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Avoiding the Eye of the Storm: How to Deal Effectively with Job Crises

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Although economic crises are difficult to predict, their recurrence is a salient feature of emerging market economies. Nevertheless, many developing countries continue to lack an effective policy infrastructure that can mitigate the impacts of economic downturns on employment opportunities without affecting long-term growth prospects. This was painfully highlighted by the hasty reactions implemented by many countries in response to the global downturn of 2008–9, and by the ad hoc and reactive nature of many of the policies implemented. The weak ability of governments to systematically foresee, monitor, and offset adverse labor market impacts of economic downturns is of particular concern in developing countries where poverty incidence is high and labor is typically the only asset for the majority of the population (Lustig 2000). The main objectives of this note[1] are (i) to highlight the need for policies that limit earnings volatility and (ii) to guide policy makers through the challenges inherent in crafting effective and comprehensive policy packages.

Creative or Destructive Destruction: The Need for Policy Interventions

A host of macroeconomic models dating from Schumpeter (1939) imply that negative shocks can foster "creative destruction" by weeding out unproductive firms and workers. However, previous crises show that when markets are imperfect (as is predominantly the case in developing countries), even short-lived shocks can have destructive long-term consequences for aggregate productivity and individual workers' earnings and welfare. Households facing income losses may be forced to take children out of school, spend less on health, or cut back on caloric consumption and productive assets (for example, livestock or household enterprise inventories), leading to future losses in income, welfare, and productivity (Ferreira and Schady 2009; Fafchamps 2003; Dercon 2001). Crises can also lead to excess cleansing and can destroy potentially efficient and innovative firms as they may be the most credit constrained (Barlevy 2002, 2003; Ouyang 2009; Hallward-Driemeier and Rijkers 2010).

Unmanaged, crises can thus result in irreversible productivity losses and damage long-term prospects for growth and poverty reduction. Moreover, even when structural changes enhance productivity, the burden of the adjustment is likely to fall disproportionately on the most vulnerable. Therefore maximizing development potential requires effective crises management through policies that reduce the negative short-term impacts of economic downturns on employment, earnings and household income, and at the same time foster recovery. This note offers an overview of some the principal issues in formulating effective crisis-mitigating policy packages.

Constraints and Trade-offs

Most developing countries struck by a jobs crisis face three policy constraints. First, monitoring systems and high frequency labor market indicators are largely lacking, and decisions often need to be made against a backdrop of extreme uncertainty as to who is hit the hardest and how. Second, the fiscal space for policy intervention is often narrow and shrinking. Third, policy makers may be confronted by institutional and political economy constraints, such as few preexisting social insurance mechanisms on which to build, limited administrative capacity, and little maneuvering space to pursue economically optimal, yet politically unpopular, reforms.

The extent to which these constraints are binding will vary across countries and over time and policies must be based on an assessment of how best to work around these country-specific constraints. For example, if lack of information or institutional capacity makes it difficult to identify the groups hardest hit by crisis, policy makers may opt for public works programs that rely on self-selection. Moreover, in the recent crisis for example, countries with fiscally sound outlooks in Asia and, to a lesser extent, Latin America have been able to implement large countercyclical packages, but many other countries, especially in Europe and Central Asia and Africa, had limited fiscal scope for such responses. And even in the context of shrinking fiscal space, expanded safety net spending may make sense, because targeted assistance is likely to result in higher consumption.

Policy makers also face two thorny trade-offs. First, policies that ease the short-term impacts on employment may destroy incentives for long-term recovery, especially during a prolonged, structural crisis involving significant sectoral reallocation. Countercyclical policies that focus on protecting employment levels in unviable firms and sectors may undermine a country's medium-term competitiveness, distort adjustment, and lead to increases in public debt, all of which would hurt long-term growth prospects. In Indonesia, the 1998 crisis sparked pro-labor pressures that led to better enforcement of minimum wages and the introduction of severance pay and dismissal regulations. More stringent regulation helped raise the earnings and employment stability of manufacturing workers, but hampered the overall recovery of jobs (Manning 2000; Narjoko and Hill 2007). In such a setting, policy interventions should instead be designed to facilitate, rather than hamper, the required transformation. However, such a trade-off does not always exist. Policies to smooth the transition can still yield high payoffs by mitigating excess cleansing, preserving human capital accumulation, and encouraging continued innovation.

Limited resources mean that policy makers may also have to choose between support for those most directly affected by the crisis—typically urban-based exporters, construction, manufacturing—and protection of the most vulnerable—typically the chronically poor. If first-round labor market adjustments are concentrated in specific geographic areas or sectors, targeting interventions to those areas or sectors may be needed. However, it is also important to consider the likely impact of second-round labor market adjustment on earnings, in particular for the most vulnerable. Evidence from recent financial crises, including the 1994 Mexican Tequila crisis and the 1997 East Asian crisis, suggest that shocks rapidly spread from directly affected sectors to other parts of the economy and that the poor, because of their smaller margins and higher vulnerability, suffer the most severe welfare losses. Moreover, as the case of Indonesia shows, the trade-off can raise political economy problems, precisely because the poorest have little political voice.

A Useful Policy Typology

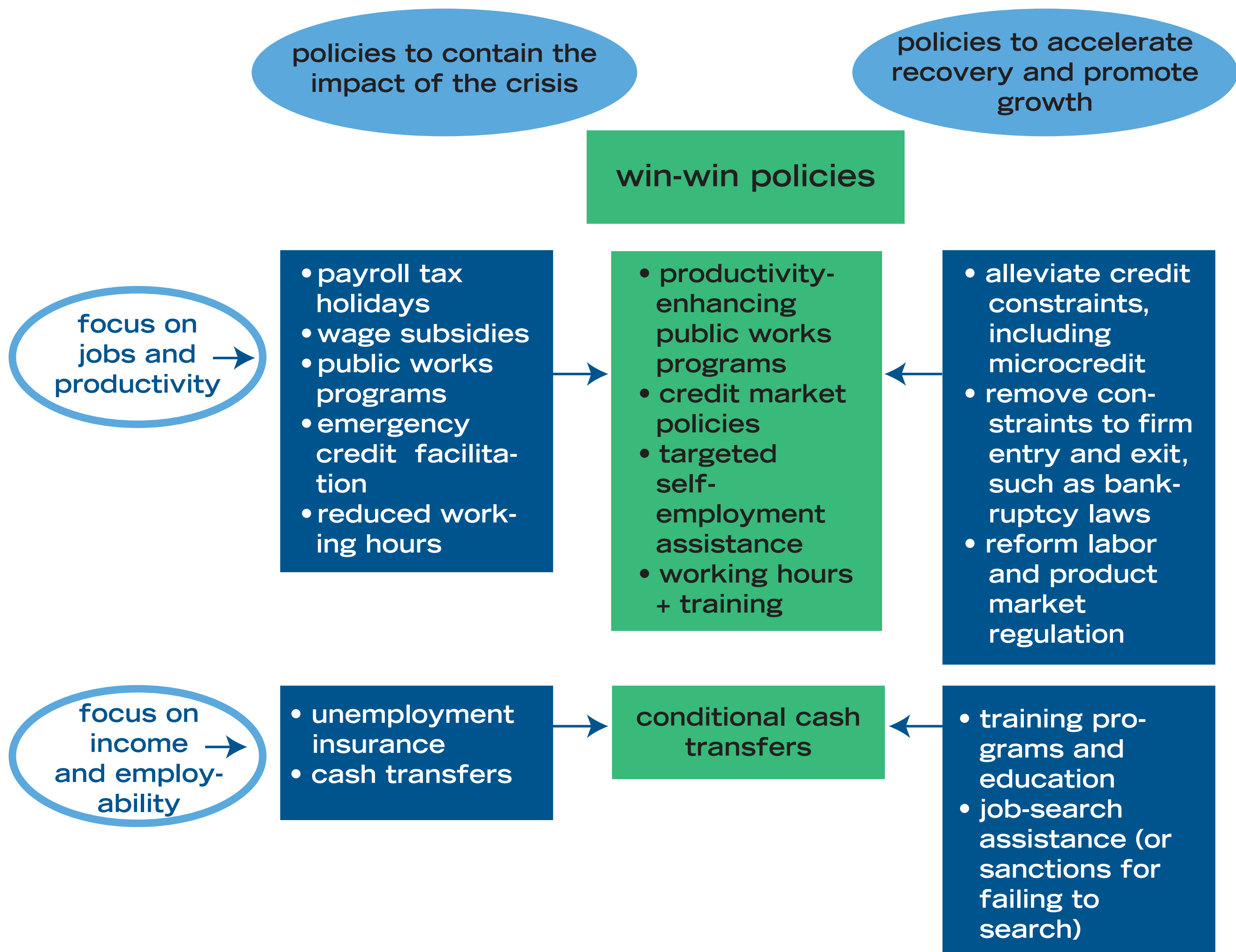
Government interventions to minimize the adverse impact of crises on labor markets can broadly be separated into four categories along two dimensions depending on (i) whether their main objective is to contain the impact of the crisis in the short-run or to accelerate recovery and promote long-term growth, and (ii) whether they promote/sustain labor demand or protect household income. Policies to contain short-term impact should typically be temporary, or at least possible to scale up during a crisis and scaled down as recovery begins; automatic stabilizers such as unemployment insurance or cash transfers also fall within this category. Policy interventions to accelerate recovery tend to be more permanent and take aim at structural market imperfections, for example, skills development, credit policies, and broader investment climate interventions.

Careful and comprehensive policy design is needed to resolve a potential tension between the two categories. Structural reforms may cause excessive cleansing and unnecessarily depress output and labor income in the short run, while short-term policies to protect jobs may hamper job creation in the long run. But there are also win-win policies that are beneficial both in the short and the long run. Figure 1 presents a rough grouping of commonly used policy interventions. The categorization is not rigid—policies may fit into various categories—but provides an overview of the potential trade-offs policy makers need to know.

What Policies Have Worked?

Three broad lessons emerge from the literature on policy responses in previous crises (Paci, Revenga and Rijkers 2010). First, no single set of policies will work everywhere, and at all times. Policy interventions need to be tailored to country-specific circumstances, including the nature of the shock, the fiscal space, institutional capacity, and political economy. Second, comprehensive policy packages beat piecemeal responses because of synergy and complementarity. Third, "on the run" policy making is no substitute for sound, existing institutions. In practice, many policy interventions have yielded limited returns because of weak targeting and the difficulties associated

Figure 1. Commonly Used Policy Interventions



Source: Paci, Revenga, and Rijkers (2010).

with implementing incentive-compatible packages from scratch (Paci, Revenga and Rijkers 2010). Expanding existing programs is likely to be a more effective strategy than implementing new and untested programs (World Bank 2008). During the 1998 Russian crisis, for instance, while the safety net fell short of fully protecting living standards, it helped provide protection against poverty (Ravallion and Loshkin 2000). In addition, some tentative messages are emerging from the literature on which policies are most likely to be effective in achieving different policy objectives.

Policies designed to contain short-term impact

Protecting existing jobs and providing "replacement jobs"

Temporary payroll, tax holidays, and wage subsidies can help to limit short-term labor retrenchment and can be targeted to vulnerable groups. But such schemes (i) affect workers in the formal sector only; (ii) typically result in high costs per job created/maintained; and (iii) can run up against political economy constraints. For example, in Argentina, union opposition to flexible employment contracts for youth and women in the wake of the 1995 crisis resulted in the elimination of most of the program. But this program may be more effective if targeted at small firms rather than capital-intensive firms (Abrahart, Kaur, and Tzannatos 2000; Kang and others 2001).

Public work programs have been used widely in past crises, such as in Latin America and Asia, and are also the most common response to the current crisis (ILO 2009). Appropriately designed programs provide a fairly efficient instrument for targeting earnings vulnerability because a low wage ensures that the scheme is attractive for the poor only, and during crises only (Ravallion 2008; del Ninno, Subbarao, and Milazzo 2009). However, their cost-effectiveness depends on budget leverage, labor intensity, overhead costs for supervision, and targeting performance, which need to be weighed against other means, such as direct transfers.

Maintaining labor-related income

Extending *unemployment benefits* or using them to cover reduced hours and part-time training has been a common re-

sponse to the current jobs crisis (ILO 2009). Unemployment insurance may be appropriate when formal sector workers are most affected, when adjustment occurs through jobs rather than earnings, and governments have the fiscal and institutional capacity to design, implement, monitor, and target benefits. Many countries do not, however, and only a small number of developing countries have a comprehensive and effective system of unemployment benefits in place. Even in such countries, like Chile, unemployment insurance has been complemented by public works schemes.

When labor market adjustments take place through reduction in earnings rather than job destruction, *targeted cash transfers* can also provide a more cost-effective means of compensating the vulnerable: they have relatively low administrative costs and do not distort prices. There are drawbacks to the targeted transfers, however: they cannot rely on self-selection and political pressures may potentially make a scaling back of temporary programs impossible once the crisis is over.

Policies designed to accelerate recovery and promote growth

Job creation and imperfect markets

While there is evidence that weaknesses in the investment climate hamper growth and job creation in stable times, there is no evidence on the impact of *business and labor market policies* during crises. *Job search assistance schemes*, for example, may effectively address information gaps that constrain employment during normal times, but are not likely to work during times of mass unemployment (Betcherman and others 2004).

Improving employability

The impact of *training programs* to enhance worker productivity has been limited, although it strongly depends on context and implementation (Auer, Efendioglu, and Leschke 2008). Training also seems to be most effective when used in conjunction with other policies. Overall, training policies risk excluding the most vulnerable and least productive workers.

Self-employment assistance programs likewise often show low cost-effectiveness and limited outreach. This is because assisted enterprises drive out other potentially more efficient enterprises (new or incumbent) from the market and program beneficiaries include entrepreneurially skilled persons who would have started up their own enterprises anyway—and their outreach tends to be very limited. They can be more promising when targeted at particular groups such as women and older individuals (Auer, Efendioglu, and Leschke 2008; Abrahart, Kaur, and Tzannatos 2000).

Win-win policies

Conditional cash transfer (CCT) programs provide cash transfers conditional upon investments by households in education and health that in turn should benefit productivity and growth over the long run. Mexico's *Oportunidades* and Indonesia's scholarship program *Jaring Pengamanan Sosial* show CCTs can protect poor children's school enrollment in times of shocks. However, poorly designed schemes can exclude the most vulnerable, such as those who do not have access to the public services that transfers are conditioned upon (Fizbein and Schady 2009). Where cash transfer programs are not in place, as in many low-income countries, conditional schemes are likely to take longer to implement than unconditional schemes. As a crisis response, targeted unconditional cash transfers may then yield better results.

Credit market policies have shown some promise in resolving cash-flow problems in otherwise viable firms, thus protecting them from going out of business. But credit policies can result in substantial incentive problems. In Japan, banks levied additional credit to the weakest firms to avoid balance sheet problems, leaving more viable firms to exit, and stifling economic recovery. Quick fixes such as loan forgiveness, subsidized lending, and interest caps risk limiting long-term access to financing. *Microfinance schemes* may work better in contexts of high self-employment and informality. In Indonesia, microfinance institutions (MFIs) appear to have been very resilient to the East Asian crisis because of their specific design features. However, there are other cases where MFI lending has been procyclical and has exacerbated crisis situations (Marconi and Mosley 2006).

Productivity-enhancing public works schemes, finally, also fit into this category. Cost-efficient schemes that provide public/community goods can protect labor income while simultaneously reducing vulnerability and increase income growth in the future.

Conclusions: Prepare, Preserve, and Expand Policies That Work

Events of the last two years have reminded us that crises are a recurring phenomenon with deep and protracted impacts on labor markets. Designing, implementing, and evaluating sound policies ex ante is a more effective crisis coping strategy than scrambling for responses ex post. Good policies and institutions—prudent fiscal management, reliable labor market information systems, flexible labor market regulations, well-functioning credit markets, and sound safety net systems—can provide the basis for a coordinated and coherent response to a crisis, while maximizing future growth prospects. For countries in need of additional policies, crises can provide an opportune time to institute needed safety nets. Experiences with previous and recent crises have clearly shown that having a system of automatic stabilizers in place to mitigate the impact of the crisis is not a luxury. It is a necessity to avoid considerable long-term costs in terms of foregone growth prospects. Automatic stabilizers are particularly vital for countries where a large proportion of the population is in poverty or highly vulnerable.

Efficient and effective policy making and crisis response require timely and relevant information. The global jobs crisis has

also shown the importance of being better prepared on the analytical front. First, increasing the collection and availability of high frequency data is critical for monitoring the impact of crises and policy responses on labor markets. Second, it is important to be prepared by evaluating the vast amount of policy responses undertaken to the current crisis and identifying effective policies and by developing simulation tools to assess impacts ex ante. The repeated crises faced by the developing world should act as catalysts for an increased global effort to put in place efficient policy systems and high frequency data collection to monitor labor market outcomes.

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Note

1. This note draws heavily on Paci, Revenga, and Rijkers (2010).

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