



## Active Labor Market Programs: How, Why, When, and to What Extent are they Effective?

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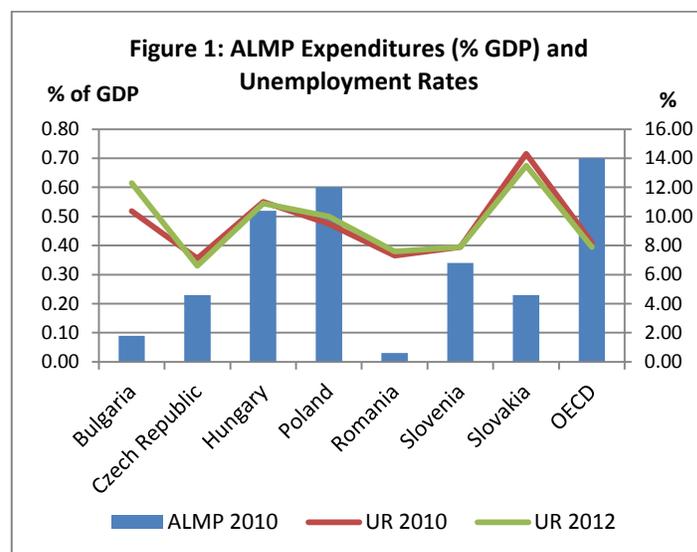
### Key Messages<sup>1</sup>

- **Active labor market programs (ALMPs) aim to keep workers employed, bring them into employment, increase their productivity and earnings, and improve the functioning of labor markets.**
- **ALMPs to retain employment – for example, work-sharing schemes – should be used only for short periods during severe recessions. More cost-effective and useful during recoveries are ALMPs to create employment, which strengthen outsiders' labor market attachment and support the outflow out of unemployment.**
- **In-work benefits and public works are not cost effective in raising employment, but possibly work to reduce poverty and inequity. Policies that readjust distorted employment incentives, such as activation and sanction measures, have delivered cost-effective results.**
- **Training programs are especially effective over the long term, particularly the more they target disadvantaged outsiders. ALMPs that improve labor market matching are highly beneficial, but effective only in the short run.**
- **ALMPs in general might be more cost effective over the long term (3–10 years) and some may even be self-financing, suggesting that long-term evaluations are needed to better ascertain the impact of individual policies.**

<sup>1</sup> This brief is based on A. J. G. Brown and J. Koettl, "Active Labor Market Programs - Employment Gain or Fiscal Drain?" IZA Discussion Paper 6880 (Bonn: Institute for the Study of Labor (IZA), 2012). The results and insights discussed here are based primarily on studies mainly from OECD countries.

### Introduction

The global economic crisis has had a substantial impact on labor markets in both industrialized and developing economies. Both witnessed massive layoffs as well as reductions in wages and hours worked, and thus significant increases in unemployment and poverty. Although economic recovery is on its way, the job crisis will persist for some time yet. As experienced in previous crises, employment growth will lag behind and not suffice to accommodate the high unemployment, leading to longer unemployment spells, higher long-term unemployment, and eventually skills attrition, thereby negatively affecting future employment prospects.



Source: For selected ECA countries, expenditures on ALMPs (% of GDP) according to the Eurostat Database and unemployment rates based on the ILO Database; OECD averages according to OECD Database, October 2012.

Active Labor Markets Programs (ALMPs) have been heavily advocated by the Organisation for Economic Co-operation and Development (OECD) and are of growing interest and relevance to transition and developing countries. In contrast to passive labor market policies, such as unemployment insurance and transfers to provide income replacement, active policies increase and enhance labor

supply, increase labor demand, and raise the efficiency of labor market matching. Although many Europe and Central Asia (ECA) countries have been introducing ALMPs in response to the economic crisis, the ECA region is lagging behind in the adoption of these measures relative to OECD averages (see figure 1). The unemployment rates in ECA countries, as well as tighter budget constraints and deficits, highlight the need to encourage these countries to invest further in cost-effective ALMPs to support their recovery.

### A New Perspective on ALMPs

Presented here is a new perspective to bridge the gap between understanding the value of cost-effective ALMPs and working to boost recovery. The different types of ALMPs are classified in terms of their primary target:

Category	Instruments
I. incentives to retain employment	work sharing and short work and wage subsidies
II. incentives to create employment	wage and hiring subsidies, start-up support
III. incentives to seek and keep a job	in-work benefits, subsidies, tax credits, public works, activation and workfare, sanctions
IV. incentives for human capital enhancement	on-the-job and classroom training
V. improved labor market matching	job search assistance, employee-employer intermediation services, counseling, and monitoring

### Incentives to Retain Employment (Category I)

ALMPs that offer incentives to safeguard employment via subsidies to employers or work-sharing schemes aim to support or increase labor demand and thereby prevent lower employment after a fall in economic activity. Wage subsidies, however, are subject to substantial deadweight and displacement costs and tend to put upward pressure on wages; they have also proven to be cost ineffective, and have not provided the incentives needed to retain workers.

Work-sharing arrangements, on the other hand, if applied for a limited period of time at the onset of a severe economic crisis, may alleviate the crisis' impact on employment, when the outflow from unemployment is likely to drop significantly in any case. One example is the German "Kurzarbeit" scheme, whose success at keeping unemployment down has generated interest in these programs as a tool to combat economic crises. Work-sharing schemes enable employers to reduce labor costs and at the same time retain skilled employees with full or partial preservation of their income. Importantly, these cost-intensive schemes should be combined with: (i) training

during off-hours to support skills development;<sup>2</sup> and (ii) measures to support outsiders whose positions are significantly weakened. At the same time, the appropriate design of these ALMPs and the adaptability of existing minimized programs are crucial.

The usefulness of this category ALMPs is of limited duration, however, due to the risks associated with increasing labor market persistence, long-term unemployment from having disadvantaged outsiders, and delaying inevitable labor reallocation, any or all of which might also obstruct recovery.

### Incentives to Create Employment (Category II)

ALMPs that promote the creation of employment involve mainly financial incentives – for example, subsidies for employers, grants and credits, and entrepreneurship advisory services encouraging start-ups. As noted above, wage subsidies<sup>3</sup> are cost ineffective, due to the significant and undesirable indirect effects, including the long-run negative implications for skills development.

Conversely, for a limited period, hiring subsidies to private employers can indeed be cost effective and have sizeable macroeconomic employment effects.<sup>4</sup> However, such measures should be sensibly targeted in order to balance negative effects and employment impacts. To maximize the positive labor market outcomes (as well as the competition, transition,<sup>5</sup> and screening effects), hiring subsidies should be targeted at the losers in the labor market, for example, the long-term unemployed and inactive workers. Moreover, to increase cost effectiveness, subsidy payments should continuously increase as unemployment endures.

Even if the positive and negative consequences of these measures cancel each other out and result in no increase in total employment, hiring subsidies may still be desirable. By redistributing employment incentives to the disadvantaged, strengthening the latter's attachment to the labor market and thereby reducing long-term unemployment (at the cost of increasing short-term unemployment), hiring subsidies increase labor market flows, reduce labor market persistence, and enable a more equitable distribution of unemployment. Hiring subsidies can also be a significant countercyclical labor market stabilizer in ordinary times to avoid increases in long-term unemployment and detachments from the labor market.

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<sup>2</sup> Skills training is also needed to counteract the increase in unemployment-prone labor market groups due to the disincentives for skill acquisition inherent in these measures.

<sup>3</sup> They target all employed workers of a specific skill-class or sector.

<sup>4</sup> Strong evidence for this exists, especially in Sweden.

<sup>5</sup> By bringing workers back to work, their human capital appreciates, which increases their retention and, if fired, their reemployment probability. These effects are evidenced in German hiring subsidies.

In response to the recent crisis, various OECD countries have adopted hiring subsidies targeted at disadvantaged elements of the workforce (the long-term unemployed, the disabled, younger and older workers) as well as reductions in non-wage labor costs for hires. Though these instruments can be cost ineffective once an economic crisis hits and labor demand plummets, they are also an important way to support the recovery once it is in sight and to incentivize the recruitment of disadvantaged workers. In any case, during a recession, the equity aspect might be relevant to prevent disadvantaged workers from leaving the labor market and give them a competitive edge in the search for jobs. Targeting should be tightened once the recovery accelerates to reduce costly negative indirect effects.

ALMPs that offer incentives for self-employment are smaller in size and applicability and involve financial and advisory support. Besides the direct objective of supporting the outflow of workers from unemployment into self-employment, these programs' indirect desired outcome is the additional employment created by the start-ups.

Recent evidence confirms the positive impacts of providing incentives for self-employment, even though its applicability is limited to a small fraction (up to 3 percent) of the unemployed workforce. Advisory services on their own or combined with financial incentives generally generate better results than financial incentives alone. A recent evaluation of two German self-employment subsidies shows that the programs lead to significantly higher income for participants after five years, and a 20 percent higher employment probability. Due to their generally low employment prospects, self-employment subsidies are especially effective for the disadvantaged workers in the labor market, namely the young, low-skilled, long-term unemployed, and inactive workers, as the subsidies boost their labor market attachment and adaptability to labor market conditions and thereby support recoveries.

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### Incentives to Seek and Keep a Job (Category III)

This category includes measures that address labor supply by increasing the payoff of employment for workers, either by raising the return from employment or making unemployment more costly. Financial transfers to workers and public works programs do not target employment exclusively but are aimed also at reducing inequality and in-work poverty.

Financial transfers to workers are not cost effective, and due to various disincentives, they have no (longer-run) positive employment effects, though under certain conditions, they might prove to be cost-effective redistribution policies. These transfers fail especially because of their implicit aim of supporting the unskilled in work without promoting their adaptability. Still, if applied temporarily in crises within a package of instruments that also address demand-side

incentives, financial transfers to unskilled workers can be an effective redistributive tool to soften income shortfalls.

Similarly, public works programs are also something of a fiscal drain and can even have negative effects on participants' later employment prospects. The evidence on the ineffectiveness of public works has been widely documented: they neither enhance the labor supply nor promote adaptability in the labor market. During crises, however, the temporary use of such programs targeting poor families is justified as a means of combating poverty by providing a safety net. In middle-income countries, where existing safety nets cannot be expanded swiftly, ready public works schemes can provide a needed cushion, or in low-income countries, where safety nets are broadly nonexistent, public works can offer an employment of last resort.

However, the combination of public works instruments with activation policies such as workfare has shown positive results, especially due to the significant threat effects. For example, within the rights and duties framework of the unemployed, the introduction of workfare has been particularly effective in Denmark's "flexicurity" set of policies. In general, sanctions and activation measures have been very successful in restoring search and work incentives; moreover, imposing such measures with requirements to participate in job search assistance, training, or subsidized employment might also be more cost-effective alternatives in light of the considerable locking-in effect of public works.

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### Human Capital Enhancement (Category IV)

ALMPs that provide incentives for human capital enhancement, such as on-the-job or classroom training, are widely used and represent the largest share of governments' expenditures on such programs. Evaluations of these ALMPs, however, show mixed results. Their high cost often leads to "cream-skimming," for example; since case workers must demonstrate a high rate of success with the transition into regular employment, they may choose unemployed workers with higher employment prospects, thereby increasing the deadweight effects.

Training can substitute for work experience. To maximize the screening and transition effects, based on the available evidence it is clearly important to orient the training towards the current and future skills needs of employers, who should be actively involved. In addition, such training should provide recognized formal qualifications and be available on-the-job, which has proven to be more effective than classroom training. Evidence from some European countries shows that adding on-the-job to classroom training increases the probability of a positive impact by 30 percent. Training measures involve strong locking-in effects, however, whose magnitude is directly related to

program duration, and empirical evidence suggests that the reduced employment prospects during participation may even outweigh the benefits. Such results, though, are driven by the locking-in effect and a focus on the short term.

Positive outcomes generally need one–three years to materialize. Recent findings in Germany and the United States, as well as in meta-studies, demonstrate that the effectiveness of training programs increases significantly in the medium to long term and that the short-term ranking of policy effectiveness can be reversed. In fact, evidence suggests that these measures increase employability and earnings in the long run. Thus, although costly, on-the-job training targeted at long-term unemployed workers seems to be cost effective, due to the implied competition, screening, and transition effects. To keep the long-term unemployed attached to the labor market and upgrade their skills, these measures might also be relevant in recessions, though with little or no short-term impact.

### Improved Labor Market Matching (Category V)

ALMPs that improve labor market matching are widely used in OECD countries, inexpensive, and effective in increasing the efficiency of search and match efforts. These measures are targeted mainly at outsiders and thus present competition to insiders and weaken their position. Evidence from Denmark, Romania, and the United Kingdom, for example, shows the significant benefits of intensified job search assistance for outsiders on their employment prospects and sometimes earnings, especially for long-term unemployed workers. The outflow from unemployment increases between 15 and 30 percent in OECD countries. While these effects are achievable very swiftly in contrast to other ALMPs, their effectiveness is concentrated in the short run and is not as sustainable.

Evidence from Germany underlines the argument that job search assistance should be targeted at unemployed workers with low hiring prospects to help them avoid long-term unemployment, and beyond that, at long-term unemployed workers. Recent studies confirm that ALMPs to improve job matching should be implemented at the beginning of the unemployment spell. The literature shows that ALMPs to improve labor market matching are very cost effective and can have significant short-run outcomes. The targeting minimizes the negative consequences, and potential churning incentives can be avoided with sanction mechanisms. While these ALMPs are essential to the general functioning of the labor market, they are most effective during recoveries, as they reduce the extent to which employment growth lags behind.

### Policy Implications

This brief presented a new perspective on categorizing ALMPs and assessed their cost effectiveness. It is important to stress that longer-run evaluations of ALMPs are essential to further measure their value, as the various ALMPs have different application advantages:

Cat.	Policy	Cost Effectiveness
I.	Work sharing / Short work	Very costly and potential negative longer-term impacts. Only useful for a limited time for existing schemes at onset of severe recessions.
I. / II.	Wage subsidies	Cost ineffective and potential negative longer-term impacts.
II.	Hiring subsidies	Cheapest and most cost-effective measure. As automatic stabilizer, target disadvantaged, especially long-term unemployed worker for limited period.
	Self-employment incentives	Cost effective, but restricted applicability.
III.	In-work benefits and subsidies	Cost ineffective: costly and no long-run positive employment effects. Cost-effective redistribution policy in crises, but targeting issues.
	Public works	Cost ineffective: costly and no long-run positive employment effects. However, safety net role in crises.
	Activation and workfare	Cost-effective policy in shifting toward active income support.
	Sanctions	
IV.	On-the-job training	On-the-job-training targeted at long-term unemployed workers particularly cost-effective in the long-run.
	Classroom training	
	Job search assistance	Cost-effective policy, essential for labor market functioning with short-run impact. Search assistance proven strong impacts on employability, especially for disadvantaged workers
	Employer inter-mediation service	
	Counseling, monitoring	

Overall, ALMPs can have a positive impact, albeit modest, but may be desirable even if the impact is not on net employment. The evidence and lessons learned from various developed countries will be instrumental in helping the ECA countries catch up on ALMP expenditures and other ongoing efforts to promote employment in the post-crisis recovery.

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