ADDRESSING THE EMPLOYMENT EFFECTS OF THE FINANCIAL CRISIS

The Role of Wage Subsidies and Reduced Work Schedules

As countries look forward to the resumption of growth following the economic crisis there are concerns about the response of labor markets. Indeed, the human impact of the recovery in terms of resumed poverty reduction and increased well-being will be determined by the responsiveness of jobs—both their quantity and quality—to increased economic activity.

The response of employment to growth will depend, in part, on the efficacy of labor market policies, including those adopted in industrialized countries, to stabilize/promote employment and provide assistance to those who lose their jobs. In the first category the most common interventions include: (i) various forms of wage subsidies; (ii) reduced work schedules; and (iii) access to credit. The second category involves mainly: (i) the extension of unemployment benefits, (ii) employment services (including training); and (iii) cash-transfers for low income workers and the poor often through public works.

This note briefly reviews the experiences with wage subsidies and reduced work schedules in promoting employment and avoiding the depreciation of accumulated skills and knowledge due to a temporary downturn. These policies have been adopted by many high income countries as well as some middle income countries. It is too early to comment on their impact; to date, they have not been rigorously evaluated in the context of the financial crisis. And any results would also be difficult to generalize, since much depends on local conditions and the structure of the labor market. Still, based on the past performance of these programs and what is known about the adjustment of labor markets during a downturn, five preliminary overarching implications can be derived (this note later offers more details on the implications as they apply to each of the two types of policy).

First, both wage subsidies and reduced work schedules can have an important role in helping employment recover, but their success will depend on the context. Both programs are likely to be more effective in countries and/or sectors where the contraction in labor demand is temporary, reflecting the economic cycle. In such cases, wage subsidies and reduced work schedules can mitigate the effect of the economic slowdown on formal employment and reduce the depreciation of skills usually associated with long term unemployment or informal work. However, in countries where structural changes in the economy are needed, these two programs could delay necessary labor reallocations and thus compromise sustainable growth and employment creation over the medium term.1

1 See, for example, Revenga and Rijkers (2009).

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Second, when adopting wage subsidies and reduced work schedules, it is important to assess the tradeoffs with other active labor market programs that benefit the most vulnerable workers. Wage subsidies and reduced work schedules mainly benefit formal sector workers, which represent less than 50% of the labor force in most middle and low income countries. Informal sector workers, agricultural workers in rural areas, and the self-employed—none of whom have access to social insurance and also face higher earnings risks during a down-turn—are unlikely to benefit. Other programs such as public works could serve some of these groups better, but fewer public resources would be available to implement them.

Third, the design of the programs matters:

- Employer-based subsidies can cost less and have a larger social impact if targeted to individuals with lower pay. Their main role is to smooth the impact of a temporary downturn.
- Targeted employee-based subsidies linked to other active labor market programs such as training and job counseling can be considered to improve the employability of low-income unskilled workers over the medium-term.
- For work-sharing arrangements, much depends on the negotiations between employers and employees. Two important elements are the design of training programs and the setup of the wage compensation mechanism.

### Wage Subsidies

Wage subsidies come in different forms, pursuing different but related objectives. Subsidies can be given to employers to stimulate demand or to employees to provide incentives for re-employment. They can take the form of direct transfers, reductions in social security contributions, or income tax credits. They can be targeted to vulnerable workers or be provided across the board. And they can focus on those already employed or only on new hires. Choices at all these levels determine their impact on employment and their costs.\(^2\)

In the context of the crisis, wage subsidies have two main functions: (i) dampening the pace of job destruction in the formal sector and avoiding the depreciation of skills; and (ii) stimulating hiring and facilitating reemployment. In the first case, the subsidies allow employers to keep workers who would otherwise fill the ranks of the unemployed or move to lower productivity jobs in the informal sector—in both cases risking losing their skills. In the second case, the focus is to increase exit rates from the unemployment pool, particularly among vulnerable workers, thus reducing the destructive persistence of long term unemployment.

\(^2\) See Jae-Kap Lee (2005) for a typology.
Between 2008 and 2009, the majority of OECD countries have adopted wage subsidies—mainly through reductions in social security contributions, and often targeted at small enterprises or disadvantaged groups. France, for instance, has reduced employer social security contributions for firms with less than 10 employees hiring new low-wage workers in 2009. The reduction is the largest for workers hired at the minimum wage and declines as the wage increases up to 1.6 times the minimum wage. In Germany, there has been a reduction of the employee and employer contributions to the unemployment insurance system. Spain has reduced employer social contributions for the first two years of employment for unemployed people with children who transit to full-time permanent contracts. It has also implemented a reduction in social security contributions for youth or disabled workers who start up a business as self-employed. A different approach has been taken in United Kingdom, where companies will receive £2,500 for hiring workers who have been unemployed for more than six months.

Several middle income countries have also adopted wage subsidies. In Mexico, there has been a temporary reduction in employer social contributions and a deferred payment of up to 50% of contributions. The Slovak Republic has introduced a temporary exemption from health insurance payments for up to 24 months for persons entering self employment after a period of 3 months on the jobseekers register. Other countries, however, are not using the subsidies as a temporary measure. Turkey has legislated a permanent reduction in employer contributions to disability, old-age and survivor pensions, as well as reimbursement of employer social security contributions for firms with 50 or more workers and that have at least 3% of disabled workers in their staff. It has also introduced a permanent reduction in employer social contributions for the first five years of employment targeted to new women and youth (aged 18–29). Chile, on the other hand, has introduced an employment subsidy for hiring of young workers (age 18 to 24 years). Similarly, in Korea the government is providing wage subsidies to SMEs for new hires, interns, as well as those that convert irregular into regular jobs.

Based on past evaluations of wage subsidies, mainly in OECD countries, a few lessons are worth noting:

- **There is mixed evidence over the effects of wage subsidies on employment.** Some studies emphasize that subsidies often go to workers who would have been hired (or would not have been fired) in any circumstance, or induce substitutions between subsidized and non-subsidized workers. Others, however, show that at the macro level net effects are usually positive. Moreover, there is evidence of positive (dynamic) effects on the ability of beneficiaries to improve their labor market opportunities over the medium-term.

- **During the crisis, reductions in social security contributions are likely to achieve their objective of maintaining employment and preserving human capital.** Indeed, most evaluations agree that a lower wedge between the total cost of labor and take-home pay can both reduce dismissals and stimulate hiring.

- **The costs of effective wage subsidies, however, should not be underestimated.** Meaningful effects may require sizable reductions in the contribution rate (e.g., a 4 percentage point reduction in the contribution rate to avoid a 2 percentage point reduction in employment), which implies substantial budgetary transfers or an increase in the unfunded liabilities of the social security system.

- **In terms of design, subsidies targeted to vulnerable workers (and linked to the stock of employees) are likely to be a better option than across the board subsidies.** The later are not only more expensive but also subject to larger “dead-weight” losses, as they end-up subsidizing workers who would have stayed in their jobs or would have been hired anyway. The focus could be instead on lower paid workers (usually low skilled and young workers), probably with a declining subsidy as wages increase (as in the example of France above). It is also important to link the subsidies to changes in the stock of employment. Wage subsidies that are simply linked to the wage could give firms more room for “gaming the system”.

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2. See Bell et al. (1999) and Richardson (1997) for a discussion.
5. Studies suggest that, overall, a 10 percentage point reduction in the tax-wedge (the difference between the cost of labor and take-home pay) could increase employment between 1 and 5 percentage points (see Nikell, 2003; Kugler and Kugler, 2003; Rutkowski, 2007; and Betcherman and Pages, 2007).
In all cases, it is important to consider the tradeoff between providing assistance to formal sector workers and informal sector workers. Employer-based wage subsidies benefit mainly the former and thus reduce available resource to protect the later. They can thus be regressive.

Alternative options to consider are targeted employee-based subsidies linked to others active labor market programs such as training. The focus of these programs would be on helping find jobs to the already unemployed—particularly vulnerable groups such as youth and/or unskilled workers. This is the case of the Jovenes programs that have been implemented successfully in several Latin American countries (e.g., Argentina, Colombia, Dominican Republic). These programs combine on the job-training, employment assistance, and training stipends—which can be assimilated to wage subsidies.

Reduced Work Schedules

Under this type of programs, workers are required to reduce working hours and accept a proportional reduction in wages. The programs are thus accompanied by interventions that involve access to partial unemployment benefits, provision of paid holidays, or provision of short-term training stipends.

Like wage subsidies, reduced work schedules can contain unemployment and prevent skills depreciation, loss of firm-specific human capital, and informality. The arrangements effectively spread the burden of labor market adjustment across workers. Although earnings might decline, workers remain gainfully employed and preserve access to social insurance benefits. The programs are also expected to bring benefits to employers in two ways. First, firms are able to retain skilled workers (including those with acquired firm-specific skills), thus avoiding the substantial costs of recruiting and training new workers when demand recovers. Second, enhanced employee morale (vis-à-vis layoffs) can lead later to lower turnover costs.

Most OECD countries have introduced these programs as a result of the crisis. One of the largest is the Kurzarbeit in Germany, which is expected to cost €5 billion between 2009 and 2010. The program just extended the maximum benefit period from 6 to 24 months for companies who sign on in 2009. The Federal Employment Agency covers up to 67 per cent of wage losses for workers whose hours have been reduced, while also reimbursing employers 50 per cent of social security contributions (and 100 per cent if reduced working hours are used for training). Similarly, in Japan, the Employment Adjustment Subsidy is payable directly to employers and has been increased from one-third to two-thirds of the of the employee’s wage loss in the case of large enterprises, and from two-thirds to nine-tenths in the case of SMEs (there is a maximum of $USD 80 per day). The subsidy is financed from employer contribution to employment insurance.

Middle income countries that have implemented this type of program include Argentina, Colombia, Mexico, Poland and Turkey. Argentina, quickly reactivated the “Programe de Recuperacion Activa” that was designed during the 2002 crisis: a monthly wage supplement is provided to employees for up to 12 months with an agreement not to dismiss workers and adjust work schedules. Colombia and Mexico are using subsidized training to maintain workers within the formal sector, while enhancing their employability. In Poland, a work sharing program supported by workers and employers organizations was added in July 2009 financed from the Guaranteed Employee Benefits Fund. It also establishes training support with up to 90 per cent of the costs to be paid from the Unemployment Benefit Fund (the rest is financed by employer training funds). Similarly, in Turkey, the government has extended the length of time that workers can benefit from the reduced hours fund from three to six months and increased the benefit level by 50 per cent.

As in the case of wage subsidies, there have been no impact evaluations of these programs in the context of the crisis, but from past experiences a few lessons can be derived:

Overall, the effect of mandatory work sharing on employment is still under debate. There is evidence in the case of France, for instance, that aggregate employment was unaffected but that labor turnover increased as firms shed workers who became more expensive. A review of programs in European
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countries suggests that the results are mixed, with impacts depend on the setting.14

- During the crisis, much will depend on the types of arrangement negotiated between employers and employees. Thus, social dialogue, collective bargaining and other forms of negotiations play an essential role in determining the conditions for the implementation of work sharing programs.15

- Two important issues in terms of design involve training and compensation mechanisms for lower wages. A practice in industrialized countries worth considering is encouraging employees who are on work-sharing schemes to participate in training and retraining activities to upgrade their skills and improve their employability. In terms of the compensation mechanisms, the unemployment insurance system is usually used to top-up wages. When not available (the case of most middle and low income countries) reduced work schedules could be implemented linked to pension systems. In this case, compensation for lower wages can be financed by borrowing from individuals' pension wealth.16

- In all cases, the administrative costs for employers and the demands in terms of institutional capacity to manage wage compensation should not be underestimated. Employers need to introduce substantial changes in human resources management practices. There are also costs in the short term due to changes in scheduling and work organization. From the government side, implementation can be difficult when the social security administration does not have well-developed contribution collection and record keeping systems that provide information about earnings of various workers in a firm.

- Finally, as in the case of wage subsidies, attention needs to be paid to costs. Unless there is a well-funded unemployment system, reduced work schedules involve government subsidies that can be costly and regressive—since transfers are likely to benefit mainly formal sector workers.

Conclusions

- Wage subsidies and reduced work schedules show some promise as measures that can help countries to increase the employment elasticity of growth during the recovery and avoid the depreciation of skills associated with unemployment or informal work.

- The efficacy of both programs, however, will depend on the economic context. The programs are likely to be more effective in countries and/or sectors where the contraction in labor demand is temporary (cyclical). In countries where structural changes in the economy are needed, these programs can delay necessary labor reallocations.

- When designing wage subsidies and reduced work schedules it is important to assess costs and the trade-offs with other active labor market programs that benefit the most vulnerable workers. Wage subsidies and reduced work schedules mainly benefit formal sector workers, which represent less than 50 percent of the labor force in most middle and low income countries.

- Finally, the design of the programs is important. Employer-based wage subsidies can cost less and have a larger social impact if they are targeted to individuals with lower pay. Governments can also consider employee-based subsidies targeted to vulnerable groups and linked to other active labor market programs. The impact of work-sharing arrangements, on the other hand, will depend on the negotiation process and the type of compensation mechanism. Ideally these programs should be linked to unemployment benefit schemes.

References


Bell, B., R. Blundell and J. Van Reenen. 1999. “Getting the Unemployed Back to Work: The Role of

14 Kapteyn et al. (2000).
15 See Messenger (2009).
16 See Robalino et al. (2009).

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