POLICY BRIEF

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Promoting Employment Recovery While Meeting Fiscal Goals

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Preface

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As global growth returns to positive territory in 2010, policy makers are struggling to reconcile the urgent need to support job creation with fiscal constraints. This Policy Brief shows that the benefits from adopting and pursuing fiscal measures in support of jobs are significant. Such measures are crucial for reducing the lag between the incipient economic rebound and job creation. Indeed, a premature exit from such measures would weaken the economic recovery, prolong the jobs crisis and, paradoxically, compromise fiscal goals in the medium term. By 2015, a premature exit would lead to lower employment by 4 per cent and worsen fiscal deficits more than would be the case with a job-centred strategy.

The paper also provides concrete examples of how implementation of job-centred measures along the lines of the Global Jobs Pact can promote employment recovery and achieve medium-term fiscal sustainability.

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Introduction

Soon after the start of the global crisis, most major countries launched fiscal packages to stimulate aggregate demand and output. While some of the early emphasis of government responses was centred on restoring stability to the financial sector, eventually a number of fiscal stimulus measures were introduced to support the labour market. The rapidity of the response provided crucial support to the economy and estimates suggest that 7 to 11 million jobs were saved or created thanks to these measures.[1] By the end of 2009, the world economy had resumed modest growth and, in some countries the trend increase in unemployment, which had been registered since Autumn 2008, began to slow.

Despite the fragility of the economic rebound, concern about budget deficits is leading to heated debate as to how quickly fiscal stimulus measures should be withdrawn. Between 2007 and 2009, on average in G20 countries, public debt as a per cent of GDP increased from 62% to 75% motivating worries about the risk of a public debt crisis and nurturing claims for an early exit strategy.

Such an early exit from stimulus measures would, however, strongly compromise employment prospects. By suppressing the main engine of the economic rebound, an early exit would threaten the employment recovery – which typically happens long after any economic recovery. This would not only have severe long-term implications for the labour market, but also for the economic recovery itself while also fuelling social unrest.

How can policies promote employment recovery, while at the same time achieving medium-term fiscal stability? This is the question which is addressed in this paper. The first section examines the risks associated with an early exit strategy. It looks at how a carefully designed crisis response, along the lines of the Global Jobs Pact, would support both employment and fiscal goals in the medium-run, even though this means a lower cut in deficits in 2010.[2] The second section provides examples of countries that have successfully followed this path.

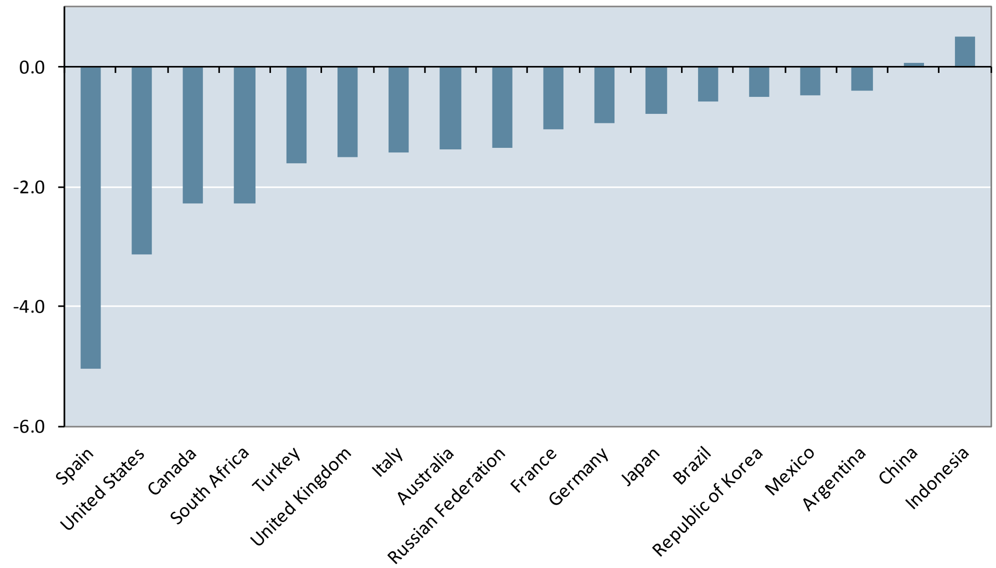
A. Risks associated with early exit from job-centred measures

Underemployment increased significantly since the start of the crisis...

For the world as a whole, employment grew by almost 2% per year in the decade preceding the crisis but fell significantly to just over 0.5% in 2009 – insufficient to absorb the growth in the working-age population. As a result, the employment rate – the share of people of working age who have a job – fell dramatically during the crisis, undoing most of the gains registered over the previous decade. The trend is particularly strong in the G20 countries where the crisis originated (Figure 1).

[1] See ILO. 2009. *Protecting People, Promoting Jobs*, Geneva.
[2] ILO. 2009. Recovering from the crisis: A Global Jobs Pact, Geneva.

Figure 1. Change in employment rates between third quarter 2008 and third quarter 2009 (percentage points)



Source: IILS based on OECD Quarterly Labour Force Survey; ILO Laborsta.

The global unemployment rate increased by around two percentage points between the end of 2007 and the end of 2009.[3] In developing countries, a substantial increase in the incidence of vulnerable employment has been registered suggesting that many more workers have difficulty realising their potential. They perform jobs with limited career prospects, which entails considerable negative impacts in terms of aggregate productivity and growth potential.[4]

... which requires policy action, as market forces are too weak to cut underemployment significantly...

Despite the sizeable labour market slack, the business sector generally lacks the dynamism to grow and make significant inroads into underemployment. First, financial crises typically take longer than other crises before economic growth resumes at a sufficient pace to bring underemployment down to pre-crisis levels. This reflects the fact that households and firms will need to "de-leverage", thus adding upward pressure on saving rates and in turn, continuing to negatively affect consumption and investment decisions in the near-term. Second, there are indications in the countries where the crisis originated that enterprises, in particular job-rich SMEs, continue to face obstacles getting access to bank credit. Third, even in the presence of economic growth, firms will tend to be cautious in their recruitment practices until economic growth is firmly underway. In addition, sectoral shifts in demand and output may be at work, further aggravating labour market challenges (Box 1).[5] This may translate into low employment intensity of growth, in other words a job-less recovery.

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[3] See ILO *Global Employment Trends 2010*, Geneva.
[4] See Joint ILO-WTO Study. 2009. *Globalization and Informal Jobs in Developing Countries* (Geneva).
[5] See GB.307/STM/1, "The sectoral dimension of the ILO's work", ILO, Geneva.

Box 1. *Labour market impacts of crisis-related changes in sectoral demand and output*

*The economic crisis has triggered sectoral shifts in economic activity and jobs. Certain sectors which had built up substantial capacity during the upswing – such as financial services, real estate and construction – have been strongly hit by the crisis. This may trigger a permanent reduction in activity and employment levels in the sectors in question. Evidence suggests that for financial and real estate services alone, permanent employment loss could range between 1.5 and 2% of total employment.**

Additional pressure on certain sectors comes from the fact that with the onset of the crisis, saving rates have increased in almost all countries. This means that sectors producing durable consumer goods may experience sluggish demand growth in the coming years. This would also have strong implications for suppliers.

* Escudero, V. 2009. *Effects of the crisis on the financial sector: Trends and policy issues*, Discussion Paper 197 (Geneva, International Institute for Labour Studies).

... which may result in growing labour market exclusion ...

The above trends suggest that employment levels are below potential and there is significant scope for promoting job growth. But there is a risk that unless further action is taken quickly, many unemployed and underemployed workers will either endure sustained periods out of work or drop out of the labour market entirely, leading to permanent skills erosion. In the aftermath of the recession that hit EU countries in the 1990s, the incidence of long-term unemployment increased by over 5 percentage points while at the same time participation rates declined significantly.

Labour market exclusion has started already. In most developed countries, participation rates dropped in 2009 (Figure 2). Certain groups are disproportionately affected by labour market exclusion, notably disadvantaged youth, young mothers, migrants and older workers.

The fall in the labour force, therefore, does not bode well for the sustainability of the ongoing recovery and may further limit the possibilities for countries to return to previous employment levels quickly.[6]

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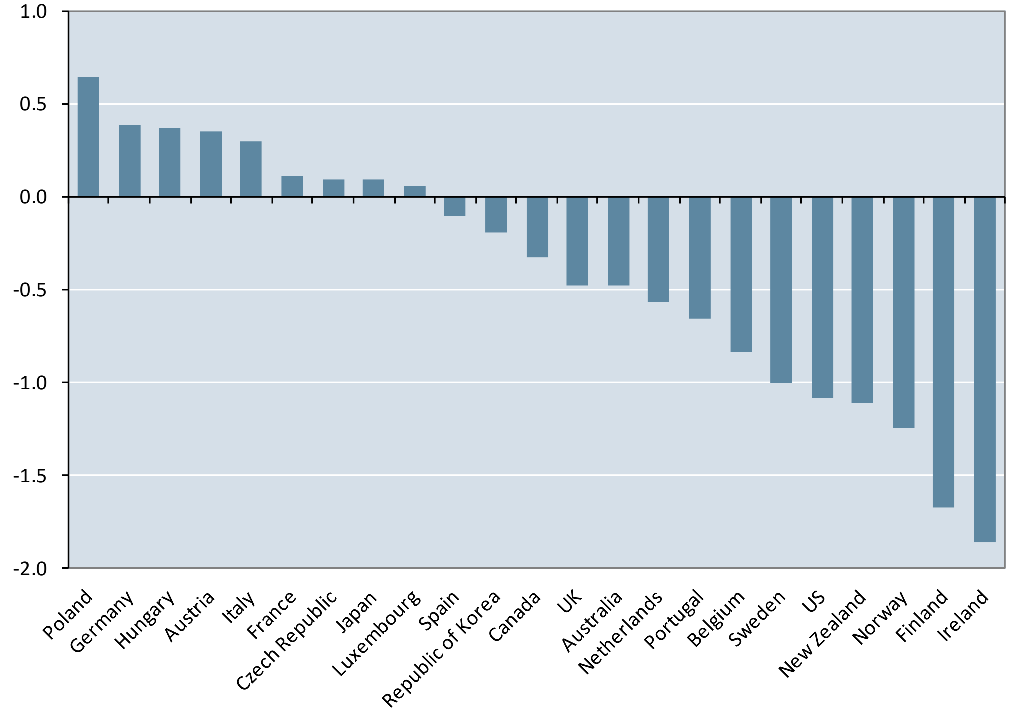
[6] International Institute for Labour Studies. 2009. *World of Work Report 2009: The Global Jobs Crisis and Beyond*, ILO, Geneva.

Figure 2. Labour force growth, Q4 2008 to Q4 2009 (percentage point change in labour force participation rates)



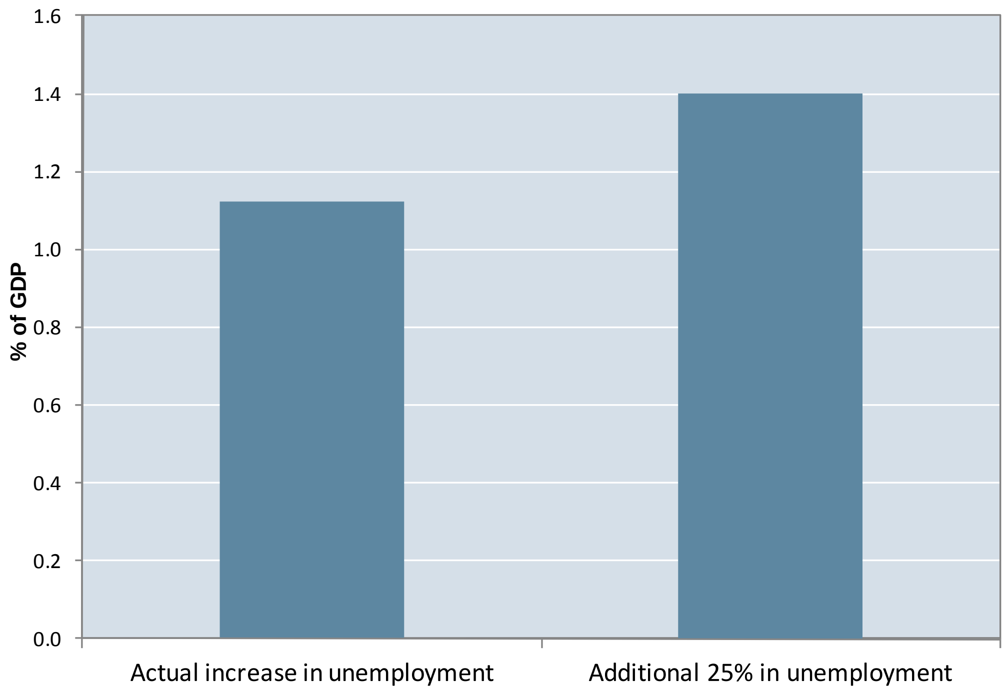
Source: IILS based on OECD, Economic Outlook, EO 86.

... compromising the achievement of medium-term fiscal goals.

Therefore, tightening fiscal and monetary policies instead of taking action to address these labour market challenges will depress further employment growth. Moreover, an early exit would also aggravate fiscal deficits over the medium term in number of ways. First, in developed countries, the increase in unemployment benefit recipients which happened since the crisis – entails additional budget spending of approximately 1% of GDP (Figure 3). This figure rises to around 1.4 % of GDP in the case of a further 25% increase in the number of recipients.

Second, an early exit would also erode the tax base. A permanent reduction in labour force participation would deprive the economy, thus the budget, from valuable resources. This is especially the case in developing countries where many job losers that worked in the formal economy shift permanently to the informal economy, where both productivity and the tax base are limited.

Figure 3. Budgetary cost of early exit (percentage of GDP)



Note: The Figure refers to spending on unemployment benefits associated with i) the increase in the number of benefit recipients that has been observed since the crisis ("actual increase in unemployed") and ii) a further 25% increase in the number of recipients. The Figure gives a weighted average for the countries for which the estimates could be made, i.e. Australia, Canada, Czech Republic, Finland, France, Germany, Iceland, Ireland, Japan, Republic of Korea, Luxembourg, Netherlands, Slovak Republic, Sweden, the United Kingdom and the United States. The calculations are based on net replacement rates for an average two-earner household with two children in 2008.

Source: IILS estimates based on OECD tax and benefit models.

Job-centred measures help achieve both employment and fiscal goals

Additionally, evidence from recent expansionary periods indicates that providing individuals with the skills necessary to participate effectively in the labour market after a long period of detachment could prove more costly to the public purse than taking preventative action early.

Based on past relationships between policies and employment, it is estimated that an early exit from job-centred measures would significantly aggravate the employment outlook. Figure 4 presents two employment scenarios: i) an early exit from stimulus measures and ii) pursuit of job-centred policies (or "baseline" scenario). This analysis was carried out for developed countries only. It suggests that, if restrictive measures were adopted now, employment would be 4% lower in five years time (by the end of 2014) which is equivalent to around 16 million jobs in the developed countries under analysis.

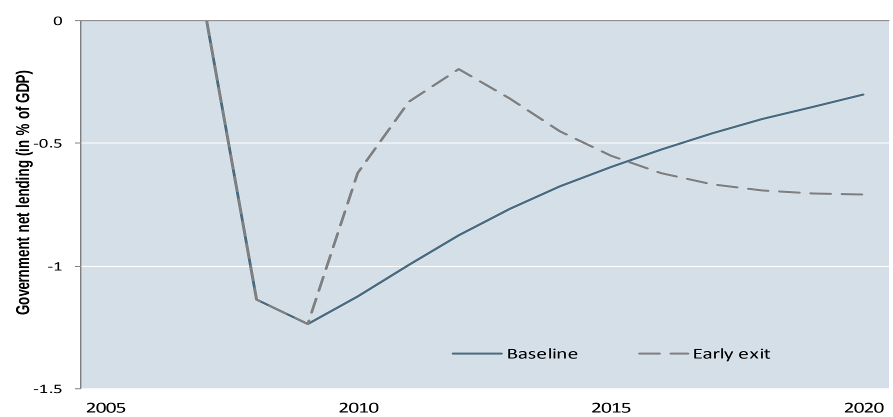
An early exit from stimulus would improve fiscal balances in the short run. However, it is crucial to note that this improvement would prove short lived.

Shortly after early exit measures were adopted, fiscal deficits would deteriorate once again. This reflects the fact that i) many workers would move out of the labour market, depriving the economy from valuable resources and reducing the tax base; and, ii) unemployment and labour market inactivity resulting from early exit measures have a strong bearing on spending, as noted above.

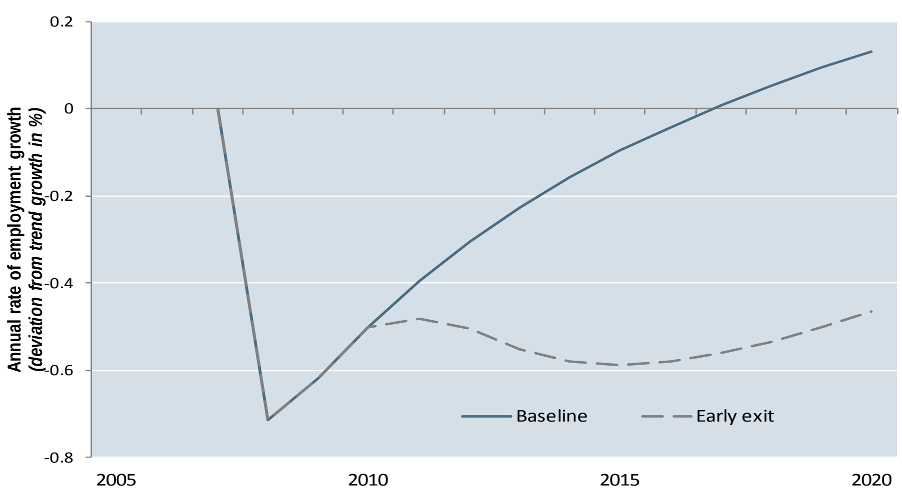
Interestingly, the continuation of job-centred policies, though costly to the public purse in the short run, would in five years time lead to fiscal deficits similar to those of an early exit strategy. In particular, by putting greater emphasis on labour market measures, they will be able to limit further increases in job destruction, avoid a downward spiral of wages[7] and boost job creation.

Figure 4. Exit scenarios from the crisis (advanced G20 countries)

Panel A - Government deficit



Panel B - Employment



Note: The chart displays two different exit scenarios from the crisis. Scenario 1 assumes the continuation of job-centred policies whereas scenario 2 describes an early exit where deficits are aimed at being brought back to baseline within 3 years. The graphs describe deviations of government net lending (in % of GDP) and employment growth (in % per year) from the reference value that would have been observed in the absence of the crisis (indicated in red). The graphs display weighted average of G20 dynamics where public deficits have been weighted using the level of GDP and employment growth has been weighted by the size of the labour force.

Source: IILS estimates (see Annex for details).

[7] See ILO. 2009. *Global Wage Report Update*, Geneva.

B. Country examples of well-designed job-centred measures

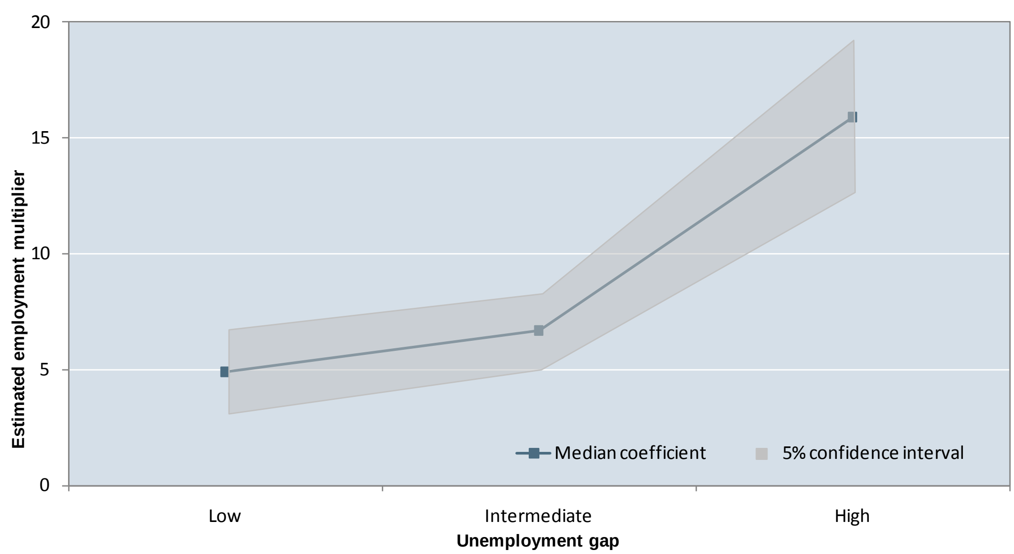
Though an employment-oriented stimulus would improve the medium-term prospects for both employment and public, care should be taken in the design of any fiscal measures that are continued.

In general, the "employment multiplier" of an intervention depends on i) the timing of the intervention; ii) the direct employment effect of the intervention in question; and iii) the indirect effects, taking into account the fact that the measures need to be funded and that this, in turn, may have negative implications for the economy and jobs.

The employment multiplier is larger when measures are adopted quickly…

Evidence suggests that moving quickly is essential for reducing the risk of long-term unemployment and informality. Figure 5 shows that the employment multiplier of policies is strongest in the presence of high cyclical unemployment – as has been the case until now in many countries.

Figure 5. The larger cyclical unemployment, the higher the employment multiplier of government spending



Note: The figure gives estimates of the effect of government spending on the probability to move from unemployment to work, at various levels of the unemployment gap (a measure of the extent of labour market slack).

Source: IILS estimates.

However, the employment multiplier is low for highly indebted countries. According to recent estimates, the effectiveness of fiscal measures tends to weaken when government debt exceeds 85 to 90% of GDP.[8] This is because financial

[8] Reinhart, C.M.; Rogoff, K.S. 2010. *Growth in a time of debt*, Working Paper 15639 (Cambridge, MA, National Bureau for Economic Research).

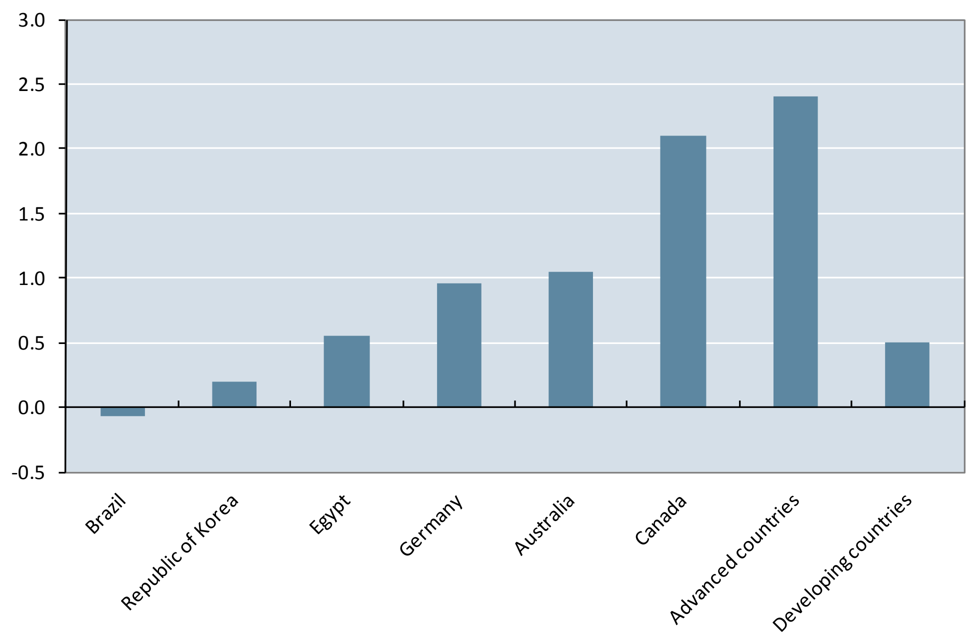
markets tend to demand higher interest rates on any new lending beyond this threshold.

... and are job-centred, as illustrated by the experiences of some of the most successful countries he employment.

Spending on labour market programmes can bring multiple benefits at both the macro- and the micro-economic levels. Properly designed labour market policies help job seekers to find new employment opportunities more rapidly, while at the same time sustaining disposable income and demand. Such policies also strengthen incentives for firms to advertise new vacancies and can help reorient job searchers to occupations and sectors where new growth opportunities arise.

This is confirmed by an examination of crisis responses in Australia, Brazil, Canada, Egypt, Germany and the Republic of Korea (Figure 6). These 6 countries, covering different regions, have started to emerge from the crisis.

Figure 6. Changes in unemployment between end-2008 and end-2009 (percentage points)



Source: IILS estimates based on national sources and *Global Employment Trends*, 2010.

As evidenced in the previous section, countries that were better able to cope with the ramifications of the crisis are those that had adequate fiscal space. Such fiscal space allowed for swift and aggressive stimulus packages over the course of the year. Also of importance was the institutional capacity to quickly enact such stimulus measures, including both social protection and labour market initiatives much in line with the recommendations put forward in the Global Jobs Pact.

Although there is no 'perfect policy package' for overcoming such an unprecedented crisis, the policy approach of these six countries which were better able to cope with the crisis suggest possible strategies for avoiding the risks associated with an early exit, as identified in part A. The examples demonstrate that in practice as well as theory, well-designed job-centred measures can promote employment recovery and at the same time achieve medium-term fiscal sustainability. .

i. ***Job saving measures stemmed the surge of underemployment***: Direct financial support to the private sector has been used in successful country cases, particularly when used to lower labour costs and maintain employment through job-sharing. There is also the added social benefit of keeping workers tied to the labour market. In this respect, Germany extended the maximum length of its existing short-time working programme (Kurzarbeit) to 24 months in May 2009. The number of beneficiaries under the shortened working hour scheme rose from over 130,000 participants in November 2008 to more than 1.4 million workers in June 2009 and is credited with saving around 500,000 jobs so far.[9]

ii. ***Swift action on social protection: brought multiple benefits***: Each of these countries had strong social protection initiatives in place prior to the crisis that could quickly be scaled up. Automatic stabilizers such as unemployment insurance and pension schemes are crucial, but additional elements of discretionary policy such as minimum wage increases and cash transfers are other examples of such support.. For example, Brazil's pre-existing Bolsa Familia programme that provides cash transfers to poor families was quickly ratcheted up (the number of families benefiting rose by over 1 million and benefits were increased by approximately US$76, i.e. from R$120 to R$137). In addition, Brazil has institutionalized increases in the minimum wage, and frontloaded spending on its public infrastructure programme. Such programmes aided in the recovery process by: a) providing an efficient mechanism for transfer payments; b) mitigating the social impact on the most vulnerable groups; and c) supporting demand by providing income support to cash-constrained households who would likely use the transfers for consumption.

iii. ***Targeted assistance to vulnerable groups prevented labour market exclusion***: Social assistance to low income households, youth and older workers has helped to boost consumption as well as prevent labour market detachment and long term unemployment. Such targeted assistance is commonplace in Canada and stimulus efforts have reinforced and provided additional support in the form of temporary employment and skills and training for youth, minorities, and older workers.

iv. ***Consumption and employment was boosted through targeted assistance to labour-intensive sectors***: Temporary tax rebates and subsidies have been used to preserve employment in important sectors and boost consumption. For example, small business owners in Australia received an additional 20 per cent tax deduction expenditures on capital assets. In other cases, tax rebates for automobile purchases and other durables (as was the case in Brazil), as well as homebuyers subsidies such as those implemented in Australia have proven effective.

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[9] RSM International, Labour Market Trends in the Wake of the Great Recession: Implications of the 'New Normal', October 2009. http://www.rsmi.com/en/global-challenges/labour-market-trends-in-the-wake-of-the-great-recession.aspx

v. ***Social dialogue helped identify appropriate solutions***: Tripartism and collective bargaining between employers, workers and government has helped in finding appropriate solutions to the crisis and avoiding some measure of social unrest. The Republic of Korea is one of the countries where social dialogue with workers, employers and government has played a significant role in its crisis response. For example, it was agreed that workers would refrain from strikes during the crisis and that employers should foster trust and transparency in management matters. The groundwork for the culture of tripartism and social dialogue was laid during the Asian financial crisis.

vi. ***Job creation measures are achieving both employment and fiscal goals***: Infrastructure spending has been a large component of successful stimulus packages, particularly as it has aided vulnerable sectors through consumption support and job creation. In Egypt, fiscal stimulus efforts have been predominately geared towards employment-intensive infrastructure spending, mainly in potable water, sewage, roads and bridges, but also targeting the construction of new schools and basic health care facilities. In fact, infrastructure spending has the largest multiplier effects and is the most direct way to create employment, particularly when such projects are labour intensive and have short implementation lags. Within this area public works programmes have been used for reaching disadvantaged groups, such as low-income and the long term unemployed.

In short, timely and aggressive policy initiatives aimed at boosting effective demand through targeted cash transfers, job creation and saving strategies, as well as extra assistance to vulnerable groups and sectors have generally been favourable to the recovery process. Additionally, social dialogue has featured prominently in the process of finding crisis mitigation policies.

Countries have drawn on these principles to varying degrees in order to address their country-specific needs. In Australia and Brazil, two large commodity exporters with strong internal demand and adequate fiscal space, the economic recovery was supported by large infrastructure investment and household expenditures – of which increased social assistance to targeted groups was a significant catalyst. In Australia targeted assistance to vulnerable groups and labour hoarding helped to underpin employment until economic activity rebounded. Both countries have strong elements of social dialogue in the decision making process.

In countries with a more muted economic recovery, specific employment and social policies have aided in labour market stabilization and provided critical support to those most in need. Canada's plethora of smaller labour market initiatives provided targeted support for the unemployed and vulnerable workers. In Germany and the Republic of Korea, job losses were limited by enhancements to existing job-sharing schemes; while in the Republic of Korea negotiated wage restraint with the social partners played a key role as well as targeting social assistance to the most vulnerable groups, particularly youth and the recently unemployed. Egypt's labour market response also consists of frontloading of budgeted public investment projects as well as additional infrastructure projects in an attempt to prop up domestic consumption and stabilize the employment situation. The country has also tried to tackle both the food crisis and the fallout from the global financial crisis concurrently with initial measures to increase social assistance to low-income households and increase minimum wages.

C. Concluding remarks

Despite the encouraging signs of economic rebound, the crisis continues to pose serious challenges to labour markets across the globe. This calls for an implementation of job-centred measures along the lines of the Global Jobs Pact. Though some of the measures have a budget cost in the short run, the benefits for employment are significant.

The effectiveness of these measures is heightened if they are put in place quickly. The longer the labour market crisis continues, the more unemployed workers get discouraged and leave the labour market. In this respect, implementing the Global Jobs Pact as swiftly as possible will help support labour market recovery while also achieving medium-term fiscal goals.

Finally, the effectiveness of job-centred crisis responses will be constrained as long as the root causes of the crisis are not addressed. Rescue packages to financial institutions have reached unprecedented levels in countries where the crisis originated. The bill will be expensive for taxpayers and job losers. It is therefore essential to ensure that an end is put to those financial practices and irresponsible risk-taking that preceded the crisis.

Annex: Crisis exit scenarios

The purpose of this Annex is to explain how the exit scenarios, as illustrated in Figure 4, were obtained. The scenarios are the outcome of a small macroeconomic model established for G20 countries. In this model, the effects of an increase in government spending on both job loss and job creation are estimated. Estimates suggest that well-designed government spending helps prevent job loss while supporting re-employment of unemployed workers. For the sake of simplicity, the analysis considers that public spending measures have a direct impact on aggregate demand (instead of indirectly through private consumption), which will stimulate labour demand at the firm level.

The analysis also includes a feedback loop from unemployment in- and out-flows to government spending and net lending. These feedback loops reflect both automatic stabilizers and discretionary spending in reaction to changes in labour market conditions. Taking such a feedback mechanism into account is essential for properly assessing the fiscal-labour market dynamics. Moreover, unemployment in- and out-flow equations are estimated simultaneously, to best reflect the different adjustment mechanisms of job destruction and job creation, as well as the interaction between both phenomena.

Importantly, the model does not take into account the possible reaction of interest rates to higher government deficits and rising public debt. This is probably reasonable for the purposes of this analysis, given stable expectations regarding interest rates on public bonds for major G20 countries. The retroactive effects of fiscal policy on monetary variables and the real economy will be assessed in later research.

The model is estimated for the G20 countries for which the relevant data are available, using panel data estimation techniques. The sample covers the period 1970-2007 to make the results robust to the business cycle. The equations which serve as a basis for the simulations shown in Figure 4 can be found in www.ilo.org/inst. They were estimated using General Method of Moments techniques.

The baseline scenario considers the endogenous behaviour of the system following the shock to labour demand observed during the crisis and taking into account the policy reaction that happened so far. Thus the baseline scenario assumes a continuation of job-centred policies as adopted soon after the crisis. The early exit scenario considers that governments try to close the budget balance prematurely by tightening public spending to pre-crisis levels within three years following the full impact of the crisis on government budgets. This scenario considers that no additional tightening is attempted thereafter, leaving the system adjusting itself to the policy shock.