

Rigidities in Employment Protection and Exporting

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Summary. — There have been significant improvements in traditional trade policies in the past few decades. However, these improvements can only be fully effective when they are complemented with a favorable investment climate. This study focuses on a particular aspect of investment climate, namely labor regulations, and shows how these regulations can be discouraging from exporting. Using firm level data from 26 countries in Eastern Europe and Central Asia region, the paper empirically shows that firms that cannot create new jobs due to stringent labor regulations are less likely to export. Firms that plan to export expand their sizes before they start to export. However, the rigidities in labor markets make this adjustment process costly. Higher costs of employment decrease operating profits and lead to a higher productivity threshold level required for entering export markets. As a result, a smaller fraction of firms can afford to export.

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1. INTRODUCTION

Recent research in international trade literature as reviewed by Bernard, Jensen, Redding, and Schott (2007) and Greenaway and Kneller (2007) show that exporting firms are larger, more productive and they grow faster. Higher performance of these firms and their significant contribution to economic development make it imperative to understand how investment climate affects their progress. A sound investment climate can be crucial to complement firm specific, technological, or market driven factors in order to make exporting a profitable activity. In fact, Dollar, Hallward-Driemeier, and Mengistae (2006) show that highly bureaucratic and corrupt governments, inefficient financial services, or low quality of infrastructure make it difficult for firms to expand into foreign markets in developing countries. They argue that a good investment climate works in the direction of decreasing the sunk costs of exporting and eventually leads to higher participation in export markets. Focusing only on the elimination of trade barriers without considering the inefficiencies in investment climate might not yield the expected gains from trade. This study investigates the relationship between a particular aspect of investment climate namely labor regulations and exporting. It shows that firms that find it difficult to create new jobs due to stringent labor regulations are less likely to participate in export markets.

Evidence from theoretical and empirical research shows that efficient firms self-select themselves into foreign markets. The entry into these markets is associated with significant changes in firm performance. In the data from Enterprise Surveys employment levels of firms that subsequently enter export markets (future-exporters) grow by 13% which is four times higher than the growth rate of nonexporting firms.¹ Bernard and Jensen (1999) who analyze the evolution of future-exporters among the firms in the United States, find that in addition to being larger in employment, shipments, and labor productivity, future-exporters also grow faster than nonexporters in all three measures. They find that growth premiums between future-exporters and nonexporters are 1.4% per year for employment and 2.4% for shipments. Greenaway and Kneller (2007) summarize a collection of studies that similarly find faster total factor productivity or labor productivity growth of future-exporters relative to nonexporters. Alvarez and Lopez

(2005) argue how firms increase their productivities with the explicit purpose of becoming exporters. Using data of Chilean manufacturers they show that future-exporters invest more in physical capital than nonexporters. They find that a 1% increase in investment increases the probability of exporting by 0.2%. All these evidences highlight the changes in performances of firms that self-select themselves into export markets before exporting starts. In this study I show that labor regulations can obstruct this self-selection process and discourage firms from exporting.

Labor regulations are an important element of investment climate. Studies like Micco and Pages (2007) and Kugler (2007) show that stringent labor regulations hinder job flows in firms by raising the costs of hiring workers. These regulations can also have detrimental effects on exporting. In a recent study, Helpman and Itskhoki (2010) construct a theoretical model that explains how rigidities in labor markets impact trade. In a general equilibrium model of trade with two countries, they show that labor market flexibility is a source of comparative advantage for firms. Frictions in labor markets which cause high hiring costs reduce operating profits. Lower profits decrease the competitiveness of firms and obstruct the self-selection process into foreign markets. I present empirical evidence that supports the theoretical results of Helpman and Itskhoki (2010)².

For the analysis, I use firm level data from Enterprise Surveys which is conducted in Eastern Europe and Central Asia (ECA) region. Using one of the survey questions, for each firm I compute the difference between current employment level and a hypothetical level that would be obtained if labor regulations were not constraining. Then I investigate whether firms that are more severely affected by labor regulations in creating new jobs are less likely to export. The analysis shows that a 1% increase in the severity of labor regulations yields a 0.7% decrease in the probability of exporting.

Almost all empirical work that analyzes the effects of labor regulations on firm performance has concentrated on the

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effects on size, investment, and productivity with no particular focus on exporting. Besley and Burgess (2004) analyze how labor regulations affect firm performance across Indian states. They find that restrictive labor regulations lead to lower investment, employment, and productivity in the formal sector. Basani and Ernst (2002) and Scarpetta and Tressel (2004) show that innovation activity and productivity are negatively affected by the distortions in institutional environment including labor regulations. Khan (2006) performs a similar analysis in French industries and finds that restrictive labor regulations have negative effects on total factor productivity growth. Almeida and Carneiro (2009) find that in Brazil, stricter enforcement of labor regulations reduce firm size measured in both employment and sales. Caballero, owan, Engel, and Micco (2004) find that job security regulations hamper the process of creative destruction especially in countries where these regulations are likely to be enforced. They show that higher levels of job security decrease productivity growth roughly by 1%. I extend the existing literature on labor regulations by showing how detrimental they can be for export activities.

A novel feature of this study is that it does not only look at the cross-country differences in labor regulations but also looks at the variation of their effects across sectors like construction, manufacturing, and retail. Even when the same de jure labor laws are applied across all firms in a country, differences in the intrinsic demand and supply shocks can lead to differential effects of labor regulations across sectors. It is also possible that enforcement of these laws could show variation across sectors or industries which could be a reason for the variation in the distortions caused by labor regulations.

Performing a cross-sectoral analysis is also important for the research on international trade. Most of the existing studies analyzing exports focus on export of products in manufacturing sector. Services are the fastest growing sector and the growth in service trade has surpassed the growth in goods trade. Data from Enterprise Surveys show that in both 2002 and 2005 roughly 20% of firms in service sector export part of their services. The analysis is also performed across industries within the manufacturing sector. There are only a few studies like Micco and Pages (2007) and Haltiwanger, Scarpetta, and Schweiger (2008) that perform cross-industry analysis on the differential impacts of labor regulations on firm performance within a country. Both of these studies show that high hiring and firing costs are detrimental to job flows particularly in those industries that require more frequent labor adjustments.

The rest of the paper is organized as follows. In Section 2, I explain the methodology and the specification of the model. Then in Section 3, I describe the data used in the analysis. The empirical analysis is presented in Section 4 and a sensitivity analysis using additional controls, different specifications, and the panel data is performed in Section 5. Finally, in Section 6 I present concluding remarks.

2. MODEL SPECIFICATION AND METHODOLOGY

The analysis is based on two studies by Melitz (2003) and Helpman and Itzhoki (2010). Melitz (2003) presents a model with heterogeneous firms where efficient firms self-select themselves into export markets. Efficient firms who earn the highest profits are the only ones who can compensate the sunk costs of exporting. Helpman and Itzhoki (2010) construct a two-country model of international trade allowing labor markets to be subject to search and matching frictions and wage bargaining. They introduce Diamond-Mortensen-Pissarides type frictions into an economy with heterogeneous producers as

in Melitz (2003). With this setup, they allow firms to exercise market power in the product market on one hand and bargain with workers over wages on the other. They analytically show how labor market frictions impact trade. The rigidities in labor markets increase the costs of hiring workers which results in lower operating profits. In a sense, these increases in hiring costs are similar to a proportional reduction in the productivity of firms. In order to make exporting profitable, the disadvantage created by high hiring costs must be compensated with high productivity levels which cause an increase in the productivity cutoff for exporting. Higher cutoff value leads to lower fraction of exporters.³

The uncertainties about a firm's potential performance and its competitiveness in foreign markets might contribute to its decision of not participating in export markets. Besedes and Prusa (2010) show that 30–40% of firms fail in exporting within their first 2 years of service. Brenton, Saborowski, and Uexkull (2009) also find low survival rates in export markets especially in developing countries. The uncertainties in foreign markets complemented with possible low competitiveness caused by restrictive labor regulations can make firms reluctant to participate in foreign markets.

In the analysis I use data from manufacturing and service sectors. Both Melitz (2003) and Helpman and Itzhoki (2010) present models that are constructed for manufacturing firms. Although the definition of exports is likely to vary across sectors, the idea of self-selection of more efficient firms into export markets and how labor market frictions affect exporting decision can be applied to firms in service sectors. A wholesaler or a construction firm needs to incur extra costs to provide its services for foreign buyers and these firms also have to consider the effects of regulations on the decision of adjusting their workforces.

Enterprise Surveys conducted in 2002 and 2005 include a section regarding firm's employment level. In one of the questions in this section the firm is asked how much it would adjust the number of its full-time workers if there were no restrictions in the labor markets for hiring and firing. The exact question is asked as follows:

"If you could change the number of regular full-time workers your firm currently employs without any restrictions (i.e., without seeking permission, making severance payments etc.), what would be your optimal level of employment as a percent of your existing workforce? (e.g., 90% implies you would reduce your workforce by 10%, 110% means you want to expand by 10%)".

The question targets to measure the restrictiveness of labor regulations, on firms' hiring/firing decisions. Out of the firms who responded to this question, 40% want to increase, 20% want to decrease and the rest 40% do not want to change their employment levels. In manufacturing sector these statistics are 40%, 22%, and 38% in respective order.

Using this survey question, I calculate the desired employment growth rate for each firm if it was not constrained by the labor regulations. In finding these growth rates I follow Davis and Haltiwanger (1992). I divide the difference between actual employment level and the ideal level that would be obtained if hiring or firing decision was made by the simple average of both employment levels. Let l_i be the actual employment level of firm i and l'_i be the ideal employment level once hiring or firing decision is made. Define $\bar{l}_i = (l'_i + l_i)/2$ as the average of these two levels. The percentage desired change in employment that would have been achieved by making labor regulations flexible is formulated as

$$g_i = \frac{l'_i - l_i}{\bar{l}_i}.$$

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