

# Lessons from the ongoing crisis for labour market institutions in Russia

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## Abstract

The paper discusses the role of unemployment insurance system in economic development in general and in the context of the ongoing crisis due to the forced lockdown related to COVID-19. The key elements of employment subsidy programs with reduced working hours or partial unemployment benefits, based on the experience of OECD countries get special attention.

## Keywords

COVID-19, economic crisis, unemployment insurance system, labour market; Russia

## JEL codes: J65

The resilience of the economy to various shocks depends on its institutional organization, and on the development of labour market institutions in particular. One of the most important and complex institutions of the labour market is the unemployment insurance system. Most developed countries, who have a long history of facing and overcoming economic crises of different origins, have gradually developed such institutions and adjusted them not only to support those who have lost their jobs, but also to compensate for forced leave and reduced working hours. The existence of a well-functioning system of this kind greatly facilitates the governments of these countries to cope with the economic consequences of forced lockdown related to COVID-19 by providing effective mechanisms to support the population in a period of temporary but large-scale decline in economic activity.

Russia, which has much shorter experience of overcoming economic crises, has no developed system of this kind. Moreover, the current mechanisms of adaptation to shocks in Russia lie in the field of reducing real wages and expanding informal employment. Though reducing economic efficiency through slowing down the processes of economic restructuring, the Russian way of adaptation of the labour market did work under economic shocks, reducing but not stopping economic activity. The today's almost entire stopping of economic activity in some

sectors during the COVID lockdown put Russia in completely different conditions. Some of the previous adjustment mechanisms are not available (the activity of the informal and semi-formal sectors has been stopped to an even greater extent than the corporate sector) and urgent demand for mechanisms to support people in anticipation of a sharp reduction in wages and forced leave emerged. Durable fully paid period of forced vacations is a sensitive issue for large employers, and not affordable for medium and small businesses, which all parties understand.

Measures to support the population declared by the Government already include elements which can be channeled through state employment services. However, without radical changes in the rules of registration with the employment service in order to receive benefits for loss of employment or forced leave, the support measures run the risk of being vague and not reaching small and medium, often semi-formal, business, which is millions of people. These new rules are to be applied during the lockdown and the following recession. The experience of developed countries in the organization of employment subsidy programs with reduced working time, short-time work (STW) programs, or partial unemployment benefits, is very important. It is impossible to deploy a similar system in Russia in the shortest time. However, it is possible to introduce the essential elements of such a system for the time being, in fact, to carry out public transfers through the extended powers of the employment services. The deployment of full-scale schemes of insurance against total or partial loss of employment needs to be carried out “in peacetime”, without the hope that the COVID-19 pandemic is a single case that will not reoccur in the foreseeable future. It can be said that the pandemic opens a window of opportunity for unemployment insurance schemes, without which adaptation to shocks of different nature will remain ineffective. Time will show to which extent we shall use this window of opportunity.

Below I discuss the role of unemployment insurance in economic development and the key elements of employment subsidy programs with reduced working hours or partial unemployment benefits, based on the experience of OECD countries.

## **The role of the unemployment insurance system**

The classic Diamond-Mortensen-Pissarides search theory draws attention to the fact that unemployment is an important and productive state. In the process of search for the best suitable employment by the employee (and search for the best suitable employee by the employer) the “worker – workplace” matching takes place, which then largely determines the productivity of the economy.

Underestimation of this important role of unemployment results in distortion of the adjustment processes of the economy to a variety of shocks, both structural and cyclical. For example, as shown in Boeri and Terrell (2002), among transition economies, countries with underdeveloped unemployment insurance system were slower in job cuts in the obsolete sectors and slowdown in economic restructuring.

Moreover, Asemoglu and Shimer (1999) have shown that unemployment insurance not only enables diversification of risks, but also increases output (GDP). The emergence of unemployment insurance enables eliminating the distortions in job creation caused by uninsured risk. If workers were risk-neutral, the maximum level of output in the economy could be achieved without unemployment insurance. However, if workers are not neutral, but are risk-averse, maximizing output in such an economy requires a system of unemployment insurance and payment of an unemployment benefit in case of lay-off.

The main explanation for this relationship between output and unemployment insurance is the difference in incentives for the creation of highly productive jobs. If there is no unemployment insurance scheme, workers agree to jobs with low salaries/productivity. In this case unemployment is low, but wages are also low. Low unemployment increases the risk of unfilled vacancies, resulting in a decrease in the capital/labour equilibrium, which means a lower quality of jobs. Unemployment insurance increases the incentive to continue to search for better-paid (and hence more productive) jobs. Unemployment is increasing. However, the incentives of employers to create more productive and highly paid jobs are also increasing. This leads to a higher capital/labour equilibrium. An improved structure of jobs in terms of productivity ensures an increase in total output.

Loss of work is related to loss of income. Since optimal behaviour requires income smoothing over time (adjusted for the individual discount rate), the employee is ready to spend part of his income during a favourable period and to purchase an insurance policy, payments under which occur when the unfavourable situation, namely layoff, takes place. This economic motive for improving social and individual welfare underpins the unemployment insurance schemes that exist in all developed and in many developing countries. In the vast majority of cases, such systems are public systems, sometimes with some additional insurance through industry unions.

## **The mechanism of the unemployment insurance system**

Unemployment insurance, like any other type of insurance, has two key potential problems that need to be taken into account in the formulation of insurance rules.

The first problem is the so-called adverse selection. Employees differ in their productive abilities, motivation, and many other characteristics of importance for the labour market. These differences, together with different demand for work of various qualifications, determine differences in the probability of loss of work and the ability to quickly find a new one. In the absence of a public (i.e. compulsory for all) unemployment insurance system, the private insurance system will not arise: those with high risks of loss of work will be the first to apply for insurance, and those who consider their chances of losing their job as low will not acquire insurance. In this case, the voluntary insurance pool consists mainly of workers with a high risk of losing their jobs. In conditions of limited ability to identify individual-specific risks of job loss, insurance premiums for the operation of the private insurance system are extremely high and are not attractive to insured persons. Thus, private insurance simply won't arise. State insurance, making the purchase of an insurance policy compulsory for all groups of employees (through payments to the social unemployment insurance system), ensures diversification of insurance system risks, since in this case both those whose risks of job loss are high and those whose risks are minimal are insured.

The second common problem for all insurance systems is the so-called moral hazard. In general, this means less safety and more risky behaviour behalf the insured than the uninsured. In the case of unemployment insurance, this results in higher (compared to the social optimum) selectivity of the insured and those receiving unemployment benefits in relation to new a job and a decrease in the intensity of job search. The demand for co-financing and the availability of deductions are well-known tools for reducing opportunistic behaviour. In the case of unemployment benefits, the examples of co-financing designed to reduce opportunistic behaviour are: establishment of a rate of substitution of salary with a benefit below one, the reduction of this

indicator as the unemployment period increases, and the establishment of the deadline for payment of the benefit. The requirement of registration with the employment service and active job search, including through strict definitions of suitable (professionally and geographically) work, are mechanisms that help to separate the unemployed from those who do not have a job and do not want to work, and therefore do not seek it (economically inactive).

For employers, participation in the unemployment insurance system is not only an additional tax aimed at achieving a socially beneficial insurance system. An employer is able to reimburse part of his or her costs from public insurance funds if the rules for assigning the status of unemployed and thus the right to compensation for loss of part of the income are granted to those who are transferred to part-time work (as within the framework of reduced working hours subsidy, short-time work (STW) programmes, or partial unemployment benefits). Short-time work programmes or partial unemployment benefits are designed to preserve jobs in enterprises with temporary decline in demand for their products by stimulating cost sharing by a large number of workers and compensating loss of earnings for workers with a reduced working day/week or on short-term leave without pay (see below for details). The main task is to avoid unnecessary lay-offs where the rapid correction of the economic situation will make jobs attractive again.

Indeed, dismissal is not always the best strategy for the employer. If the drop in demand for products is seen as a temporary phenomenon, it is more reasonable for the employer to reduce production volumes and working hours, but to keep the employee recruited. This is especially important in the case of skilled labour and a large proportion of specific skills required to work in a given enterprise, as well as in the case of competition for workers in the labour market (a large share of jobs per unemployed person). In the absence of an extensive system of insurance against labour market shocks, the employer is forced to either dismiss the employee and then again incur the costs of hiring and training, or to bear (and share with the employee) the cost of reducing the working time. Recognition as unemployed and compensation of the lost part of income for those who work reduced time allows transferring the burden of costs from the individual employee and/or the employer to the insurance system. This expands the benefits of unemployment insurance.

In an economic crisis, where firms face liquidity constraints, this kind of government support improves public welfare. In addition, it allows to distribute the costs of adjustment to the shocks of the economic crisis more evenly (Hijzen and Venn 2011; Hijzen 2012).

In such a system, it is important to reduce the employer's incentives for opportunistic behaviour (excessive use of public funds as compared to payments made). For this purpose, the dependence of the amount of the insurance premium on the intensity of the use of public funds by employees of companies is usually introduced.

## **Short-time work programmes, or partial unemployment benefits, worldwide**

STW programmes, or partial unemployment benefits, are of great interest in times of economic crises. In 2009, 25 OECD countries used such programmes, with the total number of participants reaching about 4.5 million workers. The most active partial unemployment benefit schemes were implemented in Belgium (7% of employees), Germany and Japan (4-5%). Between 1% and 2% of employees participated in Austria, the Czech Republic, France, Ireland, Italy, the Netherlands and Slovak Republic (Hijzen 2012).

The literature notes four groups of characteristics according to which STW programmes differ from country to country (Hijzen and Venn 2011): the requirements for the proportion of employees involved in the programme and the reduction of working hours; conditions of access to the programme; a set of conditions for participants; the amount of subsidy or terms of co-financing.

### **Work-sharing requirements**

Requirements for the proportion of employees of the enterprise involved in the programme and for the reduction of working hours specify the minimum proportion of employees of the enterprise transferred to a reduced working week, and the allowable limits for weekly working hours that do not contradict participation in the program. The requirement of a minimum proportion of employees transferred to a reduced working week allows allocating the costs of the crisis to a larger group of workers (in comparison with the situation where this requirement is missing). A minimum limit of working time reduction is introduced to ensure that only firms that face serious financial difficulties due to a temporary fall in demand for their products are involved in the programme. The maximum threshold is introduced in order to discourage temporary lay-offs.

Most OECD countries set a minimum threshold (from 40% in Norway to less than 10% in Austria, Germany, Switzerland and Slovak Republic). Most OECD countries do not have a maximum reduction limit (equal to 100%), which means that the program allows temporary lay-offs. Temporary lay-offs are excluded from STW programs in Austria, Canada, Luxembourg, the Netherlands, New Zealand and some US states. Canada, Denmark, Hungary, Korea, Switzerland and the United States require a minimum number (or percentage) of workers to be transferred to a reduced working week, which allows for the allocation of crisis adaptation costs for a larger number of participants (Hijzen and Venn 2011).

### **Eligibility requirements**

Eligibility requirements set conditions that employers or workers must meet in order to participate in the STW programme. In most countries, the employer is required to confirm or justify the economic necessity of resorting to programme funds. Firm eligibility is based on the proof of economic need, such as a minimum reduction in production and/or business activity. For example, a minimum threshold of reduction in production/fall of business activity is set at which an enterprise can become a participant in the programme. In addition, an explicit agreement between social partners or between employer and employees confirming the parties' consent to participate in the programme, is often required. These requirements are likely to reduce deadweight losses. Workers participating in the programme are generally subject to the same requirements as applying for regular unemployment benefits. This is, first of all, at least the minimum length of participation in the unemployment insurance system. In some countries, irregular, temporary or part-time workers are not allowed to participate in the programmes. During the 2008–2009 crisis, some countries eased this requirement, but there was no increase in the involvement of temporary and non-regular workers in STW programs (Hijzen and Venn 2011). This is due to the relatively high cost of the employer to involve this group of workers in the STW program compared to the costs of hiring and dismissal.

### **Conditionality requirements**

Conditionality requirements set behavioural requirements for both employers and workers participating in STW schemes. Thus, employers may be prohibited from dismissals during the period of participation in the programme and some period afterwards (such requirements are present in Austria, Hungary, the Netherlands, New Zealand and Poland). They

may be required to develop a plan for the restoration of normal activities of the enterprise (in Italy, Luxembourg, Poland, Spain and Belgium, for employees). Requirements for employees participating in the program are reduced to the requirement of active job search (usually in countries where the program is administered by the public employment service within the framework of unemployment insurance). Some countries (the Czech Republic, Hungary, the Netherlands and Poland) have introduced a requirement to participate in part-time training programmes. In some countries, an enterprise receives STW training grants, or a discount on participation in the programme if they train personnel transferred to a reduced working week (Hijzen and Venn 2011).

The idea of introducing such requirements is to increase the capacity of the company's personnel (through training) or to stimulate the search for a new job (if the employee does have to leave the enterprise). At the same time, such requirements increase the cost of participating in the STW program for enterprises and in some sense contradict the basic idea of the STW program to support throughout difficult times those employee-employer relationships that are successful with regards to long-term viability. If the employee and the employer really "found one another", neither training nor search are justified.

### **Amount of subsidy, financing**

The amount of the subsidy is determined by the cost of participation in the programme (for both firms and workers) and the maximum possible period of participation in the programme. The latter is necessary in order not to distort the processes of extinction of old and creation of new jobs in normal (not crisis) periods of functioning of the economy. The cost of participation in the programme for employer is determined by his share of co-financing the costs of the non-working (but paid) time. The employee's costs are set by the rules of compensation for reduced working hours and are reflected in the corresponding salary substitution ratios.

Co-financing rules vary from one OECD country to another (Hijzen and Venn 2011). Thus, there is no requirement for co-financing in Belgium, Canada, Denmark, Finland, Iran, Spain and Turkey, and in these countries, employers do not bear costs of participation in the programme (additional to participation in the system of social insurance).

In the United States, firms also do not pay part of the wages to workers in reduced employment, but their contribution (premium) to unemployment insurance is likely to increase in the future, since insurance premiums in the United States depend on how often employees of the enterprise applied for benefits. In fact, the US tax lay-offs, and the proceeds are used to supplement unemployment insurance. The insurance premiums of employers in the United States depend in part on previous experience of applying for funds ("experience rated"). In most states, two approaches are used to determine the rate of contribution to the insurance fund for a particular employer. In the first of them ("benefit ratio" system), the firm pays the tax in proportion to the ratio of insurance payments received by the employees dismissed by it to the amount of wages from which the insurance contribution was paid. Both are averaged over the last three or five years. In the second mode ("reserve ratio" system), the firm pays the tax in proportion to the accumulated "reserves" (i.e., paid in the past, in the entire history of the existence of taxes less insurance payments received by employees dismissed from the enterprise) to the amount of insurance payments from the wage fund (averaged over the last three years). The higher these proportions, the higher the company's insurance payment rate (OECD Employment Outlook 2006: 94).

In other countries, the employer either co-finances wages for time unworked due to reduced working hours (France, Hungary, Japan, Poland, Portugal, Slovakia) or pays a full

salary for the first few days (Norway and Switzerland), or co-funds the training of employees participating in the program (Hungary and the Netherlands). In many countries, there is a requirement to pay regular insurance premiums for unworked hours (due to reduced working conditions). In some cases, the employer pays a salary up to the level of a full-time salary, voluntarily or according to a collective agreement (the Netherlands). As a result, the average co-financing by the employer of the costs of payment of unworked hours in the mode of reduced working week is about 15% in Poland, Portugal, Austria and Italy, from 25% to 30% in the Czech Republic, Korea and Japan, and almost reaches 40% in France and 48% in Slovak Republic (Hijzen and Venn 2011).

The substitution rates for unworked (due to reduced working hours) time are the same as the substitution rates for the standard unemployment benefit in the first months. Taking into account full payment of the time worked, participation in the program is more profitable for the employee than dismissal and a living only on an unemployment benefit.

Limiting the maximum duration of participation in the STW program is important to minimize the distortions the program makes in the labour market. Such restrictions exist in all countries except Finland, and on average the maximum duration of participation in the program is 14 months (median 12 months). In times of economic crises, this time limit is weakened and the allowable duration of the programme increases. Some countries (Belgium, France, Japan and Korea) have fixed the maximum number of hours or days paid by their public funds per employee on a part-week basis (Hijzen and Venn 2011). Thus, the maximum period of participation in the program also depends on the hours worked: the shorter the saved and paid duration of employment, the lower the allowable period of participation in the program.

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