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Labour market institutions and the cyclical dynamics of employment

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Abstract

We present an empirical analysis of the effects of labour market institutions on the employment dynamics over the cycle. In the first part of the paper, a theoretical framework is provided with particular emphasis on working time regulations. The conclusions of the theory are tested in the second part on a sample of 20 OECD countries observed over the period 1975–1997. The empirical analysis is focused on expansions, contractions and different expansion segments. The claims of the theory are confirmed and a measure of the influence of labour market institutions on the employment responsiveness to the business cycle is provided through simulations.
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1. Introduction

The analysis of the impact of labour market institutions on the economic performance of OECD countries has proliferated in the empirical economic literature of recent years. Studies of Belot and van Ours (2000), Blanchard and Wolfers (2000), Bertola et al. (2002) and Nickell et al. (2002) have principally focused on the impact of labour market institutions on the unemployment performance of OECD countries in the last

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decades.[1] However, one important feature of labour market institutions remains unexplored at the empirical level: their impact on employment dynamics over the cycle.[2] This paper aims to fill that gap.

The theoretical literature that analyses cyclical employment dynamics has largely focused on the influence of adjustment costs induced by employment protection legislation.[3] Less attention has been devoted to the analysis of the impact of working time regulations. Indeed, most of the theoretical studies about the employment impact of working time regulations are concentrated on their static properties, with special attention to exogenous worksharing policies.[4] The focus of this paper is, instead, on working time regulations over the cycle.

In what follows, Section 2 introduces a simple theoretical analysis of the effects of working time regulations and employment protection on employment dynamics over the cycle. This is a modified version of Nickell's (1978) seminal model of cyclical labour demand. In Section 3, the theoretical implications of the model are tested using a sample of 20 OECD countries observed for the period 1975–1997. The analysis concentrates on the impact of labour market institutions on different phases of the cycle, as well as over different segments of each phase.[5] Some concluding remarks are presented in Section 4.

2. The theoretical framework

2.1. The model

Following Nickell's approach,[6] it is assumed that a representative firm faces a known deterministic cyclical weekly demand for its products x (t), of period 2τ. Other relevant assumptions are the absence of inventories, no voluntary quits and the constancy of the level of capital over the cycle. This means that the firm's decisions about the capital stock are not

[1] Nickell and Nunziata (2000) examine instead the effect of institutions on the employment adjustment speed in a model of dynamic labour demand, while Nunziata and Staffolani (2001) concentrate on the impact on permanent and temporary employment/population ratios. A useful survey on labour market institutions is provided by Nickell and Layard (1999) while some introductory readings are Layard et al. (1991) and Nickell (1997).

[2] For example, Nickell (1998) and Nickell and Nunziata (2000), although focusing on the effects of labour market institutions on the dynamics of employment, do not analyse them in a cyclical perspective.

[3] See, among others, Nickell (1986), Bentolila and Bertola (1990) and Hamermesh (1993). An excellent survey is contained in Bertola (1999). See also Garibaldi (1998) and Garibaldi and Mauro (1999) for an analysis of the impact of employment protection legislation on job flow dynamics.

[4] See for example Hart (1987), Calmfors and Hoel (1989) and Hoon (1995). An exception to this is Staffolani (1992).

[5] The terminology adopted in the literature about the different phases of the cycle is not exempt from confusion. To avoid any misunderstanding, in what follows our terminology will be the following: an expansion (contraction) phase is the phase during which cyclical output is growing (declining) and the rise (decrease) in output is translated into a rise (decrease) in employment; a boom (slump) is the phase when cyclical output and employment are greater (lower) than the trend.

[6] An alternative approach to the modelling of employment dynamics over the cycle is Bentolila and Bertola (1990). Their model has the advantage of incorporating the role of uncertainty in a stochastic setting. However, we benefit from Nickell's deterministic approach in terms of simplicity as well as in the straightforward identification of an empirical test of the implications of the theory.

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