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Labour market prospects and policies to soften the impact of the financial crisis

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Summary

The global downturn is now strongly affecting EU labour markets. In light of the downward revision to the growth projections and the uncertainty created by the financial meltdown, the outlook for employment has deteriorated considerably. This would also be consistent with the experience from previous downturns, where the full labour market impact only materialised after 2-3 quarters. On current policies, the Commission projects employment growth to turn negative during the next two years, accompanied by a steep rise in unemployment, which would be around 11.5% in 2010 in the euro area.

However, labour market outcomes depend crucially on policy responses. The good news here is that our assessment shows that measures undertaken so far within the framework of the European Economic Recovery Plan are promising. The in-built capacities of the social safety nets are fully playing their role and a number of new innovative policies are also keeping people in employment. However, given the spillovers that many of these policies create on other Member States labour market measures could be more effective if co-ordination at the European level was strengthened. A stronger more co-ordinated response would also help to soften the impact of much higher unemployment levels on Europe's potential rate of growth in the future.

Introduction and outlook

The economic and financial crisis and the ensuing global downturn are beginning to impact significantly on labour markets. While the bulk of the increase in unemployment so far has been concentrated in Spain and the United Kingdom, it is now beginning to rise across all Member States. The recent Commission forecast (Spring 2009) indicates that, on current policies, employment will decline substantially in absolute terms over the next two years leading to a steep rise in unemployment. Employment is expected to contract by 2½% in both the EU and the euro area this year and a further 1½% in 2010. In sharp contrast with the creation of about 9½ million additional jobs during 2006-2008, employment is thus expected to fall by some 8½ million in the EU. As a result, the unemployment rate would increase to close to 11% in the EU by 2010 (11½% in the euro area). The most pronounced increases in unemployment are expected in countries facing substantial downturns in activity, notably Estonia, Ireland, Latvia, Lithuania and Spain.

However, on a more positive note, in a number of European countries, job losses have been contained so far, largely due to recourse to increased internal flexibility in the form of shorter hours or temporary partial unemployment benefits. The in-built capacities of the social safety nets are also fully playing their role as automatic stabilisers to cushion the impact of the economic downturn. In addition, Member States are pursuing a wide range of employment policies aimed at containing the impact of the crisis on labour markets. This Economic Brief assesses the effectiveness of these measures against a set of policy "do's and don'ts" and addresses the question whether further action is warranted.

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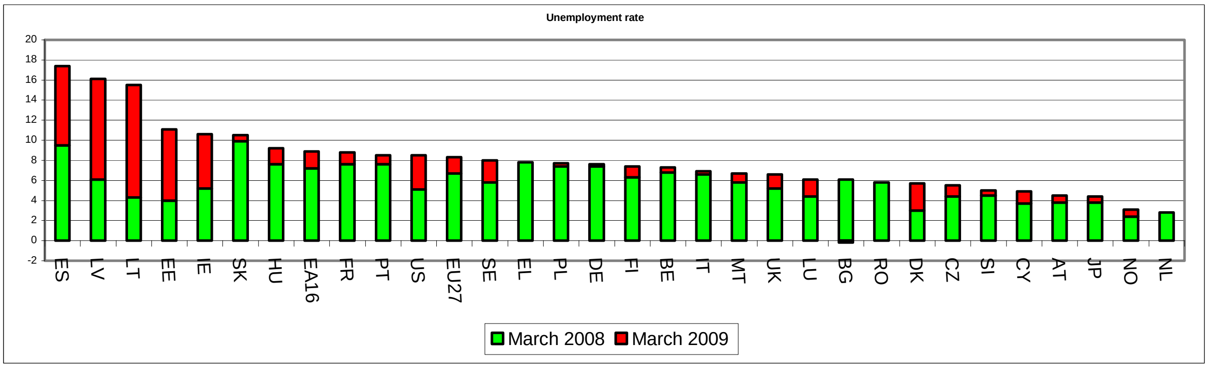
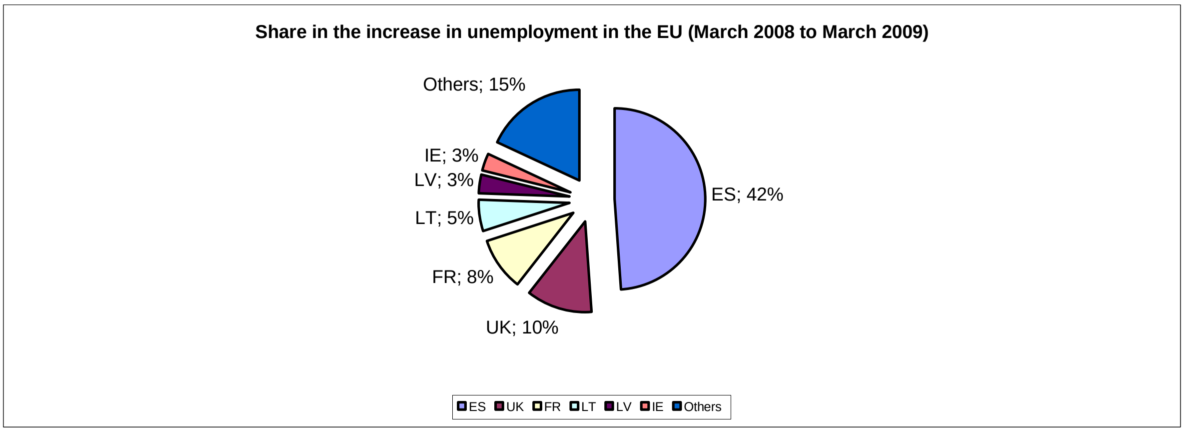
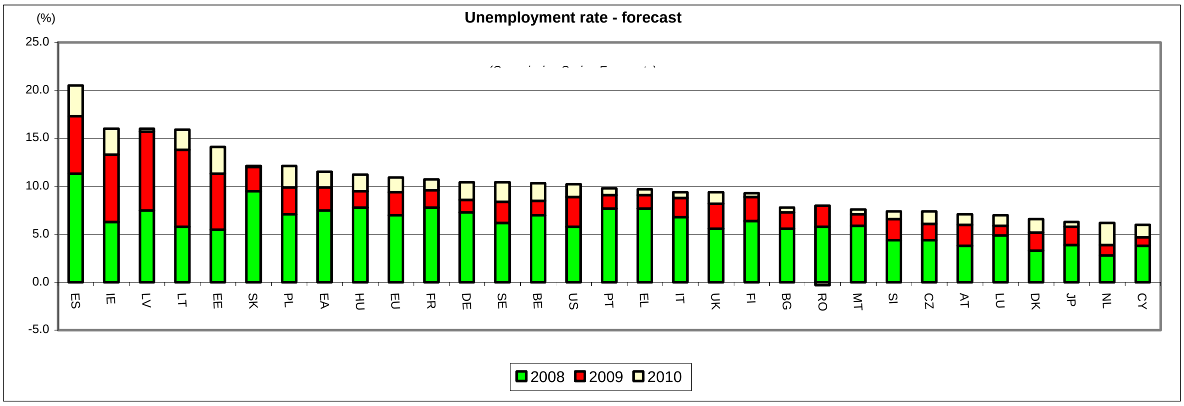
[1] "ECFIN Economic Briefs" is a new series in which DG ECFIN staff summarise policy relevant work for a general audience.

Graph 1 - Unemployment - recent trends and forecasts







Employment policies in the crisis: European principles for action

The European Economic Recovery Plan which was endorsed by the European Council in December 2008 underlined the importance of **stabilising economies, restoring growth and maintaining social cohesion and called for a co-ordinated approach** given the increasing interconnections, spill-overs and common challenges.

The basic approach is articulated around a set of overarching principles to devise appropriate labour market measures aimed at mitigating the impact of the crisis and shaping a sustainable recovery.

In particular, measures should aim at reducing the costs of adjustment and speed up transitions from old to new jobs to avoid more permanent losses in employability (hysteresis effect). In addition, policies should be in synergy with the social policy goal of supporting the incomes of the most disadvantaged groups of the population, which in itself will assist with stimulating aggregate demand given the relatively high propensity to consume out of these incomes. Especially in euro area countries these policies should also facilitate structural adjustment, in particular with regard to addressing significant divergences in external competiveness, through their impact on unit labour costs.

Finally, short-term measures should be time-consistent with long-term reform objectives: policies to address the crisis should not run counter to long-term reform strategies, notably the implementation of the flexicurity principles under the Lisbon strategy. A major responsibility of the governments is to avoid damaging the long-term health of their economies and to look beyond the crisis at the recovery that will eventually come. The European Commission is intensifying its efforts to help governments overcome the crisis and prepare an "exit " strategy for the longer term.

Policy do's and don'ts

On the basis of the principles and an assessment of the effectiveness of policies in previous crises, it is possible to develop a series of "*policy do's and don'ts*[1] to fight unemployment in the crisis. This approach was also followed in the Commission Communication addressed to the 2009 Spring European Council ("Driving European recovery")[2]. The main policy "*do's and don'ts*" relevant in the present crisis are:

- Keeping people in employment, notably by providing financial support to temporary flexible working-time arrangements. Temporary adjustment of working hours ("short-time") in line with production needs can be an important source of labour input flexibility. Such action needs to be combined with measures supporting employability and guiding people towards new jobs, empowering workers to take advantage of new opportunities when the economy recovers. These measures need to be coordinated to avoid negative spill-overs in other Member States (e.g in function of the effects on production and capacity decisions in industries facing a very significant drop in demand in all Member States). Finally, there are important design issues relating, for example, to the necessary temporariness of the measures and to eligibility criteria (where it is important to avoid locking workers into jobs that were declining already prior to the crisis). There are significant differences across Member States in both respects.

- Reinforcing activation and providing adequate income support for those most affected by the economic slowdown, making full use of social protection benefits, in line with the flexicurity approach. In those countries where unemployment insurance is strictly limited in time, consideration should be given to its temporary expansion and/or a reinforcement of minimum income provisions. Back to work incentives should be kept intact, and vulnerable groups supported in line with the active inclusion strategy.

- Investing in re-training and skills upgrading particularly for workers on short time and in sectors that are declining. Preference should be given to training targeted at future labour market needs. Employment Services should be enhanced, where necessary, to cope with increased unemployment.

[1] For a more extensive discussion and analysis see: EC-DG ECFIN European Economy-Occasional Paper," Assessing employment and social policies to soften the impact of the crisis", forthcoming

[2] Communication for the Spring European Council, "Driving European recovery", COM(2009)114.

- Considering supporting measures such as lowering non-wage costs for low-skilled workers. Wage developments and fiscal measures should take account of each Member State's competitive position and productivity growth.
- Sufficient support needs to be provided to tackle youth unemployment and to support school leavers. Time spent out of education or employment while young can have lasting effects. Member States should prepare for and encourage an increase in demand for education and training, as existing students stay on and displaced workers seek to re-skill. In this respect, future labour market growth areas such as 'green jobs' may already be anticipated.
- Decisions on reducing labour market segmentation notably through better aligning employment protection for workers on temporary and permanent contracts should be taken, even if the implementation of these decisions would be phased in.

In line with the principle of devising measures that are consistent with long term reform needs and do not hamper the adjustment capacity of labour markets or put the brake on recovery, the following measures should be avoided:

- Indiscriminate, tax-funded support for jobs in declining industries or regions should be avoided, as they could reduce economic efficiency/ delay necessary restructuring.
- Direct job-creation schemes such as in the public sector, outside of planned and needed staffing improvements in education, health and the social services, should not be resorted to on a large scale since these would artificially inflate the public sector and not be sustainable in the longer run. Only schemes targeted at specific vulnerable groups to help them keep in touch with the labour market should be considered.
- Policies that facilitate economic restructuring by pushing workers in declining sectors out of the labour market through early retirement need to be avoided because of their negative effects on labour supply which will come under pressure as a result of demographic ageing. Enabling older workers to remain active is important to support the economic recovery and to preserve the long-term sustainability of public finances.

An assessment of the recovery measures

We have carried out a preliminary assessment of the recovery measures undertaken by Member States, against the above mentioned principles and policy do's and don'ts[3]. It was made using the data set on structural reform stimuli measures developed in cooperation with specialised Council Committees: the Economic Policy Committee (EPC), the Employment Committee (EMCO) and the Social Protection Committee (SPC). More specifically, labour market and social protection measures in recovery programmes have been classified into nine broad types of action, and assessed against a number of criteria: these include timeliness, the degree of targeting, the time consistency of short-term support measures with long-term policy such as those in the Lisbon Strategy, and the possible need for coordination in light of cross-border spillovers. On this basis, an attempt has been made to determine the degree of consistency of measures (high/medium/low) with the principles. Table 1 gives an overview of the results.

[3] See EC-DG ECFIN European Economy-Occasional Paper," Assessing employment and social policies to soften the impact of the crisis", forthcoming

Table 1- Overview of labour market and social protection measures in Member States' recovery efforts (as of 31.03.2009)*

	No of measures	Countries
Encouraging flexible working-time	20	16 MSs: AT, BE, BG, CY, CZ, DK, DE, FR, HU, IT, LT, LU, NL, PT, SI, SK
Improving job placement and investing in re-training	64	21 MSs: AT, BE, BG, CZ, DK, DE, EL, ES, FI, FR, HU,IE, IT, MT, NL, PT, RO, SE, SI, SK, UK
Maintaining/reinforcing social protection	21	12 MSs: BE, BG, EL, FI, FR, IE, IT, LV, PT, RO, SE, UK
Reinforcing activation	34	19 MSs: AT, BE, BG, CZ, DK, DE, EL, ES, FI, FR, IE, IT, LT, LU, MT, PL, SE, SI, SK
Supporting employment by cutting labour costs	35	17 MSs: AT, BE, BG, DK, DE, ES, FR, HU, LT, LU, LV, NL, PT, RO, SE, SI, SK
Revising EPL in line with flexicurity	2	4 MSs: BG, EE, CY, LT
Enhancing education and life-long learning	10	7MSs: AT, BG, DK, DE, LT, PT, SE
Supporting household purchasing power	48	18 MSs: AT, BE, BG, DK, DE, ES, FI, FR, IT, LU, LV, MT, PL, PT, RO, SE, SK, UK
Mitigating the impact of financial crisis on individuals	27	13 MSs: AT, BG, CZ, EE, ES, FI, FR, HU, IE, IT, LT, LU, PT
Others	12	11 MSs: AT, BE, CZ, DK, EE, FI, FR, LT, LV, RO, SE

*** Information is based on SCPs and their Addenda, National recovery Plans, and information provided by the members of the Economic Policy Committee, the Employment Committee and the Social Protection Committee .**

Overall, and bearing in mind the necessary caveats on the preliminary and qualitative nature of the assessment exercise, the following broad tentative conclusions can be drawn:

- Overall Member States have put significant emphasis on employment in designing their recovery packages: measures to support a proper functioning of the labour market and supporting household purchasing power represent just over half of the recovery measures undertaken by Member State. Although they cover a smaller share of the total fiscal stimulus, overall, considerable budgets are being allocated to supporting employment. Preliminary estimates of the budgetary impact points to as much as 0.87% of GDP for measures aimed at raising household purchasing power and 0.14% for labour market measures.[4]

- However, there is considerable variation across Member States in the composition of their labour market response by type of measures. Consequently, there seems to be a large scope for policy learning between Member States. A preliminary assessment of the same type of measures in different countries suggests that there are significant differences in the likely effectiveness of policies.

- About a quarter of the measures are likely to generate quite considerable spill-overs into other Member States. This concerns policies aimed at e.g. reducing social security contributions and, in particular, subsidies to working time flexibility (e.g. through part time unemployment support). Especially in the latter case, there may be a need for stronger EU-level co-ordination to avoid competitive distortions in the internal market.

- Assessed individually on a measure- by- measure basis, most measures seem compatible with the agreed principles and policy do's and don'ts. The majority of measures seem to address the specific policy objective they pursue in a rather ambitious manner, although there are a considerable number of measures which could be made more effective by rendering them more comprehensive. There is also a

[4] Commission services, DG ECFIN.

considerable degree of targeting of measures on labour market categories that need support most (low income groups; recently laid-off workers). "Short work" measures seem to be amongst the most ambitious[5], although they would benefit from more co-ordination. Investments in job placement and retraining are relatively well designed, but there seems scope for improving other measures (such as cutting labour costs, activation measures etc). Short term policies also seem to be contributing to long term reform challenges, with some 40% of the measures addressing Country Specific Recommendations or Key Challenges identified under the Lisbon Strategy.

- However, there are a few measures that may risk undermining long-term policy goals or might be difficult to reverse. This concerns in particular large scale public job creation schemes. Other measures, such as fiscal support for overtime could be undesirable in the short term, since they could negatively affect job creation during the recession. Also, some 10% of the measures are likely to have permanent adverse effects on public finances. These measures should be reviewed and, where necessary, amended. Unfortunately, there seem to be very few measures aimed at improving the efficiency of welfare systems; thus, the reforms do not seem to directly contribute much to improving the sustainability of public finances. Of course, the measures addressing long term responses will indirectly support public finances.

Conclusions

To sum up, measures undertaken so far are moving in the right direction. The in-built capacities of the social safety nets are fully playing their role as automatic stabilisers to cushion the impact of the economic downturn and there is considerable "policy innovation" to avoid significant labour shedding. However, the forecast figures suggest that, given the risk of a particularly deep and protracted recession, policies may need to be intensified in order to avoid very high levels of unemployment with potentially long lasting effects on the labour markets and potential growth. While it is impossible to put a precise figure on the budgetary impact of an intensification of policies, it is clear that this could be significant. This means that decisions on key structural reform measures relating to social security systems, which are needed in any event in many Member States to guarantee the long-term sustainability of public finances in view of an ageing population[6], should be brought forward even if the implementation of such reforms would only kick in over time. This would restore confidence in the sustainability of public finances which has come under pressure as a result of the crisis and which would further suffer from additional expenditure on labour market measures. Finally, in view of the spill-over effects these further measures are likely to have and to minimise distortions in competitive positions, especially across the euro-area, a better co-ordination of such measures would be warranted. In particular, a common approach to the design of supporting measures to temporary unemployment or adjustment schemes to working time would be highly beneficial.

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[5] In March, almost 24 000 companies applied short-time work for a total of 670 000 employees. Source: ING, Global Economics.

[6] See the Commission Communication on "*Dealing with the impact of an ageing population in the EU*", COM(2009)/180 and the " the *'2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060)*', European Economy 2009.

Table 2

	Gross domestic product, volume					Employment				
	(percentage change on preceding year)									
	2002-06	2007	2008	2009	2010	2002-06	2007	2008	2009	2010
Belgium	2.1	2.8	1.2	-3.5	-0.2	0.7	1.8	1.6	-1.2	-1.5
Germany	0.9	2.5	1.3	-5.4	0.3	-0.7	1.6	1.4	-1.5	-2.2
Ireland	5.5	6.0	-2.3	-9.0	-2.6	3.2	3.6	-0.9	-9.0	-4.0
Greece	4.3	4.0	2.9	-0.9	0.1	1.7	1.3	1.2	-1.1	-0.1
Spain	3.3	3.7	1.2	-3.2	-1.0	2.8	2.9	-0.6	-5.3	-2.7
France	1.7	2.2	0.7	-3.0	-0.2	0.5	1.7	0.6	-2.2	-1.2
Italy	0.9	1.6	-1.0	-4.4	0.1	0.8	1.0	-0.1	-3.3	-0.6
Cyprus	3.3	4.4	3.7	0.3	0.7	3.0	3.2	2.6	-0.4	0.1
Luxembourg	4.4	5.2	-0.9	-3.0	0.1	2.8	4.5	4.7	0.5	-0.8
Malta	2.1	3.6	1.6	-0.9	0.2	0.7	3.0	1.1	-0.5	0.2
Netherlands	1.6	3.5	2.1	-3.5	-0.4	-0.1	2.3	1.8	-1.0	-2.8
Austria	2.2	3.1	1.8	-4.0	-0.1	0.6	1.8	1.5	-2.7	-0.9
Portugal	0.7	1.9	0.0	-3.7	-0.8	0.0	0.0	0.4	-1.4	-0.6
Slovenia	4.3	6.8	3.5	-3.4	0.7	0.6	3.0	2.9	-4.7	-0.6
Slovakia	5.9	10.4	6.4	-2.6	0.7	0.9	2.1	2.9	-1.7	0.4
Finland	2.9	4.2	0.9	-4.7	0.2	0.9	2.2	1.5	-2.9	-0.8
Euro area	1.7	2.7	0.8	-4.0	-0.1	0.6	1.7	0.7	-2.6	-1.5
Bulgaria	5.7	6.2	6.0	-1.6	-0.1	2.4	2.8	3.3	-2.2	-1.0
Czech Republi	4.6	6.0	3.2	-2.7	0.3	0.4	2.7	1.2	-1.7	-1.3
Denmark	1.8	1.6	-1.1	-3.3	0.3	0.3	2.7	1.0	-2.2	-2.0
Estonia	8.4	6.3	-3.6	-10.3	-0.8	1.9	0.4	0.2	-7.3	-3.3
Latvia	9.0	10.0	-4.6	-13.1	-3.2	2.2	3.6	0.7	-8.9	-3.3
Lithuania	8.0	8.9	3.0	-11.0	-4.7	2.0	2.8	-0.5	-7.7	-2.4
Hungary	4.3	1.1	0.5	-6.3	-0.3	0.3	-0.1	-1.2	-3.0	-2.0
Poland	4.1	6.6	4.8	-1.4	0.8	0.5	4.1	4.0	-2.3	-1.4
Romania	6.2	6.2	7.1	-4.0	0.0	-1.1	0.4	0.3	-2.2	0.6
Sweden	3.2	2.6	-0.2	-4.0	0.8	0.1	2.2	0.9	-2.4	-2.3
United Kingdo	2.5	3.0	0.7	-3.8	0.1	0.9	0.7	-0.7	-2.4	-0.9
EU	2.0	2.9	0.9	-4.0	-0.1	0.6	1.7	0.7	-2.6	-1.4
USA	2.7	2.0	1.1	-2.9	0.9	0.6	1.1	-0.5	-3.5	-0.9
Japan	1.7	2.4	-0.7	-5.3	0.1	-0.2	0.5	-0.4	-3.0	-1.2

Source: Commission' Spring 2009 forecasts.