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Promoting employment recovery and meeting fiscal goals. Part I[1]

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This feature article is an excerpt from the Policy Brief *Promoting employment recovery while meeting fiscal goals* (pdf 698 KB). It is published in two parts. Part two will be published next week.

Introduction

Soon after the start of the global crisis, most major countries launched fiscal packages to stimulate aggregate demand and output. Initially the responses centred on restoring stability to the financial sector, but soon fiscal stimulus measures were introduced to support the labour market. The rapidity of the response provided crucial support to the economy and it is estimated that 7 to 11 million jobs were saved or created (ILO, 2009b). By the end of 2009, the world economy had resumed modest growth and, in some countries the increase in unemployment began to slow.

Despite the fragility of the economic rebound, concern about budget deficits is leading to a heated debate on how quickly fiscal stimulus measures should be withdrawn.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% stirring worries about the risk of a public debt crisis and prompting calls for an early exit strategy.

An early exit from stimulus measures, the main engine of the economic rebound, would threaten employment recovery which typically happens long after economic recovery. This would have a severe long-term impact on the labour market, and even for economic recovery itself, while also fuelling social unrest.

How can policies promote employment recovery, while achieving medium-term fiscal stability at the same time? In Part One of this article we examine the risks associated

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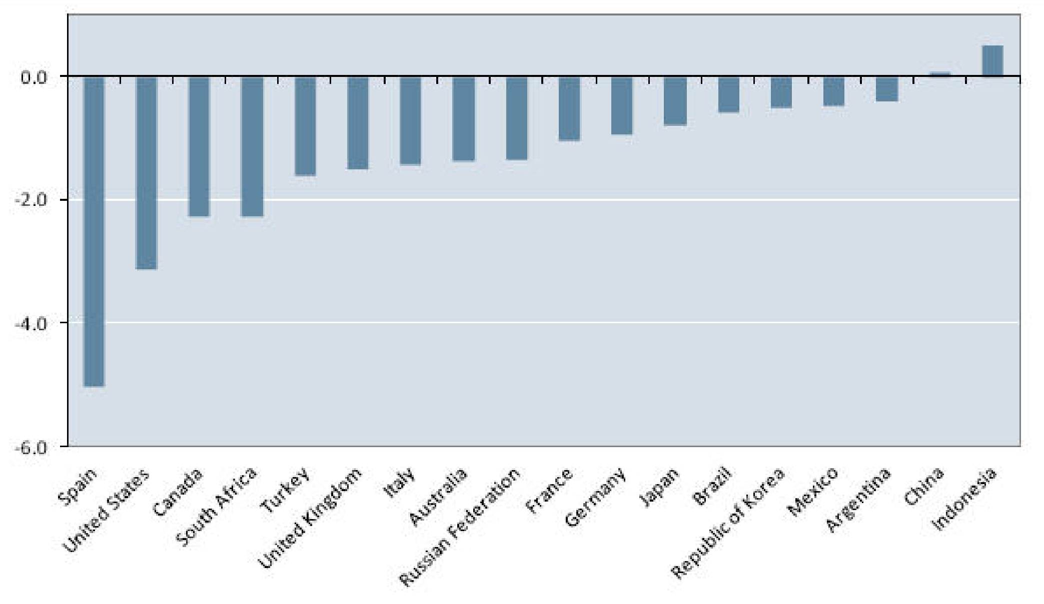
with an early exit strategy. We look at how a carefully designed crisis response, in line with the ILO's Global Jobs Pact, supports both employment and fiscal goals in the medium-run, even though this means a lower cut in deficits in 2010 (ILO, 2009c). In Part Two (published next week) we examine how some countries have successfully followed this path.

The risks of an early exit

Globally, employment grew by almost 2% per year in the decade preceding the crisis. But between the end of 2007 and the end of 2009 global unemployment increased by around two percentage points (ILO, 2010). In 2009 the employment rate fell to just over 0.5% which was insufficient to absorb the growth in the working-age population and undid most of the gains of the previous decade. In the G20 countries, where the crisis originated, this effect was particularly strong (Figure 1). In developing countries, high unemployment rates were accompanied by a substantial increase in vulnerable employment which suggests that an even larger number of workers will have difficulty in realising their potential.

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



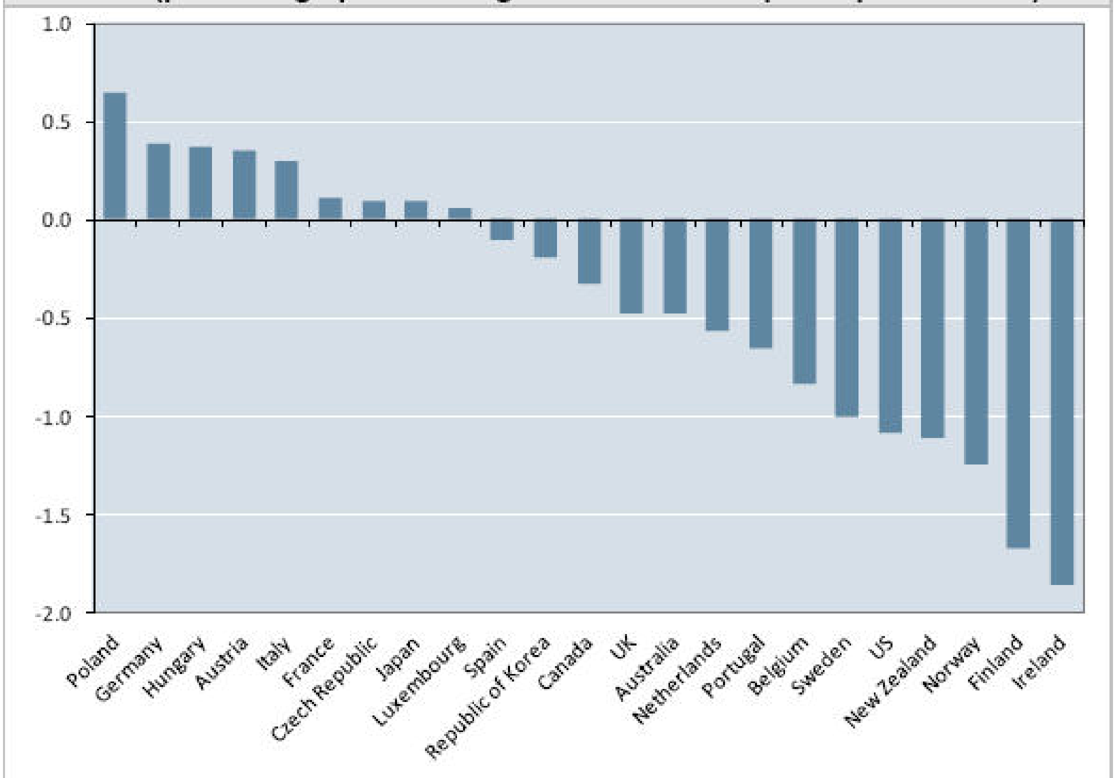
Source: IILS based on OECD Quarterly Labour Force Survey; ILO Laborsta.

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. Second, there are indications in the countries where the crisis originated that enterprises, in particular job-rich small and medium enterprises, continue to face obstacles to getting access to bank credit. Third, even in the presence of economic growth, firms will tend to be cautious about rehiring until economic growth is firmly underway. Finally, sectoral shifts in demand and output may be further aggravating labour market challenges (ILO, 2009d). This may translate into a job-less recovery.

These trends suggest that employment levels are below potential and that there is significant scope for promoting job growth. There is a risk, though, 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 a permanent erosion of skills.

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. 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.

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

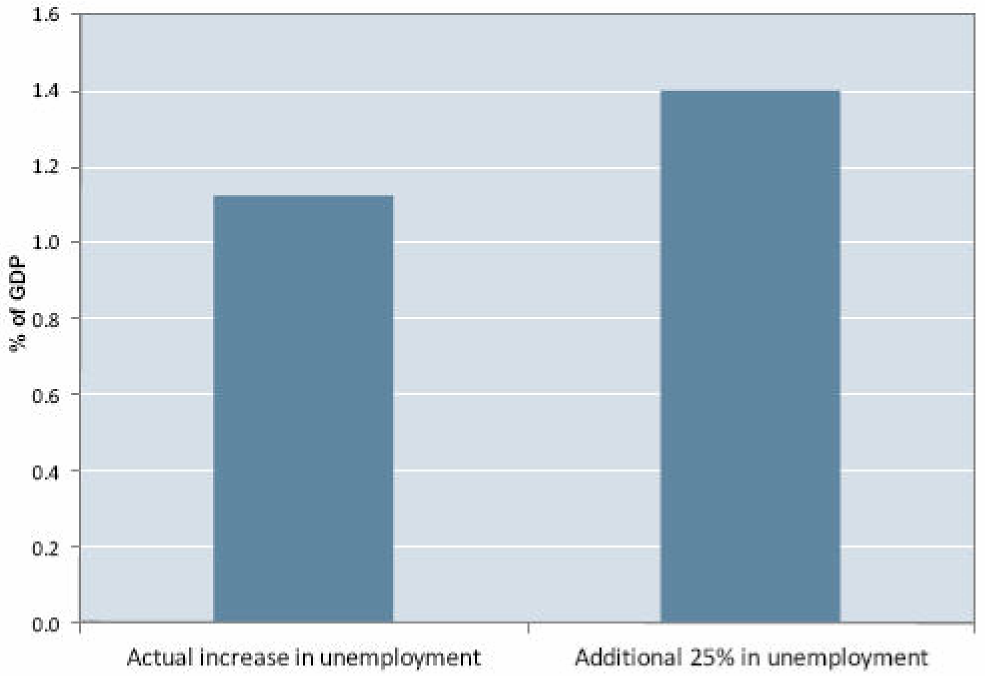


Source: IILS based on OECD, Economic Outlook, EO 86.

The fall in the labour force does not bode well for the sustainability of the ongoing recovery and may further limit the possibilities for countries to return quickly to previous employment levels (ILO, IILS, 2009b). Tightening fiscal and monetary policies, instead of taking action to address these labour market challenges, will depress employment growth even further.

Moreover, an early exit would aggravate fiscal deficits over the medium term in two ways. First, in developed countries, the increase in unemployment benefit recipients as a result of the crisis entails additional budget spending of approximately 1% of GDP (Figure 3). This figure would rise to around 1.4 % of GDP in the case of a further 25% increase in the number of recipients.

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.

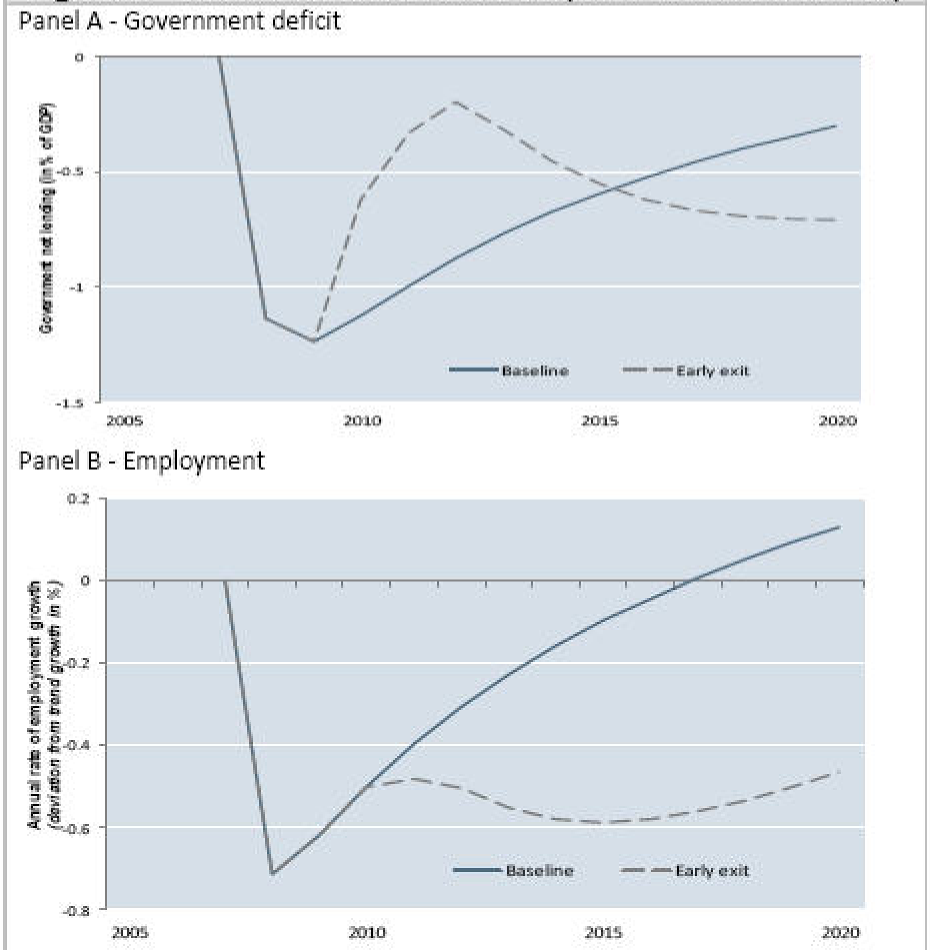
Second, an early exit would erode the tax base. A permanent reduction in labour force participation would deprive the economy, and thus the national budget, from valuable resources. This is especially the case in developing countries where many of those who lost jobs in the formal economy shifted permanently to the informal economy, where both productivity and the tax base are limited.

Job-centred measures help achieve employment and fiscal goals

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

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). 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.

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



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).

Although an early exit from stimulus measures would improve fiscal balances in the short run, this improvement would prove to be short lived. Shortly after the adoption of early exit measures, fiscal deficits would deteriorate once again because 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 will have a strong bearing on spending.

In contrast, continuing 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 achieved through an early exit strategy. In particular, because job-centred polices put greater emphasis on labour market measures, they would limit further increases in job destruction, avoid a downward spiral of wages (ILO, 2009a) and boost job creation.

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Further resources

ILO Publications

Cazes, S.; Verick, S.; Heuer, C. 2009. *Labour market policies in times of crisis* (pdf 699 KB) (Geneva, ILO).

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ILO Events

"Real economy" leaders discuss policy responses to global economic and jobs crisis

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ILO Director-General Juan Somavia presents his report to the ILO's 99th International Labour Conference -

The Global Jobs Pact and macroeconomic policy -

ILO Websites

Global Job Crisis Observatory: Employment Promotion

Global Job Crisis Observatory: National Recovery Policies

Global Jobs Pact

Global Statistics on the Labour Market