



Dismissal protection and worker flows in OECD countries: Evidence from cross-country/cross-industry data[☆]

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HIGHLIGHTS

- We study the effect of EPL on gross worker flows using cross-country data.
- We use both a difference-in-difference approach and standard time-series analysis.
- The more stringent the EPL, the smaller the rate of within-industry transitions.
- EPL has no effect on separations leading to industry change/non-employment.
- The extent of reinstatement is found the key regulatory determinant of gross flows.

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ABSTRACT

Exploiting a unique dataset including cross-country comparable hiring and separation rates by type of transition for 24 OECD countries, 23 business-sector industries and 13 years, we study the effect of dismissal regulations on different types of gross worker flows, defined as one-year transitions. We use both a difference-in-difference approach – in which the impact of regulations is identified by exploiting likely cross-industry differences in their impact – and standard time-series analysis – in which the effect of regulations is identified through regulatory changes over time. We find that the more restrictive the regulation, the smaller is the rate of within-industry job-to-job transitions, in particular towards permanent jobs. By contrast, we find no significant effect as regards separations involving an industry change or leading to non-employment. The extent of reinstatement in the case of unfair dismissal appears to be the most important regulatory determinant of gross worker flows. We also present a large battery of robustness checks that suggest that our findings are robust.

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1. Introduction

Market-based economies are characterised by a continuous reallocation of labour resources. New firms are created; existing firms expand, contract or shut down. A number of firms do not survive their first few years in the market, while other successful young businesses develop rapidly. In the process, large numbers of jobs are created and destroyed. At the same time many individuals enter the market and fill new job vacancies, while others change jobs or leave employment. Each year, more than 20% of jobs, on average, are created and/or destroyed, and around one-third of all workers are hired and/or separate from their employer (see e.g. OECD, 2009).

A large body of theoretical and empirical literature suggests that employment protection legislation (EPL hereafter), and especially

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dismissal regulation, is a key determinant of labour reallocation. From a theoretical viewpoint, standard equilibrium models of the labour market (e.g. [Bentolila and Bertola, 1990](#); [Bertola, 1990](#)) describe firms' optimal behaviour in the presence of positive firing costs – as well as wage rigidities, financial market imperfections and/or uncertainty about the future of the firm – and show that the best strategy for firms is to reduce both job creation and destruction, with an ambiguous effect on average employment levels.¹ These predictions are by and large confirmed by the empirical literature: both micro-econometric evaluations of policy reforms and cross-country macroeconomic studies tend to find, with few exceptions, that restrictive dismissal regulations hinder job creation and hiring while simultaneously compressing job destruction and separations.² In other words, stringent dismissal regulations dampen the reallocation of labour resources across firms.

In this paper we ask whether dismissal regulations affect also where labour resources are reallocated. Put it another way, in economies with less stringent regulations, do separations result more often in job-to-job transitions within the same industry as opposed to job-to-job transitions across industries or transitions from employment to non-employment? Job-to-job transitions are defined here as situations in which an individual is with one employer at one year and with another one at the subsequent year.³ In order to investigate this issue, we build and exploit a unique dataset including cross-country comparable hiring and separation rates by type of transition for 24 OECD countries and 23 business-sector industries. To anticipate our results, we find that the more restrictive the regulations, the smaller is the rate of job-to-job transitions within the same industry – and in particular of transitions towards permanent jobs – while no significant effect is detected as regards other types of separations. Moreover, as we have very detailed data in terms of regulatory provisions, we can assess the different importance of each of them as regards these transitions. In particular, we find that the possibility of reinstatement in the case of unfair dismissal is key in shaping gross worker flows.

We think that tracing where labour resources are reallocated and assessing the impact of employment protection on different types of transitions is interesting because structural reforms that relax the stringency of regulations might decrease the efficiency of the reallocation process while increasing overall reallocation. For example, the Spanish experience of the past thirty years suggests that reforms that increase the use of temporary contracts have opposite effects on reallocation and productivity (see e.g. [Dolado and Stucchi, 2010](#)). A key concern about reforms of dismissal regulations is that if they induce excessive turnover they might enhance inefficient destruction of industry-specific human capital, thereby impairing productivity growth in the long-run. In fact, the literature on job displacement has shown that dismissals leading to protracted unemployment spells and/or industry changes induce long-lasting wage penalties that are interpreted as due to destruction of (usually industry-specific) human capital.⁴ Therefore, by increasing displacement, reforms relaxing firing restrictions might reduce the efficiency of the reallocation process. However, to the extent that laxer firing restrictions prompt firms to do more experimentation with new

recruits and more hirings, more productive matches might also be realised, resulting in greater efficiency. Although in our dataset we cannot distinguish dismissals from voluntary quits, by distinguishing separations leading to either unemployment spells or a job in the same industry or a job in another industry, our analysis sheds some light on the likelihood that the increase in reallocation associated with the relaxation of firing restrictions could induce excessive destruction of (industry-specific) human capital.

One key problem in the cross-country analysis of the impact of regulations is that it is difficult to control for an exhaustive list of confounding factors. In addition, regulatory changes might be endogenous to worker flows, in particular insofar as they might be prompted by a sudden rise in dismissals and job destruction. Theory however predicts that, under standard assumptions on adjustment costs, dismissal regulations have a greater impact on job and worker flows in industries with greater natural propensity to make staff adjustments on the external labour market, in the absence of adjustment costs (see e.g. [Micco and Pages, 2006](#)). For example, if firms need to lay off workers to restructure their operations in response to changes in technologies or product demand, high firing costs are likely to slow the pace of reallocation of resources. By contrast, in industries where firms restructure through internal adjustments, changes in employment protection can be expected to have little impact on adjustment costs and, therefore, on labour reallocation. As done in a few recent cross-country studies on EPL and labour reallocation (e.g. [Haltiwanger et al., 2008](#); [Cingano et al., 2010](#)), we identify the effect of dismissal regulations by exploiting this theoretical property and using a difference-in-difference approach à la [Rajan and Zingales \(1998\)](#), where low-reallocation industries are used as a sort of control group for high-reallocation industries. The advantage of this approach is that it allows controlling for all factors that are unlikely to affect labour flows in a different way in high- and low-reallocation industries. In addition, through this approach we can better address endogeneity issues. In contrast with cross-country studies on labour reallocation, however, we explicitly acknowledge possible cross-industry general-equilibrium effects, which would not be identified through industry comparisons, and check that our results also hold when we estimate a standard cross-country/time-series model in which the effect of EPL is identified through regulatory changes over time.

Our paper complements existing micro and macro studies on EPL and labour reallocation. [Autor et al. \(2007\)](#) study the impact of the adoption of wrongful-discharge protection norms by state courts in the United States on several performance variables constructed using establishment-level data. By using cross-state differences in the timing of adopting stricter job security provisions, they find a negative effect of these provisions on job flows and firm entry. Using Italian firm-level data, [Boeri and Jimeno \(2005\)](#) exploit exemption clauses exonerating small firms from job security provisions within a difference-in-differences approach. Their estimates confirm a significant effect of employment protection on job turnover and job destruction in particular. Similar findings are obtained by [Schivardi and Torrini \(2008\)](#) and [Kugler and Pica \(2008\)](#). [Marinescu \(2009\)](#) exploits a 1999 British reform that reduced the trial period for new hires from 24 to 12 months of tenure, thereby directly affecting only employees within this window, and finds that the firing hazard for these employees significantly decreased with respect to that of workers with longer job tenure. [Kugler et al. \(2003\)](#) study the effects of a 1997 Spanish reform, which lowered dismissal costs for older and younger workers, and find that it was associated with a relative increase in worker flows for these groups. By contrast, insignificant effects are found by [Bauer et al. \(2007\)](#), [Martins \(2009\)](#) and [von Below and Thoursie \(2010\)](#) – who look at the impact of small-firm exemptions on worker turnover in Germany, Portugal and Sweden, respectively – possibly because of the small economic significance of the exemptions, typically concerning only procedural requirements. The fact that significant changes to labour legislation are rare

¹ Search and matching models, such as those of [Garibaldi \(1998\)](#) or [Mortensen and Pissarides \(1999\)](#), also come to the conclusion that job mobility is negatively affected by the stringency of dismissal regulations.

² See among others [Autor et al. \(2007\)](#), [Boeri and Jimeno \(2005\)](#), [Marinescu \(2009\)](#), [Gomez-Salvador et al. \(2004\)](#), [Messina and Vallanti \(2007\)](#), [Haltiwanger et al. \(2008\)](#), [Cingano et al. \(2010\)](#), and, for less conclusive findings, [Bauer et al. \(2007\)](#), [Martins \(2009\)](#) and [von Below and Thoursie \(2010\)](#).

³ Obviously, workers might experience short spells of unemployment between the two dates. By contrast, employment to non-employment transitions imply that individuals are not in employment the subsequent year.

⁴ See e.g. [Neal \(1995\)](#), [Gregory and Jukes \(2001\)](#), [Kletzer and Fairlie \(2003\)](#), [von Wachter and Bender \(2006\)](#), [Schmieder et al. \(2012\)](#).

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