Labour Market Flexibility: More a Source of Macroeconomic Fragility than a Recipe for Growth

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During the years of the recent European crisis (and also before), the economic policy debate has been marked by the *need* of labour market structural reforms to boost productivity and GDP growth. This rhetoric has been particularly vivid in the European Union, especially during the current Euro crisis. And the call for such reforms finds support in the consensus among "mainstream" macroeconomists on the idea that labour market rigidities are the source of unemployment. The well-known OECD (1994) Jobs Study was among the first to advocate the benefits from labour market liberalization. The report and a series of subsequent papers basically argued that the roots of unemployment rest in social institutions and policies such as unions, unemployment benefits, employment protection legislation.

There is an alternative view, however, which we believe to be well in tune with Keynes himself, according to which, involuntary unemployment is the outcome of systematic *coordination failures* – in the current economic jargon –, whereby "bad equilibria", characterized by insufficient level of aggregate demand, are self-fulfilling in decentralised economies. In fact, wages are an element of cost affecting the competitiveness of individual firms. But the wage bill is

also a crucial element of aggregate demand. Hence it could be that more flexible and "fluid" labour markets, while allowing for faster inter-firm reallocation of labour and lowering costs, may also render the whole economic system more fragile, more prone to recession, more volatile. In a recent work ("When more Flexibility Yields more Fragility. The Microfoundation of Keynesian Aggregate Unemployment", *OFCE Working Paper* No. 2016-07, we investigate the conditions under which such a conjecture applies, by exploring to what extent labor market flexibility can led to coordination failures trapping the economy in stagnation.

The model we develop is built upon the Agent Based "Keynes meets Schumpeter" family of models (Dosi *et al*., 2010, Napoletano *et al*., 2012, Dosi *et al.*, 2013, Dosi *et al.*, 2015), explicitly incorporating different microfounded labour market regimes, populated by heterogeneous firms and workers who behave according to boundedly rational behavioural rules. We comparatively study two archetypical types of decentralised labour markets, which we shall call the *Fordist* and the *Competitive*, and variations thereof. Under the *Fordist regime* wages are insensitive to labour market conditions but indexed to productivity. There is a sort of lifetime employment (firms fire only when their profits are negative) matched by the loyalty of the workers to their employers (employed workers do not seek for alternative occupations). Labour market institutions contemplate a minimum wage indexed on productivity and unemployment benefits. Such a regime corresponds to the one experienced by France, among other Western industrial countries, during the "Trente Glorieuses". Conversely under (different shades of) the *Competitive regime*, wage changes respond to unemployment. Also employed worker with some probability search for notionally more rewarding jobs. Firms fire their excess workforce given their planned production. Minimum wages are only partially indexed to productivity, if at all and unemployment benefits might or might not be there. The Competitive regime tries to capture

the process of flexibilization of the labor market occurred in most Anglo-Saxon countries and in some continental European countries (e.g. the Netherlands) since the eighties.

First, we compare the Fordist regime with the most extreme version of the Competitive one, basically institution-free, with no employment protection and also with no minimum wage and no unemployment benefits. Note that the latter is the nearest to textbooks "market perfection". Well, we find that under such perfection the whole system is always near to collapse: the *long-term* rate of growth is close to zero and the *short-run* dynamics is equally dismal, with extremely high unemployment rates, higher overall volatility and higher inequality.

Next, we compare the Fordist regime with other milder forms of Competitive regimes, embedded nonetheless into institution of wage and income support. The Competitive set-ups show still an overall fragile and more prone to crises dynamics when compared to the Fordist, even in presence of active welfare policies. In fact, volatility of GDP, unemployment rate, likelihood of crises are significantly higher in the competitive scenarios. Conversely, the Fordist case is in full employment for about 60% of the simulation time. Finally, in the Competitive regimes with milder forms of welfare policies – lower (or zero) indexation of minimum wage on productivity growth and absence of unemployment benefits – productivity growth is significantly lower and inequality *even among workers* is higher, and the more so the lower the constraints in wage settings.

The model robustly shows that more flexibility in terms of variations of monetary wages and labour mobility is prone to induce systematic coordination failures, higher macro volatility, higher unemployment, and higher frequency of crises. In fact, it is precisely the downward flexibility of wages and employment – as profitable as it might be for individual firms – and the related higher degrees of

inequality that lead recurrently to small and big aggregate demand failures. This property, we suggest, is also at the heart of both the 1929 and 2008 crises, no matter what the triggering factors (often to be found at the financial level). Only when flexibility in wages and employment is accompanied by policy measures which mitigates the recurrent downward pressures, such as unemployment subsidies and minimum wage, the system does not collapse. Furthermore, contrary to the argument that higher labour flexibility fosters productivity growth, our model clearly shows the opposite: productivity in the Competitive regime grows, at *best*, at the same rate as in the Fordist one, but with higher volatility, unemployment and incidence of crises. Our results cast serious doubts on the agenda of structural reforms in labor markets advocated by the European Union and pursued by many European countries: more employment guarantees, more rigidities in firing rules, less wage inequality, more welfare protection are not only good for the workers' concern, but also for the economy as a whole.

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