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On the impact of firing costs under different wage setting regimes

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ABSTRACT

We build a model where firing transfers and firing taxes interact with the degree of centralisation in wage bargaining. The comparative statics of the model imply that firing taxes are less harmful for aggregate employment in economies with centralised bargaining as opposed to economies with decentralised bargaining. By contrast, firing transfers are less harmful in economies with decentralised bargaining providing outsider wages are sufficiently downward flexible. We investigate the empirical consistency of these predictions by using data that allow for a proper separation of firing taxes from firing transfers.
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1. Introduction

In recent years labour market reforms have changed direction in many advanced economies, notably in southern-European countries. Up to the beginning of the great recession, the demand for flexibility tended to be addressed through a reduction in protection for temporary workers. By contrast, after the beginning of the recession, the typical reform has consisted of a reduction in protection for permanent workers (OECD, 2013, Chapter 2).

The change in the design of reforms is itself a by-product of the crisis. The recession, in fact, has mainly hit workers in precarious occupations and, as a consequence, has made more compelling the concerns on the intrinsic unfairness of dual regulations. Thus, while in the pre-crisis period charging the burden of flexibility only on temporary workers represented the most comfortable option for governments, during the crises the objective of securing social cohesion has prevailed. The burden of flexibility has therefore been partly shifted on the shoulders of permanent workers.

Inspired by this change in policy, the objective of this paper is to appraise the impact of variations in the protection of permanent workers. We pursue this objective either by setting up a theoretical model and by producing new econometric evidence.

In the economic literature, the body of rules that protect the employee from a sudden and/or unjustified dismissal is interpreted as inducing a firing cost for the employer. Thus, in a business environment that is intrinsically stochastic and dynamic, a notable effect of this cost is to reduce the extent of workforce adjustments face to exogenous demand and productivity changes. Firing costs, in fact, on the one hand reduce job destruction almost by definition while, on the other hand, also reduce job creation since employers anticipate the cost of future dismissals. Yet, the reduction in workforce adjustments does not imply by itself a reduction in employment levels. The net employment effect of a lower workforce turnover is inherently ambiguous and, in any case, it is likely to be negligible (Bentolila and Bertola, 1990 and Bertola, 1990).

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In a seminal paper, Lazear (1990) clarifies that to reduce the level of employment firing costs need to increase the cost of labour. This increase, however, may or may not occur depending on the particular component of firing costs that is considered. In fact, firing costs can be conceptually separated in two components. The first component, often termed *firing transfers*, is made of payments that the employer is obliged to give to the dismissed worker. Severance payments and wages perceived during the notice period represent the two most obvious examples. The second component is made instead of all those red-tape expenses ensuing from procedural duties. To emphasise the non-transfer nature of these expenses this component is often referred to as *firing taxes*. From the perspective of this distinction, Lazear shows that the tax component is bound to reduce employment but the transfer component may turn out to be neutral. In particular, neutrality arises if the market operates so as to undo the transfers imposed by the legislation. This typically happens when the outsiders concede wage discounts – i.e. reverse transfers – that compensate for future expected firing transfers.

Following the direction indicated by Lazear, subsequent research has investigated under what institutional conditions firing transfers are likely to be neutral. Notably, Ljungqvist (2002) and Garibaldi and Violante (2005) study these conditions within a labour market with search and matching imperfections. The first contribution shows that neutrality depends on how firing transfers affect the bargaining over match surplus. The second shows that the neutrality of firing transfers requires decentralised wage bargaining as opposed to centralised bargaining. Centralised bargaining, in fact, prevents the outsiders from offering wage discounts. In a model with a monopoly union and risk-averse workers Piccirilli (2010) extends this line of research to firing taxes. Since they represent payments to third parties, firing taxes cannot be undone by means of reverse transfers. Yet, firing taxes also act as a device that strengthens the bargaining power of the insider (Lindbeck and Snower, 1988). Thus, firing taxes generate indirect transfers from the firm to the insider in the form of higher insider′s wages. It follows that these indirect transfers may be potentially undone exactly as it happens for direct transfers.

The present paper contributes to the literature on the link between firing costs and wage setting institutions in three ways. First, we build a model sufficiently general to contain mechanisms that have been studied in isolation in previous papers. Notably, we show that the model produces the results of Lindbeck and Snower (1988), Lazear (1990), Garibaldi and Violante (2005) and Piccirilli (2010) as particular cases. The model thus contributes to a better understanding of which elements really govern the impact of firing costs and what elements are instead peripheral. Second, due to its simplicity, the model also accommodates imperfections that are relevant but that have so far been neglected in more complex settings. Imperfections that cause downward wage flexibility, for instance, inhibit outsiders from conceding compensative wage discounts. Yet, these imperfections cannot be easily included in the microeconomics of wage setting which is common in search and matching environments. For this reason, papers that adopt such a framework abstract from this important element. Third, since the model produces distinct predictions for the transfer and the tax component of firing costs, we assess its empirical consistency by means of an econometric analysis conducted upon separate measures of the two components. For this reason, we resort to data produced by the World Bank that have so far been disregarded in the literature of reference.

Overview of results: In the theoretical part of the paper we build a model and study the employment impact of changes in firing taxes and firing transfers. Close in spirit to Garibaldi and Violante (2005), the main issue addressed in the model is the interaction between the two components of firing costs and the extent of bargaining centralisation. In this respect, we find that firing taxes are more harmful for the performance of the labour market if bargaining is decentralised. By contrast, firing transfers are more harmful if bargaining is centralised. However, while the prediction for firing taxes is clear-cut, the prediction for firing transfers holds under the qualification that the labour market is only mildly affected by other imperfections that reduce the downward flexibility of wages independently from the structure of bargaining. Efficiency wages, fairness concerns or poor access to credit represent the most obvious sources for this type of imperfections.

The mechanism that produces these results hinges on the well documented fact that centralised bargaining curbs market forces and subtract degrees of freedom for wage setters in the various segments of the labour market (Blau and Kahn, 1996). In the context of a labour market where firing provisions separate the outsider from the insider, this fact produces two consequences. On the one hand, centralisation reduces the degrees of freedom for the outsider and inhibits the latter from offering a wage discount in exchange of future insider′s rents. On the other hand, centralisation also reduces the degrees of freedom for the insider and prevents the latter from fully exploiting the stronger bargaining power afforded by protection. Thus, with regard to the performance of the labour market, the interaction between employment protection and centralisation may either be positive or negative. By tying the hands of the outsider, centralisation turns out to be detrimental for market performance. By contrast, by tying the hands of the insider, centralisation may be beneficial for market performance.

In the model, we find that the net effect of these two countervailing forces depends on whether one considers the transfer or the tax component of protection. For taxes, the impact of centralisation on the insider′s wage turns out to dominate. As a consequence, the interaction with centralisation is positive for market performance. For transfers, the impact on the insiders' wage may or may not dominate depending on whether, under decentralised bargaining, outsider wages are sufficiently downward flexible.

In the second part of the paper, we assess the empirical consistency of the model. We find that the evidence from a set of OECD countries does not contradict the prediction regarding the interaction between centralisation and firing taxes. As for the interaction between centralisation and firing transfers, the finding is that the sign of this interaction is negative. This is consistent with results of previous studies and suggests that, for the countries included in our dataset, decentralisation allows a degree of downward wage flexibility which is sufficient to achieve neutralisation.

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