Strict labor market regulation increases global unemployment, study shows

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This is a picture of a job center in the UK. Credit: Image by Jason Cartwright, Flickr

Tight labour market regulation increases unemployment all over the world, finds a study of 73 countries by the University of Bath.

The study, published in the Journal of Comparative Economics, is one of the first to cover not only industrial countries but also developing and transition countries.

Based on data for the years 2000 to 2003, the findings suggest that if, for example, Italy (a typical country with strict regulation) had enjoyed the same flexibility in labour market regulation as the United States (a typical country with flexible regulation), its unemployment rate might have been 2.3 percentage points lower among the total labour force, 3.4 percentage points lower among women and 5.6 percentage points lower among young people.

"The adverse labour market effects are probably due to lower investment by domestic firms as well as lower foreign direct investment inflows caused by stricter labour market regulation." said Dr Horst Feldmann, from the University's Department of Economics & International Development, who carried out the research.

One area of labour market regulation that appears to have particularly adverse effects on unemployment are stringent hiring and firing rules, the study finds.

While strict hiring rules restrict temporary work agencies and the use of fixed-term contracts, tight firing rules make it difficult and costly for employers to lay off workers.

According to the findings, these rules, as well as strict labour market regulation in general, have a particularly adverse impact on women and young people.

Dr Feldmann explained: "Women often take a career break to have children and later on try to get back into employment. Young people are just entering working life.

"Therefore, it is plausible that both groups are more strongly affected when employers are reluctant to hire staff due to stringent labour market regulation."

Another type of labour market regulation that appears to raise unemployment on a world-wide scale is military conscription, the study finds.

"A main reason may be that conscripts leaving the armed forces after the end of their service have difficulties finding a job because they did not gather the skills and work experience that employers are looking for." said Dr Feldmann.

"The longer the conscription period, the more severe this mismatch is likely to be. According to my findings, this effect is the strongest among young people. This is obviously because conscripts typically are in this age group.

"This is the first time the effects of military conscription on the labour market have been analysed."

Apart from the indicators that measure the strictness of hiring and firing regulation and the use of conscription, Dr Feldmann used indicators that measure the strictness of minimum wage laws, the centralisation of wage bargaining and the generosity of unemployment benefits.

His aggregate indicator measuring the overall strictness of labour market regulation is the average of these five individual indicators.

On average over the years 2000-2003, Italy's flexibility of labour market regulation (as measured by the aggregate indicator) was rated 3.6 out of 10 - while the United States was rated 7.2 and the United Kingdom was rated 6.8.

Dr Feldmann said: "The research suggests that the UK's fairly flexible labour market regulation is likely to strengthen the economy's resilience to weather the current crisis.

"Although unemployment is going to rise sharply for some time, countries with more flexible regulation will probably experience a faster and more pronounced fall in unemployment once the crisis is overcome."

Source: University of Bath