

[State Dependence in Labor Market Fluctuations: Evidence, Theory, and Policy Implications](#)

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This paper documents state dependence in labor market fluctuations. Using a Threshold Vector-Autoregression model, we establish that the unemployment rate, the job separation rate and the job finding rate exhibit a larger response to productivity shocks during periods with low aggregate productivity. A Diamond-Mortensen-Pissarides model with endogenous job separation and on-the-job search replicates these empirical regularities well. The transition rates into and out of employment embed state dependence through the interaction of reservation productivity levels and the distribution of match-specific idiosyncratic productivity. State dependence implies that the effect of labor market reforms is different across phases of the business cycle. A permanent removal of layoff taxes is welfare enhancing in the long run, but it involves distinct short-run costs depending on the initial state of the economy. The welfare gain of a tax removal implemented in a low-productivity state is 4.9 percent larger than the same reform enacted in a state with high aggregate productivity.