IZA Newsroom

ResearchMay 20, 2021

Short-time work reduces unemployment and stabilizes aggregate demand

Lower risk of income loss moderates drop in consumption

Short-time work (STW), a policy that subsidizes working time reductions and thereby aims to prevent firings, is used in almost all OECD countries in the Covid-19 crisis as a labor market stabilizer. In Germany, almost every fifth employee (6 million workers) was affected by STW in spring 2020. When comparing this to the peak during the Great Recession, which was at about 1.5 million, it becomes clear that the use of STW has reached an unprecedented level, and so have public expenditures on these subsidies.

This is not only true for Germany. Equally high numbers were observed in Italy, Spain, France, Belgium, Austria and the UK. For example, the UK introduced the furlough scheme that covered up to almost 9 million workers in May 2020. At the European level, the EU has implemented the “Temporary Support to mitigate Unemployment Risks in an Emergency” (SURE) scheme, which provides financial support of up to 100 billion Euro in the form of loans to member states, specifically to finance the implementation or extension of schemes to preserve employment.

Short-time work reduces income risk and stabilizes demand

In a new IZA discussion paper, Thomas Dengler and Britta Gehrke investigate different mechanism of how this policy stabilizes the aggregate labor market. In particular, they focus on aggregate demand effects next to the direct reduction of labor costs for firms. In a recession when firings increase, employed workers aim to self-insure against rising unemployment risk and reduce their consumption. This fall in demand triggers a further reduction of production and even more firings – a contractionary spiral. Short-time work may break this spiral as it reduces the unemployment and income risk of workers.

Using a dynamic macroeconomic model with incomplete asset markets and labor market search frictions that is calibrated to the German economy, the authors find that a recession that would generate an increase of the unemployment rate by 3 percentage points with STW would increase unemployment by 4 percentage points without STW. Out of the total stabilization of 1 percentage point, 0.2 percentage points is due to the reduction of aggregate demand channel. The effects may be even larger in an economy with on average higher labor market flows such as the US. With higher flows labor market risk is generally larger and the demand channel plays a more prominent role.

Increasing the subsidy to short-time workers is very effective

An increase of the subsidy to short-time workers can provide additional stabilization of consumption demand and hence the aggregate economy. The effects are particularly strong if monetary policy is constrained by the zero lower bound, as it is the case in the current situation. An increase of the subsidy to short-time workers can even be more effective compared to a similar increase of the unemployment benefit replacement rate. Intuitively, the latter generates direct upward pressure on wages via the reservation wage, whereas this effect plays less of a role for short-time compensation.

In sum, these results support that short-time work can be a powerful policy in temporary crisis times to stabilize the labor market. But short-time work should never be a permanent phenomenon. Then, it may trigger biases and inefficiencies. For example, short-time work may hinder the reallocation of labor to growing and productive firms or it may lead to excessive hours reductions.

Featured Paper:

IZA Discussion Paper No. 14329 Short-Time Work and Precautionary Savings Thomas Dengler, Britta Gehrke