High European unemployment

It seems a pertinent argument that the harder it is to lay people off the lower unemployment is expected to be. Therefore, given the firing restrictions in the labour market of EU countries such as France, Germany and Italy it is surprising that unemployment performance is so much worse than in the US where it is comparatively easy to make labour redundant (see figure 1). The alternative hypothesis is that the harder it is to lay people off, the less likely it is that labour will be hired in the first place.

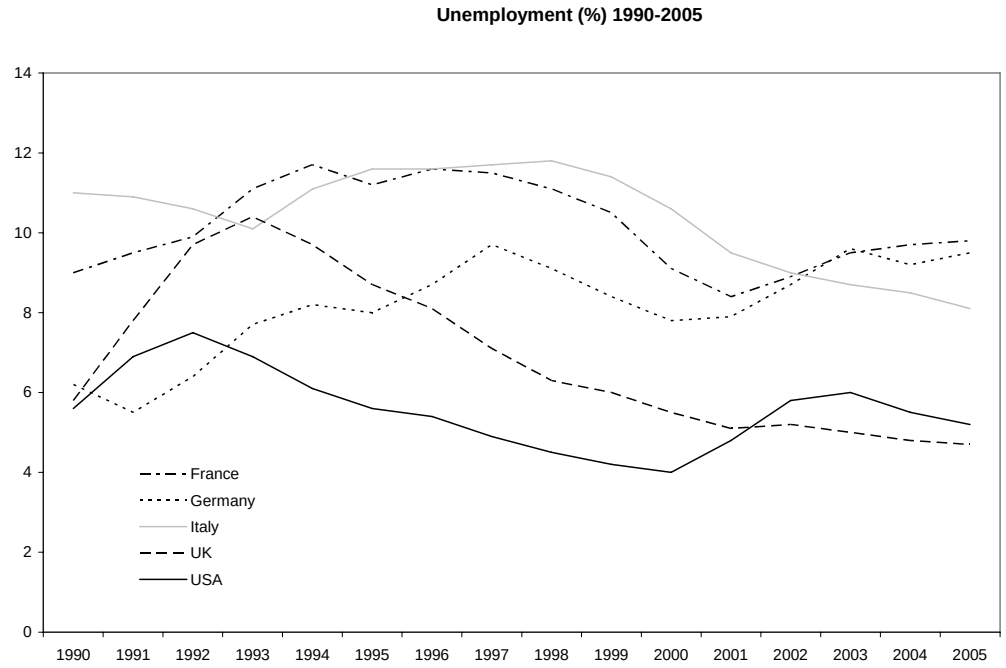

Figure 1: Source IMF World Economic Outlook database

It is widely accepted that there are costs involved for a firm adjusting its labour force. To reduce it severance payments are made and the firm is effectively scrapping any investment it made in those workers' skills. Hiring labour on the other hand requires an investment in training or integrating that labour with the existing capital stock and work force. Crucially, it also entails a commitment to pay the future severance costs should the firm ever need to reduce its workforce.

Empirically, employment tends to fluctuate less than output and the presence of these adjustment costs might explain why. Faced with fluctuating demand firms will resist costly adjustments in their labour force until the change in demand can be judged as not insignificant, and not transitory. In fact- firms hiring and firing patterns may be described by two thresholds. It is only when output passes these that action is taken, in the meantime the firm leaves its labour force unchanged as the costs of adjustment outweigh the benefits.

How might firing costs influence the position of these thresholds? If the costs of firing labour are greater then it is reasonable to expect that the threshold for reducing labour will be lower, so output would need to fall more considerably before unemployment starts rising than otherwise. However, the hiring threshold would also rise- so output would need to be higher than otherwise in order for firms to start hiring labour. This is because the cost of hiring labour must also reflect the cost of making it redundant if future output were to decline. These costs naturally make firms more cautious about hiring labour in the first place. The overall consequences are that the hiring and firing margins are much wider when there are larger costs to making workers redundant.

The position of these thresholds could explain some of the patterns seen in US and EU unemployment dynamics during the 1990s as seen in figure 1. US employment is expected to be more responsive to output movements- a sign of its more flexible labour market in this regard. The hiring and firing margins are therefore estimated to be narrower for the US than for EU countries such as France, Germany and Italy.

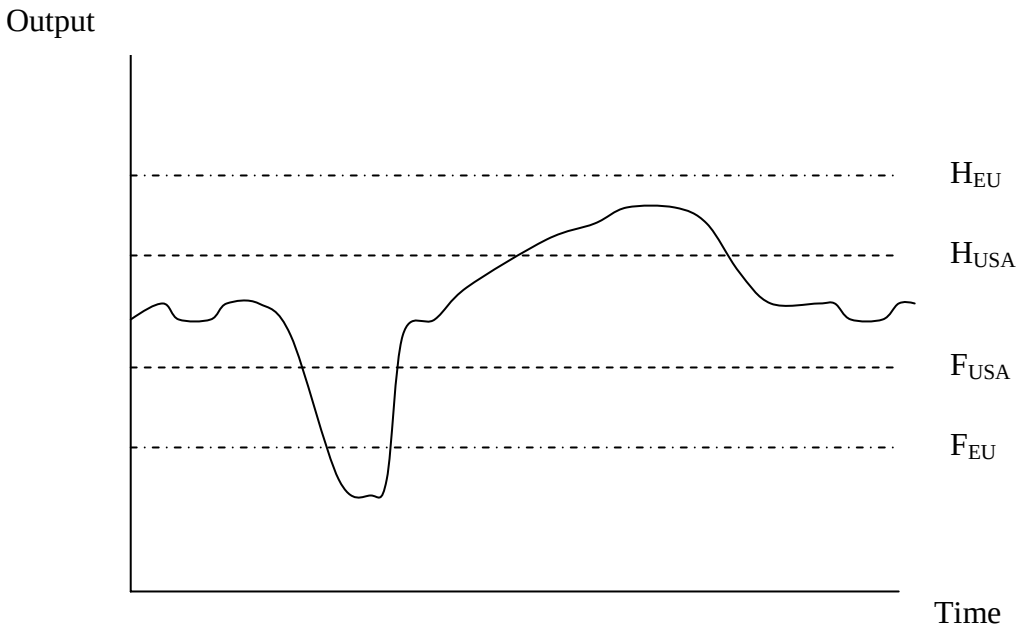

Figure 2

This is reflected in figure 2 where the hiring and firing margins, with respect to output, are narrower in the USA than in the continental EU. What is the association between figures 1 and 2? Well, at the start of the 1990s there was a global slowdown in output growth and a rise in unemployment. This would suggest that output fell below the firing margins in both countries, but that the rise in unemployment would be sharper in the USA and more protracted in the EU. Figure 1 concurs with this. However, output must recover to a much higher rate in the EU than the US for the economy to move back through the hiring margin.

It appears that the recovery in output during the late 1990s was sufficient to move through the USA hiring margin, but not through that of the EU. Therefore, unemployment would fall more quickly in the US, whereas the EU faces a more persistent rise in unemployment. The fact that the output recovery was stronger in the US than in continental EU would only strengthen these unemployment dynamics.