Labour market regulations and capital labour substitution

Gilbert Cette\textsuperscript{1,2}, Jimmy Lopez\textsuperscript{1,3}\textsuperscript{*}, and Jacques Mairesse\textsuperscript{4,5}

\textsuperscript{1}Centre de recherche de la Banque de France – Banque de France – 31 rue Croix des petits champs 75001 PARIS - France
\textsuperscript{2}Aix-Marseille School of Economics (AMSE) – Ecole Centrale Marseille (ECM), Ecole des Hautes Études en Sciences Sociales (EHESS), Centre national de la recherche scientifique (CNRS) – GREQAM, Centre de la Charité, 2 rue de la Charité, 13236 Marseille Cedex 02, France
\textsuperscript{3}Laboratoire d’Economie de Dijon (LEDi) – Université de Bourgogne, CNRS : UMR6307, Inserm – Pôle d’économie et de gestion - 2 boulevard Gabriel - BP 26611 - 21066 DIJON CEDEX, France
\textsuperscript{4}Centre de Recherche en Economie et Statistique (CREST) – INSEE Paris – France
\textsuperscript{5}Maastricht University – Universiteitssingel 40:6200 MD Maastricht, Netherlands

Abstract

On the basis of a country*industry unbalanced panel data sample for 14 OECD countries and 18 industries covering the years 1988 to 2007, this study proposes an econometric investigation of the effects of the OECD Employment Protection Legislation (EPL) indicator on four investment components of total capital and two skill components of total labour. Relying on a difference-in-difference econometric approach, we find that an increase in EPL has: (i) positive and significant effects on the non-ICT and construction capital - labor ratio and the share of high-skill labour; (ii) non-significant effects on the ICT capital – labour ratio; (iii) negative and significant effects on the R&D capital – labour ratio and the share of low-skilled labour. These results suggest that firms consider that the strengthening of Employment Protection Legislation is equivalent to a rise in the cost of labour, resulting in capital-to-labour substitution in favour of non-ICT and construction capital relatively to ICT and R&D capital, and working at the disadvantage of low-skill relatively to high-skill workers. They indicate to the contrary that structural reforms for more labour flexibility weakening this legislation could have a favourable impact on firms’ R&D investment and their hiring of low-skill workers.

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\textsuperscript{*}Speaker