

# Job recovery in times of constrained public finances\*

# 3

## Main findings

- In many G20 countries, fiscal positions have worsened significantly since the onset of the present financial crisis. This trend mainly reflects bailouts of the financial system, general spending increases and losses in tax revenues. Only less than 15 per cent of the increase in fiscal deficits can be ascribed to specific labour market programmes.
- Concerns have been raised regarding the sustainability of fiscal positions. Sovereign debt risk premia have increased, notably in certain European countries, triggering a wave of fiscal consolidation packages in many advanced economies. The announced size of these packages is substantial, often going beyond the initial stimulus that these countries had enacted at the onset of the crisis. Moreover, many of the cuts have concentrated on labour market programmes.
- Notwithstanding the necessity in some countries to return to safe fiscal positions, a rapid general move to fiscal consolidation would be counter productive. So far, there is no evidence that fiscal deficits have crowded out private demand. On the contrary, stimulus measures have proved effective in preventing a major depression and have helped to save or create jobs. In emerging economies, these effects are particularly strong, suggesting that even small increases in government spending on job-centred programmes have lasting positive effects on employment.
- It is crucial to support the economy now. Existing measures may lose effectiveness as public debt ratios increase further and the unemployed lose skills or get discouraged. Fiscal measures are all the more important because financial systems do not provide adequate credit to the real economy, as shown in Chapter 5.

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- Early exit from fiscal stimulus and lack of coordination of consolidation measures are likely to worsen both employment growth and the state of public finances. Given the current severe lack of aggregate demand, continued job-centred fiscal measures, if well designed, will pay off by themselves through faster job creation and thereby also lead to higher government revenues:
  - Aggregate demand spillovers through international trade from countries that front-load their consolidation packages will delay the global job recovery. In addition, it will lower policy effectiveness in those countries that continue with their stimulus packages.
  - Conversely, those countries that are pressured to implement consolidation packages due to the short-term unsustainability of their public finance positions need to be able to rely on an improved external position. At the current juncture, this means that those countries that still command fiscal space should use it, which would also contribute to rebalance the global economy, an issue addressed in more detail in Chapter 4.
  - In summary, early and uncoordinated exit from stimulus measures could choke off the job recovery process, with adverse consequences for fiscal sustainability.

## Introduction

Countries around the globe have started to consolidate their public finances. With public debt levels reaching triple-digit figures in many advanced countries, and large public deficits being seen even in emerging economies, concerns had been mounting fast as regards the long-term sustainability of these fiscal policies. As a consequence, policy-makers have come under increasing pressure to start phasing out stimulus measures amidst rising costs of public debt and fears of rapidly rising inflation rates. Discretionary measures are still sizeable, but political discontent is increasingly being felt as to sharing the final bill that is being presented to taxpayers. Indeed, increasing market pessimism regarding the state of public finances has pushed many governments to put forward consolidation packages that often take back more than what had initially been pumped into the economy as discretionary stimulus.

However, overly restrictive fiscal policies may further delay global employment recovery. Indeed, in June 2009 the International Labour Conference adopted the Global Jobs Pact (GJP) to support countries in designing effective labour market policy responses and to coordinate international efforts in that area. In that respect, this chapter documents that labour market spending takes the brunt of the consolidation packages, even though its role in the deterioration of public finances has only been limited. Such consolidation comes at an unfortunate moment as labour markets have only started – tepidly – to recover from the worst global recession in the past 80 years. Indeed, evidence points to an alternative policy option, whereby public spending can be reoriented towards employment creation which is based more broadly on job recovery, creating the conditions to put fiscal policies on a sustainable footing as well.

Against this background, the purpose of this chapter is: (a) to gauge the extent to which fiscal consolidation measures, as currently designed, may affect employment recovery prospects; and (b) to assess how a more careful exit strategy, which takes into account country-specific circumstances, may support the economy and

employment while still meeting fiscal goals over the medium term. This assessment has been carried out on the basis of estimations and model simulations for advanced G20 countries.<sup>1</sup>

The analysis presented here confirms that many labour market programmes are cost-effective. They foster job creation and mitigate job destruction at similar rates as generic public spending, but at a fraction of its costs. At the current juncture, this means that governments can improve both the state of their public finances and the labour market situation by reorienting part of their spending to these specific policies. Conversely, the costs of inaction or an early exit from labour market and stimulus measures can be substantial in terms of higher unemployment, more vulnerable employment and permanently depressed wage growth. Importantly, consolidation measures and early exit from fiscal stimulus will also manifest themselves in depressed job growth among trading partners, thereby further delaying the economic and employment recovery. This chapter therefore argues that rather than an exit, there should be a shift in policies towards a more dynamic use of active labour market measures that promise higher employment content for government spending.

The chapter is structured as follows. Section A discusses the shift to fiscal austerity measures that has occurred in a large number of countries. Section B examines the impact that this policy shift might have on both employment and fiscal outcomes. Section C discusses the optimal design of country-specific recovery packages in times of constrained public finances.

## A. The shift to fiscal austerity

### Fiscal deficits increased markedly after the crisis...

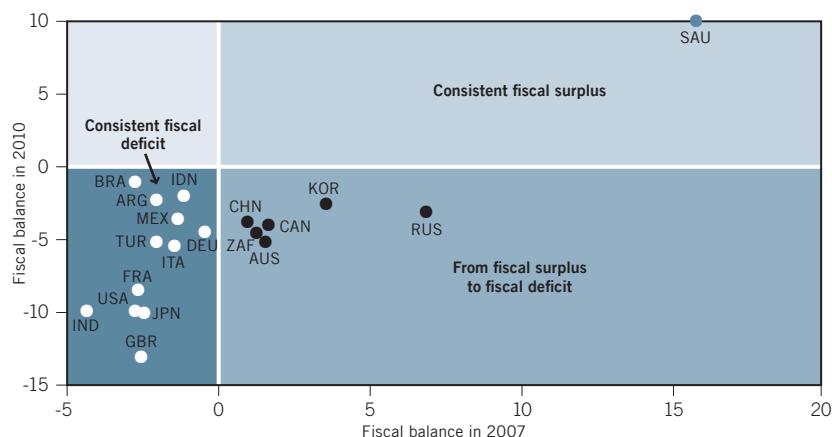
Between 2007 and 2010, net government lending – a measure of the fiscal stance – increased in almost all G20 countries, with the exceptions of Brazil, which managed to reduce its lending needs due to a very short-lived recession, and Saudi Arabia, which ran consistent surpluses thanks to a quick recovery of international oil prices over the period (figure 3.1). In the remaining G20 countries, public deficits increased by between 0.3 and 10.6 percentage points over the period, driven by automatic stabilizers, financial sector support and discretionary programmes, but also by shortfalls in tax revenues.<sup>2</sup>

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1. The chapter deliberately concentrates on public spending and revenue options in the current recovery process. More longer-term issues related to public investment and social security systems or the interaction of fiscal and monetary policies under different exchange rate regimes have not been taken up here even though their importance from a wider development-oriented perspective is acknowledged.

2. Automatic stabilizers refer to elements in the public budget balance that adjust automatically with cyclical conditions. For instance, tax revenues from corporate profits or personal income will decline as macroeconomic conditions worsen. Similarly, spending on social security and unemployment benefits will automatically increase with a rising number of jobless people. In contrast, discretionary measures refer to all those additional spending or tax measures that a government undertakes independently of the country's position in the business cycle. In the context of this chapter, the term mainly refers to additional spending programmes or tax cuts that have been implemented at the onset of the crisis.

**Figure 3.1 Changes in the fiscal balance, 2007 vs. 2010**



Note: The figure shows changes in the fiscal balance as measured by general government net lending as a share of GDP in 2007 and 2010. Fiscal balance in 2010 is forecast. The country sample includes: ARG: Argentina; AUS: Australia; BRA: Brazil; CAN: Canada; CHN: China; DEU: Germany; FRA: France; GBR: United Kingdom; IDN: Indonesia; IND: India; ITA: Italy; JPN: Japan; KOR: Republic of Korea; MEX: Mexico; RUS: Russian Federation; SAU: Saudi Arabia; TUR: Turkey; USA: United States; ZAF: South Africa.

Source: IMF (2010a).

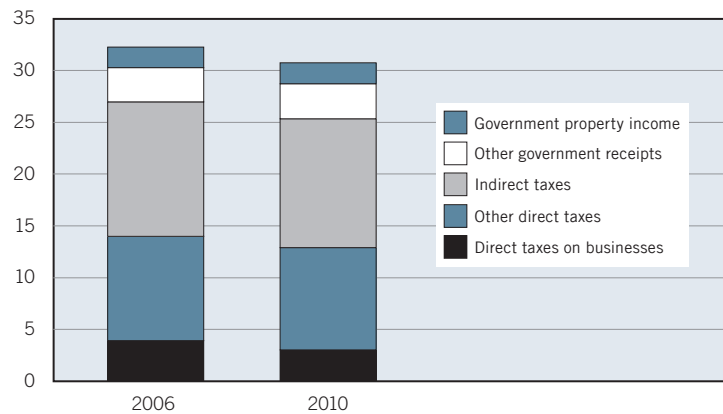
### ...partly related to shortfalls in government revenues...

Part of the increased government deficits can be explained by shortfalls in tax revenues (figure 3.2). Indeed, on average, advanced G20 governments lost almost 2 percentage points of total revenues (when measured as a share of GDP) due to substantially smaller corporate profits and reversals in income taxes. In certain cases, government revenues declined even up to 4 percentage points due to reduced direct taxation but also due to a deliberate effort to reduce tax rates to stimulate the economy (such as the temporary VAT decrease in the United Kingdom). Other sources of revenue, such as indirect taxation or income from government property, were also held up. So, some of the revenue losses may turn out to be permanent as they relate to tax cuts introduced during the crisis. In addition, the corporate profit taxation regimes in several countries allow for substantial accumulation of gain/loss over several years so as to smooth out tax payments. This means that current shortfalls in corporate profits are likely to create smaller tax payments over the next few years. Moreover, if the recovery turns out to be weaker than expected, then tax revenues would only gradually return to the previous high levels. Hence, in the current situation, and despite the fact that persistence in government revenues is typically lower than for public spending, loss in tax revenues is expected to contribute almost half of the projected increase in government debt in advanced G20 countries over the medium term (IMF, 2010a).

### ...and to financial sector support...

Fiscal support to safeguard the financial sector has been substantial, with direct support in the United Kingdom reaching up to 12 per cent of GDP (table 3.1). Not all of these support measures had an immediate impact on spending as some were in the form of guarantees, thereby creating contingent liabilities to the public sector that may or may not affect the fiscal balance in the future. In particular,

**Figure 3.2 Sources of government revenues in advanced G20 countries (percentage of GDP)**



Note: The figure shows different sources of government revenues in advanced G20 countries, excluding contributions to social security and other parastatal institutions.

Source: OECD (2009a).

**Table 3.1 Financial sector support in G20 countries (percentage of GDP)**

	Direct support			
	Capital injection	Treasury purchase of assets and lending	Guarantees	Central bank interventions
Argentina	0.0	0.0	0.0	0.0
Australia	0.0	0.0	0.0	0.0
Brazil	0.0	0.8	0.5	0.0
Canada	0.0	9.1	0.0	0.0
China	0.0	0.0	0.0	0.0
France	1.3	0.2	16.9	0.0
Germany	3.4	0.0	17.2	0.0
India	0.0	0.0	0.0	0.0
Indonesia	0.0	0.0	0.0	0.0
Italy	1.3	0.0	0.0	2.7
Japan	2.5	4.1	7.2	0.0
Korea, Rep.	1.2	1.5	11.6	0.0
Mexico	0.0	0.0	0.0	0.0
Russian Federation	7.1	0.5	7.7	0.0
Saudi Arabia	0.0	0.0	0.0	0.0
South Africa	0.0	0.0	0.0	0.0
Turkey	0.0	0.0	0.0	0.0
United Kingdom	8.2	3.7	40.0	28.2
United States	5.1	2.3	7.5	12.1
<b>G20 average</b>	<b>2.6</b>	<b>1.4</b>	<b>6.4</b>	<b>4.6</b>
Advanced G20	3.8	2.4	10.9	7.7
Emerging G20	0.7	0.1	0.8	0.0

Note: Central bank interventions refer to asset swaps and purchase of financial assets (including treasuries) by the central bank. Only pledged amounts are reported in the table.

Source: IMF (2010a).

guarantees, such as in France and Germany) will only materialize if the situation worsens. Other measures, such as buying up toxic assets or bailing out failing banks, however, create huge up-front costs. These measures have proved to be essential in mitigating the crisis and preventing further damage to the real economy. At

the same time, they have contributed significantly to increasing public debt in advanced economies. Typically, the gross fiscal cost at the time these measures are enacted exceeds the net cost once the situation stabilizes and governments proceed in selling off these assets. For instance, during the Nordic crisis in the early 1990s, Norway and Sweden suffered fiscal losses similar to the ones currently observed to support their financial sectors. Most of these losses, however, were eventually covered by selling back the assets at a much higher price to the market, leaving the net fiscal cost at almost zero (Laeven and Valencia, 2008). Also, during the current crisis, evidence from Switzerland and the United States suggests that the final bill from financial sector support may be much lower than the present situation might lead us to fear, raising hopes that the direct cost of this crisis might actually be very low by historical standards (Schildbach, 2010).

### **...but much less on stimulus measures.**

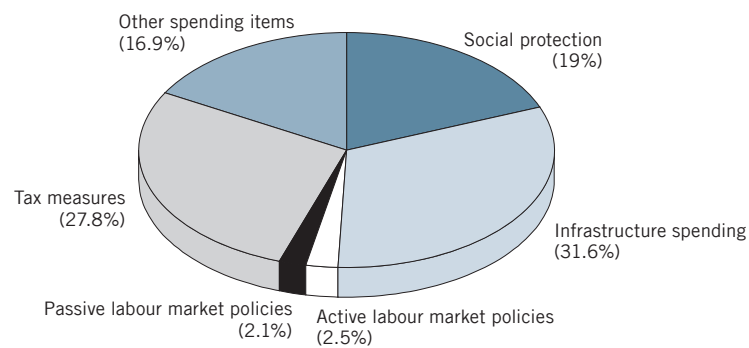
In comparison with the large efforts that governments have undertaken to safeguard the financial sector, labour market programmes have received much less attention and funding, representing less than 5 per cent of the total stimulus measures (figure 3.3). Indeed, most of the G20 countries have responded to the global economic crisis by relying on the automatic stabilizers built into their social security and tax system. Spending on unemployment benefits has increased tremendously as job losses have increased, and many governments have tried to increase resources for active labour market programmes. In addition, countries have provided additional stimulus through discretionary measures. The bulk of this extra spending is provided by only four countries – China, Germany, Japan and the United States – which account for about 78 per cent of the overall global stimulus measures announced and spend between 1.4 per cent and 2.1 per cent of their respective GDP. For most of the European countries the amounts are lower. In most developing economies the fiscal stimulus is less than 1 per cent of GDP.

With faltering employment, labour market spending has started to increase, sometimes substantially. In particular, passive labour market measures have expanded by around 20 per cent among OECD countries. On the active side, the rise in labour market spending has been more muted (at least regarding the GDP effect). However, given the size of the labour market challenge arising from substantially higher unemployment rates, further – and possibly permanent – spending increases can be expected here as well, particularly as the current downturn might also lead to a rise in long-term unemployment. Based on past experience regarding the evolution of labour market spending in reaction to unemployment developments, labour market spending is expected to increase by up to 1.5 percentage points of GDP in some OECD countries in 2010 (Charpe, 2010). In addition, countries may need to continue to stimulate employment creation, not only through labour market policies, but also through continuous support for aggregate demand, so as to guarantee that a sufficiently large number of vacancies are available for the rising number of job seekers.

### **Increasing public debt has raised concerns about fiscal sustainability...**

As a result of automatic stabilizers and discretionary stimulus measures, strong increases in public debt levels are expected over the medium term (table 3.2). This has raised fears that credit conditions for private businesses are becoming more expensive in the longer term, to the extent that public and private bond

**Figure 3.3 Composition of fiscal stimulus measures in G20 countries (percentage of total package size)**



Source: ILS estimates based on OECD, 2009b; Andes and Castro, 2009; Robins et al., 2009; Reid, 2009; Meyer-Ohlendorf et al., 2009; Zhang, et al., 2009; ministry websites of various countries and other national sources.

issues compete for limited global savings. Crowding out of private investment may take place, in particular in emerging countries with less well developed domestic capital markets, which need to rely on international capital flows to finance their investment opportunities (Ağca and Celasun, 2009). As a consequence of such crowding out, an increase in public debt would limit the effectiveness of government spending, at least above a certain threshold. According to recent estimates by Reinhart and Rogoff (2009), this threshold – considered to be around 85–90 per cent of GDP – may already have been reached by some advanced G20 economies following the current recession, although increases in long-term interest rates have so far remained limited (see next section). In addition, in less advanced economies with smaller domestic capital markets and larger need for external financial investment for their public bonds, risk premia could go up and the maturity of new bond issues could shorten, making financing the budget deficit more expensive and more risky, and with consequences also for financing conditions in the private sector (Pettis, 2001).

However, a recent study has questioned both the association of debt and growth and the threshold limits (Irons and Bivens, 2010). In particular, their study shows that it is low growth that drives up public debt but not the reverse.<sup>3</sup> This may indicate that at least for those G20 countries that command over well developed domestic sovereign debt markets, more fiscal space for stimulus is available.

### **...and has pushed countries into fiscal consolidation.**

Even though signs of crowding out are generally lacking, sovereign debt spreads have substantially increased during the first half of 2010 in certain countries, in particular in Europe (figure 3.4). This has raised serious doubts about the medium-term sustainability of some of the stimulus measures put in place at the beginning of the crisis. This can be related in part to long-standing fiscal sustainability problems in these countries prior to the crisis, which have been made more transparent by the vulnerabilities that the crisis has caused. It might also reflect an increase in risk aversion among (institutional) investors with the onset of the crisis, and a

3. In technical terms, this is done using Granger causality tests between time series of GDP growth rates and public debt ratios. In addition, their paper points to flaws in the measurement of debt used in the Reinhart-Rogoff analysis, which do not allow for a well-defined threshold for debt.

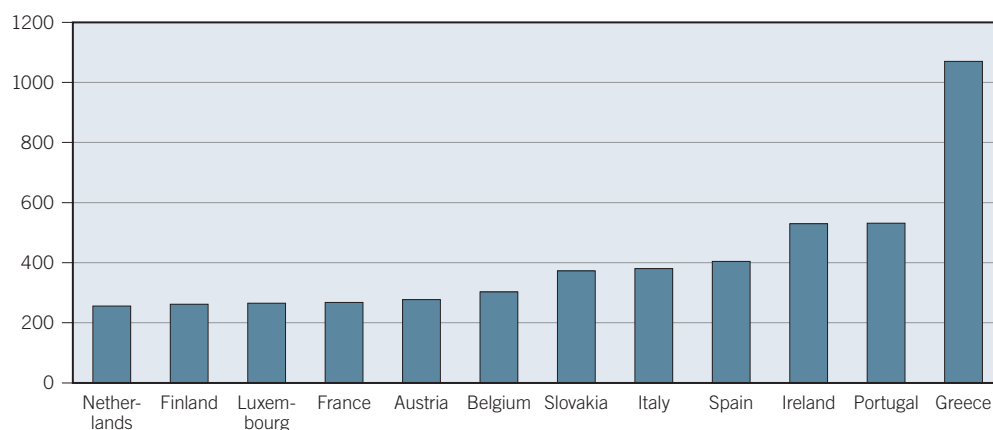
**Table 3.2 Evolution of public debt and the fiscal balance in G20 countries (percentage of GDP)**

Country	Public debt (in % of GDP)					Fiscal balance (in % of GDP)				
	2007	2009	2010	2014	2015	2007	2009	2010	2014	2015
Argentina	67.9	59.8	51.4	46.9	50.4	-2.1	-3.9	-3.5	-2.7	-2.2
Australia	9.4	15.5	19.8	22.1	20.9	1.4	-4.1	-5.0	-0.7	-0.2
Brazil	65.2	68.9	67.2	58.9	54.1	-2.7	-3.3	-1.5	-0.9	-0.7
Canada	65.0	82.5	83.3	74.2	71.2	1.6	-5.1	-5.2	-0.4	0.0
China	20.5	18.9	20.0	19.7	17.5	0.9	-3.0	-3.0	-2.2	-2.4
France	63.8	77.4	84.2	94.3	94.8	-2.7	-7.9	-8.2	-4.6	-4.1
Germany	65.0	72.5	76.7	82.0	81.5	0.2	-3.3	-5.7	-2.3	-1.7
India	79.2	80.8	79.0	70.3	67.3	-4.4	-10.5	-9.2	-4.7	-4.4
Indonesia	36.9	28.6	27.5	23.8	23.1	-1.2	-1.6	-2.0	-1.7	-1.6
Italy	103.4	115.8	118.6	123.9	124.7	-1.5	-5.3	-5.2	-4.7	-4.6
Japan	187.7	217.7	227.1	247.7	250.0	-2.4	-10.3	-9.8	-7.6	-7.3
Korea, Rep.	29.6	32.6	33.3	28.5	26.2	4.2	0.0	1.1	2.9	2.9
Mexico	38.2	44.9	44.5	42.4	42.4	-1.4	-4.7	-3.4	-2.7	-2.7
Russian Federation	8.5	9.0	8.1	10.0	13.0	6.8	-6.2	-2.9	-3.5	-4.2
Saudi-Arabia	18.5	16.3	12.8	7.3	6.4	15.7	-0.8	5.3	6.3	4.9
South Africa	28.3	31.5	34.7	36.8	35.7	1.2	-6.1	-6.1	-2.5	-1.2
Spain	36.1	55.2	66.9	89.8	94.4	1.9	-11.4	-10.4	-8.0	-7.7
Turkey	39.4	45.5	44.5	43.9	43.5	-1.7	-5.6	-3.4	-2.1	-1.9
United Kingdom	44.1	68.2	78.2	90.7	90.6	-2.7	-10.9	-11.4	-5.2	-4.3
United States	62.1	83.2	92.6	106.4	109.7	-2.7	-12.5	-11.0	-6.0	-6.5
G20 (weighted)	61.3	72.5	76.8	82.2	82.5	-0.9	-7.5	-6.8	-3.9	-3.9
All countries (unweighted)	53.4	61.2	63.5	66.0	65.9	0.4	-5.8	-5.0	-2.7	-2.5
Advanced countries (unweighted)	66.6	82.1	88.1	96.0	96.4	-0.3	-7.1	-7.1	-3.7	-3.4
Emerging countries (unweighted)	40.3	40.4	39.0	36.0	35.3	1.1	-4.6	-3.0	-1.7	-1.6
Advanced G20 (weighted)	77.9	96.9	104.4	115.5	117.1	-1.7	-9.4	-8.9	-4.9	-4.9
Emerging G20 (weighted)	37.3	37.4	37.0	34.3	32.7	0.3	-4.8	-3.7	-2.4	-2.5

Note: Averages are based on 2008 Purchasing Power Parity (PPP) GDP weights.

Source: IMF (2010a).

**Figure 3.4 Average government bond spread over German government bonds in euro area (August 2010) (basis points)**



Note: The figure shows the differences between long-term interest rates of government bonds in individual euro area countries and the rate of German treasury bonds. Differences are presented in basis points.

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Source: ILS estimates based on [www.ecb.europa.eu/stats/money/long/html/index.en.html](http://www.ecb.europa.eu/stats/money/long/html/index.en.html) (accessed 15 Sept. 2010).



sudden apprehension regarding the outlook for the real economy for some of these countries as the recovery started to set in. Most importantly, however, this can be related to the support measures for the financial sector that have transformed bank credit risk into sovereign risk, in particular for smaller countries with less developed domestic financial markets (Ejsing and Lemke, 2009).

The rapid increase in sovereign bond spreads, the deterioration of government bond ratings and the ensuing rise in the cost of public finance have pushed authorities in several countries to enact fiscal consolidation packages. Often, the announced packages are larger than the original discretionary stimulus measures (see table 3.3). In addition, most of the packages concentrate on easy to implement and quick measures, often related to increases in taxation or social security contributions and employment and wage cuts in the public sector. As will be argued in the next section, these measures are likely to make the recovery more

**Table 3.3 Fiscal stimulus vs. consolidation packages for G20 countries and selected EU countries**

	Amount of announced fiscal stimulus package (Billions)	Fiscal stimulus as % of GDP (2008)	Amount of fiscal consolidation (Billions)	Planned fiscal consolidation as % of GDP (2009)
Argentina	AR\$32.18	3.1		
Australia	A\$67.90	5.8		
Brazil	US\$20	1.2		
Canada	C\$51.61	3.2		
China	CNY4000	13.3		
Denmark		3.1	DKK24.5	1.5
Estonia			EEK20	9.0
France	€26	1.3	€100	5.1
Germany	€81	3.3	€80	3.3
Greece			€30	13.0
Hungary	HUF3200	12.0		1.6
India	Rp1860	3.5	Rp55	0.1
Indonesia	IDR69300	1.4	IDR9900	0.2
Ireland			€13.85	8.5
Italy			€24.9	1.6
Japan	JPY56800	11.2		
Latvia			LVL1	7.6
Lithuania			LTL5.3	5.6
Netherlands	€6	1.0	€16.5	2.7
Portugal	€2.18	1.3		3.4
Korea, Rep.	W67200	6.6		
Romania			€1.7	1.4
Russian Federation	RUB1576	3.8		
Slovenia	€0.86	2.3		4.0
South Africa	ZAR92.13	4.0		
Spain	€25.7	2.3		8.2
Turkey	TL57.87	6.1		
United Kingdom	£20	1.4	£128	9.0
United States	US\$787	5.5		

Note: See table 3.4 for more details on the fiscal consolidation measures.

Source: ILS estimates based on National sources; OECD (2009b); IMF (2010b); Zhang et al (2009).

**Table 3.4 Overview of fiscal consolidation programmes in G20 and EU countries**

	Effective increase in taxation	Effective cuts in social security	Public sector cuts	Other spending cuts
Australia	×			
Canada			×	×
Denmark	×	×	×	×
Estonia	×	×		×
France	×	×		
Germany	×	×		×
Greece	×	×	×	×
Hungary	×		×	
India	×	×		
Indonesia	×			
Ireland	×	×	×	
Italy		×	×	
Latvia	×	×	×	
Lithuania	×	×	×	×
Netherlands		×	×	×
Portugal	×		×	×
Romania		×	×	
Slovenia				×
Spain	×	×	×	×
United Kingdom		×	×	×

Note: The table indicates planned or actually implemented consolidation measures in four main areas up to 2015. Tax measures include increases of excise taxes, personal and capital income taxes and taxes on financial services. Cuts in social security cover measures related to public pension, health care, education and unemployment benefit systems. Public sector cuts include wage cuts and/or reductions in public sector employment. Other spending cuts include cuts in infrastructure, military spending and foreign aid.

Source: ILS, based on National Sources.

protracted as they typically have the highest employment multiplier effects. Partly, this may be related to the institutional set-up, where many spending responsibilities have been given to lower level governance structures while revenue responsibilities remain with central government, a dangerous cocktail for successful fiscal consolidation. In addition, and to the extent that the recovery might be short-lived due to these consolidation efforts, the original goals of reduced public debt and lower deficits might not even be achieved. Finally, the uncoordinated nature in which these consolidation packages are currently being designed and implemented is likely to worsen their already harsh effects (Ernst and Charpe, 2009). In this respect, it is worrying to observe that – at least in the euro area – countries have started to put forward concrete proposals to reduce their outlays substantially in the course of this year, even though their fiscal room for manoeuvre is still available and despite the fact that it is public spending that has so far contributed to the avoidance of further job losses (ILO, 2010a and 2010b).

Notwithstanding the continuous need for further stimulus, the return to safe fiscal positions seems to be warranted from a longer-term perspective. Given the loss in revenues, however, this cannot be achieved solely through spending cuts or the return to higher growth rates, which would take too long to restore sustainable public finances given the depth of the crisis (Miyazaki, 2010). Also, an exclusive emphasis on spending cutbacks to restore soundness in public finances poses not only an economic but also an equity issue: indeed, corporations and middle- and high-income earners have seen their tax burdens decrease. In contrast, announced

consolidation packages are mainly targeting social security and labour market spending programmes, often at the expense of lower-income households or those that are experiencing high labour market risk (job loss, atypical work conditions; see table 3.4 for an overview of announced or implemented consolidation packages). In addition, public sector wage and employment cuts, which are included in many consolidation packages, have immediate negative labour market consequences. Such consolidation efforts may be appropriate in more tranquil times; however, under current circumstances, with large unused productive capacities, these measures are premature and are likely to worsen the labour market crisis (Almunia et al., 2010). In light of the discussion regarding the social dimensions of the crisis in Chapter 2, governments may, therefore, try to find a more balanced approach of returning to sound fiscal positions by also considering adjustments in tax revenues. In this regard, approaches such as (temporary) tax hikes on commodity exports and mining products, such as the recently announced Resource Super Profit Tax in Australia, might be considered more widely, especially in countries where the overall tax burden is low.

## **B. What do we know about the employment effects of fiscal policy in times of crisis?**

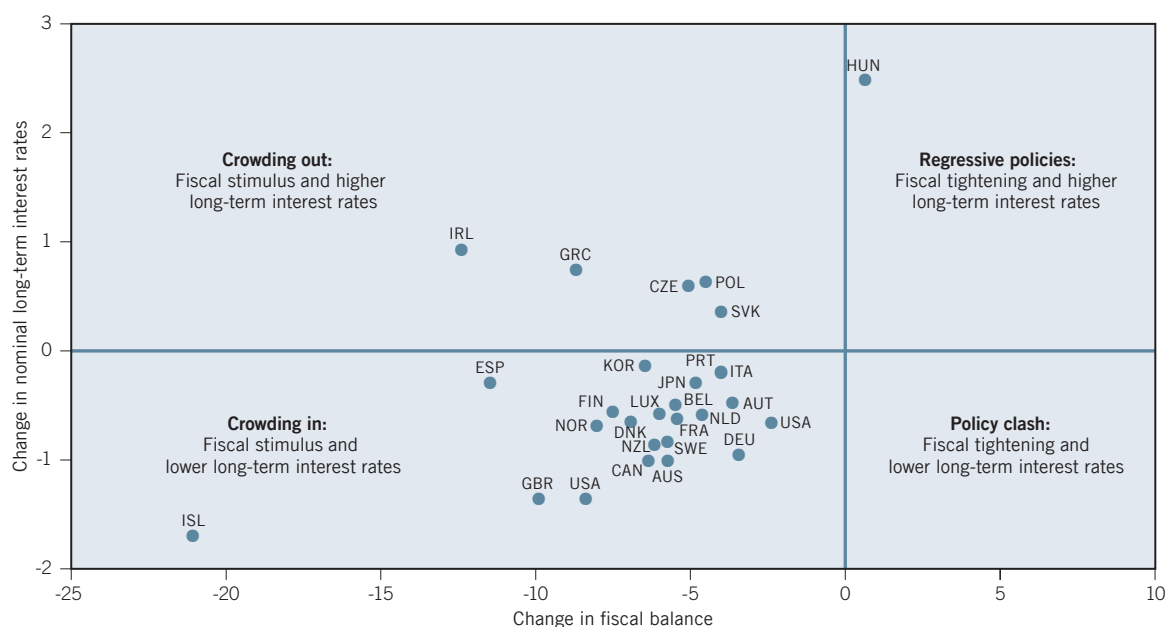
### **First, so far, fiscal stimulus has not crowded out private demand...**

So far, government spending programmes do not seem to have crowded out private consumption or investment. Indeed, in most countries, long-term interest rates (on government bonds) have continued to fall throughout the crisis (figure 3.5), in part due to the rapid easing of monetary policy. Only in certain countries, where concern over the long-term fiscal sustainability arose, there was a sizeable increase in long-term interest rates. However, the longer the recovery takes to materialize fully, the larger the spending purse remains open and the more likely it is that there will be an impact on (long-term) interest rates, thereby crowding out private spending. Such an effect might take time to materialize, and it partly depends on (shifting) perceptions of market participants regarding the speed and shape of the recovery. In addition, for long-term rates to increase rapidly, inflation expectations would need to shift substantially. At the current juncture, with the output gap still wide in many (advanced) economies and further deflationary pressure from a globally ageing workforce, the inflation outlook can be considered to be benign. Nevertheless, to the extent that long-term interest rates also include a risk premium to reflect uncertainties about the outlook, sudden shifts in perception and risk aversion can lead to public spending programmes having abrupt and non-linear effects on the private economy (Haugh et al., 2009).

### **...and has had a significant impact on employment, especially in emerging economies.**

Government spending programmes appear to have been an essential ingredient in helping to avoid further job losses and allowing labour markets to recover from the crisis. In particular, in emerging and developing countries, the available fiscal space has been used to implement some, albeit small, countercyclical measures to stem the crisis. This is a welcome change in contrast to earlier episodes, where countries have

**Figure 3.5 Changes in long-term interest rates vs. changes in fiscal balance, 2007–09 (percentage points)**



Note: The figure shows (i) the change in fiscal balance between 2007 and 2009 measured by the difference in general government net lending as a percent of GDP and (ii) the change in nominal long-term interest rates on government bonds over the same period. The country sample includes: AUS: Australia; AUT: Austria; BEL: Belgium; CAN: Canada; CHE: Switzerland; CZE: Czech Republic; DEU: Germany; DNK: Denmark; ESP: Spain; FIN: Finland; FRA: France; GBR: United Kingdom; GRC: Greece; HUN: Hungary; IRL: Ireland; ISL: Iceland; ITA: Italy; JPN: Japan; KOR: Republic of Korea; LUX: Luxembourg; NLD: Netherlands; NOR: Norway; NZL: New Zealand; POL: Poland; PRT: Portugal; SVK: Slovakia; SWE: Sweden; USA: United States.

Source: IILS estimates based on IMF (2010a).

often suffered from procyclical fiscal tightening as limited fiscal space has forced them to rein in spending and raise taxes (often trade-related) in order to balance the books (see box 3.1 for a discussion of the experience of sub-Saharan Africa).

Going forward, however, no agreement exists regarding the extent to which additional public spending can boost employment creation. Most existing evaluations of the impact of government consumption on output and private consumption seem to suggest that both for advanced and emerging economies the effects of government spending can be sizeable, especially over the longer term. Several studies have documented such fiscal multipliers in advanced countries (Barro and Redlick, 2009; Blanchard and Perotti, 2002; Mountford and Uhlig, 2009; Perotti, 2005; Romer and Bernstein, 2009), but there are only a few estimates for emerging and developing countries (Davoodi et al., 2010; Ilzetzki and Vegh, 2008). Also, other country characteristics, such as the degree of trade openness and the existence of well-functioning (domestic) financial markets, appear to influence the effectiveness of fiscal policy. In particular, the latter feature has received some prominence in the actual debate because, in theory, simulated fiscal multipliers can be more than twice as large in situations where investors face a liquidity trap than under normal circumstances (Christiano et al., 2009; Woodford, 2010).<sup>4</sup> Finally, there is little or no evidence on the effect of a fiscal policy change on employment.

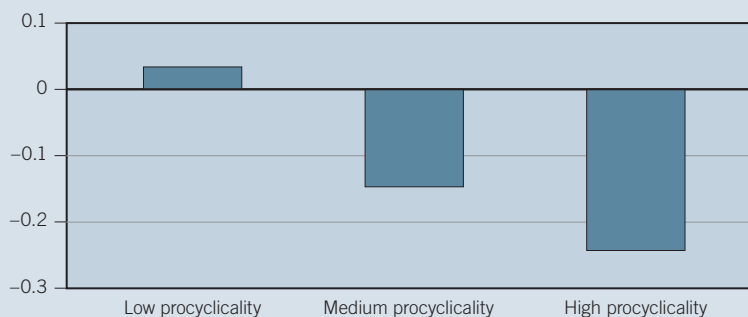
4. An economy is said to be in a liquidity trap when monetary policy no longer affects the real economy. This may happen either when monetary policy can no longer decrease interest rates due to the zero lower bound (i.e. nominal interest rates cannot, in principle, be set below zero) or when further decreases in interest rates and/or the expansion of money supply would only raise money holdings by private households and firms without affecting their consumption or investment decisions.

### Box 3.1 The danger of procyclical fiscal policies for employment: The case of sub-Saharan Africa

The current difficulties of European governments with rapidly increasing public debt have triggered some debate on the potential benefits of procyclical tightening. Some observers have argued that the improvements in confidence and lower risk premia that result from public spending cuts could have the potential to overcompensate any direct adverse effects on aggregate demand caused by such a policy shift (Alesina and Ardagna, 2010). These insights may apply, however, only in specific circumstances and be less relevant in developing countries. This box discusses the large negative effect of procyclical public spending on employment creation in sub-Saharan African countries.

Sub-Saharan African countries have suffered in the past from highly procyclical government spending patterns (Fofack, 2010; Thornton, 2008). Limited fiscal space and the fact that much of government revenue are tightly linked to volatile income components, such as commodity trade and remittances, limit the capacity of many countries in the region to smoothen economic activity and job creation over the economic cycle. This has proved vastly damaging to sustainable employment creation (figure 3.6). Indeed, the increased volatility of economic activity that this procyclical stance for public spending had implied has destroyed on average more jobs than if there had been acyclical public spending (i.e. public finances that do not react to cyclical conditions). Such increased volatility holds back private investment and increases the risk premia, in particular for small and medium-sized enterprises, thereby heavily weighing on job creation. For instance, if the United Republic of Tanzania – a country with a relatively high degree of procyclical spending – had experienced the same low degree of spending procyclicality as Namibia, it could have added almost 170,000 jobs per year over the period 1991–2008, or 10 per cent of its current employment level.

**Figure 3.6 Net employment creation in sub-Saharan Africa relative to degree of procyclicality of government spending, 1991–2008 (percentage growth per annum)**



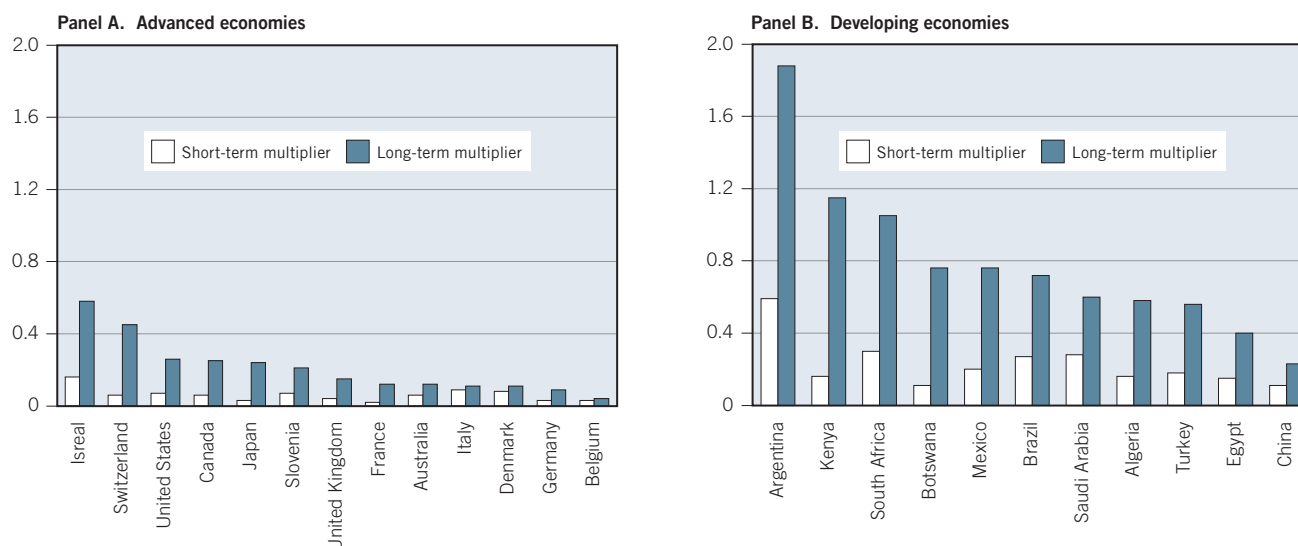
Note: Net employment growth is defined as the difference between employment growth and labour force growth (compound rates) between 1991 and 2008. Terciles have been constructed using unweighted averages of net employment growth. The degree of government spending procyclicality is measured with respect to GDP growth based on Thornton, 2008. The following countries are included: Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea-Bissau, Côte d'Ivoire, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Somalia, Swaziland, United Republic of Tanzania, Togo, Uganda, Zambia, Zimbabwe.

Source: ILS estimates based on Thornton (2008) and ILO Laborsta database.

In order to get a more precise understanding of the effects of government spending on employment, the multipliers for a selection of advanced and developing countries have been estimated.<sup>5</sup> The estimated multipliers are sizeable, in particular in the long term (figure 3.7). For instance, the estimated multiplier for

5. The estimates are carried out using structural vector autoregressive (SVAR) techniques, following the methodology developed by Ilzetzki and Vegh (2008); see Agu and Rani (2010) for a detailed discussion of this approach.

**Figure 3.7 Estimated employment multiplier of government spending**



Note: The figure shows estimated employment multipliers following increases in government spending both after one year (short term) and after five years (long term). The estimates cover the period 1980 to 2008 (on an annual basis). The employment multiplier is computed by dividing the “impulse response” by the average ratio of government consumption to GDP. For example, the employment multiplier for Argentina is 0.6, which would mean that an additional 1 per cent shock to government consumption will lead to an increase in employment of 0.6 per cent in the short term and an increase in employment of 1.9 per cent in the long term.

Source: ILS estimates based on IMF (2010a) and ILO Laborsta database.

the United States is 0.1 per cent in the short term and 0.3 per cent in the long term. Applying a 3 percentage point increase to the government spending to GDP ratio, as was recommended by international observers at the onset of the crisis, would have lifted employment by 0.8 per cent in the short term and 2.3 per cent in the long term. The actual stimulus packages have been much larger, reaching around 10 percentage points. Accordingly, this has prevented a further decline in employment of roughly 2.5 per cent and might lead to employment creation equivalent to 7.5 per cent of total employment over the long term, which should be sufficient to absorb a large proportion of the jobs lost so far. Figure 3.7 also demonstrates that employment responses to government consumption shocks in advanced countries appear to be considerably smaller than in developing countries. The impact multipliers were higher across all the developing countries than for developed countries. For instance, Argentina and South Africa had impact multipliers of 0.6 and 0.3, respectively, and their long-term multipliers were at least twice that of any of the developed countries. Among developing countries, China has the smallest short-term impact, slightly above the value for Italy. As regards the long-term effects, emerging economies also show substantially higher multipliers than advanced economies. This might partly be related to a higher responsiveness of labour supply to positive demand shocks in emerging economies, where informal economies are large. In addition, government spending output multipliers, which show a similar pattern across advanced and emerging economies, suggest that aggregate demand is the most constraining factor in these emerging economies, making them particularly receptive to additional public stimulus.

**Second, some programmes have larger employment effects than others.**

**68** Which policies should countries implement? Does a generic approach exist, or is it necessary to identify concrete areas of policy intervention to guarantee success?

At the current juncture, with severely adverse macroeconomic conditions, the existing evidence on labour market programme effectiveness is only of limited help in selecting different policy options. Under more tranquil circumstances, some consensus had emerged in the past regarding the importance of certain policies, such as job search assistance and training programmes, for stimulating employment growth and bringing unemployed workers back to employment, even though there is almost no available cost–benefit evidence for these programmes.<sup>6</sup> There exists no evidence with regard to the effectiveness of these labour market policies taking macroeconomic and financial sector crisis conditions into account. These conditions must be taken into account, if countries want to select the right mix of policies as policy multipliers vary widely depending on the general macroeconomic environment. In this section, a novel approach is presented that aims to overcome – at least partially – this missing link between labour market policies and the aggregate state of the economy and employment. On the basis of a new database on unemployment dynamics, the macro- and microeconomic implications of fiscal and labour market policies are analysed. In particular, the analysis includes bidirectional effects between unemployment dynamics and fiscal variables to account for potential adverse effects from the costs of labour market policies at the macroeconomic level. This allows the fiscal implications of labour market policies to be taken into account explicitly and provides a more accurate picture of policy effectiveness under the current circumstances.<sup>7</sup>

Countries face increasingly diverse challenges for their labour markets as a result of the crisis. Therefore, for the assessment of appropriate policy options, it is helpful to distinguish in more detail between different generic fiscal policies and specific labour market policies. In particular, this will allow assessment of the timing of when policies need to switch from income-support policies to those that facilitate long-term adjustment processes on the labour market. In this regard, total government consumption (excluding interest payments) is split into wage and non-wage government spending, the former being principally related to spending on public employment whereas the latter relates to policies directly relevant to supporting consumption in the private sector. Within this category also fall various labour market programmes, which have been further detailed in the analysis. A first distinction in these labour market programmes has been made between active and passive measures. The active measures comprises of direct job creation, hiring incentives, training programmes and spending on public employment services. The passive measures, on the other hand, comprise all those pertaining to income maintenance, at least temporarily.

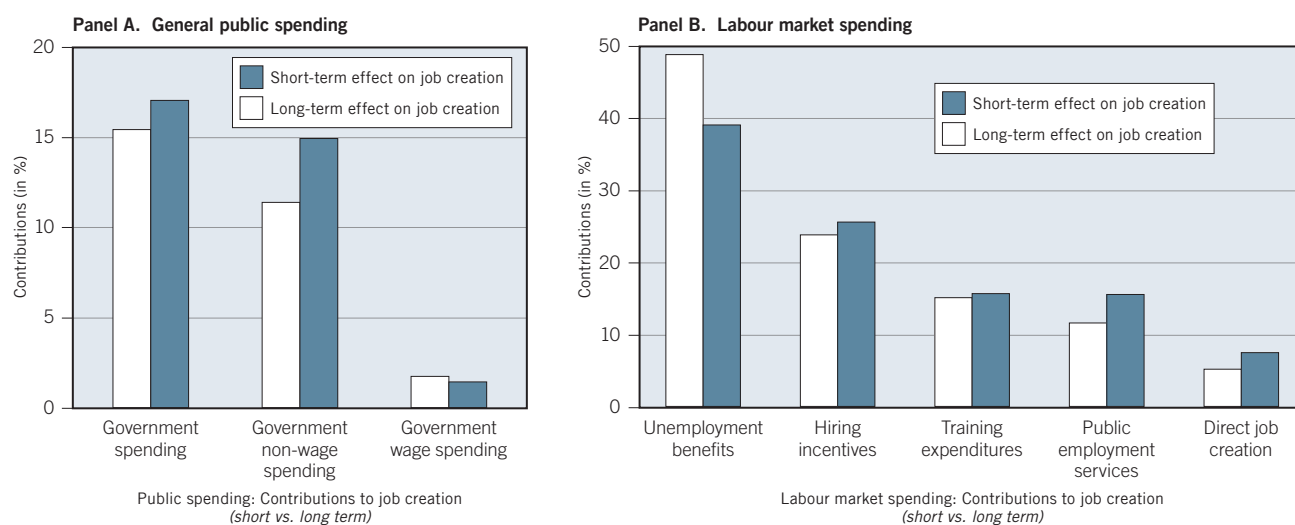
On the basis of this analysis, general government spending seems to have a strong impact on job creation rates. In line with the above evidence on employment multipliers, the analysis presented here suggests that certain spending programmes have larger effects in the long than in the short run (see figure 3.8 panel A). On the other hand, public employment seems to have a more limited effect on job creation, even though it has played an important role in preventing employment from declining further at the beginning of the crisis.

The analysis also makes it possible to give a more detailed picture of various labour market programmes, including both passive and active measures

6. See Card et al. (2010) for a recent meta-analysis of existing studies in this area.

7. See [www.ilo.org/inst](http://www.ilo.org/inst) and Ernst (2010) for a more detailed discussion of the empirical strategy, the estimation methodology and a summary of the estimation results. It should be noted that due to data restrictions the analysis in this section and the scenario simulations in the next section are limited to advanced G20 countries.

**Figure 3.8 Estimated effects on job creation of different policy options in selected advanced economies**



Note: The figure presents the contributions (in %) to job creation (measured by outflows out of unemployment) of different fiscal and labour market policies in a panel of 14 advanced economies. Contributions are measured relative to the total variance of cross-country job creation rates and are calculated with respect to the average spending shock across the country sample for each individual policy. Each bar corresponds to a single estimation of the employment effect of the respective policy, controlling for other policies affecting employment. Short-term effects are based on exogenous interest rates, long-term effects take into account the impact of an increase in government debt on real long-term interest rates. See [www.ilo.org/inst](http://www.ilo.org/inst) and Ernst (2010) for detailed estimation results and methodology.

Source: ILS, based on Ernst (2010).

(see figure 3.8 panel B). Moreover, the particular macroeconomic focus and the detailed analysis of competing labour market programmes provide a more detailed understanding of the different policy trade-offs that countries are currently facing. In particular, direct job creation outside the public sector seems to come with high deadweight costs as it lowers job destructions substantially more than it increases job creation. In other words, the programmes often seem to benefit those already in a job or who would have been hired even in the absence of such policies. The absence of economically or statistically significant effects of direct job creation programmes on job creation is also confirmed when considering its effect over the long-term. Conversely, hiring subsidies seem to have the expected effect on job creation more than on job destruction, both in the short term and the long term.

Expenditures on training programmes and public employment services have the expected (positive) effects on job creation, confirming existing evidence in the literature. The estimated effects do not take into account the particular design of public employment services (PES) or training programmes in the countries of this sample. Some countries may actually find these policies have a much better effect on labour market flows when used in combination with appropriately designed unemployment benefits schemes. Nevertheless, it should be noted that these programmes often come with an increase in measured unemployment rates, an indication for the importance of programme design, in as much as the participation in certain programmes requires official inscription in the unemployment register.<sup>8</sup>

8. Partly, the rise in unemployment following an increase in expenditures on public employment services and training can be considered a statistical artefact: these measures particularly target inactive people to return to the labour market, causing measured unemployment rates to increase while inactivity rates decline.



As such, these programmes are not only an effective way of bringing unemployed workers back to employment, they also seem to constitute a useful instrument to activate those that currently have very limited ties with the labour market or have dropped out of the labour force altogether. The macroeconomic long-term effects of some of these policies, however, seem to be less significant than those in the short term, partly related to the high cost of these programmes, which weighs on public finances. In reality, these costs may be compensated by the individual long-term benefits regarding improved job matching rates and higher salaries; the estimates do not allow these to be taken properly into account.

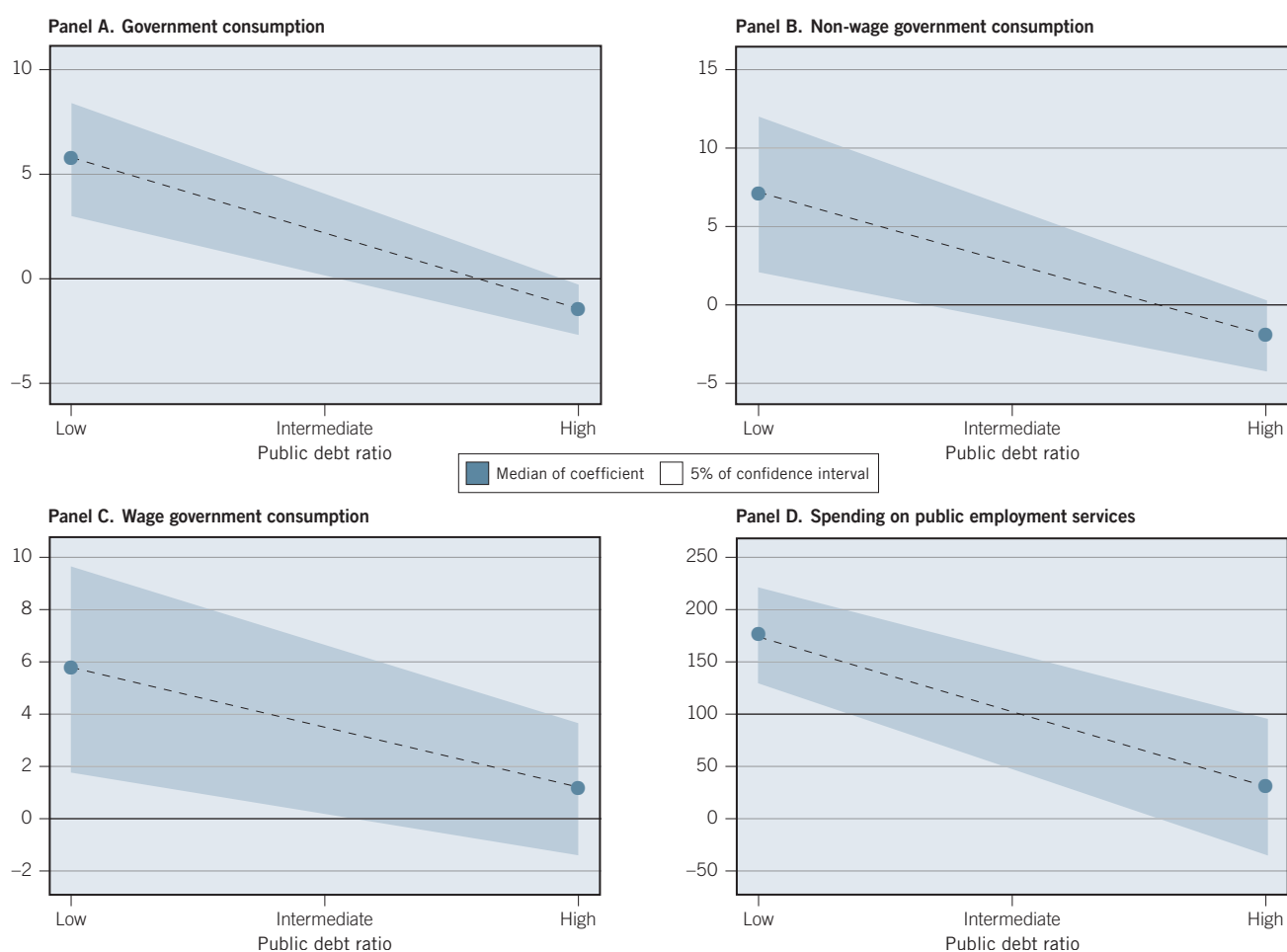
Finally, as regards the impact of unemployment benefits on labour market dynamics, these seem to produce the strongest effect among labour market policies in both the short term and the long term. In addition, such benefit systems – where they are in place – yield a positive contribution to job creation and help to reduce job destruction. This confirms the importance of such policies within the framework of stabilization policies. In contrast to fears expressed in the microeconomic literature, the results of the analysis presented here suggest that such benefit systems are acting in a stabilizing manner on labour market flows, thereby not overly distorting the process of job separation. Indeed, certain authors have suggested that the procyclical evolution of the tax wedge, due to benefit systems that need to balance their books, may increase the unemployment inflow rate, making labour market recovery more protracted (Den Haan, 2007). The above results do not suggest that this effect is particularly strong; rather – and in line with other studies, such as Acemoglu (2001) – the stabilizing impact on aggregate demand seems to dominate any possible dead-weight costs from such systems.

### **Third, the employment impact of fiscal policy depends on country conditions, notably the level of public debt...**

Differentiating the effectiveness of fiscal policy intervention depending on the initial level of public debt confirms concerns voiced earlier: for most spending types – including spending on labour market policies – the effectiveness declines and becomes insignificant (figure 3.9).<sup>9</sup> As public debt rises, private borrowers will find it increasingly difficult to finance their consumption and investment plans at reasonable rates, pushing up long-term interest rates. Certain private spending plans will be postponed, helping to support the savings rate, albeit in a procyclical way, and thereby slowing down the recovery (Afonso, 2008; Röhn, 2010). It should be noted that the results reported below suggest that these effects materialize independently of the immediate effect on aggregate demand: even those spending components which are likely to increase aggregate demand directly – such as spending on public sector wages – lose their effectiveness in supporting job creation. Conversely, coordination between fiscal and monetary policy is necessary for government outlays to have maximum impact on economic activity. When monetary policy-makers increase interest rates in reaction to additional government spending in an uncoordinated manner, the positive impact on activity will be smaller, or even absent, even in the short term. In part, the central bank reaction will depend on the cyclical situation: when the economy is running

9. Throughout this section, policy effectiveness is measured by the point estimate of the coefficient corresponding to the estimated impact of a particular policy on unemployment outflows. See Ernst (2010) for detailed results of the regressions.

**Figure 3.9 Estimated employment effects of different spending policies, by level of the public debt ratio**



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various levels of public debt as a percent of GDP.

Source: See ILS web site: [www.ilo.org/inst](http://www.ilo.org/inst).

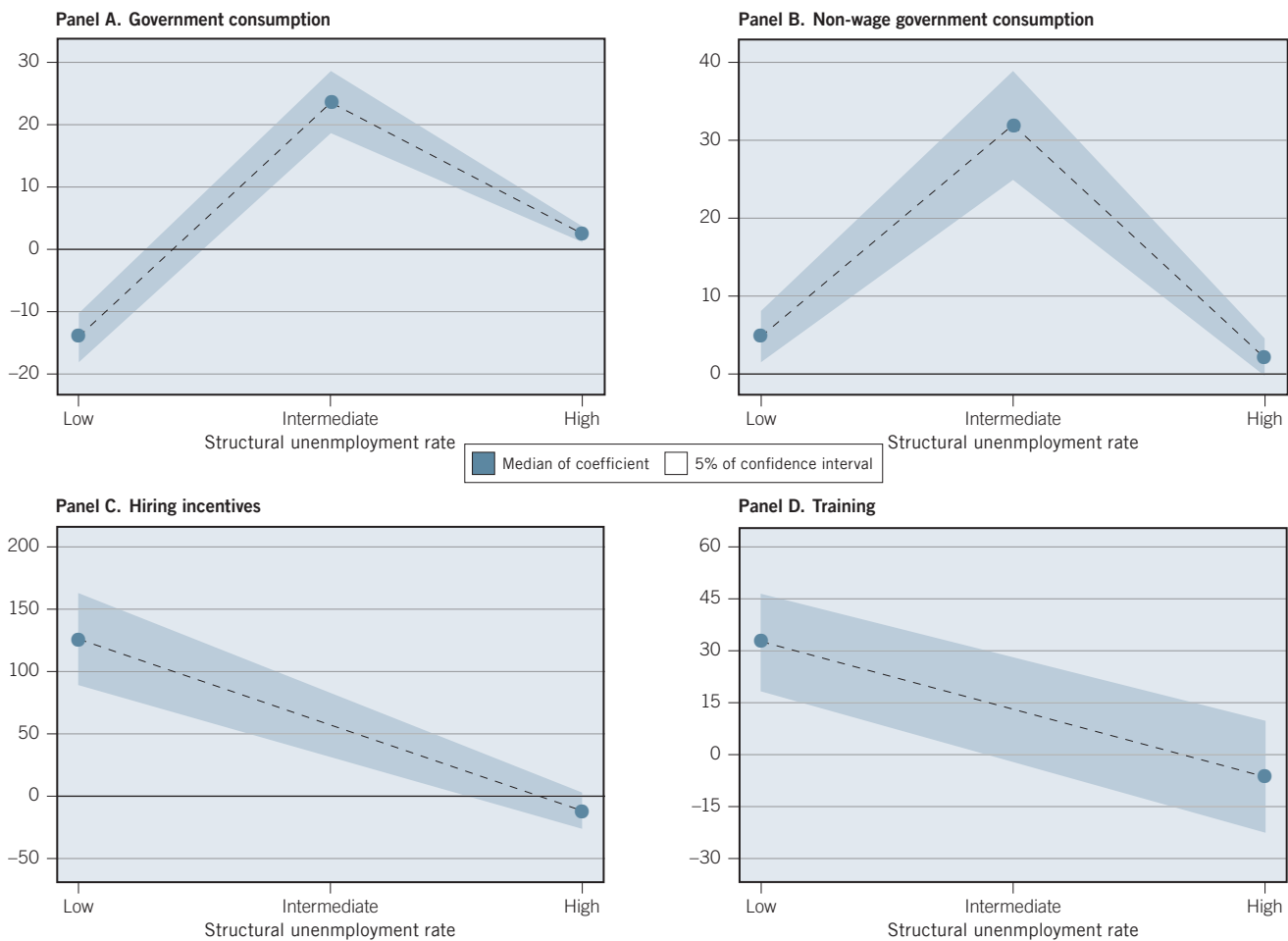
at or close to its potential, monetary policy-makers will be less inclined to guarantee the effectiveness of additional fiscal spending than at moments of large economic slack, such as in the current situation.

### ...structural unemployment...

Of particular concern coming out of the crisis will be the expected increase in long-term or structural unemployment.<sup>10</sup> Indeed, structural unemployment is rising among all OECD countries, with similar developments discernible also in some emerging countries, which will require labour market policies to reorient their efforts towards activation of those that are losing ties with the labour market or that have already left the labour force. In this regard, the estimates show that this will be no easy task. Indeed, general government consumption loses its

10. The notions of long-term and structural unemployment will be used interchangeably in this chapter as a way to characterize labour market segments that react only weakly or not at all to policy stimuli, such as automatic stabilizers or more targeted labour market measures. Typically, when structural unemployment is increasing, macroeconomic policies return to normalcy more rapidly to prevent inflationary pressures from building up.

**Figure 3.10 Estimated effects of different spending policies by level of the structural unemployment rate**



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various levels of the structural unemployment rate.

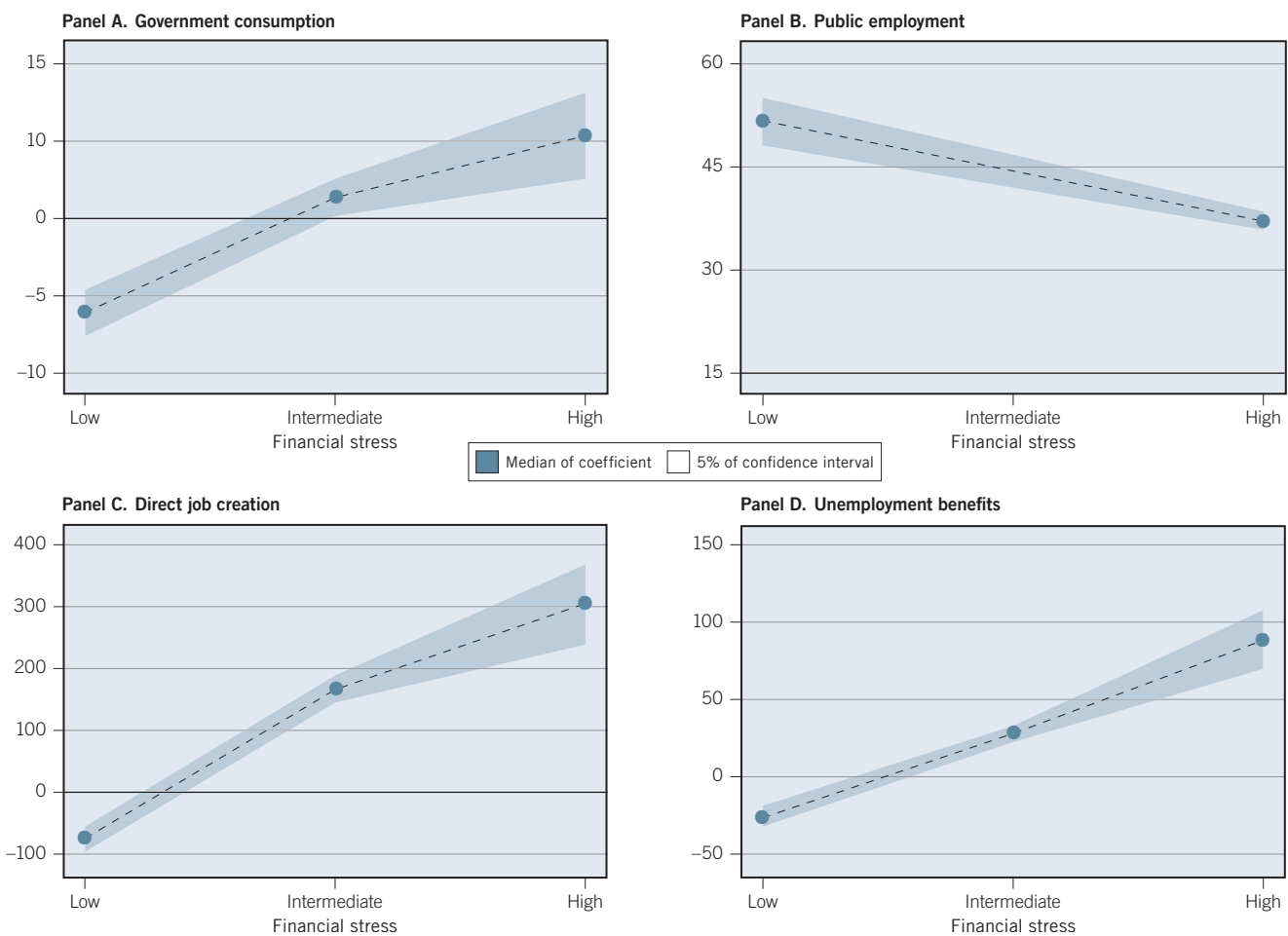
Source: See ILS web site: [www.ilo.org/inst](http://www.ilo.org/inst).

effectiveness with very high structural unemployment rates, irrespective of which spending component is analysed (see figure 3.10, panels A and B). Analysing labour market policies in more detail confirms this result: policies that are typically considered to be of great use when activating long-term unemployed – hiring incentives and training programmes – show strong signs of weakening effectiveness when structural unemployment rates increase (see figure 3.10, panels C and D).

### ...and financial market conditions.

Financial market stress is particularly relevant for understanding spending effectiveness in the current crisis (figure 3.11). Indeed, as mentioned above and discussed in detail in Chapter 5, several authors have suggested that financial market conditions can substantially alter the functioning of the real economy, leaving fiscal policy as the only effective tool for boosting production and employment creation. The results presented in figure 3.10 seem to support this view, in particular regarding general government spending, but also more specifically with respect to income support and direct job creation measures. Similar results are found for other active labour market spending programmes. It is notable,

**Figure 3.11 Estimated effects of different spending policies, by degree of financial stress**



Note: The figure shows coefficient estimates for the effect of various policy measures on job creation at various degrees of financial stress, as measured by Balakrishnan et al. (2009).

Source: See ILS web site: [www.ilo.org/inst](http://www.ilo.org/inst).

however, that this result does not seem to carry over for public sector employment creation, even though the above results suggest that under more normal economic circumstances, public employment creation can contribute to job creation. One explanation might be that the expansion of public employment during crisis would actually worsen the outlook for fiscal sustainability, thereby further increasing financial stress, with adverse spillovers into the real economy. This could also be one of the reasons why countries with consolidation programmes have targeted spending on this particular item as one area where public spending effectiveness is particularly low.

## C. Fiscal austerity versus well-designed exit strategies

### As the crisis continues, structural unemployment becomes more pervasive...

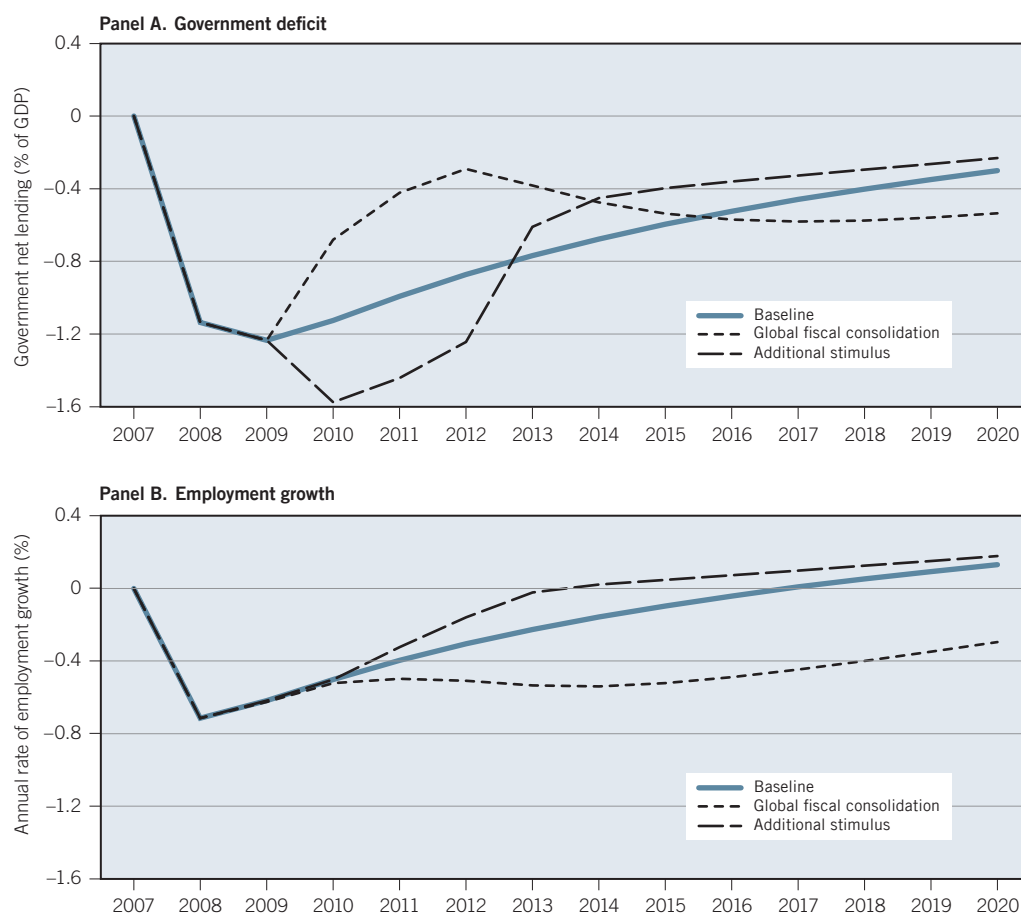
The fragile and muted nature of the recovery is likely to feed the structural unemployment rate. Indeed, after a financial sector crisis it typically takes a long time before growth returns to earlier rates. Partly, this is related to the fact that households and firms need to de-leverage before they can return to a stronger consumption and investment path (see also Chapter 5). As discussed in Chapter 1, this will cause the return of employment to pre-crisis levels to be only gradual. Indeed, in high-income economies, the adjustment period may be longer than six years, whereas upper-middle-income countries may have already returned to pre-crisis levels. Nevertheless, even in these countries the continuous growth in the size of the active population is putting additional pressure on labour markets. At any rate, the challenges that the crisis has created for labour markets will cause employment growth to remain at a lower rate than before the crisis for the foreseeable future. The flip side of these developments is that long-term challenges will arise on the labour market. Recent estimates of changes in structural unemployment rates across OECD countries indicate their likely increase – sometimes substantial – over the next two years, an important break with the past trend of falling structural unemployment rates in that region (OECD, 2010). Indeed, by 2011, structural unemployment rates are expected to rise by 3.5 percentage points for Spain and 0.5 percentage points for the OECD country average. As indicated by the analysis in the previous section, the growing structural problems in the labour market further complicate exit strategies by reducing the effectiveness of labour market and demand management policies.

In this context, what policy options do countries have, given the challenges for fiscal sustainability and labour markets as identified in this chapter? And how should they time and coordinate their policy interventions? At the current juncture, three scenarios for policy options can be distinguished for advanced G20 countries (figure 3.12). These scenarios provide some general lessons as regards both the timing and the cross-country coordination of policies. In particular, they demonstrate that there are some options to strengthen the labour market recovery. More importantly, there are policy choices that countries should refrain from if they want to avoid further deterioration of their employment situation.

The baseline scenario reflects the continuation of job-centred policies, as implemented with the onset of the crisis. These measures, though costly to the public purse in the short term, would in five years' time lead to fiscal deficits similar to those of an early exit strategy. In particular, by putting greater emphasis on labour market measures, they will be able to limit further increases in job destruction, avoid a downward spiral of wages and boost job creation.

In contrast, global fiscal consolidation from job-centred measures would significantly aggravate the employment outlook. Such a fiscal consolidation would improve fiscal balances only in the short term. However, it is crucial to note that this improvement would be short lived and would come at the cost of substantially worsened labour market dynamics. In particular, the analysis suggests that if restrictive measures were adopted now, employment in advanced G20 countries would be 4 per cent lower in five years' time (compared with the baseline). Shortly after early exit measures were adopted, fiscal deficits would deteriorate once again. This reflects the fact that (a) many workers would move out of the labour market, depriving the economy of valuable resources and reducing the tax

**Figure 3.12 Exit scenarios from the crisis**



Note: The figure shows three different exit scenarios from the crisis. Scenario 1 is at current policies; scenario 2 suggests a global fiscal consolidation, with global trade only expanding at half its pre-crisis rate (starting in 2010); and scenario three suggests an additional 3 per cent of GDP stimulus cut for 3 years (starting in 2010) and return to baseline public finances afterwards.

Source: See ILS web site: [www.ilo.org/inst](http://www.ilo.org/inst).

base, and (b) unemployment and labour market inactivity resulting from early exit measures have a strong bearing on public spending, as noted above. The adverse consequences of an early exit is particularly strong if fiscal consolidation were to be undertaken globally: as world trade in this situation would not recover to its earlier rate of expansion, a further dampening effect on aggregate demand and hence employment creation can be expected. In other words, uncoordinated fiscal contraction which disregards the situation of the global economy would produce a further drag on the recovery.

The simulated scenarios suggest that, in contrast to these consolidation measures, countries should use their available fiscal space to the full. Indeed, these countries could even consider a further increase in spending over the next three years in the order of 3 per cent of GDP. As the simulation scenario demonstrates, such additional spending would lead to a robust reaction of employment that is sufficiently strong to overcompensate the initial deterioration of public finances. Four years after the first additional spending measure has been set up, public deficits would actually be lower than under the baseline scenario. In light of the above discussion, such a scenario is only possible in those countries where some fiscal space remains and the labour market challenge continues to be one of lack in aggregate demand.

None of the three scenarios considers the structural challenges that arise from the crisis for labour markets. Changes in inactivity and necessary sectoral reallocation of resources and jobs, as described in Chapter 1, are not being properly reflected in these simulations and so policy measures need to be implemented along the lines suggested in the earlier discussion. However, to the extent that these measures also have some fiscal implications, the scenario simulations demonstrate that those measures that develop aggregate demand effects in the short term show superior labour market effects over the medium term, with the potential to improve the fiscal balance at the same time.

The analysis in this chapter suggests that policies will need to be decided on a country-specific basis as the recovery process takes divergent routes, notably due to differences in the level of public debt, the structural unemployment rate and the severity of financial stress. In particular, in light of the worsening situation as regards sovereign debt risk, not all countries that should continue stimulating their economy will be able to do so. In this regard, it is imperative that fiscal consolidation does not happen in an uncoordinated manner. In such a case, fiscal austerity is likely to turn out more severe than necessary. More generally, on the basis of the analysis and the simulations presented in this chapter, four principles can be put forward to inform the design of these policies:

- Countries will need to switch gradually from generic demand management policies to more targeted labour market and structural policies when recovering from the crisis, thereby using their remaining fiscal space most effectively. In particular, those labour market policies that contribute more to job creation than general/generic government spending could be given greater priority when reorienting public spending, following the guiding principles of the Global Jobs Pact, the ILO's key instrument for global policy coordination. Moreover, as the effectiveness of labour market policies is being less influenced by cyclical conditions than other public spending categories, they should be of priority when economies are recovering.
- Countries with low public debt – most notably some of the emerging G20 countries – will be able to support their economy longer and with smaller losses in policy effectiveness than countries with large public debt. This way they will support their own economy while also contributing to job recovery among those of their trading partners that benefit from less fiscal space. This issue and the contribution of such a policy on rebalancing the global economy will be discussed in depth in Chapter 4.
- It is crucial to tackle the rise of long-term unemployment and increase in informality quickly and decisively, even during the recovery phase. This may imply further support to aggregate demand to prevent an increase in long-term unemployment. Measures to limit job losses – such as part-time and work-sharing agreements – that have currently been put in place should be maintained until more normal cyclical conditions prevail. However, countries should prioritize measures that prevent a further increase in unemployment duration for those who have already lost their job.
- Fiscal space permitting, there is a strong case for maintaining well-designed, job-centred stimulus programmes in countries that continue to experience particularly high levels of financial market stress. In particular, labour market programmes can be of help here, with their lower fiscal costs and high policy effectiveness in an environment of high stress on financial markets.

In short, a majority of countries still have some room for fiscal manoeuvre, but are experiencing high long-term unemployment (such as Germany and Japan). These countries should use their available fiscal space and put more emphasis on active labour market policies, even beyond the forecast increases in spending on these programmes. Early action here is decisive in preventing structural unemployment from increasing too much or long-term unemployment becoming too persistent. Similarly, in countries like China where fiscal space is still available but lack of labour demand is the main contributor to unemployment rates, governments could use their room for manoeuvre and tackle joblessness head on. This will not only help to bring unemployment rates down, but will also prevent existing joblessness and informality from becoming structural. Finally, when fiscal space is no longer available, countries will need to concentrate on fiscal consolidation, as argued above, but should avoid cutting more effective labour market programmes. In particular, general spending cuts might not be the most appropriate policy. Rather, spending cuts or tax increases should take specific labour market challenges into account.

## Policy considerations

The current global financial and economic crisis poses serious challenges for labour markets across the globe. Many countries are still to feel the full impact of the crisis on their labour markets but are already running out of fiscal space as public budgets have been stretched to safeguard the financial system. This chapter argues that despite these difficulties, several countries still have margins of adjustment to react to the labour market crisis. In particular, by reorienting current generic spending programmes more specifically towards labour market measures, they will be able to limit further increases in job destruction and help to boost job creation. Indeed, certain labour market measures – such as unemployment benefits and financial incentives for (private sector) job creation – have an effect on job creation that is comparable with unspecific government spending and may be better at preventing further job destruction. These measures should be favoured when considering re-orientation of fiscal policies. At the current juncture, however, they only represent a very small share of the total stimulus that has been put in place, and have even come under scrutiny by certain governments in their consolidation efforts.

In addition, this chapter stresses the importance of international coordination, which has already helped to stem the first wave of the crisis. Such coordinated action should continue during the recovery stage to maximize policy effectiveness in stimulating global job creation. Indeed, countries that need to consolidate faster due to their deteriorating fiscal sustainability could still benefit from stronger world demand if all countries use their available fiscal space. For this, the Global Jobs Pact offers yardsticks to countries to facilitate the task of bringing into line their fiscal and labour market policies so as to maximize employment creation.

Finally, this chapter shows that once the appropriate measures have been decided they must be implemented quickly. The longer the labour market crisis continues, the higher the long-term unemployment will be and the more unemployed workers will get discouraged and leave the labour market. Moving ahead quickly is also important for maintaining policy effectiveness. Indeed, as public debt piles up, any measure will lose effectiveness, which further worsens the economic and fiscal outlook. In this respect, implementing the Global Jobs Pact quickly will ensure countries return to safer ground and support the labour market recovery.



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