Softening the pandemic’s blow to workers

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KEY TAKEAWAYS

- Recessions typically hit younger workers in smaller firms the hardest.
- Policymakers should rapidly work to restore a sensible unemployment benefit level so that workers have the incentive to look for new jobs where available.
- To cushion the impact on the young, policymakers should focus not only on helping young workers find jobs but also helping them find the “right” jobs.
- Coming out of the crisis, government should explore how it can raise more taxes from older, richer workers. While not without issue, a well-designed wealth tax could be an appropriate response to the COVID-19 shock.

The COVID-19 pandemic is turning into a global recession — threatening the biggest drop in economic activity since the Great Depression. The latest forecasts put U.S. and European GDP both down by about 10 percent in the second quarter of 2020, or 40 percent on an annualized basis.

GDP is an important measure, but the primary way workers feel an economic shock is in their paycheck. This policy brief draws on our ongoing work on the impact of aggregate shocks on individual workers to analyze the likely effects of the current crisis on earnings and, most importantly, to identify groups of workers that are most exposed to risk. We then discuss a number of policies, which we argue would help cushion the shock for the worst-affected workers.

Our analysis is based on more than 3 million earnings observations drawn from more than 400,000 workers in the United Kingdom between 1975 and 2016. We estimate a set of “exposure parameters,” which are essentially estimates of how earnings of different types of workers are impacted by changes in GDP. These figures are similar to those estimated in the U.S. (Guvenen et al. 2017), so our conclusions are broadly applicable to the U.S. context as well.

We assume a plausible year-on-year real GDP decline of 10 percent caused by the pandemic and predict how the crisis will affect workers. We stress that this is a period of immense uncertainty and one in which unprecedented policy responses make forecasting difficult.

We argue that in terms of understanding which types of workers are more likely to bear the brunt of the aggregate fluctuations induced by the COVID-19 pandemic, it is instructive to investigate past fluctuations in GDP.

On aggregate, feeding a 10 percent decline in real GDP through our GDP sensitivity estimates, we estimate a fall in real weekly earnings of about 3 percent. For a worker at $50,000 per year, this corresponds to a drop of $1,500.
This would be a significant shock to household incomes. However, as will be shown below, this is very unevenly spread across different workers and can translate to a nearly 6 percent drop in income for those just entering the workforce.

**Big impact for young workers in small firms**

Figure 1 plots the estimated changes in weekly earnings by age group and firm size. There is a clear age profile in earnings responses to GDP changes. The earnings of workers under 35 are the most affected. For these younger workers, an average 10 percent drop in real GDP corresponds with a 3.2 percent fall in real weekly earnings. For those between 45 and 55, the fall is 2.5 percent.

Younger workers typically see higher wage growth than older workers, but this is very much dependent on economic conditions. Even more concerning for the youngest workers is the substantial literature demonstrating a lifetime penalty from entering the labor market in a recession (Kahn 2010).

We also find that the earnings effect is largest for those employed in smaller companies and it declines substantially with firm size. The pattern is striking but perhaps unsurprising, given that larger firms are likely to have greater access to the liquidity required to smooth over temporary shocks.

Workers at smaller firms already tend to earn lower wages. This suggests that the “large firm wage premium” (Bloom et al. 2018) — the earnings advantage accrued by working at a larger employer — could grow even larger. The firm size effect dominates the age effect, so that even older workers at the smallest firms will see large earnings losses. Taken together, this evidence suggests that a younger worker in a small firm will see earnings fall by about 5.7 percent compared with 1.2 percent for an older worker in a large firm. For a young worker at a small firm on $30,000, the effect is $1,710 whereas an older worker in a large firm earning $60,000 would see a loss of $720.

**The gender gap might look different this time**

Men and women tend to work in different industries and occupations, work different hours, and are found at different types of employers. Therefore, it is not surprising that aggregate shocks have different effects by gender.

Figure 2 demonstrates that, historically, female earnings have been less impacted by fluctuations in GDP, in part since they are more likely to work in sectors that are typically less exposed to GDP fluctuations, such as the public sector or the food preparation sector.

For men, on aggregate a 10 percent drop in real GDP corresponds to a 3.9 percent fall in weekly earnings.

![Figure 1](image-url)
compared with a 1.8 percent drop for women. Here, however, we might expect to see a difference between previous patterns and those stemming from the current crisis. As emphasized in a recent paper by Alon et al. (2020), some of the most immediately affected industries — such as hospitality and travel — contain a high proportion of female workers. This stands in sharp contrast with previous downturns, where male-dominated industries such as finance, construction, and manufacturing have borne the brunt of the decline in output. There is also a long-standing literature suggesting that mothers have systematically higher child care responsibilities than fathers, which can in part explain gender differences in the labor market (Petrongolo 2019). With the majority of children now taken out of school, it is possible that this asymmetry could amplify the impact of the crisis on female workers.

Adding it all up

Combining the differences by sex with the firm-size and age results above, this suggests that young male workers at small firms could see earnings losses of 6 percent to 7 percent, with older women at large firms seeing little or no change in their earnings. While our sensitivity estimates are based on U.K. data, similar work for the U.S. finds similar qualitative patterns and, if anything, larger magnitudes (Guvenen et al. 2017).

We should note that our data omit self-employed workers, who could be particularly badly hit — for many have already seen their earnings fall to zero. Moreover, while earnings are important, we do not discuss unemployment effects here. Recent data on unemployment insurance claims suggest there has been a massive spike in unemployment, meaning many people have lost their paychecks and reliable sources of income.

Finally, a large amount of literature in economics has documented that firms occasionally shield workers from significant wage losses in downturns in exchange for higher profits in better times (e.g. Guiso et al 2005). This is a key prediction from a family of “implicit contract” models in which risk-neutral firms employ risk-averse workers. But with a shock as large as the COVID-19 recession this is unlikely to be possible. When firms are facing the risk of bankruptcy, they may be forced to pass the economic costs onto their employees.

What can policymakers do?

Based on previous patterns, we should expect earnings losses to be concentrated among young workers at smaller firms. But what can policymakers do to soften the blow?

Restore a sensible unemployment benefit level

When workers and firms separate, the firm-specific skills and experience that workers have accumulated, and which make them more productive at their firm, are lost. Equally, finding “good matches” with a given firm takes time, implying that involuntary separations induce
costly job searches and potentially poor matches with subsequent firms.

Through these mechanisms, the separation of firms and workers in response to a temporary shock can lead to inefficient labor market outcomes and a longer-term stagnation in the economy. For these reasons, preserving worker-firm links is valuable not only for individual workers and firms but also for the economy at large.

Nonetheless, it is clear that some worker mobility is required in the current economic context. There is strong demand for labor in such sectors as agriculture, e-commerce, and parts of retail (e.g., grocery stores, etc.), and it makes sense for workers in the most affected industries to move into these jobs, even if only temporarily. There are many cases of firms taking steps to promote this temporary rapid re-allocation.

For example, the Hilton hotel chain, having furloughed tens of thousands of hospitality workers, has invested in an expedited recruitment path with Amazon, CVS, and grocery stores. This means that workers are directed through a dedicated website toward job openings and in some cases able to avoid background checks and other paperwork. The expectation is that these workers will return to their previous roles when the demand for hospitality services resumes.

Following this example from the private sector, government policy may be designed to strike a balance between preserving worker-firm relationships and allowing some re-allocation of labor toward essential activities and expanding sectors.

To achieve this, many European countries have opted to subsidize the wage bill of firms directly while their workers are furloughed, whereas the U.S. has instead primarily opted for changes to the generosity of unemployment benefits. This has created a classical example of what economists call the trade-off between providing “insurance” to workers hit by an unavoidable shock and avoiding “moral hazard” distortions induced by more generous benefits.

On the one hand, the expansion of unemployment benefits under the CARES Act is welcome and is required to soften the income shock caused by the crisis. On the other hand, benefit levels have been pushed above what many workers earn on the job, which works against both the policy goals given above. Businesses may have low incentives to preserve jobs if workers have access to high unemployment insurance benefits.

Equally, workers may have low incentives to search for a job in a booming sector if they earn more by staying at home. We recommend that policymakers take a second look at the generosity of benefit levels in the CARES Act — maintaining the relaxation of job search requirements and the inclusion of gig workers and the self-employed while ensuring that workers have incentives to maintain employment relationships where possible and to accept new work where available. The Payroll Protection Program, offering small businesses a forgivable loan to assist with cash flow during the crisis, goes some way toward achieving this goal. However, the conditions on loan forgiveness mean that it is not a good fit for all businesses. For some businesses, the program is riskier than allowing their employees to take advantage of the expanded unemployment benefits.

**Supporting younger workers in job search**

A wide literature in labor economics has shown that how good your first employer is may have surprisingly strong effects on long-term career prospects. As discussed in a recent paper by Arellano-Bover (2020), the search for jobs later in life depends on the quality of first employers, and opportunities for the development of useful skills vary substantially across firms. Therefore, if we hope to cushion the impact of the crisis on the young, it is imperative that policymakers focus not only on helping young workers find jobs but also helping them find the “right” jobs.

The Workforce Innovation and Opportunity Act of 2014 coordinates federally funded state employment and training programs, with a particular focus on the most
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vulnerable workers. Academic research has questioned the long-term effectiveness of some aspects of the U.S. education and training programs, particularly for younger workers (Schochet et al. 2008).

Never has the need for these programs been greater, and the U.S. could potentially learn something from the European experience. The German vocational training program model, mixing company-based and in-school training, is broadly considered a standout success. A comparison of this and other less-successful programs demonstrates that successful training schemes require cooperation between government, the business community, and social partners.

The German example shows the effectiveness of an integrated system, in which employment agencies become involved with job matching several months before an apprentice finishes a vocational program. Coming out of the current crisis, younger workers will be key to re-establishing economic growth and we recommend that where they have been shown to be successful, policymakers should expand existing employment and training services.

Raising taxes from older, richer workers

While the health risks from COVID-19 are greater for older workers, the analysis above suggests that the economic impact is likely to be greater for the young. The financial commitments included in the CARES Act (as well as likely additional spending to counter the health and economic crises) will put public finances under immense strain over the coming years. Policymakers must consider carefully how best to implement the inevitable tax raises that will follow — trying in particular to avoid that the burden of high taxes fall on the so-called millennials and Gen Z, compounding the negative effect of the initial shock on living standards. This will require a radical rethinking of the way taxes are raised.

The recent wealth tax proposals of Saez and Zucman (2019) have been controversial. The practicality of these policies has been particularly scrutinized, and there exist additional concerns about the methodology used to estimate the revenue that can be raised through wealth taxes (Fagereng et al. 2016).

The proposal by Saez and Zucman sets out a relatively narrow tax base covering only the wealthiest individuals, with a high tax rate. The disadvantage of this approach is that it could potentially be highly distortive — the wealthy can move around their money to avoid such taxes — with large economic costs, and wealth taxes may disincentivize entrepreneurial effort and innovation. However, given the severity of the crisis we would recommend exploring a wealth tax, possibly with a low rate and a wider base. Politically, the introduction of such a policy is constrained by low-interest rates — it is hard to see people accepting a tax that would shrink their savings.

Data from the Survey of Income and Program Participation shows that U.S. households headed by 55- to 64-year-olds hold three times as much wealth as those headed by 35- to 44-year-olds, and 20 times as much as households headed by those younger than 35. Since an individual’s wealth grows over the life course in this fashion, a wealth tax would have the advantage of being targeted toward individuals who are older and possibly with a history of higher earnings, which may have protected them from the worst aspects of the current crisis.

Raising more tax revenue from wealth will not be easy, but in the wake of the current crisis it could well be necessary if we are to ensure fiscal sustainability in an equitable fashion. While ambitious, a well-designed tax could be appropriate for the COVID-19 shock and raise a substantial amount of revenue, at least for the short run. Whether a wealth tax, in light of the distortions discussed above, is viable in the longer term is an important topic for policy and future economic research.
Avoiding disaster

Before COVID-19 struck, there was already a crisis of economic inequality. We fear the recession caused by the pandemic will drive an even larger gulf between rich and poor. But this is not inevitable.

Our three policy recommendations could soften the severe shocks hitting workers and lead to a stronger economy coming out of the crisis. The first is a more careful consideration of the insurance/incentive trade-off involving the generosity of unemployment benefits.

The second is a call for an expansion of support for younger workers making their first steps into the labor market at this inopportune time.

The third proposes that government explores new approaches to taxation once the economy is growing again. We argue that these policies could help mitigate the inequality-increasing effects of the shock and limit its catastrophic damage on aggregate growth.

References


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