Coping with Creative Destruction: Reducing the Costs of Firm Exit

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Creative destruction, the process through which a market economy replaces failing firms with successful ones, is a key driver of productivity growth. Reversing the current slowdown in productivity growth will therefore partly depend on structural reforms to recharge the engine of creative destruction. This will necessarily entail a more intense churning of jobs, which implies benefits for workers via improved job-worker matching but also costs through heightened job destruction. In this context, a key question is what happens to workers who lose their jobs due to firm exit – how quickly are they re-employed and what are the policies that can aid this process?

New research shows the probability that workers displaced by firm exit are re-employed one year later ranges from at least 70% in Denmark and Switzerland to around 50% in Greece and Spain. These estimates suggest that some countries are more effective at coping with creative destruction than others. What explains these differences?

As it turns out, public policy plays a key role. Higher spending on active labour market policies (ALMPs) – e.g. retraining and job placement services – tends to boost the re-employment probability of displaced workers, while the reverse is true for spending on passive measures (e.g. generous and long-lasting unemployment benefits). This implies that a

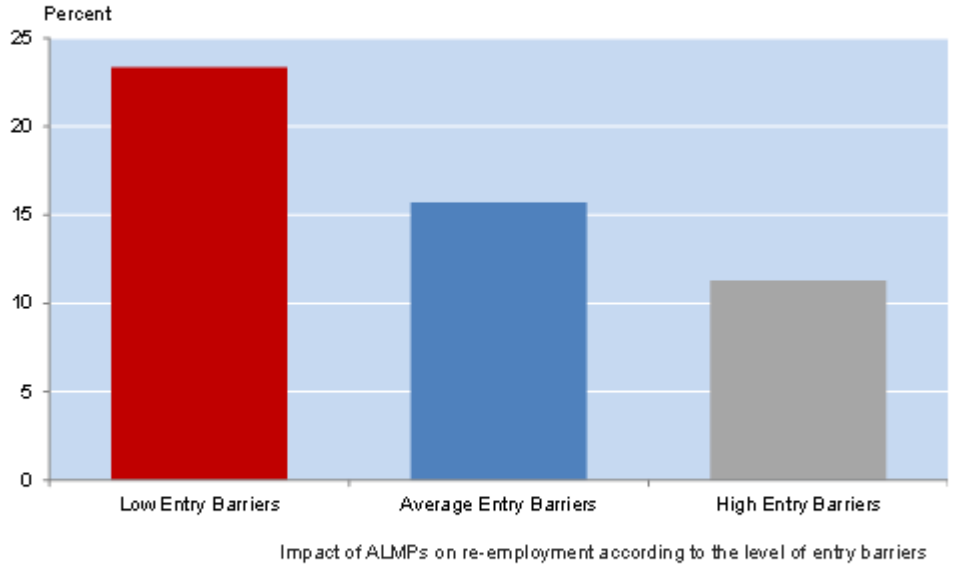
(revenue-neutral) reform that partially switches the composition of labour market expenditures towards ALMPs could be desirable in countries where spending is overly tilted toward passive measures.

Crucially, ALMPs are more powerful at raising the re-employment prospects of workers displaced by firm exit than other displaced workers. This is significant given that the former are considerably older and have been tenured at the firm for longer – characteristics which ordinarily make transitioning to other jobs more difficult. Job loss due to firm exit is also politically salient since it is typically viewed as an exogenous event that is not specifically due to the actions of the worker. One implication is that for every worker who is laid out due to firm exit, many more may fear a similar fate, which may create political resistance to reforms that intensify job reallocation.

Thus, it is crucial that structural reforms which unleash the benefits of creative destruction are flanked by well-designed ALMPs. But labour market policies alone are insufficient to cope with creative destruction. Indeed, the effectiveness of ALMPs in returning displaced workers to work is significantly enhanced by reductions in administrative entry barriers in product markets (Figure 1), which tend to stimulate job creation, particularly by young firms.

Figure 1. Entry barriers in product markets shape the impact of ALMP spending on the re-employment probability

Impact of a 1% increase in ALMP spending (as a % of GDP) on the re-employment probability of workers displaced due to firm exit



Notes: The bars show the percentage point impact on the re-employment probability of a 1% increase in spending on ALMPs (as a share of GDP) for three levels of entry barriers: *i*) the level corresponding to the average of the two best performing countries over the sample period (red bar); *ii*) the average level observed over the sample period (blue bar); and *iii*) the level corresponding to the average of the two worst performing countries over the sample period (grey bar).

Source: Andrews, D and A. Saia (2016), "Coping with Creative Destruction: Reducing the Costs of Firm Exit," OECD Economics Department Working Paper No. 1353.

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