Review of Economic Dynamics 12 (2009) 479–504

Contents lists available at ScienceDirect

Review of Economic Dynamics

www.elsevier.com/locate/red

Product market deregulation and the US employment miracle ☆

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ARTICLE INFO

Article history:
Received 13 December 2006
Revised 10 November 2008
Available online 25 November 2008

JEL classification:
E24
J63
L16
O00

Keywords:
Product market competition
Barriers to entry
Wage bargaining

ABSTRACT

We consider the dynamic relationship between product market entry regulation and equilibrium unemployment. The main theoretical contribution is combining a job matching model with monopolistic competition in the goods market and individual bargaining. We calibrate the model to US data and perform a policy experiment to assess whether the decrease in trend unemployment during the 1980s and 1990s could be directly attributed to product market deregulation. Under our baseline calibration, our results suggest that a decrease of less than two-tenths of a percentage point of unemployment rates can be attributed to product market deregulation, a surprisingly small amount.

1. Introduction

This paper studies the impact of product market deregulation on labor markets, with special emphasis on the Carter/Reagan deregulation of the late 1970s and early 1980s.

There has been quite some interest recently in the impact of product market institutions on labor markets. However, the focus of this literature has been to use differences in US and European product market regulation to try to explain the divergent performance of US and European labor markets over the 1980s and 1990s. One obstacle faced by this literature is that the presence of a multitude of rigidities (and attempts at reform) in European labor markets makes it difficult to disentangle the roles of product and labor market institutions in accounting for high European unemployment rates. In contrast, the US labor market is both highly flexible and its institutions were more stable during the period of interest

☆ We thank Philippe Bacchetta, Olivier Blanchard, Jan Boone, Michael Burda, Antonio Cabrales, Jordi Galí, Adriana Kugler, Etienne Lehmann, Pietro Peretto, Chris Pissarides, Julien Prat, Michael Reiter, Albrecht Ritschl, Roberto Samaniego, Eric Smith, Chris Telmer, Harald Uhlig, Etienne Wasmer, and Fabrizio Zilibotti for helpful comments and discussions. Two anonymous referees and an associate editor provided valuable suggestions that substantially improved this paper. We also thank seminar audiences at Cambridge, Duke, the European Central Bank, Humboldt, IZA, Tilburg, UPF, and Universitat Autonoma de Barcelona, as well as the participants of the 2003 European Summer Symposium in Macroeconomics, 2003 North American Winter Meetings of the Econometric Society, the CEPR DAEUP meeting in Berlin and the 2003 SED meetings for helpful comments. All remaining errors are our own. Haefke acknowledges financial support from EU grant HPMF-CT-2001-01252 and CICYT grant SEC2001-0792.

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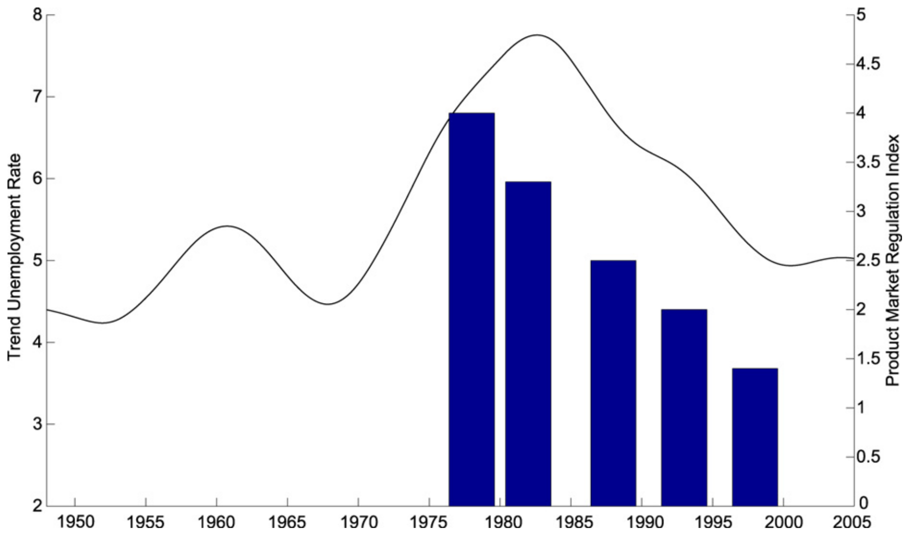
1094-2025/$ – see front matter
doi:10.1016/j.red.2008.11.002



Source: BLS and Nicoletti and Scarpetta (2003).

Fig. 1. Unemployment rate and entry regulation.

(Fig. 2). This allows us to focus only on changes in product market regulation, while holding labor market institutions constant.

Consider the graph of HP-trend unemployment rates[1] in Fig. 1. US unemployment rates began trending downward in the early 1980s, falling from a peak of 7.6% in 1982 to only 5.0% in 2000. The deregulation of US product markets runs parallel to this decrease in unemployment, as shown by the OECD data on product market regulation plotted in Fig. 1. This, together with the fact that deregulation took place around the time of the trend reversal in unemployment, makes it worth investigating whether product market deregulation could explain what has widely been termed the 'employment miracle' (Krueger and Pischke, 1997).[2]

Indeed, there is some amount of empirical evidence to support the link between product markets and labor markets. At a micro level, Bertrand and Kramarz (2002) examine the impact of French legislation[3] which regulated entry into retailing. They find that those regions (departements) which restricted entry more strongly experienced slower rates of job growth. At the cross-country macro level, Boeri et al. (2000), using an OECD index of the degree of product market regulation, also report a negative relationship between their countrywide regulation measure and employment. Fonseca et al. (2001) show that their index of entry barriers is negatively correlated with employment and positively correlated with unemployment rates. However, the high degree of correlation between labor and product market regulation documented in Nicoletti et al. (2000) makes it difficult to disentangle the effects of each type of regulation in a cross-country setup.

The main contributions of this paper are both quantitative and theoretical. Our main quantitative contribution is to quantify the effect of product market deregulation on unemployment. Using our baseline calibration, along the lines of Shimer (2005), we find that increasing product market regulation from 1998 to 1978 levels can account for only a surprisingly small increase in unemployment of less than two-tenths of a percentage point, from 5.10% in 1998 to 5.26% in 1978. We do, however, find, that our results depend on the calibration strategy. Under an alternative small surplus calibration similar to Hagedorn and Manovskii (2008), we find that decreased product market regulation between 1978 and 1998 can account for the entire decline in trend unemployment in the United States from 7.2% in 1978 to 5.1% in 1998. It is well known, however, that the small surplus calibration has many drawbacks (cf. Costain and Reiter, 2008).

In addition, we also examine alternative explanations for the drop in unemployment, namely tax reform and a decline in worker's bargaining power. We do this by allowing for both product market deregulation and either a tax reform or a decline in worker's bargaining power. We find that our result that product market deregulation is unable to account for most of the decline in unemployment is robust to the inclusion of both tax reform and declining worker's bargaining power. In order to account for the full 2.1 percentage point decline in trend unemployment, product markets would need to be deregulated and labor taxes would have had to decrease from 56.6% in 1978 to 32.0% in 1998. In this case, the product market deregulation would have accounted for less than one-fifth of the decline in unemployment. Alternatively, product market deregulation combined with a decline in worker's bargaining power from 66.6% in 1978 to 50% in 1998 could

[1] We emphasize that these are *trend* unemployment rates, whose business cycle component has been filtered out.

[2] At the same time, the major change in US labor market institutions—the 1996 welfare reform—took place after most of the gains in unemployment had already been realized. Unemployment in 1996 had already fallen to 5.4%. In fact, one might argue that the immediate transitory effect of welfare reform should have been to increase unemployment, as welfare recipients were pushed into the labor market.

[3] Loi Royer of 1974.