

# **State Dependence in Labor Market Fluctuations: Evidence, Theory and Policy Implications**

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## **Abstract**

This paper documents a novel fact: the volatility of the unemployment rate and the job separation rate is larger in periods with low aggregate productivity. A Diamond-Mortensen-Pissarides model with endogenous job separation and on-the-job search replicates these empirical regularities well. Endogenous job separation embeds powerful state dependence: fluctuations in the job separation rate are larger in periods of low aggregate productivity and in response to contractionary shocks.

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 3.5 percent larger than the same reform in the state with high aggregate productivity.