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The impact of employment protection legislation on labour productivity in a general equilibrium matching model

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Abstract The standard analysis of the impact of EPL on labour market outcomes concentrates mainly on unemployment and job flows, disregarding possible effects on labour productivity. In this paper we make (a component of) labour productivity endogenous and analyze how the presence of a stringent protection legislation affects labour market in an equilibrium matching model with endogenous job destruction. In particular, in our study we imagine that an employed worker has to exert effort to produce and this generates disutility. Therefore, in this framework high labour productivity on one hand is costly for a worker in terms of disutility, and on the other hand might be beneficial in terms of lower job destruction. We find that high firing costs partially substitute high labour productivity in reducing job destruction and this, consequently, brings down the optimal level of productivity. Furthermore, the impact of EPL on unemployment is ambiguous but numerical exercises show unambiguously how higher firing restrictions reduce different measures of aggregate welfare. To some extent, the clear emergence of these results leads to interesting policy implications and, indeed, rationalizes the recent empirical evidence on the impact of EPL.

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Impacto de la legislación de protección del empleo sobre la productividad laboral en un modelo combinado de equilibrio general

Resumen El análisis estándar del impacto de la EPL sobre los resultados en el mercado laboral se concentra sobre todo en el paro y en los flujos de trabajo y paro. En este documento hacemos endógena (un componente de) la productividad laboral y analizamos cómo afecta al mercado laboral la presencia de una legislación de protección rigurosa en un modelo combinado de equilibrio apropiado con la destrucción de empleo endógena. Concretamente, en nuestro estudio imaginamos que un trabajador por cuenta ajena debe hacer esfuerzos para producir y esto genera desutilidad. Por lo tanto, dentro de este marco, para un trabajador la alta

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Destrucción de empleo

productividad laboral es costosa en términos de desutilidad, pero también puede ser beneficiosa por lo que se refiere a la menor destrucción de empleo. Observamos que el alto coste del despido sustituye parcialmente la alta productividad laboral al reducir la destrucción de empleo y, en consecuencia, esto reduce el nivel óptimo de productividad. Además, el impacto de la EPL sobre el desempleo es ambiguo, pero los cálculos numéricos muestran de manera evidente cómo las mayores restricciones del despido reducen diferentes medidas de bienestar global. En cierta medida, la aparición evidente de estos resultados conlleva implicaciones normativas interesantes y, lo que es más, racionaliza la evidencia empírica reciente sobre el impacto de la EPL.

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1. Introduction

Recent empirical evidence from European countries and the US shows that the presence of stringent employment protection legislation (EPL) affects significantly labour productivity. In particular, cross-country (DeFreitas and Marshall, 1998), diff-in-diff (Micco and Pages, 2006; Autor et al., 2006, 2007; Bassanini and Venn, 2007; Bassanini et al., 2009; Lisi, 2013) and other studies (Riphahn, 2004; Ichino and Riphahn, 2005) found that higher EPL have a negative impact on labour productivity.

Nonetheless, standard theoretical analysis of EPL focuses mainly on unemployment and job flows, disregarding possible effects on labour productivity. In particular, both standard analysis of labour demand under uncertainty (Bentolila and Bertola, 1990; Bertola, 1990; Bentolila and Saint-Paul, 1992; Bentolila and Dolado, 1994; Boeri and Garibaldi, 2007) and general equilibrium models (Mortensen and Pissarides, 1994, 1999b; Garibaldi, 1998; Pissarides, 2000; Cahuc and Postel-Vinay, 2002) tend to consider an exogenous productivity, not influenced by the presence of labour-market policies. Indeed, some studies analyze the role of EPL in distorting the adjustment of employment and investment, consequently affecting productivity (Hopenhayn and Rogerson, 1993; Saint-Paul, 1997, 2002; Bartelsman and Hinloopen, 2005).

In this paper, in the spirit of Ichino and Riphahn (2005), we concentrate more on the behavioural component of productivity. Therefore, we make (a component of) labour productivity an endogenous object of the model and, then, study the impact of a stringent protection legislation. Since our concern is to understand the equilibrium impact on productivity, unemployment and welfare, we need to embed the analysis into an equilibrium model of the labour market. To this extent, the matching approach to equilibrium unemployment should represent the best candidate for this kind of analysis.

In the canonical matching model total productivity is usually characterized by an exogenous common component, affecting productivity in all jobs, and an idiosyncratic component, governed by a stochastic process. Indeed, in such specification of productivity there do not seem to be place for workers. Differently, in our study we imagine that an employed worker has to exert effort to produce and this generates disutility. Following this argument, we assume

that a component of productivity is determined by the level of effort exerted by workers. Thus, in this framework high labour productivity on one hand is costly for a worker in terms of disutility, and on the other hand might be beneficial in terms of lower job destruction. Since stringent protection legislation has the same well-known effect of reducing job destruction (e.g. Pissarides, 2000), EPL might affect total productivity also through this behavioural component. Therefore, the novelty introduced in this paper should contribute to offer a more comprehensive evaluation of the impact of EPL on labour productivity and, more generally, on labour-market outcomes.

An equilibrium is a job destruction and job creation rule, a labour productivity and a level of unemployment implied by the rational expectations behaviour of individual firms and workers and by the matching technology. We study how the presence of a stringent protection legislation affects productivity, unemployment and welfare in the aggregate steady-state. We find that high firing costs partially substitute high labour productivity in reducing job destruction and this, consequently, brings down the equilibrium labour productivity. Furthermore, the impact of EPL on unemployment is ambiguous but numerical exercises show unambiguously how higher firing restrictions reduce different measures of aggregate welfare. To some extent, the clear emergence of these results leads to interesting policy implications, especially in the light of the great debate emerged in the last years regarding EPL. Moreover, the extension pursued in this paper would offer a reasonable interpretation to rationalize the recent evidence on the negative impact of EPL on productivity. Indeed, this approach to consider labour market outcomes and personnel economics together in addressing policy questions has already turned out to be successful (see e.g. Shapiro and Stiglitz, 1984).

In regards to how this paper places in that strand of literature aiming to evaluate the impact of EPL, the main contribution consists in introducing labour productivity (besides unemployment and job flows) in the general equilibrium evaluation of this particular policy in the labour market. To this extent, the paper shares the same spirit of Lagos (2006). In particular, that paper proposes an aggregative model of TFP in the matching framework, allowing to evaluate the impact of labour-market policies on the general aggregate production function and, especially, on average TFP. Nonetheless, in Lagos (2006) higher firing costs affect

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