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Article

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UNEMPLOYMENT PERSISTENCE

TORBEN M. ANDERSEN*

Higher unemployment is an inevitable consequence of the financial crisis. According to OECD projections, unemployment for the OECD countries will on average rise from less than 6 percent in 2007 to 9 percent in 2010. Higher unemployment is a direct cost of the financial crisis, and there is a widespread fear that the increase in unemployment may become persistent. The experience from the 1970s and 1980s with high and persistent unemployment stands out as a worst case scenario with large social costs and severe consequences for the already much strained public finances. Accordingly, how to minimize the risk of persistent high unemployment is an important policy question.

Many countries have resorted to an active demand management policy as a response to the crisis, and this has undoubtedly helped mitigate the consequences of the crisis. It has also been argued that an aggressive demand management policy may even pay off in the medium to long run by reducing persistence in unemployment. The argument being that by reducing the impact effect of the crisis on unemployment, fewer will risk becoming long-term unemployed. While this argument has some weight, one must be realistic about the potential of fiscal policy in this respect. This is so due to labour market dynamics and heterogeneity, where two dimensions are particularly important. First, the sectors adversely affected by the crisis (building sector, financial sector, export

sector) are not necessarily those which would benefit from a more expansionary policy increasing public and/or private demand. Hence, the perceived effect of fiscal stimulus on aggregate demand may underestimate the implied need for labour restructuring and adjustments. In short, the areas experiencing job creation are not necessarily the same as those suffering from crisis induced job destruction. The second reason is that labour dynamics imply that increasing unemployment is an unbalanced event tending in particular to affect the young, the old, the less skilled, immigrants and other marginal groups in the labour market.

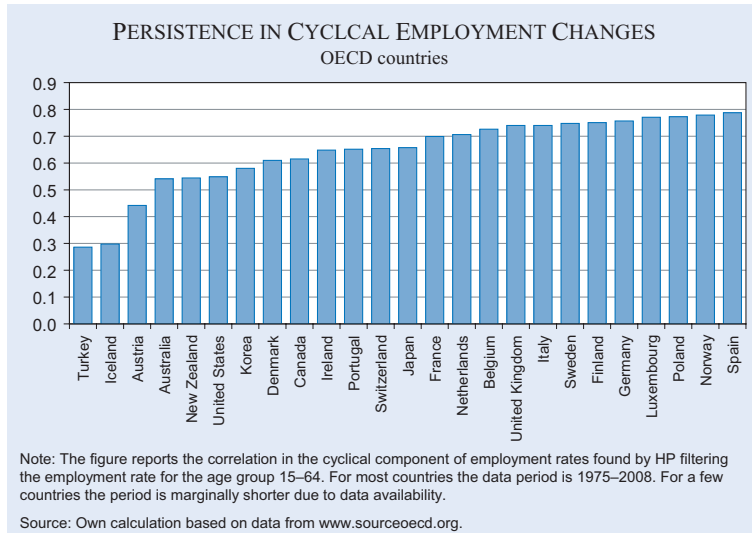
In sum, aggregate demand management policies are effective in mitigating some of the consequences of the financial crisis, but it is neither a guarantee against persistence in unemployment, nor necessarily well-targeted in counteracting persistence.

Persistence in the labour market

It is well-established empirically that labour markets display substantial inertia in the sense that (un)employment is highly persistent. Figure 1 illustrates this by reporting a metric for the persistence in the employment rate for OECD countries. The employment rate is used rather than the unem-



Figure 1



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ployment rate, because the measured unemployment rate is affected not only by changes in employment but also by changes in labour supply tending to move pro-cyclically. Hence, a more reliable measure of the state of the labour market is the employment rate. This variable also better summarizes the implication of the labour market stance for public finances. Although there is some variation across countries, the figure shows that the persistence in the employment rate is high in most OECD countries.

Such simple historic measures should be interpreted with some care. They do not clearly separate the role of shocks and their persistence from the persistence generating mechanisms arising from sluggish adjustment of various forms. Moreover, the adjustment path and thus persistence depend on institutional settings and policy reactions which may shorten or prolong the adjustment.

While unemployment persistence may arise for various reasons, it becomes particularly important when it reflects that unemployment is concentrated on a specific group, the long-term unemployed. In itself this has social costs, and it also implies that the effective labour supply is reduced in a medium-term perspective due to human capital depreciation. The latter, in turn, makes it difficult to bring employment back to its initial level and thus reinforces persistence. Prolonged unemployment may imply a depreciation of human capital along various dimensions including work experience, self-esteem, social capital, networks etc.

Losing the young or dropping the old?

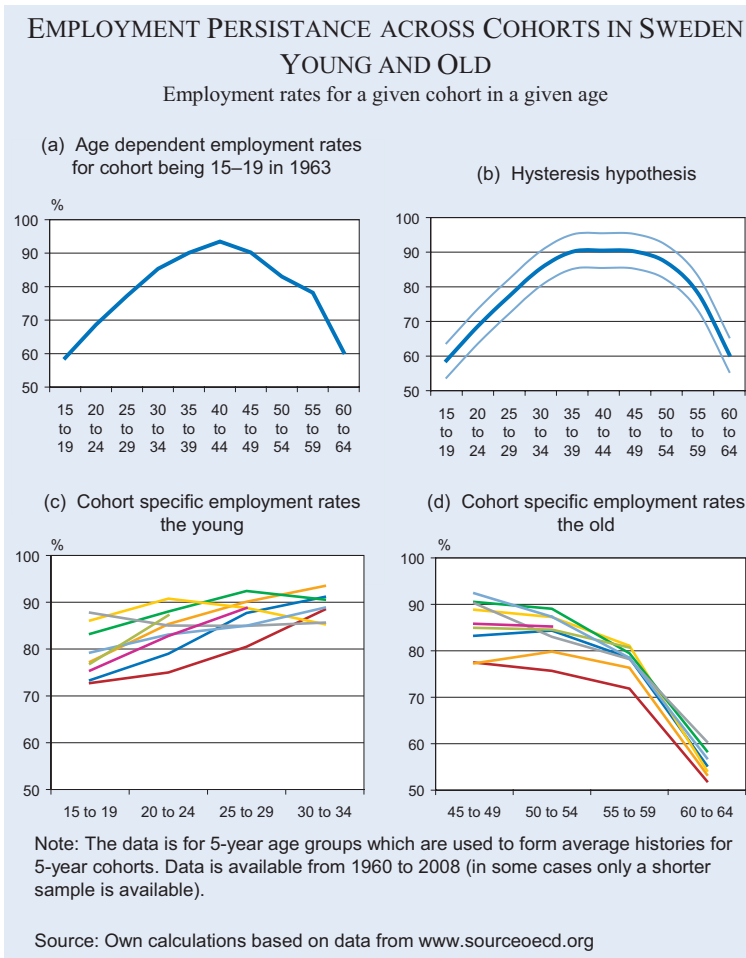
These concerns are supported by the fact that a number of countries have experienced a steep increase in youth unemployment and there is fear that generations will be lost. At the same time, increasing unemployment among older workers is in itself a problem, which moreover may challenge the agenda in most countries to increase retirement ages as a remedy to counteract the effects of ageing. The fact that youth unemployment is particularly sensitive to the business cycle is often taken as an indication that persistent youth unemployment is the major risk. However, it is not clear that one can infer from cyclical variability to the risk of persistence, as is seen by considering the labour market performance of young and old.

The typical labour market history has the employment rate at first increasing and then decreasing with age, i.e., an inverted U-curve – see Figure 2a. The persistence hypothesis can be summarized as follows: if a cohort for some reason is exposed to a negative or positive shock, then this will tend to affect the labour market history of this cohort for several years, and possibly its remaining labour market horizon. This is illustrated in Figure 2b by the dotted lines indicating two such profiles: a young generation happening to enter the labour market in a very favourable period which permanently results in a higher employment rate at all ages, or – in contrast – another generation entering in a period with low employment and later suffering from lower employment rates. Clearly, such shocks may arise at different ages for different cohorts. Figures 2c and 2d look at this issue separately for the young (age 15 to 34) and the old (age 40 to 64): the separation is made as the data availability provides few complete labour market histories. Figure 2c thus addresses whether the young become a ‘losing’ or ‘winning’ generation depending on whether they enter the labour market during a boom or recession. Similarly, Figure 2d considers how the old fare in the labour market.

Figures 2c and 2d provide the data for Sweden, but the pattern is similar for most countries for which data is available. For the young there is an unclear pattern; some generations start out with a low employment rate relative to other cohorts, but end up with a relatively high employment rate. Obversely, some cohorts starting out with a relatively high employment rate end up with a relatively low employment rate. In short, there is no clear pattern suggesting strong persistence in employment across cohorts in the younger ages. For elderly individuals there is a clearer picture in accordance with the persistence hypothesis. Cohorts having a relatively low (high) employment rate in the midst of their labour market career also tend to have a low (high) employment rate for their remaining labour market history. Persistence in employment for elderly workers is resolved when they retire. Hence, shocks affecting the middle-aged will typically produce persistent effects on the overall employment rate for a period of 15 to 20 years.

Figure 3 illustrates the correlation in cohort specific employment rates at various ages. The correlation indicates how employment of the age group 30–34 depends on employment of the age group (20–24) and how the employment of the old (60–64) depends

Figure 2



on employment as middle aged (45–49). In the case of the young there is no clear evidence of persistence, and in many cases the effect is wrongly signed.¹ The employment rate for the young seems to depend more on the current business cycle situation than their earlier employment rate. For the old, in most cases, there is a much clearer indication of persistence implying that a low employment rate as middle aged tends to lead to a low employment rate for the remaining labour market history.

Thus, there seems to be a particular risk that a deep recession may permanently reduce employment rates for older workers, whereas it is less clear whether youth unemployment will produce ‘losing’ generations. Either persistence is more important for the old or policies have been more active or successful towards the young. There are various possible explanations for these facts. The implications of human capital depreciation may be more important

¹ Note that this focuses entirely on employment rates, but there can be other scarring effects of youth unemployment, see Bell and Blanchflower (2010).

for elderly workers since knowledge and experience accumulated through a long work career may become suddenly obsolete. Moreover, a shorter remaining labour market horizon may have adverse effects on both the demand and the supply side of the market in relation to employment. The employment path for elderly individuals is also affected by various pathways out of the labour market such as early retirement and disability pensions. In contrast, there has been more political willingness to pursue more active policies towards the younger age groups.

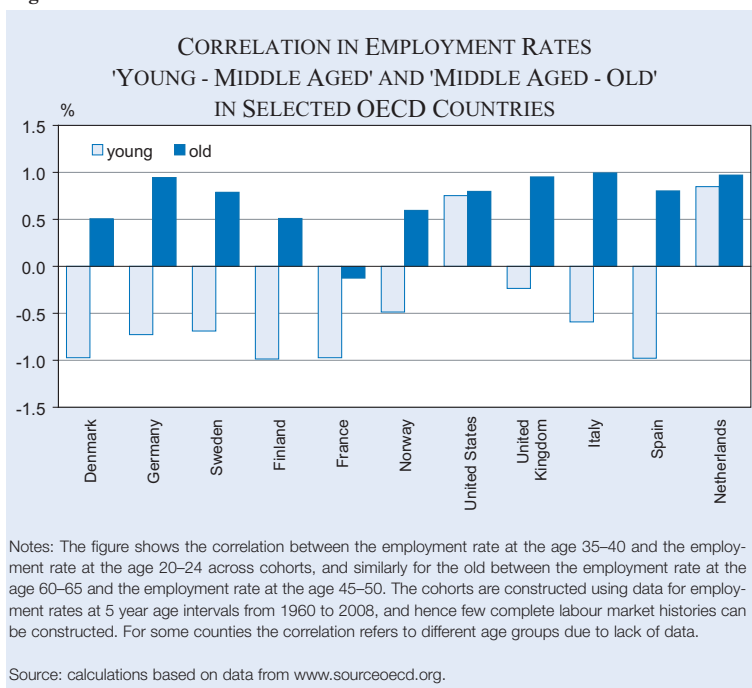
The role of labour market policy

It is a primary purpose of labour market policies to address the problem of persistence and long-term unemployment. As a consequence of the crisis, the policy orientation therefore has to change from focussing on reducing the stock of long-term unemployed and marginalized to minimizing the inflow into long-term unemployment. The evidence above shows that it is particularly important to avoid that middle-aged workers become marginalized.

The clearest policy lesson from the 1970s and 1980s is that reductions of labour supply (e.g. early retirement schemes) were not successful in solving the underlying problems, but had large long-term costs since the schemes have been politically difficult to reverse. This lesson seems to have been learned, since few new passive measures allowing easier exit from the labour market have been introduced in response to the financial crisis. However, some of the existing pathways out of the labour force via early retirement, disability pensions and the like may be further used as a response to the increasing unemployment problem.

As a first response to the increase in unemployment, some countries – beyond aggregate demand measures – have made changes to unemployment insur-

Figure 3



ance schemes and the social safety net to ensure income protection for those adversely affected by the crisis. There is not necessarily a problem in offering better insurance in a difficult situation with a high unemployment rate. This has direct welfare effects, and the implied distortions are likely to be smaller in a situation with high unemployment. The critical aspect is to ensure that such changes are temporary. This can be achieved by linking the properties of the unemployment insurance benefit (UIB) scheme more explicitly to the state of the labour market. This is known from the United States where the benefit duration depends on the unemployment rate. An even more sophisticated scheme is applied in Canada where benefit eligibility, benefit levels and duration depend on the labour market situation. Theoretically, it may be argued that such a scheme may strike a better balance between insurance and incentives by providing more insurance when the need is largest (high unemployment periods) and strengthening incentives when the distortions are potentially largest (low unemployment periods) – see Andersen and Svarer (2009).

It is sometimes argued that schemes offering better insur-

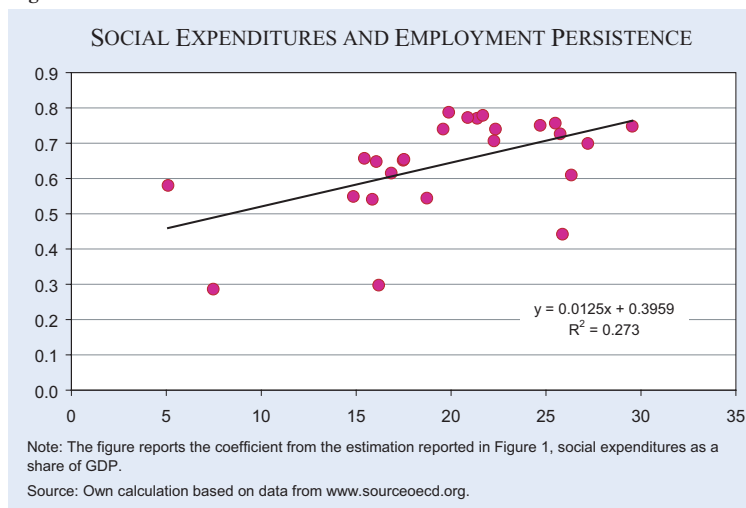
ance are bound to cause more persistence due to a weakening of incentives. The latter arises from the fact that needed adjustments or changes in reservation demands are delayed. Hence, there is allegedly a trade-off between cushioning the effects of the shocks and their persistence. Whether this is the case obviously depends on various dimensions of the safety net (e.g. duration of unemployment benefits) and policies aiming at strengthening job search and employment including active labour market policies. It is an open question whether there is empirical support for the view that a generous social safety net strengthens persistence. Based on summary statistics as given in

Figure 1, there is no evidence of such a relation. Obversely, it is clear that persistent unemployment has significant effects on public finances in a system with a generous tax-financed social safety net.

Active labour market policies

The main reason for the changed labour market situation is a fall in aggregate demand and thus labour demand. Therefore an obvious short-term remedy is measures aiming at increasing labour demand. However, as argued above, the risk of long-term unemployment is not necessarily well-targeted by

Figure 4



aggregate demand measures, and more specific measures may be more appropriate. One such instrument is a wage subsidy targeting particular groups like long-term unemployed, immigrants etc. Work sharing arrangements are also a useful instrument for sharing jobs over a short period of time, since it permits a larger pool of workers to remain in job. This will keep a larger group in contact with regular jobs for which it is hard to think of equally efficient active labour market policies. A more unequal sharing increases the risk of long-term unemployment for the affected. Clearly, it is important for such schemes to be temporary so as not to impede structural changes.

To reconcile insurance with incentives, and hence to counteract persistence, active labour market policies play a crucial role. An increase in unemployment raises a number of issues for active labour market policies. The direct effect is that an increase in unemployment causes a volume increase for given rules with respect to the timing and type of activation programmes. This means a larger inflow into programmes. Moreover, the composition of the pool of unemployed people changes. In recent years with falling unemployment, the focus shifted towards integrating more marginalized groups in the labour market, but the increase in unemployment will bring more core workers into active labour market programmes.

Active labour market programmes serve various purposes including incentives, matching and qualifications. In the current situation when unemployment increases due to falling demand, the main problem is not to maintain incentives for job search. For many groups affected by unemployment there is a strong economic incentive to search for jobs. Moreover, matching problems cannot be argued to be the main problem. Hence, both of these factors imply that there can be a huge deadweight cost of early intervention applied to the increasing number of unemployed. Politically, there may be strong pressure to focus on such schemes to signal that problems in the labour market are taken seriously, but it is questionable whether this is a sensible strategy. Although unemployment increases and affects many, it does not imply that all of them are on the verge of becoming marginalized. Despite increasing unemployment, there are still substantial dynamics in the labour market, and many are affected only by a short spell of unemployment. For example, in Denmark 40 percent of those who became unemployed in early 2009

have found a job within 13 weeks, which underlines the risk that early intervention may cause huge deadweight costs.

The key task of active labour market programmes is to ensure that an unemployment spell does not turn into long-term unemployment. The crucial difficulty is to identify those in the risk group. In some cases this may depend on individual characteristics, e.g. lack of qualifications, but in other cases it is more difficult to predict who will be affected. The crisis is associated with large structural shifts, and this implies that labour has to be reallocated and thus possibly re-trained, and although such macro changes can be identified, it is not necessarily clear which individuals will be adversely affected. An increase in unemployment thus raises a sorting problem of how to target groups with a high risk of long-term unemployment. Some useful criteria can be found by combining education, previous experience, and age. Profiling may be one way to address this problem.

Retraining of various forms may be required for many unemployed. For the young the focus should be on entry into the ordinary educational system. For older workers there may be a need for retraining to overcome structural changes and facilitate job finding. Standard arguments against such programmes are that they imply lock-in and have moderate effects on later labour market performance. While there are good reasons to be sceptical about very general across-the-board training programmes for all unemployed, there is also a good case to be made that re-training is required in many cases. Moreover, the cost of lock-in is clearly smaller in a high unemployment period. Recent Swedish experience indicates more positive effects which may be attributed to the fact that the programmes have been well targeted to job relevant education (see De Luna et. al. 2008).

One way to balance these considerations may be to design active labour market policies so that intensive intervention starts when unemployment duration passes some time threshold and to focus on maintaining contact with the labour market. Since private job training has been found to be the most effective in bringing the unemployed into regular work, there is a case for focussing more on this, but also for making workers more willing to accept short-term jobs. The latter can be implemented by changing the

employment criteria for remaining eligible for unemployment insurance benefits.

A recession raises a number of risks for active labour market policies. This includes increasing cost and overload, but also questioning the efficiency of such programmes. The latter may raise a political risk that it becomes difficult to maintain support for such policies when unemployment is increasing. However, in this debate is it important to take into account that the likely alternative to active labour market policies is an exit from the labour market, and this is an irreversible decision with large costs. A first priority of labour market policy is to ensure that the current crisis does not translate into a shrinking labour force.

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