences in protection across different types of contracts have contributed to labour market duality in countries like France, Italy and Spain, thus generating unemployment turnover and high insecurity for certain categories of workers (*e.g.* youth, women) but with no permanent effects on the unemployment rate.

## **The crisis has brought new insights**

8. Given the magnitude of the recession, its effect on employment and participation can be seen as relatively moderate. This outcome can in part be attributed to earlier reforms along the lines advocated in the long-standing OECD Jobs Strategy. Hence, the crisis has underlined the importance of some policy recommendations conveyed in the OECD strategy but it has also brought a number of new insights which, with time and empirical confirmation, may lead to the reassessment of some OECD advice.

- The recession and subsequent recovery has yet again underlined the importance of macroeconomic policies and conditions in supporting activity and demand for labour. This serves as a reminder of the need for macroeconomic policies during the good times to create room for manoeuvre during bad times.
- 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. One lesson emerging from the recent episode is that when these policies are set right it may be possible to temporarily extend the duration of unemployment benefits during periods of bleak labour market prospects without unduly undermining financial incentives to seek work.
- The surprisingly good employment performance of older workers, both relative to earlier recessions and in comparison to other age groups, may to some extent reflect pre-crisis reforms in pension systems and the closing of early routes to retirement.
- Benign labour market outcomes in countries such as Belgium, Finland, Germany, Japan and Luxembourg have underscored that work-sharing agreements and short-time work schemes can cushion the impact of output shocks on employment. Therefore, having such options in place and being able to activate them in severe downturns can be useful, especially in the context of wage-bargaining arrangements that provide individual firms with the necessary leeway for reaching such agreements.

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