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The consequences of labor market flexibility: Panel evidence based on survey data☆

Rafael Di Tella[a,*], Robert MacCulloch[b]

[a] *Harvard Business School, Soldier Field Road, Boston, MA 02163, USA*
[b] *Princeton University, Princeton, NJ, USA*

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Abstract

We introduce a new data set on hiring and firing restrictions for 21 OECD countries for the period 1984–1990. The data are based on surveys of business people in the countries covered, so the indices we use are subjective in nature. Controlling for country and time fixed effects, and using dynamic panel data techniques, we find evidence that increasing the flexibility of the labor market increases both the employment rate and the rate of participation in the labor force. A conservative estimate suggests that if France were to make its labor markets as flexible as those in the US, its employment rate would increase 1.6 percentage points, or 14% of the employment gap between the two countries. The estimated effects are larger in the female than in the male labor market, although both groups seem to have similar long-run coefficients. There is also some evidence that more flexibility leads to lower unemployment rates and to lower rates of long-term unemployment. We also find evidence consistent with the hypothesis that inflexible labor markets produce "jobless recoveries" and introduce more unemployment persistence.

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1. Introduction

One of the biggest challenges in economics today is to explain what causes European unemployment. Commentators on the European situation often blame poorly designed

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* Corresponding author.
E-mail addresses: rditella@hbs.edu (R. Di Tella), rmaccull@princeton.edu (R. MacCulloch).

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labor market institutions, a view that sometimes goes by the ugly name of "Eurosclerosis". Economists advising governments on these issues share more or less the same diagnostic: Regulations such as hiring and firing restrictions faced by firms, as well as the generous welfare state that protects the unemployed, are behind the differential labor market performances of Europe and America. A number of countries have taken this view seriously. Great Britain and France are just two examples of countries that followed the economists' advice and reduced hiring and firing restrictions in the mid-1980s to combat high unemployment. This view of the labor market has also inspired large reform programs in the less developed world, where unemployment has recently increased. In fact, deregulation of the labor market is part of what the IMF and the World Bank often call "second-generation reforms".[1]

Since unemployment brings real misery to people's lives, and job security provisions often involve delicate redistribution issues between richer firm owners and poorer workers, one would think that economists giving such advice know what they are doing. More precisely, one would think that there are hundreds of papers studying whether more flexibility does in fact reduce a country's unemployment rate in practice. Sadly, this is not the case. To our knowledge, there is one panel study on the effects of labor market flexibility across countries (Lazear, 1990). And only a couple of cross-section studies, like the early one of Bertola (1990) based on evidence for 10 countries or that in the OECD Jobs Study (1994) based on 21 observations.[2] Addison and Grosso (1996) revise Lazear's data and obtain different estimates with respect to unemployment (they find no evidence favoring the hypothesis that severance pay increase unemployment).[3] Gregg and Manning (1997) review some of the available evidence on the effects of labor market flexibility and argue that it is "*much less persuasive than is commonly believed*", and that the profession's "*faith in the merits of labor market de-regulation is misplaced*" (p. 395). There is, perhaps, no experience more sobering to an economist than to review the state-of-the-art evidence on the effects of firing costs and to reflect on the social costs of unemployment.

The contribution of this paper is empirical. We introduce a new data set on hiring and firing restrictions for 21 OECD countries for the 7-year period covering 1984–1990. The data are based on surveys of business people in the countries covered, so the indices we use are subjective in nature. We also use the new summary measure of the parameters of the unemployment insurance system compiled by the OECD in 1994, which constitutes a significant improvement on previous benefit data available in the profession. We then present an empirical analysis of the effect of flexibility on a number of labor market variables that follows and extends the contributions of Lazear (1990). Controlling for country and time fixed effects, and using dynamic panel data techniques developed by Arellano and Bond (1991), we find evidence that relaxing job security provisions increases the employment rate and the participation rate. The estimated

[1] The IMF suggested that Argentina should increase the flexibility of the labor market, after unemployment reached 18.6% following the pro-market reforms of the early 1990s.

[2] Even in-depth single country studies are relatively rare. The interested reader is referred to the work of Abraham and Houseman (1994), Kugler (1999) and Hunt (1994) and Autor (2003).

[3] They emphasize a number of differences with Lazear's study (e.g. with respect to advance notice requirements), but they do find similar results with respect to three out of four variables.