



# Impacts of hiring subsidies targeted at the long-term unemployed on the low-skilled labor market: The French experience

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## ARTICLE INFO

### Article history:

Accepted 20 November 2009

### JEL classification:

E24

J42

J48

### Keywords:

Matching

Long-term unemployment

Targeted subsidies

Hiring subsidies

## ABSTRACT

This paper proposes a theoretical matching framework to analyze firms' and workers' response to a targeted hiring subsidy program when taking into account interactions between segments of the low-skilled labor market. By developing a general equilibrium model, the paper provides a useful tool to evaluate the aggregate effects induced on the low-skilled labor market. Then, the model is computed above French data to estimate the employment and welfare effects of a measure introduced in France in 1995, the "Initiative-for-Employment Contract". Finally, as the framework is well-suited to investigate design issues, I analyze the efficiency of the French program as well as targeting issues.

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## 1. Introduction

Employment subsidies cover various types of targeted schemes. Most of the prevailing policies in developed countries are hiring subsidies paid to private employers: for instance the Targeted Job Tax Credit in United States, Employment Subsidies in Sweden and subsidized contracts in France. Contrary to permanent employment subsidies which are mainly targeted at low-skilled or low-wage employment (for instance, reduction in payroll taxes), hiring subsidies are targeted at unemployment (see Orszag and Snower, 2003). Firms benefit from a temporarily subsidized job opportunity for a selected group of new hires. Such programs are not recent: they have been in place in many OECD countries since the end of the seventies. However, the rise in long-term unemployment in the last two decades has led to a renewed interest in active labor market policies. Researches are increasingly carried out both to evaluate how successful hiring subsidy programs have actually been and then to investigate design issues.

A number of empirical studies have pointed out the relative effectiveness of hiring subsidies as a tool to improve employment prospects of the participants. These instruments were found to generate a significantly higher probability to get a job relative to the control group (Forslund et al., 2004; Sianesi, 2002; Katz, 1996;

Brodaty et al., 2002). Further, many evaluations conclude that hiring subsidies to private-sector jobs have a greater impact than public training programs or direct job creation measures (Martin and Grubb, 2001; Sianesi, 2002). Concerning the French experience, Brodaty et al. (2002) investigate the effects on the youth population of labor market policies that have been introduced in France since the mid-seventies. The majority of the programs provide a subsidy and have positive effects on employment. Empirical studies based on individual data are useful to evaluate the impact of a targeted program on the participants but only provide partial information on the policy's effectiveness. Targeted subsidies create a competitive advantage thus involving substitution and dead-weight effects. Firms are induced either to change their hiring patterns or to use the subsidy to recruit a worker they would have hired anyway. The literature on macroeconomic effects induced by targeted subsidies (both hiring and permanent) has grown fast since 1990s, putting forth substantial dead-weight and substitution effects for the whole OECD countries (OECD, 1993). For instance, in Australia, Belgium, Ireland and Netherlands, such effects are estimated to amount to 90% (Martin and Grubb, 2001), whereas in Sweden, they are estimated to be around 60%<sup>1</sup> (Calmfors et al., 2001; Dalherberg and Forslund, 1999) so the net effect on employment is limited. Calmfors (1994) argued that substitution and dead-weight effects "are likely to be most important

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<sup>1</sup> Jobs that would have been created anyway represent 60% of the creations, so that the net employment gain amounts to only 40% of the new jobs.

in the case of subsidies for private-sector work, which are common in many countries for young people and long-term unemployed". Hiring subsidies to private employers could provide targeted workers with jobs and simultaneously induce small net employment gains, thus creating a difficult trade-off for policy makers. Such evaluations rely on aggregate data and attempt to establish robust econometric relationships between regular and subsidized employment. However, they do not allow us to analyze the effects on microeconomic behaviors induced by a labor market program. Equilibrium models provide a powerful setting for such an analysis and allow for both ex-post and ex-ante evaluations.<sup>2</sup>

Most theoretical works related to employment subsidies focus on subsidy programs in general. They compare alternative forms of policies and investigate design issues (Orszag and Snower, 2003; Brown et al., 2007; Vereshchagina, 2002). This literature has already pointed out the main effects induced by subsidy programs and the existing interactions between labor markets. Subsidies are found to reduce both unemployment and wage inequalities. However, most papers focus on permanent subsidies. Mortensen and Pissarides (2003) present computed solutions to their matching equilibrium model and conclude that permanent subsidies targeted to low-skilled workers increase the related employment and wages. Cardullo and Van der Linden (2007) put forward the need to take into account the interactions between the different labor markets when evaluating aggregate effects of targeted subsidies. They argue that the Mortensen–Pissarides model overestimates the effects of permanent subsidies on the targeted population, (the low-skilled workers), whereas it underestimates its effects on high-skilled employment. As for hiring subsidies, most papers focus on subsidies to recruitment or training costs that take the form of “one-time” subsidies. Mortensen and Pissarides (2003) find that they involve ambiguous effects.

This paper focuses on subsidy programs such as most of those that have been implemented in OECD countries for three decades: temporary subsidies designed for long-term unemployed. The analysis investigates the effects of such a program on the low-skilled labor market, taking into account the minimum wage constraint. I develop a matching model that will be calibrated above French data. Thus the main contribution of the paper is to provide a macroeconomic evaluation of a French subsidy program introduced in 1995.

I first propose a model to analyze microeconomics behaviors induced by targeted hiring subsidies. A natural candidate for such an analysis would be the matching model *à la* Pissarides (1990) as it has proved its strength for analyzing labor market flows, unemployment composition and labor market policies. Then, we focus on the French experience. In France, general equilibrium models have already been developed to evaluate the impact of payroll tax subsidies on low wages (Doisy et al., 2004; Cheron et al., 2008).

France has a variety of hiring subsidy programs targeted mainly at youth and long-term unemployed which have been introduced both in the private and public sector since 1980s.<sup>3</sup> The Government introduced in 1995 a reduction in employer's contribution thus establishing a new type of contract: the “Initiative-for-Employment Contract”. It is specifically designed for unemployed excluded from the labor market, as long-term unemployed, welfare recipients or disabled workers. Various empirical studies revealed the relative efficiency of this program but did not provide any information on the net employment gain. The model is therefore computed above French data to evaluate quantitatively the performance of the “Initiative-for-Employment Contract” on aggregate employment and welfare. Moreover, we investigate

the program's efficiency in alleviating the low-skilled unemployment problem.

The framework differs from many theoretical works by the segmentation of the low-skilled labor market and by the modeling of the policy we adopt. The basic matching model is extended to account for heterogeneities of unemployed and vacancies. As the condition of free entry is determined endogenously, firms can decide to post vacancies directed to recently unemployed workers or to enter a second segment where long-term unemployed are searching for low-productivity jobs. Katz (1996) and Richardson (1998) already emphasized the risk of stigmatization against long-term unemployed. Firms have a misperception they are less-productive. In this paper, long-term unemployed face higher difficulties in the labor market but are not trapped into low-productive jobs. The subsidy program I analyze provides a stepping stone to regular employment. Orszag and Snower (2003) show that hiring subsidies are mainly designed for upwardly mobile workers whereas permanent subsidies are more effective when targeted to workers trapped into dead-end jobs with flat wage profile. The policy is assumed to be a subsidized contract. Employers benefit from the subsidy only for a fraction of recruited long-term unemployed: According to the empirical evidence, the participation rate of entitled firms does not reach 100%. When the subsidy ends, the worker can be either laid off, retained in a regular low-productive job or promoted. Further, I focus on the low-skilled labor market which is composed by a population at risk of becoming long-term unemployed. Then, interactions between segments and wage rigidities are taken into account. Workers who are employed in low-productive jobs do not have any bargaining power.

A common finding is that targeted hiring subsidies involve a direct substitution effect in the short-term, when the number of vacancies is fixed. As a free entry condition prevails on each segment, the subsidy attracts firms from the first segment to the second one by improving the relative return of low-productive jobs. Further, the subsidy affects the outside option of short-term unemployed workers by improving the employment prospects when long-term unemployed. These interactions complement the traditional substitution effect and highlight an indirect effect driven by the wage bargaining process. Moreover, by altering the employment composition and thus job destruction flows, targeted subsidies do have effects on short-term unemployment. The results provided by the model suggest that the effects on aggregate unemployment are ambiguous. Long-term unemployment should be reduced at the expense of short-term unemployed workers.

Simulations show that the French program involves a substantial reduction in low-skilled unemployment and improves the welfare of the economy. The substitution effect driven by the negotiation process reduces the impact on unemployment without overcoming it.

Similarly to the previous literature, the model is used to investigate design issues. The first question I attempt to answer is “How the French program could be improved”? The analysis shows that the policy that maximizes the welfare is not the one that maximizes employment. Increasing both the participation rate and the subsidy rate is less costly and has a greater impact on the economy's welfare than allowing for a longer duration. Further, targeting issues are investigated. Brown et al. (2007) found that hiring vouchers targeted at the long-term unemployed are more effective than those targeted at low-ability workers. Similarly, Cheron et al. (2008) show that targeting subsidies around the minimum wage are less cost efficient than when they are spreading over a wider distribution range. There is an explicit trade-off between targeting subsidies at actually disadvantaged workers and targeting subsidies at high-risk groups. One can argue that subsidies targeted at short-term unemployed would be more efficient: employment prospects would improve such that workers would never fall into the long-term unemployment pool. However, the paper shows that workers capture a part of the subsidy when negotiating their wage, which reduces welfare and employment effects of a hiring subsidy program

<sup>2</sup> Boone and Van Ours (2004) and Lise et al. (2004) outlined the restrictions of social experiments where a small subset of the population is subjected to a potential program. They demonstrated the usefulness of general equilibrium models for analyzing the implications of a policy implemented in a large scale.

<sup>3</sup> See Brodaty et al. (2002) for a presentation of employment programs in France.

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