Labour market policies and productivity

*by Rory Macqueen**

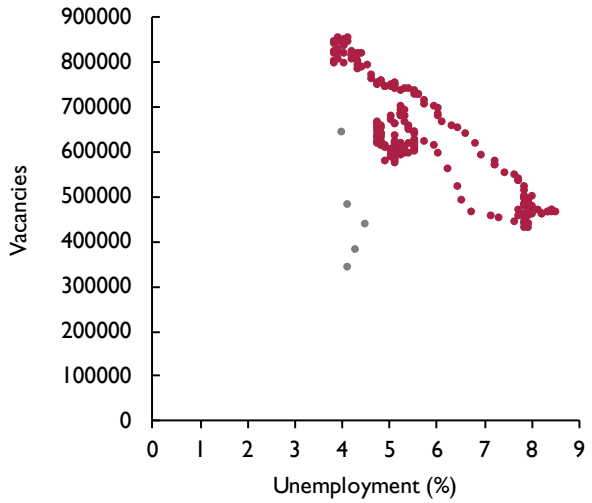
In our August *Review* we suggested that the government should extend the Coronavirus Job Retention Scheme (CJRS) in a state-contingent manner. We estimated, based on simulations in NiGEM, that to do so until the middle of 2021 would cost in the region of £10bn (around 0.5 per cent of annual GDP) but that this cost would likely be recouped through increased tax receipts and reduced social security expenditure. We also estimated that such an extension could reduce average unemployment from a projected 6.5 per cent to some 4.5 per cent in 2021, and by 0.5–1.3 percentage points in the following three years, by protecting skills, relationships and matches between employers and employees.

There are macroeconomic implications from higher medium-term unemployment on both demand and supply sides of the economy. We may expect demand to be suppressed by a period of reduced income for a substantial number of people (as well as additional precautionary saving by those worried about losing their jobs and weaker wage growth in a slacker labour market) but we may also expect to see reduced labour productivity as a result of reduced investment and the re-emergence of long-term unemployment: see research by Rothstein (2019) and Tumino (2015) on employment prospect scarring, and Crafts (1985) on the permanent unemployment effects resulting from the loss of skills during 1930s unemployment. Recent research from the US National Bureau of Economic Research (Dinerstein, Megalokonomou and Yannelis, 2020) has estimated a 'skill depreciation rate' of 4.3 per cent a year. Minimising these effects should be a central part of government policy in the recovery from the Covid-19 pandemic.

Beveridge Curve analysis – the empirical relationship between vacancies and unemployment – suggests that in April the CJRS prevented 1.4 million job losses (equivalent to a headline unemployment rate of around 8 per cent), rising to 2.1 million in May, by subsidising a shift 'inwards' of the curve (see figure 1, taken from Benito, 2020). The most recent vacancies figures imply an unemployment rate of 7.5–8.0 per cent in the absence of government interventions which have moved the curve inwards.

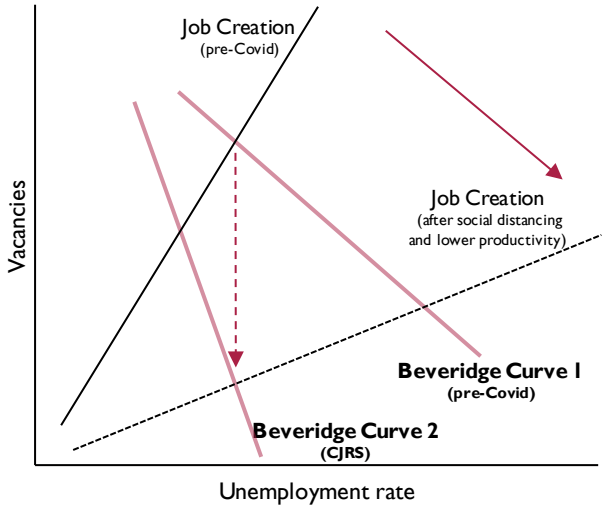
Benito (2020) uses this approach in a 'search and matching' framework to describe how increased supply costs associated with social distancing may result in lower productivity, leading businesses to shed marginal jobs to restore profitability and raising unemployment for a given level of job creation. Using this framework, illustrated in figure 2, we can consider proposed or potential employment schemes in two regards: whether they help keep the Beveridge curve to the left (maintaining unemployment below its 'usual' level for the current number of vacancies) and whether they help raise the job creation curve.

Figure 1. UK Beveridge curve 2000–2020[a]



Source: ONS.
Note: (a) Grey dots represent Covid-19 period.

Figure 2. Search-and-matching framework as represented with Beveridge curve and job creation curve



Source: Benito, 2020.

Labour market policies and productivity (continued)

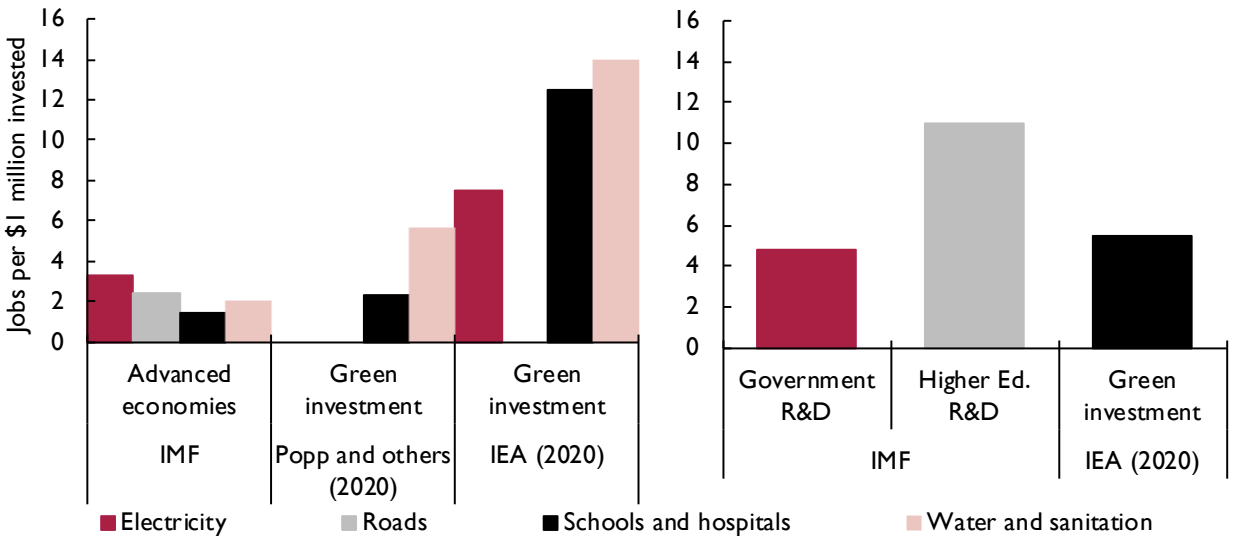
The stated purpose of the CJRS was to protect job relationships and its initial replacement with the Job Support Scheme (JSS) was motivated by a belief that 'non-viable' employments (never explicitly defined) should no longer be supported by government. This would risk unnecessary job losses in sectors which may be viable post-pandemic but cannot survive intact until then. While the new and amended schemes are estimated to support a significant number of jobs (see analysis in the main chapter text), this will be fewer than could have been maintained by an extended furlough scheme. In that sense, JSS can be thought as generating a smaller inward shift of the Beveridge Curve compared to the CJRS, implying higher unemployment for a given level of vacancies.

The challenge for the government is that, to the extent that prolonged high unemployment and associated weak recovery hamper productivity, reducing the generosity of support schemes may hold the job creation curve down by reducing productivity as described above, at the same time as the Beveridge Curve is moving back outwards. In support of the argument for ending the CJRS is the belief that it may reduce overall productivity by protecting less productive jobs at the expense of new matches, but it is hard to credit that this effect dominates at a time when so few matches are available.[1]

Job subsidies as an attempt to raise the job creation curve are not new to British policy: active labour market policies (ALMPs) such as wage subsidies, training programmes, and job search assistance, have a long history. The House of Commons Select Committee on Education and Employment's second report (1997) detailed four such subsidy schemes from the preceding twenty years. They found that all such schemes were successful in increasing job creation but with significant deadweight costs – according to one study, 80 per cent of subsidised jobs would have been created anyway – and sometimes to the detriment of non-targeted groups, e.g. substituting young workers for older workers rather than creating new positions. This last could prove problematic at a time when unemployment is rising for both old and young workers alongside longer-term rises in the state pension age.

The Government's Kickstart scheme, modelled on 2009–11's Future Jobs Fund (found to have been relatively successful) can be seen in this historical context: it pays employers for the costs at the relevant minimum wage of employing a 16–24 year old on

Figure 3. Job content per $1 million of additional investment



Sources: ORBIS; Compustat; and IMF staff estimates.
Note: The figure shows, for different sectors, types of investment, and country groups, the estimates of the job content of $1 million of investment. Based on regressions of employment on revenues overe 1999–2017, covering 47,580 observations for 5,679 privately owned and state-owned enterprises. The estimates for low-income countries are extrapolated from the other estimates. For R&D spending, the figure is based on cross-country panel regressions based on OECD data. Green estimtes are available in the literature, but only for a few sectors. AE: advanced economies; R&D: research and development.

Labour market policies and productivity (continued)

Universal Credit for 25 hours per week for six months. At the time of its announcement the government estimated its cost at around £2 billion to create "hundreds of thousands" of new jobs.

In the past these initiatives have sometimes combined with training programmes, such as the Youth Training Scheme for 16–17 year olds in the 1980s, which Dolton *et al*. (1994) found had a negative effect on post-YTS employment probability for men, but not for women. The Prime Minister recently announced a Lifetime Skills Guarantee beginning in April 2021. Retraining and reallocation of labour will be increasingly important to decrease the duration of unemployment as the economy adjusts to a new sectoral allocation following the pandemic. Although research on the effects of retraining is limited, there is some evidence on its favourable impacts on the labour market. Card *et al.* (2017) found that the effects are heterogenous across groups and particularly beneficial for women, and that training programmes have smaller short-term impacts than 'work first' programmes, but greater effects after 2–3 years.

A further option is for the government to engage in public sector (or public sector-led) job creation itself. The job creation prospects of the regional 'levelling-up' agenda may be substantial. In its recent *Fiscal Monitor* the International Monetary Fund argued that public investment projects would have a more powerful macroeconomic impact at a time of ample under-used resources, as well as reducing inequality and transitioning to a greener economy (see figure 3). The Women's Budget Group (2020) has estimated that 6.3 times as many jobs can be created by government spending on the care sector compared with in construction.

Finally, as government moves towards incentivising labour market transition rather than job preservation, the role of the social security system must be considered. The Institute of Employment Studies (Wilson, 2020) has highlighted the role of tax credits during the last recession and raised concerns that "Universal Credit just will not be able to do the same", because of the cumulative effects of a decade of cuts to social security. The temporary Covid-19 increase in Universal Credit is scheduled to end in March.

The success or otherwise of these initiatives will be weighed by policymakers against their fiscal impact but, as our scenario analysis of the furlough extension in the August *Review* illustrated, the fiscal costs of a policy intervention – even one which protects a million jobs and costs £10 billion up-front – may be significantly smaller or even zero once second-round and economy-wide effects are taken into account. A transparent, state-contingent fiscal policy framework will help decrease policy uncertainty and increase confidence, indirectly supporting investment and job creation prospects. At a time when the medium-term impact of Covid-19 remains uncertain, labour market policies which preserve existing employment relationships and those which support new job creation and matching will both be required; neither one can fully substitute for the other.

Note: *With thanks to Andrew Benito and colleagues for comments.

1 If the CJRS prevents firm bankruptcies this could theoretically also reduce productivity by creating more 'zombie' firms, though a far bigger influence on this channel is likely to be the Covid-19 business loans programme.

References

Benito, A. (2020), 'The impact of Covid-19 on the UK jobs market', NIESR blog https://www.niesr.ac.uk/blog/impact-covid-19-uk-jobs-market.

Card, D., Kluve, J. and Weber, A. (2017), 'What works? A meta analysis of recent active labor market program evaluations', *Journal of the European Economic Association*, 16(3).

Crafts, N. (1985), 'Long-term unemployment in Britain in the 1930s', CEPR Discussion Paper 76.

Dinerstein, M., Megalokonomou R. and Yannelis, C. (2020), 'Human capital depreciation', NBER Working Paper 27925.

Dolton, P., Makepeace, G. and Treble, J. (1994), 'The Youth Training Scheme and the School-to-Work Transition', *Oxford Economic Papers*, 46(4).

International Monetary Fund (2020), *Fiscal Monitor October 2020*.

House of Commons (1997), *Select Committee on Education and Employment: Second Report* (Annex), Session 1997–98.

Rothstein, J. (2019), 'The Lost Generation? Scarring after the Great Recession', University of California Berkeley Working Paper.

Tumino, A. (2015), 'The scarring effect of unemployment from the early '90s to the Great Recession', Institute for Social and Economic Research Working Paper 2015-05.

Wilson, T. (2020), 'Sunak's measures needed to protect workers and support the recovery. They don't', *Prospect*, September.

Women's Budget Group (2020), *A Care-led Recovery from Coronavirus*, June.