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JOB FLOW DYNAMICS AND FIRING RESTRICTIONS: EVIDENCE FROM EUROPE*

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We exploit homogeneous firm level data of manufacturing and non-manufacturing industries to study the impact of firing restrictions on job flow dynamics across 14 European countries. Our results suggest that more stringent firing laws dampen the response of job destruction to the cycle, thus making job turnover less counter-cyclical. Moreover, stricter EPL reduces both the creation and destruction of jobs in declining sectors relative to expanding sectors, implying that faster trend growth attenuates the impact of firing costs on firm's hiring and firing decisions.

How does the reallocation of factors of production behave along the business cycle? Are there significant differences across countries? Which are the determinants of such differences? Following Davis and Haltiwanger's (1990, 1992) seminal work, a large literature has emphasised the importance of labour reallocation and microeconomic heterogeneity for macroeconomic fluctuations. While the direction of causality is debatable,[1] the study of the behaviour of job reallocation over the business cycle is fundamental in order to understand economic fluctuations. Moreover, even if reallocation is just a consequence of the business cycle, understanding the nature and timing of job reallocation remains crucial to design the appropriate policy responses to recessions and, more generally, to business cycle fluctuations. Several studies in Anglo-Saxon countries clearly suggest that the reallocation of jobs presents a counter-cyclical pattern. During slumps the rate at which jobs are destroyed increases rapidly. Perhaps more surprisingly, job creation reacts slowly to economic downturns, sometimes even not declining at all. As a result, job reallocation (the sum of job creation and job destruction) is clearly counter-cyclical.[2]

This set of facts spurred the proposal of different theories consistent with the counter-cyclicality of reallocation. Caballero and Hammour (1994) show, within a vintage model of process and product innovation, that declines in demand are only partly accommodated by a reduction of job creation when fast creation of jobs in an industry is costly due to increasing creation costs. As a consequence, job creation is smoothed over the business cycle and job destruction is concentrated in recessions, implying a counter-cyclical pattern in the reallocation of jobs. In Mortensen and Pissarides (1994), counter-cyclical movements of job reallocation are generated by the

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[1] See Schuh and Triest (1998) for a discussion of the causality links between reallocation and business cycle fluctuations.

[2] See Davis and Haltiwanger (1992) and Davis *et al.* (1996) for the US manufacturing sector, Baldwin *et al.* (1998) for Canada and Konings (1995) for the UK.