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Offshoring, labour market institutions and the elasticity of labour demand ☆

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ABSTRACT

This paper analyses the evolution of the elasticity of labour demand and the possible role of offshoring therein using industry-level data for a large number of OECD countries. The first main finding is that the wage elasticity of labour demand has increased substantially since 1980, although some of this increase may reflect a trend increase in the speed of adjustment rather than an increase in the long-run wage elasticity. The evidence on the potential contribution of offshoring to raising labour demand elasticity is mixed. No association is found between increases in offshoring and demand elasticity during the second half of the 1990s, but there is a significant cross-sectional association between higher average offshoring intensity during this period and higher demand elasticity. We also find some evidence that strict employment protection legislation weakens the cross-sectional association between offshoring and higher labour demand elasticity, suggesting that the relationship between offshoring and the labour demand elasticity may depend on the national institutional environment.

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1. Introduction

Much previous work on the labour market effects of globalisation has focused on the way trade changes the structure of labour demand across different sectors of the economy and types of workers. In effect, globalisation is represented as a series of incremental demand shocks to which labour markets need to adjust. The overwhelming consensus in the literature is that the total gains accruing to workers from globalisation greatly exceed the losses, although there will be both winners and losers in the absence of compensating government interventions. As concerns short-run adjustment costs, workers displaced by trade represent only a small share of total labour turnover and the labour market adjustment difficulties that they encounter appear to be similar to those experienced by other job losers (Kletzer, 2002; OECD, 2005). As concerns long-run effects, globalisation appears to have been one of the factors tending to depress the relative wages of low-skilled workers, but to have played a relatively limited role in the overall increase in earnings inequality during the past several decades (Slaughter, 2000; Feenstra, 2007). By comparison, trade generates large increases in average living standards (Bradford et al., 2005).

☆ The present paper provides an extension to the analysis of the elasticity of labour demand that was published in Chapter 3 of the *OECD Employment Outlook 2007*, "OECD workers in the global economy: increasingly vulnerable?" The authors would like to thank Sébastien Martin for excellent research assistance and two anonymous referees, Andrea Bassanini, Martine Durand, Sam Hill, Molly Lesher and John Martin for very helpful comments and suggestions. The opinions expressed in this paper are those of the authors and do not necessarily reflect those of the OECD or its member states. All remaining errors are our own.

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The sanguine view of the labour market impact of globalisation that predominates in the academic literature stands in contrast to more alarmist perceptions frequently expressed in the public debate. While most of the respondents in seven OECD countries to a German Marshall Fund poll released at the end of 2006 agreed that freer trade yields benefits to business and consumers, approximately one-half of them also believed that "freer trade costs more jobs than it creates" (GMF, 2006). A 2005 Eurobarometer opinion poll further showed that more of the European Union's population has a negative than a positive view of globalisation (46% versus 37%) and that negative views often reflect concerns over job losses or a "race to the bottom" in employment conditions (European Commission, 2005). While public perceptions may not reflect an accurate assessment of the actual labour market effects of globalisation, they may nevertheless provide some useful insights. In particular, the widespread public unease about globalisation may reflect globalisation-induced changes in the way the labour market adjusts to demand shocks and the nature of the employment relation, which go beyond to the transitory adjustment costs and relative wage adjustments, which have been the focus of most of the academic literature.[1]

Rodrik (1997) hypothesised that globalisation increases the responsiveness of employment and wages to economic shocks, by increasing the own-price elasticity of labour demand. If confirmed by empirical analysis, such a link could help to explain a number of concerns that regularly feature in the public debate. First, it may explain why workers appear to feel increasingly insecure (see Alibert et al., 2006; OECD, 1997), since the wage and employment effects of a given productivity shock (or shock to labour demand) are amplified by an increase in the labour demand elasticity.[2] Second, a more elastic labour demand would also tend to reduce the bargaining power of workers relative to employers, possibly contributing to explain the fall in national wage shares (IMF, 2007). Third, such an increase might also reduce the scope for risk-sharing arrangements between workers and firms, for example when firms provide stable wages to long-term workers, despite fluctuations in external labour market conditions (Bertrand, 2004). Finally, an increase in the elasticity of labour demand will make the wage and employment effects of non-wage costs more pronounced.

There is little evidence to date about whether labour demand has become more elastic as international economic integration has deepened, although Slaughter (2001) finds using industry-level data for the United States that the elasticity of labour demand increased during the 1980s for production workers in a number of manufacturing industries. A growing number of studies have explicitly analysed the impact of globalisation on the elasticity of labour demand, but the evidence is rather mixed. Similar to the analysis in this paper, most of these studies have used industry-level data to address this question. Slaughter (2001) finds only limited evidence that increased trade integration accounts for the rising trend in his estimates of labour demand elasticity in the United States. Bruno et al. (2004) estimate dynamic labour demands for seven major OECD countries for the period 1976-1996 and find that import penetration raised the elasticity of labour demand in the United Kingdom, but had no such impact elsewhere. Molnar et al. (2007) performed similar estimations for a number of OECD countries and find that outward foreign direct investment may have rendered labour demand more elastic in the manufacturing sector, but that the opposite may have happened in the services sector.

Several recent studies have used firm-level data to analyse this question. Fabbri et al. (2003) look at the probability of plant shutdown across domestic and multinational firms, providing some evidence that multinationals have a higher elasticity of labour demand than domestic firms. Similarly, Görg et al., (2009) find that multinationals in Ireland have more elastic labour demands than domestic firms, although this difference narrows as multinationals become more integrated into the local economy through supplier linkages. By contrast, Barba Navaretti (2003) and Hakkala et al. (forthcoming) find no evidence that labour demand is more elastic in multinational firms. Barba Navaretti (2003) provides evidence that multinationals have less elastic labour demands than domestic firms in the long-run in a number of European countries.[3] However, he also finds that multinationals have a larger short-run elasticity indicating they adjust their employment levels more quickly in response to shocks, than do domestic firms. Finally, Senses (forthcoming) finds that offshoring is positively associated with the labour demand elasticity for production workers. Overall, these findings provide some evidence that international economic integration increases the substitutability of domestic workers by foreign factors, but also suggest that the relationship between labour-demand elasticities and globalisation is complex and may vary depending on the nature of the trade in question and the national labour market context.[4]

[1] Another, but not mutually exclusive, explanation is that public opinion reflects a tendency to scapegoat globalisation for wage stagnation and rising inequality, which are largely due to other factors. Scheve and Slaughter (2007) argue that the recent increase in support for protectionist policies in the United States is closely related to "the astonishing skewness of US income growth".

[2] The relative magnitude of employment and wage changes also depends on the elasticity of labour supply (i.e. the slope of the labour supply curve). When labour supply is perfectly elastic, as is commonly assumed in firm-based theories, a more elastic labour demand results in higher employment volatility, but has no impact on wages. When labour supply is perfectly inelastic, labour demand shocks only affect the wage and an increase in demand elasticity does not affect the volatility of either employment or wages. However, this is an unlikely case for firm or industry-level analysis. Intermediate values for the labour supply elasticity imply that an increase in labour demand elasticity increases both employment and wage volatility *ceteris paribus*. OECD (2007) provides estimates of the potential contribution of globalisation to employment and wage volatility.

[3] He explains this finding by pointing out that multinationals tend to have higher levels of skill intensity and that the elasticity of labour demand declines in the average level of skills (due to the greater importance of firm-specific human capital).

[4] Fajnzylber and Maloney (2000), Krishna et al. (2001) and Hasan et al. (2007) analyse the elasticity of labour demand in the context of rapid trade liberalisations in various developing countries and also obtain mixed results. Fajnzylber and Maloney (2000) do not detect a systematic relationship between the elasticity of labour demand and trade reform in either Chile, Colombia or Mexico. Krishna et al. (2001) estimate unconditional labour demands to emphasise the role of scale effects for Turkey but also find no relationship. Hasan et al. (2007) study changes in the elasticity of labour demand during the Indian trade reform. They find that trade reform increased the elasticity of labour demand and that the increase is more pronounced in states with relatively flexible labour market regulations.

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