



EUROPEAN CENTRAL BANK

WORKING PAPER SERIES

NO 640 / JUNE 2006

BCE ECB EZB EKT EKP

**EMPLOYMENT
STICKINESS IN SMALL
MANUFACTURING
FIRMS**

by Philip Vermeulen



EUROPEAN CENTRAL BANK



WORKING PAPER SERIES

NO 640 / JUNE 2006

EMPLOYMENT STICKINESS IN SMALL MANUFACTURING FIRMS¹

by Philip Vermeulen²



In 2006 all ECB publications will feature a motif taken from the €5 banknote.

This paper can be downloaded without charge from <http://www.ecb.int> or from the Social Science Research Network electronic library at http://ssrn.com/abstract_id=905086



¹ This paper was mostly written while visiting the San Francisco Federal Reserve Bank. I thank the Economic Research Department for their inspiring environment. Discussions with Lanier Benkart, Mary Daly, Mark Doms, Richard Dennis, John Fernald, Oscar Jorda and John Williams were much appreciated. I also thank seminar participants at the ECB and at the San Francisco Federal Reserve Seminar. I further thank Stephanie Wang for excellent assistance. I also benefited from an anonymous referee. The opinions reflected in the paper are entirely my own, they do not necessarily reflect those of the ECB nor the Federal Reserve system. Any remaining errors are my own.

² DG-Research, European Central Bank, Kaiserstrasse 29, 60311 Frankfurt am Main, Germany; e-mail: philip.vermeulen@ecb.int

© European Central Bank, 2006

Address

Kaiserstrasse 29
60311 Frankfurt am Main, Germany

Postal address

Postfach 16 03 19
60066 Frankfurt am Main, Germany

Telephone

+49 69 1344 0

Internet

<http://www.ecb.int>

Fax

+49 69 1344 6000

Telex

411 144 ecb d

All rights reserved.

Any reproduction, publication and reprint in the form of a different publication, whether printed or produced electronically, in whole or in part, is permitted only with the explicit written authorisation of the ECB or the author(s).

The views expressed in this paper do not necessarily reflect those of the European Central Bank.

The statement of purpose for the ECB Working Paper Series is available from the ECB website, <http://www.ecb.int>.

ISSN 1561-0810 (print)
ISSN 1725-2806 (online)

CONTENTS

Abstract	4
Non-technical Summary	5
1 Introduction	6
2 Employment adjustment: the literature	10
3 Data	13
4 The model	18
5 Some model simulations	21
6 Estimation method	24
7 Results	25
8 Conclusion	32
References	33
9 Appendix	36
European Central Bank Working Paper Series	40

Abstract

Small firms often do not change their number of employees from year to year. This paper investigates the role of adjustment costs and indivisibility of labor in the employment stickiness of manufacturing firms with less than 75 employees. When small firms have to adjust employment in units of at least one employee, indivisibility becomes an important source of stickiness. A structural model of dynamic labor demand with adjustment costs and indivisibility is estimated using indirect inference on a panel of small French manufacturing firms. Adjustment cost are estimated to be very small. Indivisibility explains around 50% of the stickiness of employment, adjustment costs explain the other 50%.

Keywords: indivisibility, labor adjustment costs, employment, sticky employment, indirect inference

JEL Classification Number: E24

Non-technical Summary

The number of employees employed by a small firm has the tendency to remain constant from one year to the other. This tendency to remain constant can be explained by two factors. A first factor is the cost of employment adjustment. The second factor is the indivisibility of employment. The main aim of the paper is to infer the role of “adjustment costs “versus "indivisibility” behind the stickiness of employment for small firms and to provide quantitative estimates on the relative importance of both of them. The paper therefore first develops a theoretical structural model an of an imperfectly competitive firm with costly employment adjustment. The model parameters (the parameters determining the adjustment costs) are estimated to fit the employment and output dynamics of a set of 1902 French manufacturing firms. Once the structural parameter estimates are obtained it is analyzed how much of the stickiness of employment is caused by adjustment costs versus indivisibility.

For small firms both factors are about of equal importance. Costs of adjustment cause firms not to react to small productivity (or demand) shocks. Indivisibility of employment causes firms with few employees to increase or decrease their number of employees less frequently than firms with a lot of employees. Small shocks to demand or costs are not sufficient to induce firms with few employees to change the number of people working at the firm. The intuition for this finding is that hiring or firing a single employee represents a much larger percentage of the total workforce (and therefore productive capability) for a small firm than for a large firm so that larger shocks are needed to warrant hiring or firing one employee.

Two lessons for policymakers can be derived. Even the reduction of small adjustment costs (legal severance payments, e.g.) will induce more flexible hiring and firing in small firms. Second, such a reduction can not overcome the indivisibility problem small firms face. A flexible adjustment of hours worked is a necessity for small firms to react to productivity or demand shocks.

1 Introduction

This paper analyses the causes of employment stickiness at small manufacturing firms. Employment at the firm level can be sticky under certain types of adjustment costs. It is well known that a fixed hiring or firing cost (or both) causes episodes of non-adjustment (see e.g. Hamermesh, 1989). In the presence of fixed costs, it is optimal to wait until large enough shocks occur before adjusting employment. There is empirical evidence that employment adjusts in a infrequent but lumpy fashion (e.g. Caballero, Engel and Haltiwanger (1997)). A fact not often emphasized in the literature on dynamic labor adjustment is the indivisibility of employment. Indivisibility is potentially important for small firms. Firing an employee for a firm with 10 employees reduces 10% of the workforce whereas for a firm of 1000 employees this is only a 0.1% reduction. Even in the complete absence of hiring or firing costs one would expect the smaller firm with 10 employees to show higher employment stickiness as larger shocks are needed to get the same employment response of firing or hiring one employee. In the words of Hamermesh (1993) "*many firms are so small that these (=indivisibilities) become important...In a small firm experiencing a relatively small positive shock, hiring an extra employee may reduce profits even ignoring the adjustment costs that are incurred.*" In other words, non-adjustment in the number of employees might be optimal even in the complete absence of adjustment costs.

It is hard to overemphasize the importance of small firms in the European context. Of the approximately 140 million people, employed in the private enterprise sector in the EU, 57% are employed by enterprises with less than 50 employees¹. Small firms are therefore major players in the aggregate reallocation of employment. In the empirical literature on dynamic labor demand at the firm or plant level², indivisibility has received a lot less attention than adjustment costs as a reason for stickiness of employment. Usually, in estimated models of dynamic labor demand, labor can adjust smoothly, i.e. in infinitesimal amounts so that production functions and adjustment cost

¹SMEs in Europe 2003, Observatory of European SMEs, European Commission. Pages 25-26.

²A large empirical literature estimate labor demand at the aggregate or industry level where indivisibility is likely less of an issue. However, labor demand estimates based on aggregate or industry level data are unlikely to lead to realistic estimates of adjustment costs at the firm or plant level due to aggregation. A summary of earlier dynamic labor demand studies using firm level data is given in Hamermesh and Pfann (1996).

functions are differentiable. This assumption is likely a good one when firms are large, however, can be far from the truth when firms are small. This paper takes indivisibility seriously and investigates when the differentiability assumption is dropped and replaced with the assumption that labor can only adjust in units (i.e. one, two, three, etc....). This allows to investigate the role of adjustment cost and indivisibility simultaneously. Indivisibility is likely to be especially important for small firms when faced with negative shocks. Imagine demand for the firms output drops by 2% for both the firm with 10 employees and 1000 employees. The firm of 1000 employees is seen to fire 20 employees and the firm of ten employees does not fire. Does the firm with 10 employees face higher adjustment costs or does it simply face indivisibility (2% of 10 employees is 0.2 employees)? The firm with 1000 employees by firing 20 employees reduced its workforce by 2%, i.e. a magnitude identical to the negative demand shock. For the firm with 10 employees however, firing 1 employee would reduce its workforce by 10%, far too much to be optimal for a reduction in demand of 2%. So in the complete absence of adjustment costs, one would readily observe the large firm to adjust its workforce from year to year to accommodate demand shocks, whereas for the small firm employment would remain sticky. Ignoring the existence of indivisibility would wrongly lead to the conclusion that the small firm suffers from adjustment costs (in the number of employees). An alternative for the firm with 10 employees would be to reduce working time (with reduced pay!) of 2%, say 48 minutes for every worker on a workweek of 40 hours. Reduction of normal hours with reduced pay is however something that is observed not that often (at least not in such a flexible way). So where the firm with 1000 employees likely can reduce production costs and production workers with 2% more easily, this will likely not be the case for the firm with 10 employees. The reverse however, reacting to positive shocks with overtime of existing workers (with extra more than normal pay!) is generally more likely. However overtime is generally an expensive solution.

The paper first shows that employment (i.e. the number of people working at the firm) is indeed sticky for small firms. The main aim of the paper is to infer the role of the "adjustment costs story" versus the "indivisibility- no-adjustment cost story" behind the stickiness of employment for small firms and to provide quantitative estimates on the relative importance of both of them. The paper remains in the spirit of the dynamic labor adjustment literature and focuses on the adjustment in number of employees and not in hours. Almost the entire literature on dynamic labor adjustment focuses on

the number of employees. There is a simple reason for this, hours data at the firm level is very hard to find. So also this paper in line with the literature will maintain the common assumption that labour input into production can be proxied by the number of employees. In the appendix it is shown that relaxation of this assumption changes little of the main conclusions of the paper.

Without a theoretical model that combines adjustment costs, indivisibility and shocks to labor demand it is very difficult to disentangle the causes of stickiness. The paper therefore first develops a theoretical structural model incorporating all these elements. Using a large firm dataset of small manufacturing firms (all have less than 75 employees on average), the paper shows that the smaller the firm, the more likely its employment level will remain stable from one year to the next. The stickiness is quite pronounced for small firms and diminishes gradually as firms become larger. The estimation of the structural model shows that both adjustment costs and indivisibility explain this monotonic relationship between stickiness and size. As small firms employ a significant amount of the total labor force and produce a substantial amount of aggregate value added (especially in Europe), their employment stickiness is potentially important for the aggregate economy.

Being able to assess the relative importance between adjustment costs and indivisibility is quite important for both policymakers and macro modelers. For policy makers it is important to understand the extent to which adjustment costs explain the employment stickiness. It has often been argued that employment protection legislation and severance payments add to firing costs of firms. High firing costs would induce sticky employment behavior. If firing costs are at the center of the non-adjustment of small firms, a case could be made to policymakers to relax those cost as they create inefficiencies and output loss. Upon reduction of firing costs, firms should be seen both to hire and fire more often. However, if indivisibility causes non-adjustment of the employment level of small firms, hiring and firing will be little influenced upon a reduction of firing costs. If indivisibility is at the center of non-adjustment, it is likely that the firm will try to adjust along other margins, such as hours worked of its workforce. To the extent that overtime is expensive and reduction of time is regulated (or impossible), a relaxation of overtime and reduction of time regulation might be more relevant for small firms. It has to be noted however that stickiness (in terms of the number of employees at the firm) could actually increase when overtime and reduction of time regulation becomes more relaxed since firms could adjust labour input more easily without adjusting their number of employees.

Macro modelers should also be interested in employment stickiness and the reasons behind it. In most of the large macro-literature on inflation in a New-Keynesian framework, employment adjustment costs are absent. Firms adjust employment fully flexibly without any adjustment costs. However recently there has been renewed interest in developing the implications of lumpy adjustment in employment in a general equilibrium setting. King and Thomas (2003) develop a model that incorporates fixed employment adjustment costs at the individual firm level and that when aggregated resembles partial adjustment for employment. In recent empirical work, Tilmann (2005) has argued that adding adjustment cost to labor can greatly improve the empirical fit of the forward looking Phillips curve in the Euro area. Understanding the magnitude and form of the adjustment costs and the possible other reasons such as magnitude of shocks or indivisibilities at the firm level is therefore also relevant for macro economics. Also if most of the stickiness stems from small firms, modelling heterogeneous firms might be important.

In this paper the "adjustment cost" story versus the "indivisibility-no adjustment cost" story for non-adjustment of employment are investigated for a profit maximizing firm. This is done in a number of steps. First, a theoretical model of optimal employment decision is developed under the presence of adjustment costs. The adjustment cost literature has convincingly argued that the traditional convex cost are not sufficient to explain employment changes. The model therefore allows a relatively broad set of possible adjustment costs, namely fixed, linear and convex and also allows for differences in the cost of increasing versus reducing employment. The firm has to hire employees in complete units and therefore the model is not differentiable in employment and has to be solved numerically. Second, the model is estimated by indirect inference (Gourieroux, Monfort and Renault, 1993) and crucially the shock process is estimated simultaneously with the adjustment cost parameters. The indirect inference methodology essentially estimates the structural parameters of the model by matching the moments of the data with the moments of the model. This paper therefore goes beyond most of this literature in estimating a fully structural model of employment adjustment³. The model parameters are estimated to fit the employment

³Another paper that estimates a fully structural model on US data is Cooper, Haltiwanger and Willis (2003), They however do not concentrate on the stickiness of employment as the plant data concerns large plants of generally more than 500 employees.

and output dynamics of a large set of French manufacturing firms. Third, once the structural parameter estimates are obtained it is analyzed how much of the stickiness of employment is caused by adjustment costs versus indivisibility.

The rest of the paper is structured as follows. In section two, a brief overview of the employment adjustment literature is given, in section three the data is described, in section four and five the theoretical model is developed and some model simulations are provided to give insight into the model. Sections six and seven provide the estimation method and results. Section 8 concludes.

2 Employment adjustment: the literature

A large empirical and theoretical literature has investigated the dynamics of employment at the firm or plant level.⁴ The dynamics of employment at the firm level are usually explained by positing certain structures of adjustment costs. If adjustment costs are convex, employment will adjust frequently in small amounts but not in large amounts. The convex (and symmetric in hiring and firing) adjustment costs are the standard assumption of the early literature on dynamic labor demand (Sargent, 1978, Shapiro, 1986).

On the contrary, if adjustment costs are fixed or linear, employment adjusts infrequently and in large amounts. Bertola and Saint-Paul (1994) provide a theoretical model of linear adjustment costs. They show that both hiring and firing are less frequent when e.g. firing costs are increased. Hamermesh (1989) using monthly data on 7 manufacturing plants finds that adjustment costs in labor are best described by fixed costs. He finds further that plants production workers remain fairly constant over time, except for large changes when also output changes in large amounts. Davis and Haltiwanger

⁴In contrast to the paper here, a lot of the earlier empirical work on employment dynamics at the firm level using panel data does not provide direct estimates of adjustment costs. Rather in the early work the emphasis is on the dynamics of employments where in the estimates of the dynamic employment regressions it is impossible to retrieve the structural adjustment cost parameters. Early examples are e.g. Arellano and Bond (1991) and Nickell and Wadhvani (1991) for UK firms and Bresson, Kramarz and Sevestre (1992) for French firms.

(1990) show that in the LRD⁵ 25% of the employment growth rates lie in the interval $[-.05, 0.05]$ They unfortunately don't specify how high the percentage on zero adjustment is, so the 25% is an upper bound of the stickiness considered in this paper. Caballero, Engel and Haltiwanger (1997) find that a large number of plants in the US (in the LRD data) choose not to adjust their employment, even when shortages are large. Varejao and Portugal (2003) report that in a large sample of Portuguese plants 75% of the plants do not adjust employment from one quarter to the next. In a study on labor adjustment in Norwegian plants Nilsen et al. (2003) allow for fixed costs and fixed cost as function of size. They find fixed cost unrelated to plant size, so that inaction is larger for small firms.

Overall, the consensus of the literature thus far seems to be that adjustment of employment can not be explained by convex cost alone, one also needs fixed or linear costs. Second, adjustment costs are generally asymmetric (e.g. Pfann and Palm, 1993); where depending on the country, time period and sample sometimes hiring is more expensive than firing or the other way around. A summary of the literature up to the early nineties is given by Hamermesh and Pfann (1996).

In this paper the dynamics of labor adjustment on a set of French firms is investigated. A number of earlier papers have estimated the adjustment costs for French firms. Goux et al. (2001) use a panel of 915 French manufacturing firms for which they can measure the number of hirings and firings for indefinite and fixed term contract workers separately. They estimate the costs of employment adjustment for these two types of workers using a dynamic labor demand model with quadratic convex adjustment costs. For indefinite contract workers they find firing cost to be much higher than hiring costs (around 40 times higher). Their estimates unfortunately only allow to make these comparative statements. They do not allow to measure the absolute amount of adjustment costs. They also find that it is practically costless to adjust workers on fixed time contracts. Using survey data on actual severance payments and actual costs (such as training hours, expenses on job advertising, etc.) upon hiring, Abowd and Kramarz (2003) provide an analysis of hiring and firing costs for French firms. They conclude that for permanent contracts, the cost of hiring are much lower than the cost of firing. However the highest cost of firing are associated with collective termi-

⁵The LRD or Longitudinal Research Database, is a database from the US Census Bureau that contains detailed company-level statistics.



nations, which are reductions in employment of 10 employees or more. These are mostly relevant for larger firms not for the firms in the dataset used here, where reductions in employment of 10 persons are very rare. Based on two cross-sections Kramarz and Michaud (2004) revisit the findings of Abowd and Kramarz (2003). Again they find that collective terminations have the highest costs. They also find hiring cost to be small, for instance they mention that in two surveys of French firms that hire workers respectively 49% (for 1992) and 62% (for 1996) of the firms declare a zero hiring cost. It is hard to tell in advance the size of hiring or firing cost as most of these costs are hard to observe directly. In principle, in the case of hiring they include job advertising, interview cost and training cost of the employee and the cost of reorganizing work. Likewise, the cost of reducing employment includes besides legal severance payments, the cost of helping employee finding new job, and other costs. According to the OECD (OECD,2005), employment protection legislation is relatively strict in France. For permanent contracts (the standard contract in the law) dismissal procedures are highly restrictive in the sense that it is difficult to fire someone for economic reasons only. However, although it might be difficult to fire someone, legal severance payments are relatively low. For instance they amount only to less than 3 months of wage in case of a dismissal for economic reasons for someone with 15 years of seniority in a firm. Temporary contracts are much less restrictive, but however are restricted in their use. However Abowd and Kramarz (2003) argue that temporary contracts are the more common method of hiring, e.g. up to 80% of all hirings in 1992 according to their data, exactly to avoid the costs associated with terminating permanent contracts. Overall, the findings of the French literature suggest that hiring costs are likely low and firing cost are mostly high for collective terminations and for employees on indefinite term contracts. However they are low for fixed term contracts. The literature also suggests that fixed term contracts are therefore the preferred choice for hiring new employees. Recent estimates for the US suggest very low adjustment cost for labor (Hall, 2004 on industry level data) (Cooper, Haltiwanger and Willis, 2003 on firm level data).

An alternative explanation for the stickiness of employment is provided by indivisibility. However, the empirical literature on dynamic labor demand has not given much attention to this issue. This has naturally been the case as the data used in most of the literature have considered plants or firms larger than those considered here. E.g. in the work by Caballero, Engel and Haltiwanger (1997) and Cooper, Haltiwanger and Willis (2003) plants are

mostly larger than 500 employees. Others have argued for a minimum role of indivisibilities. Nilsen et al. (2003) mention indivisibilities as a potential explanation of non-adjustment, however dismiss the idea as "less plausible for plants of more than 25 workers".

3 Data

This paper exploits the annual accounts of 1902 small French manufacturing firms. The employment, sales and profit data is obtained from the AMADEUS database. The yearly employment level of these firms (in number of employees) are observed over the period 1995-2003, i.e. 9 years. As is the case with many databases used in the adjustment literature, the gross hiring and firing within the year are unknown so only the net change in the number of employees from year to year can be observed. All manufacturing firms have more than 10 and less than 75 employees on average over the period. The data are trimmed to remove outliers (see the appendix for the details about trimming.)

A limitation of the study (in which it is similar to most dynamic labor adjustment studies) is the absence of hours worked data. To the extent that a fixed employment level can produce different labor inputs by working more or less hours over the year, the stickiness measured by employment level might be overstating the stickiness of labor input. However aggregate yearly manufacturing data suggests that adjustment, over a year, takes place in terms of number of people working rather than hours. Over the period 1995-2003, the simple correlation of aggregate value added growth in manufacturing with employment growth is 0.32, while the correlation with total hours worked is only 0.16. Abraham and Houseman (1994) provide evidence that in Germany, France and Belgium first hours are adjusted rather than employment, at least in the short run. They ascribe this to costly employment adjustment. Aggregate measures of the number of hours worked per employed person show a trend decline in France by 8.5% over the period 1995-2003 (i.e. from 1558 hours to 1431 hours) (OECD, 2005). Hours declined every year except 1996.

Although one can not observe how many plants these firms have, considering they all have less than 75 employees, it is likely that most have just 1 plant. Despite what one might think, small firms are quite important in

terms of total value added in the French economy. According to the French statistical office, in manufacturing, firms below 20 employees produce around 10 percent of manufacturing output and firms between 20 and 250 employees produce another 25%. The numbers for services are much higher 30.4% and 22.2 % respectively.⁶Employment stickiness for these firms is therefore also likely of importance for the aggregate economy.

For the purpose of analysis the firms are split into five size groups according to the average number of employees over the period. The five size groups are defined using the following intervals ($[10,15[$, $[15,25[$, $[25,35[$, $[35,50[$, $[50,75[$). Although the intervals are chosen somewhat arbitrary they are large enough so that there are enough firms in each group and small enough so that the firms in each group can be considered to be of similar size. The number of firms in each group are respectively: 353, 532, 302, 448 and 267. For the purpose of the analysis in this paper all statistics are calculated as across firm averages.⁷

Figure 1 depicts the frequency distribution of the absolute (i.e. number of people) yearly employment changes for each firm group. A number of stylized facts can be seen looking at the distributions. One of the more striking features of the employment changes distribution is the frequent absence of adjustment, the mode of the distribution is always at zero for every group. Otherwise said, there are many periods in which employment does not adjust from one year to the other, i.e. stays fixed. The frequency of non-adjustment is 40% for firms in the first size group of 10 to 15 employees, implying that an average firm keeps employment fixed from one year to next in 40% of the years. This frequency of non-adjustment gradually declines and is 16% for the largest size group (50 to 75 employees). These numbers are similar to those found by Nilsen et al. (2003) on yearly Norwegian data. They find, for instance, that for plants of 25 workers or less the frequency on non-adjustment is 25%. So the first stylized fact is that the frequency of

⁶See table NATTEF09204.xls from INSEE website. By comparison, for the US, plants with less than 100 employees represent about 25% of employment in the manufacturing sector (Table IV, Davis and Haltiwanger, 1992)

⁷Each statistic is first calculated for each individual firm over the period 1995-2003 after which the average (across firms) of these statistics is calculated. For example, suppose the dataset consists of 3 firms, where firm 1 has a frequency of nonadjustment of $1/8$, firm 2 of $2/8$ and firm 3 of $4/8$. The sample frequency would be $1/3*(3/8+2/8+4/8)=3/8$.

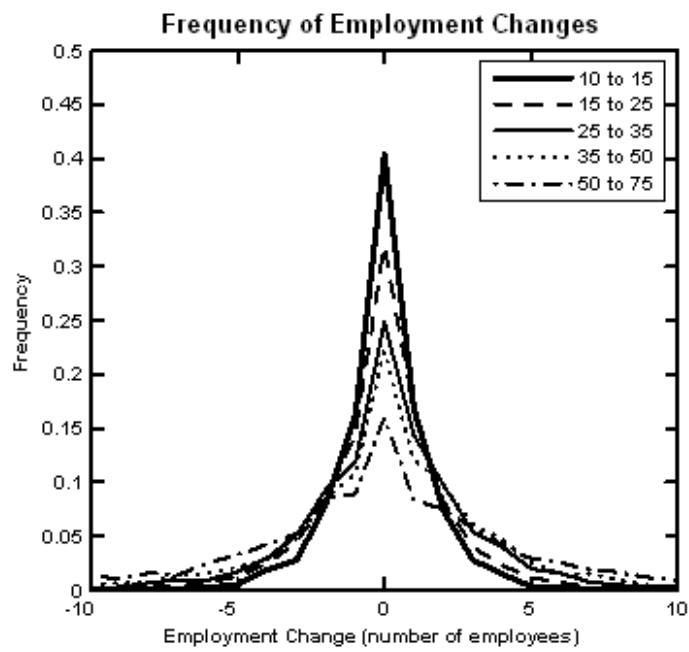


Figure 1: Frequency of employment changes

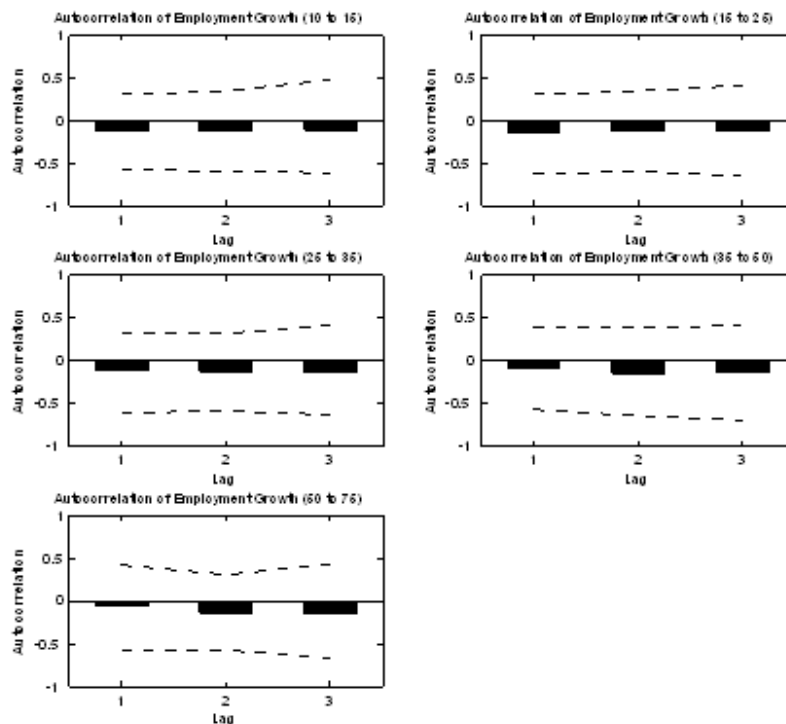


Figure 2: Autocorrelation of employment growth

inaction is high for all groups but gradually declines for larger firms. Second, firms do not adjust employment in large absolute amounts when they adjust. On the contrary, beside non-adjustment, adjusting employment upward or downward by just 1 employee is the most frequent, adjusting 2 employees is second most frequent, and so on. This seems initial evidence against large fixed costs, as such fixed cost would favour adjustment of employment in large amounts. Third, firms adjust approximately as frequently downward as they do upward.

Figure 2 shows the average autocorrelation of employment growth at lags one, two and three with 90% confidence bands (i.e. 90% of the firm level autocorrelations are within that band). In all size groups this autocorrelation

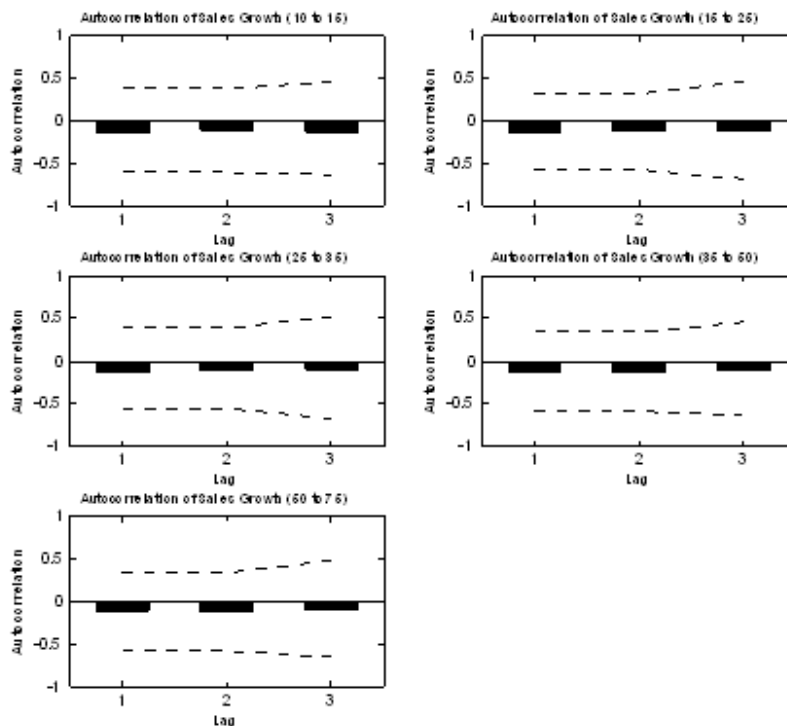


Figure 3: Autocorrelation of sales growth

is negative at all lags. High employment growth periods are followed by low periods of growth. The frequency of non-adjustment and the negative autocorrelation of employment are a first indication that a model of partial adjustment with only quadratic adjustment cost is unlikely to fit the data. Negative autocorrelation is expected when large adjustments are followed by non-adjustment. The average negative autocorrelation of employment growth at the firm level coincides with negative autocorrelation of output growth as depicted in Figure 3.

In the next section a theoretical model is developed of a profit maximizing firm. The aim is to estimate the parameters of the model such that they

match as closely as possible the features described above, the distribution of employment changes and the dynamics of employment and output.

4 The model

Consider an imperfectly competitive firm with costly employment adjustment. The firm's real output is given by the constant returns to scale Cobb-Douglas production function:

$$Y_{it} \equiv Y(A_{it}, K_{it}, L_{it}) = A_i e^{a_{it}} K_{it}^\alpha L_{it}^{1-\alpha} \quad (1)$$

where A_i is the productivity level of firm i and a_{it} a productivity shock. The productivity shock is exogenous and follows an AR(1) process

$$a_{it} = \rho_a a_{it-1} + \epsilon_{it}, \quad (2)$$

where ϵ_{it} is distributed normal with mean zero and variance σ_ϵ^2 .

The firm can adjust its number of employees L_{it} with a cost of adjustment given by the following function:

$$C(L_{it-1}, L_{it}) = I^h(\Delta L_{it})[H^f + H^l \Delta L_{it} + H^c I^h(\Delta L_{it})^2] \quad (3)$$

$$+ I^r(\Delta L_{it})[F^f + F^l |\Delta L_{it}| + F^c (\Delta L_{it})^2] \quad (4)$$

with $I^h(\Delta L_{it}) = 1$ if $\Delta L_{it} > 0$ and $I^h(\Delta L_{it}) = 0$ otherwise, and $I^r(\Delta L_{it}) = 1$ if $\Delta L_{it} < 0$ and $I^r(\Delta L_{it}) = 0$ otherwise. The function nests different cases of adjustment costs considered in the literature. First, costs are allowed to depend on the direction of change of employment, i.e. increase or reduction of employment matters so that cost asymmetries are allowed. Second, the cost of change in employment is a function of a fixed part, a linear part and a convex (quadratic) part.⁸ The production factor K_{it} has no adjustment costs and can be adjusted within the period. K_{it} should be considered here broadly as all other factors of production that can be adjusted within the period.

⁸In the literature, there are also other types of adjustment costs considered. E.g. Cooper et al. (2003) consider a disruption costs, where output is lower when employment adjusts

Demand for the firms output is given by the isoelastic demand function.

$$p_{it} = Y_{it}^{\xi-1} p_{i0} \quad (5)$$

with $0 < \xi < 1$. The price elasticity of demand is equal to $\frac{1}{\xi-1}$.

So output times price is given by $p_{it}Y_{it} = Y_{it}^{\xi-1} p_{i0}Y_{it} = p_{i0}Y_{it}^{\xi}$. Real profits⁹ at time t are given by

$$\Pi_{it} = p_{i0}(A_i e^{a_{it}} K_{it}^{\alpha} L_{it}^{1-\alpha})^{\xi} - W L_{it} - r K_{it} - C(L_{it-1}, L_{it}) \quad (6)$$

The firm maximizes the present value of the future flow of real profits discounted at a rate β . Profits can be normalized by the wage and after maximizing out the flexible production factor K_{it} the value function of the firm can be written as function of employment and the productivity shock only.¹⁰

$$\begin{aligned} V(a_{it}, L_{it-1}) &= \max_{\{L_{it}\}} A_i^* (e^{a_{it}})^{\frac{-\xi}{\alpha\xi-1}} L_{it}^{\frac{-(1-\alpha)\xi}{\alpha\xi-1}} - L_{it} - C^*(L_{it-1}, L_{it}) \quad (7) \\ &+ \beta E_{a_{it+1}|a_{it}} V(a_{it+1}, L_{it}) \quad (8) \end{aligned}$$

where A_i^* is just equal to A_i multiplied by a constant¹¹, $C^*(L_{it-1}, L_{it})$ is equal to $C(L_{it-1}, L_{it})$ up to a normalization by W . Adjustment costs can therefore be measured in terms of yearly real wages which are normalized to 1.

The value function has two state variables, current period productivity shock a_{it} and last periods employment L_{it-1} . Employment this period is the only control variable. The value function depends on twelve structural parameters: $\Theta = \{\alpha, \beta, A_i^* \xi, \rho_a, \sigma_\epsilon, H^f, H^l, H^c, F^f, F^l, F^c\}$. The 6 parameters

⁹Instead of productivity shocks one could alternatively model demand shocks leading to an identical profit function.

¹⁰The model assumes a constant real wage effectively assuming real wage rigidity. This implies that all fluctuations in employment are subscribed to productivity (or demand) shocks. At the firm level it is likely that employment fluctuations indeed stem mostly from productivity or demand shocks.

¹¹The constant is a function of A_i, r, W, α, ξ .

$H^f, H^l, H^c, F^f, F^l, F^c$ ¹² determine the form and level of adjustment costs. The productivity shock process is governed by the two parameters $\{\rho_a, \sigma_\epsilon\}$.

The effect of indivisibility

The indivisibility in the model is implied by L_{it} taking only values in the set of natural numbers $\{1, 2, 3, \dots\}$. When employment is indivisible, i.e. when it can only change in multiples of 1, firms will optimally not adjust employment in the face of small shocks *even in the complete absence of adjustment cost*. To see this, consider the static employment problem with indivisibility of labor. Indivisibility in employment creates 'jumps' in the marginal product of labor. Without indivisibility, firms will employ labor up to point where the marginal product of the last employee is equal to that employee's wage. However, with indivisibility, the marginal product of the last employee will be larger (or at best equal) than his/her wage. The marginal product of the next (not hired employee) lies below its wage. If the gap between the two marginal products is large enough, small shocks to the marginal product (e.g. productivity or demand shocks) will not lead to extra hiring or firing. The indivisibility can be seen as a real rigidity. It is optimal for the firm not to react (with hiring or firing) to small shocks to the marginal product.

The model makes the implicit assumption that the employment level also determines the level of employment input. Otherwise said yearly hours are fixed in this model. To a certain extent this will provide a maximal potential effect of indivisibility. Outside of the model are two possible ways of adjustment. First, firms could adjust by adding part-time workers. Say a firm with 10 full time employees could hire 0.2 workers if it could find a worker for 1 day per week. To the extent that this worker also has hiring or firing cost this might be too costly. Alternatively, workers could do overtime. However, overtime generally pays a premium in France of about 25% (10% for firms with less than 20 employees) making overtime quickly prohibitively expensive as a solution to increase yearly hours. Including those two margins in the model and investigating them would entail a much more detailed dataset that includes hours worked, hours paid (overtime and regular time) and employment levels in part-time versus full-time employees.

¹²One should write $H^{f*}, H^{l*}, H^{c*}, R^{f*}, R^{l*}, R^{c*}$ as they are the original parameter normalized by W . However from now on the $*$ is removed from the notation for convenience

5 Some model simulations

To understand the employment dynamics of the above model the results of a few simple parameterizations is presented in this section. By setting all six adjustment cost parameters $H^f, H^l, H^c, F^f, F^l, F^c$ equal to zero except one parameter, one can distinguish 6 baseline adjustment cost models: the fixed hiring cost model, the linear hiring cost model, the convex hiring cost model, the fixed firing cost model, the linear firing cost model and the convex firing cost model. The model without any adjustment costs is compared with these six basic adjustment cost models to illustrate the effect different adjustment cost have on the dynamics of employment.

Figure 4 shows how the policy function of the six adjustment cost models look like at the steady state employment¹³. On each graph in figure 4 the policy function of the adjustment cost model is shown (in bold) together with the policy function in the absence of adjustment costs. The policy function describes the employment change as a function of the shock a_{it} . The parameterization for this figure is $A_i^* = 2.297$, $\sigma_\epsilon = 0.0113$, $\rho_a = 0$, $\xi = 0.887$ and the adjustment cost parameters H^f, F^f are set consecutively equal to 0.10 and H^l, H^c, F^f, F^l, F^c are set consecutively equal to 0.05. Steady state employment of the non-adjustment model is 61 employees.

A number of facts can be seen. First the staircase pattern of the no-adjustment cost policy function is due to indivisibility, employment has to change in natural numbers $\{1, 2, 3, \dots\}$. Second, adjustment costs have two-sided effects. I.e. hiring costs lead also to non-firing in the face of small negative shocks and firing costs also lead to non-hiring in the face of small positive shocks. The reason is simply that shocks are temporary so that current hiring implies expected future firing and current firing implies expected future hiring. Fixed hiring costs cause the firm to not react to small positive and (small) negative shocks (i.e. the employment change is zero) and react once shocks become large enough. Linear hiring costs have a similar no reaction to small shocks effect. However in addition when adjustment takes place it occurs in smaller amounts than the non adjustment model for a given shock. Convex hiring cost also firms don't react to small shocks and react also less than the fixed and linear cost models to larger shocks. It is notable that the convex cost model also small shocks firms do not change

¹³Note that the steady state employment level is different depending on the adjustment cost model. Generally, the non-adjustment cost model has the larger steady state employment level

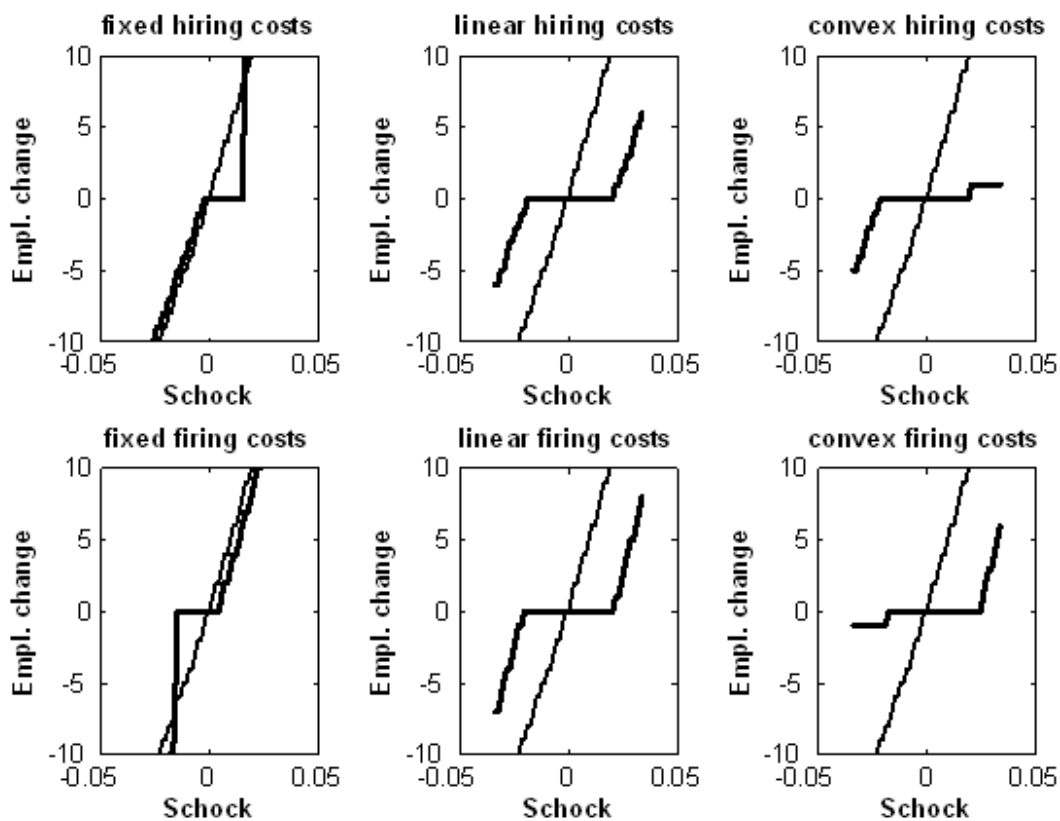


Figure 4: Comparison policy function no-adjustment cost model with 6 adjustment cost models

employment. The convex hiring schedule is actually identical to the linear hiring cost schedule up to a certain level of the shock. After that react with smaller adjustments towards large shocks than linear hiring cost model.

Table 1: Moments of employment changes for different adjustment cost models

	Frequency					std. dev. empl. growth	autocorr. empl. growth
	non adjust.	+1 empl.	-1 empl.	+5 empl.	-5 empl.		
Data*	0.40	0.17	0.16	0.0035	0.0057	0.13	-0.13
no adj. costs	0.27	0.20	0.19	0.0039	0.0071	0.13	-0.16
$H^f = 0.01$	0.43	0.05	0.17	0.0057	0.0053	0.13	-0.14
$H^l = 0.01$	0.44	0.17	0.16	0.0032	0.0032	0.11	-0.08
$H^c = 0.01$	0.42	0.32	0.15	0	0.0025	0.09	-0.01
$F^f = 0.01$	0.43	0.19	0.04	0.0039	0.0085	0.13	-0.13
$F^l = 0.01$	0.43	0.17	0.16	0.0039	0.0028	0.10	-0.05
$F^c = 0.01$	0.40	0.15	0.31	0.0032	0	0.08	0.02

The data are for comparison from group 1 , [10,15[employees

The policy functions shown above tell what happens after a shock, however do not provide insight into how the distribution of employment changes will look like if one simulates the model for a large set of firms. Table 1 contains the outcome of a set of simulations of the model (353 firms for 9 years) again under different scenarios for the adjustment cost parameters. I.e. the 6 basic models are simulated. Each time the adjustment cost parameter is set equal to 0.01. (The parameterization for table 1 is $A_i^* = 1.7399$, $\sigma_\epsilon = 0.0147$, $\rho_a = 0.8999$, $\xi = 0.8912$, which are equal to the estimated parameters for group 1) It is noteworthy to see what this implies. For instance consider hiring costs. For all three hiring cost models (fixed, linear, convex) changing employment by 1 employee will cost 1% of a yearly wage. However the hiring of two employees will still cost 1% for the fixed cost model whereas it will cost 2% for the linear and 4% for the convex cost model.

Table 1 compares the frequency of non-adjustment, the frequency of adding (reducing) by 1 or 5 employees, the standard deviation of employment growth and the autocorrelation of employment.

The first finding that can be derived from the simulation exercise is that all adjustment costs increase the frequency of non adjustment compared to the non-adjustment case. The frequency of non-adjustment is lowest in the absence of adjustment costs. However, importantly, even in the non-adjustment cost model the frequency of non-adjustment is not zero. It is still 27%. This is entirely due to indivisibility of employment. Non surprisingly, the frequency of hiring 1 employee is lowest in the case of fixed cost, while it is highest in the case of convex hiring adjustment costs. Symmetrically,

reducing one employee is lowest in the case of fixed firing costs and highest in the case of convex firing cost. The table also illustrates the well known effect of convex costs to reduce the frequency of large adjustments. Again, one-sided costs generally reduce the frequency of adjustment at both sides. Employment growth is most volatile in the absence of adjustment costs and least volatile in the presence of convex costs. Also, the autocorrelation of employment is lowest (i.e. most negative) in the absence of adjustment costs. The effect of linear adjustment costs are usually somewhat between fixed and convex costs.

6 Estimation method

The structural parameters of the model are estimated using the indirect inference method as explained in Gourieroux, Monfort and Renault (1993). Essentially the above model can be written succinctly as:

$$Y_{it}, = f^y(L_{it-1}, a_{it}, \Theta) \quad (9)$$

$$\Pi_{it}, = f^\pi(L_{it-1}, a_{it}, \Theta). \quad (10)$$

$$L_{it} = f(L_{it-1}, a_{it}, \Theta) \quad (11)$$

$$a_{it} = \rho_a a_{it-1} + \epsilon_{it} \quad (12)$$

where $\Theta = \{\alpha, \beta, A_i^* \xi, \rho_a, \sigma_\epsilon, H^f, H^l, H^c, F^f, F^l, F^c\}$.

The estimation of Θ consist of a number of steps. In a first step, for a given set of parameter values Θ the value function above is solved using value function iteration. (see e.g. Judd 1998, page 412). The state space of employment is discrete and consists of a subset of the natural numbers¹⁴ The AR(1) productivity shock process is transformed into a discrete Markov process on a very fine grid of 51 points using Tauchen (1986). The solution gives the policy function, i.e. the function $f(L_{it-1}, a_{it}, \Theta)$ (and immediately also f^y, f^π). Given the solution of the model and initial condition $L_{it} = L_0$, it is possible to simulate values of $\widehat{S} = \{\widehat{L}_{it}, \widehat{Y}_{it}, \widehat{\Pi}_{it}, \dots, \widehat{L}_{it+9}, \widehat{Y}_{it+9}, \widehat{\Pi}_{it+9}\}_{i=1}^N$, i.e. to simulate an artificial dataset, where N is the number of firms in the dataset.¹⁵ This simulation is done drawing simulated values of a standard

¹⁴The upper bounds on the employment state space should be wide enough so that the solution is not influenced by them.

¹⁵In practice the first 100 years of the simulation are dropped so that the initial condition becomes immaterial.

normal distribution which are then multiplied by σ_ϵ to obtain $\{\hat{\epsilon}_{it}, \dots, \hat{\epsilon}_{it+9}\}_{i=1}^N$. On both the actual data and the simulated data a set of moments (in the case here there are 21 moments) $\{M_{jN}\}_{j=1}^{21}$ and $\{\widehat{M}_{jN}(\Theta)\}_{j=1}^{21}$ respectively is calculated.

The indirect estimator of Θ is defined as $\widehat{\Theta}$, the solution of the quadratic loss function:

$$\min_{\Theta} [M_{1N} - \widehat{M}_{1N}(\Theta) \ M_{2N} - \widehat{M}_{2N}(\Theta) \dots M_{21N} - \widehat{M}_{21N}(\Theta)] \Omega \quad (13)$$

$$[M_{1N} - \widehat{M}_{1N}(\Theta) \ M_{2N} - \widehat{M}_{2N}(\Theta) \dots M_{21N} - \widehat{M}_{21N}(\Theta)]' \quad (14)$$

where Ω is a positive definite matrix. For the estimation the identity matrix is used. The moments taken cover both the distribution of the employment adjustments as the dynamics of employment and output. First, one would want the estimated model to match the distribution of employment adjustment as depicted in Figure 1, i.e. the frequency distribution over the range $[-5, +5]$. This gives 11 moments (i.e. the frequency of an adjustment of -5 employees, -4 etc. up to +5 employees). The distribution of employment changes however does not reveal the dynamics of employment adjustment across time. To that extent 3 additional moments are calculated, the autocorrelation of employment growth (in logs) at lags 1, 2 and 3. To also match the dynamics of output, autocorrelation of output growth (in logs) at lag 1, 2, 3 are calculated as well. Finally, 3 other moments are added: the average level of employment, the average level of profits (divided by total wages) and the standard deviation of employment growth.

To avoid estimating too many parameters, the discount rate β is set equal to 0.93 throughout the whole exercise. Likewise α is not estimated but is set equal to 0.33 throughout. This leaves 10 parameters to estimate.

7 Results

For each of the size groups the model above is estimated. The five estimated models (one for each group of firms) fit the data very closely. The estimated moments are very close to the data moments for each of the five estimated models. Figure 5 compares the frequency distribution of employment changes, the autocorrelation of employment growth and of sales between the estimated models and the data. Table 2 compares the data moments with the moments of the estimated model for the average employment level (in

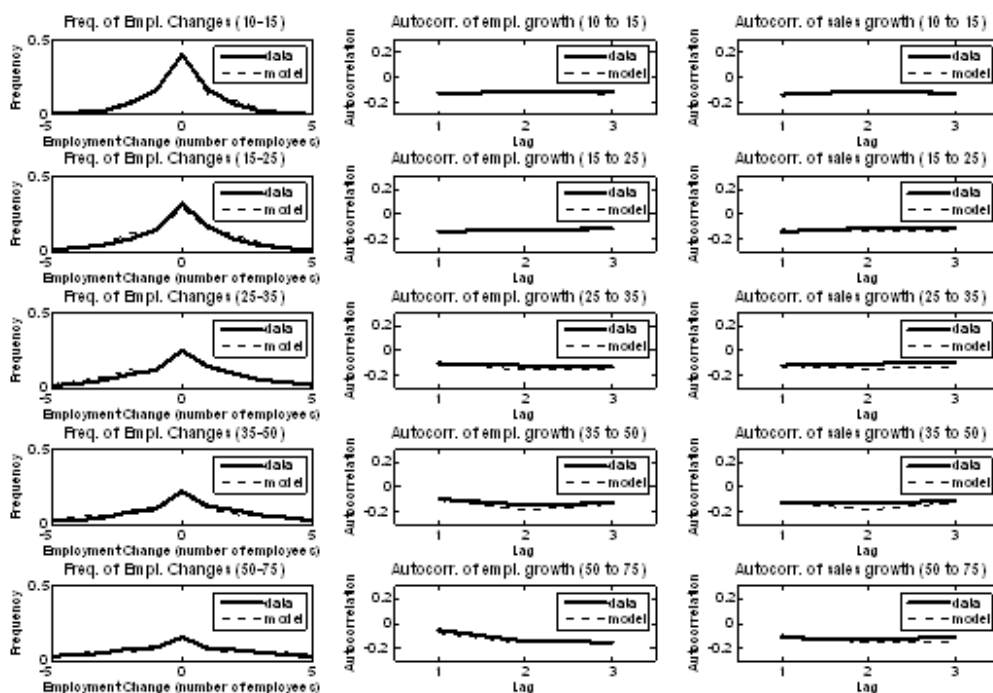


Figure 5: Moments of the data versus the estimated model

logs), the standard deviation of employment growth, the standard deviation of output growth and the profit margin.

Table 2: Data moments versus moments of estimated model

	[10,15[	[15,25[	[25,35[	[35,50[	[50,75[
av. empl (logs) model	2.50	2.93	3.38	3.76	4.11
av. empl (logs) data	2.49	2.95	3.38	3.73	4.11
st. dev. empl growth model	0.12	0.10	0.09	0.09	0.08
st. dev. empl growth data	0.13	0.12	0.10	0.09	0.09
st. dev. outp. growth model	0.14	0.11	0.10	0.10	0.09
st. dev. outp. growth data	0.16	0.14	0.14	0.14	0.14
profit margin model	0.18	0.22	0.20	0.22	0.19
profit margin data	0.18	0.22	0.21	0.22	0.19

The structural parameters of the model can essentially be divided into two subgroups. The first group are the production and demand parameters $\{A^*, \xi, \rho, \sigma_\epsilon\}$. The second group are the adjustment cost parameters $\{H^f, H^l, H^c, F^f, F^l, F^c\}$. The production and demand parameter estimates are presented in Table 3a. They have all very small standard errors (not reported).

Table 3a Structural Parameters Estimates

Size classes	Production and demand			
	A^*	ξ	ρ	σ_ϵ
Class 1 [10,15[	1.74	0.89	0.90	0.01
Class 2 [15,25[	2.09	0.87	0.88	0.01
Class 3 [25,35[	2.12	0.88	0.55	0.01
Class 4 [35,50[	2.43	0.87	0.56	0.01
Class 5 [50,75[	2.30	0.89	0.77	0.01

All parameters are significant at the 99% level

In the theoretical model, holding the other parameters constant, an increase in the parameter A^* (which is a function of the productivity level) will increase the steady state size of the firm. It is therefore not surprising that it is generally estimated to be larger for the larger firm groups than the smaller firm groups. The estimates of the demand curve parameter ξ are very similar across firm groups (in the range 0.86 to 0.89). They imply an elasticity of demand, between 7 and 9. This is quite close to other estimates

in the literature. Estimating a full general equilibrium model using US data, Rotemberg and Woodford (1997) find an elasticity of 7.88 and argue that this estimate is quite plausible. The autocorrelation of the productivity shocks is determined by ρ . For all size groups productivity shocks are highly positively autocorrelated with an estimate of ρ ranging from 0.55 to 0.90. The standard deviation of productivity shocks ϵ_{it} are also similar in size across groups. The standard deviation is around 0.01.

The estimates of the adjustment cost parameters are presented in Table 3b. The adjustment cost parameters estimates imply small adjustment costs in absolute terms. Contrary to what the non-adjustment frequencies might have suggested, the point estimates of the fixed hiring costs are very small (and sometimes even negative). The smallest firm group (10,15 employees) has the largest (and significant) fixed cost parameter estimate at 0.0045, implying a fixed cost of 0.45% of a yearly wage. Otherwise said, imagine a yearly wage of 50000 euro, this would imply a fixed hiring cost of 225 euro. The point estimates of the linear and quadratic hiring costs are also very small. Group 5 has the largest (and significant) estimate of linear hiring costs at 0.2% of a yearly wage per hired worker. Group 3 has the largest convex cost parameter estimate at 0.0003 implying a convex cost of 0.03% per worker hired (squared). Also, the firing cost parameter estimates are generally not large, they are of the same order of magnitude as the hiring cost parameter estimates. For each given firm group, not all cost parameters are significantly different from zero. This implies that the model seemingly does not need 6 parameters to fit the data well. Looking at the individual parameters however is misleading as the total cost of hiring or firing consists of the sum of a fixed, a linear and a convex part. What matters to the firm is to the total cost of hiring or firing. E.g. it is not because point estimates of some fixed costs parameters are sometimes negative that total costs are negative as total costs are the sum of fixed, linear and convex costs! To understand what the individual coefficients imply in terms of the total cost curve, Table 4 presents the costs of increasing or decreasing (in terms of 1 yearly wage) employment by 1 or 5 employees. The numbers in table 4 reaffirm the message of the individual point estimates namely that hiring and firing cost are not large. Hiring or firing 1 employee is not very costly and is between -0.2% and 0.5 % of a yearly wage for hiring and 0.1% and 0.8% for firing. Firing 5 employees costs between 0.4 and 4.2% of a yearly wage bill. Hiring 5 employees costs between -0.6% and 1.2% of a yearly wage bill.

Why are estimated hiring and firing costs so low? With respect to hiring cost the evidence of Kramarz and Michaud (2004) also mentioned above suggest that around 50% of the firms declare a complete absence of hiring costs. Interestingly, Kramarz and Michaud (2004) in their estimations also find that fixed hiring costs are very small and even negative on average. This is consistent with the finding of very low hiring costs in this paper. With respect to firing costs, a possible explanation is the use of temporary contracts. Although the type of contract is not observed in the dataset used here, Abowd, Corbel and Kramarz (1997) state that for France two-thirds of all hiring is on short-term contracts and more than half of separations are due to the ending of these short-term contracts. Goux et al. (2001) note that in 1992, about 80% of all hirings in private firms were made through fixed-term contracts. Despite legal restrictions on short time contracts, the numbers above suggest that they are used quite often in France. The findings of Goux (2001), Kramarz and Michaud (2004) and Abowd and Kramarz (2003) suggest that hiring and firing on fixed term contract has low adjustment costs. Goux et al (2001) argue that European employers can now bypass the regulations of dismissals by offering fixed-term instead of indefinite-term contract. Also, small firms might be less likely to give severance payments above those required by law (which are low) than large firms. The low levels of hiring and firing cost might therefore not be so surprising after all. Evidence from other countries also suggests that labor adjustment costs might be low. Cooper, et al. also find evidence of very small quadratic adjustment costs for the US.

The finding that absolute adjustment costs are low does not imply they are unimportant for the dynamics of employment. Even small adjustment cost can have large implications for the dynamics of employment (In the same vein that small menu costs can have large effects on pricing and output (Mankiw, 1985)). The high elasticity of demand implies that the marginal profits are sensitive to small changes in costs. This implies that small adjustment costs can have large effects. Especially the effect on the frequency of non-adjustment might be quite large. A (seemingly) small adjustment cost can make the difference between hiring or not hiring (or firing and not firing).

Table 3b Structural Parameters: Adjustment Costs

Size classes	H^f	H^l	H^c	F^f	F^l	F^c
Class 1 [10,15[	0.0045	0.0000	0.0000	0.0030	0.0007	-0.0001
Class 2 [15,25[	0.0016	-0.0011	-0.0001	0.0028	0.0002	0.0001
Class 3 [25,35[	-0.0016	0.0012	0.0003	0.0024	0.0025	0.0011
Class 4 [35,50[	-0.0006	-0.0015	0.0001	0.0002	0.0077	0.0001
Class 5 [50,75[	0.0001	0.0020	0.0001	-0.0007	0.0019	0.0001

Parameter estimates significantly different from zero at the 99% level are in bold

Table 4 The costs of changing employment *

Size classes	-5	-1	+1	+5
Class 1 [10,15[	0.4	0.4	0.5	0.5
Class 2 [15,25[	0.6	0.3	0.0	-0.6
Class 3 [25,35[	4.2	0.6	0.0	1.2
Class 4 [35,50[	4.1	0.8	-0.2	-0.6
Class 5 [50,75[	1.1	0.1	0.2	1.0

*The cost are in % terms of 1 yearly wage

One of the main aims of the paper is to provide a test whether the "shocks-adjustment costs story" versus the "indivisibility- no-adjustment cost story" is behind the stickiness of employment for small firms and in addition to provide quantitative estimates on the relative importance of both of them. The estimated model contains both the effect of indivisibility and adjustment costs. A key question is: What if adjustment cost would not just be very small but effectively zero? What would happen to the frequency of non-adjustment? The way to disentangle the effect of indivisibility from the effect of adjustment costs on the frequency of non-adjustment is to calculate the frequency of non-adjustment under different parameter assumptions. By altering the estimated model parameters, especially the adjustment cost parameters, one can see what happens with the frequency of non-adjustment.

This results of this exercise is shown in Table 5. Table 5 shows what happens with the frequency of non-adjustment in the estimated model when certain structural cost parameters are set to zero instead of their estimated value and all other estimated parameters are left unchanged. Given, the estimation of a structural model, the Lucas critique does not apply. When all adjustment costs are set to zero, one is left with the pure effect of indivisibility (conditional though on the variance of the shock process). Table 5 also

shows the frequency of non-adjustment in the data versus the fully estimated model. The estimated model (including the adjustment costs) matches quite closely the frequency of non-adjustment in the data for all firm groups. The last three columns of table 5 show the frequency of non-adjustment upon setting respectively firing cost, hiring cost and all hiring and firing cost to zero in the estimated model. It has often been argued that the high levels of protection of workers against firing in Europe would perversely cause firms also to hire less and therefore cause more sticky employment. Essentially, are the firing costs causing non-adjustment? The difference in the non-adjustment of the estimated model and the model with firing cost equal to zero gives an estimate of the magnitude purely caused by firing costs. Firing cost are indeed causing employment to become more sticky than it otherwise would be in the absence of firing costs. For instance, the smallest firm group would adjust 6.1% more often (39.6%-33.5%) in the absence of firing costs. Nevertheless still a substantial amount of non-adjustment remain even in the absence of adjustment costs. This non-adjustment is entirely due to indivisibility. Table 5 shows clearly that indivisibility becomes less and less important as firms get larger. Where firms of the first group (10-15 employees) would not adjust employment in 27% of the years in the absence of adjustment costs, this would only be 6.7% for firms of the 5th group (50-75 employees). Indivisibility clearly explains more than 50% of the frequency of non-adjustment for firms below 25 employees.¹⁶

Table 5 Frequency of non-adjustment: estimated model versus data

Size classes	Data	Est. Model	Est. Model $F^f, F^l, F^c = 0^*$	Est. Model $H^f, H^l, H^c = 0^*$	Est. model $F^f, F^l, F^c, H^f, H^l, H^c = 0$
Class 1 [10,15[	40.4	39.6	33.5	32.9	27.2
Class 2 [15,25[	32.0	29.3	22.3	29.2	22.0
Class 3 [25,35[	24.9	24.1	11.5	24.3	12.0
Class 4 [35,50[	22.2	21.4	4.7	26.3	9.9
Class 5 [50,75[	16.0	15.5	11.7	10.9	6.7

* The Model (adj. cost=0) has the same parameters as the estimated model except all cost parameters

¹⁶One could ask what happens if one relaxes the assumption that labour input is identical to the number of employees. I.e. what if 10 employees really are 9 employees and 1 employee working 4 hours instead of 40. The main conclusions of the paper still hold (see appendix).

The policy implications are that even seemingly small hiring or firing costs can have large effects. They induce firms to not adjust employment as often as they would otherwise. However, in addition, for firms of the size in this paper, i.e. below 75 employees, other margins of employment adjustment are necessary to be able to fully react to demand or productivity shocks. Simply due to indivisibility small firms will often not hire or fire. The existence of fixed term contracts does not alter this result. Flexibility in working hours (even over periods as long as 1 year) are therefore necessary for those firms to fully exploit profit opportunities that small shocks give them. However, overtime is generally expensive so that at current juncture it is unlikely to be a margin that can be used to the full extent. It is possible that many small firms have (unreported) usage of 'unpaid overtime' or 'extra effort' as an answer to the indivisibility problem they face. The results in the paper clearly show that small firms have a reduced adjustment at the margin of the number of employees compared to larger firms due to indivisibility. Adjustment costs do not even seem to be the most important factor for the smallest firms. The results in this paper also have macro implications. In France, 10% of manufacturing value added is produced in firms with less than 20 employees, for services this is even 30% (in construction even 53%). If demand growth is low (say 1%) these firms will optimally not hire any new people so that indivisibility is potentially an explanation of periods of jobless growth. Jobless growth should be more prevalent in countries where small firms are more important in terms of value added. The results in this paper do beg the question of how small firms do adjust. Much more research is needed in this respect. Does the indivisibility imply small firms adjust more on hours or do they adjust more by hiring part-time or temporary workers? This research however will require much more detailed information on hours worked, temporary workers hired and so on.

8 CONCLUSION

Small firms frequently do not adjust their employment level from year to year. Adjustment costs in terms of hiring and firing costs are only part of the reason. This paper has shown that hiring and firing costs are relatively small. However small cost do reduce the frequency of adjustment substantially. The smaller firms are, the less often they adjust their employment level. A substantial fraction of the non-adjustment stems from indivisibil-

ity. It does not pay for small firms to react to small shocks to hire or fire individual workers even in the absence of adjustment costs. To what extent adjustment on other margins such as the hours worked or effort, given overtime legislation, provide a profitable alternative adjustment mechanism for small firms remains an open question. Two lessons for policymakers can be derived. Even the reduction of small adjustment costs (legal severance payments, e.g.) will induce more flexible hiring and firing in small firms. Second, such a reduction can not overcome the indivisibility problem small firms face. A flexible adjustment of hours worked is a necessity for small firms to react to productivity or demand shocks.

References

- [1] Abowd John M. and Kramarz F, 2003, The cost of hiring and separations, *Labour Economics*, 499-530.
- [2] Abowd Corbel, Kramarz, 1997, The Entry and Exit of Workers and the Growth of Employment: An Analysis of French Establishments , *The review of economic and Statistics*, 1999, 81, 170-187.
- [3] Abraham Catherine, and Houseman, 1994, ' Does employment protection inhibit labor market flexibility? Lessons from Germany, France and Belgium, in R. Blank ed., *Social protection versus economic flexibility: Is there a trade-off?*, Chicago University Press, Chicago.
- [4] Arrellano, M and S.R. Bond, 1991, "Some tests of specification for panel data: Monte Carlo Evidence and an application to employment equations", *Review of Economic Studies* 58, 277-297.
- [5] Bentolila S and G. Saint-Paul, 1994, A model of labor demand with linear adjustment costs, *Labour Economics*, 1, 303-326
- [6] Bresson G., F. Kramarz and P. Sevestre, 1992, Heterogeneous labor and the dynamics of aggregate labor demand: Some estimations using panel data, *Empirical Economics*, 17, 153-168.
- [7] Caballero Ricardo, Engel Eduardo, John Haltiwanger, 1997, Aggregate employment dynamics: Building from microeconomic evidence, *American Economic review*.

- [8] Cooper, Russell, John Haltiwanger and Jonathan Willis, 2003, Dynamics of labor demand: evidence from plant-level observations and aggregate implications, mimeo
- [9] Davis Steven, John Haltiwanger, 1992, Gross job creation, gross job destruction and employment reallocation. *Quarterly journal of economics*, Vol 107, N03, pp 819-863
- [10] OECD Economic Surveys, France, 2005.
- [11] Gourieroux C., Monfort A. and E. Renault, 1993, Indirect Inference, *Journal of applied econometrics* 8, 85-118.
- [12] Goux Dominique, Maurin E. and M. Pauchet, 2001, Fixed-term contracts and the dynamics of labour demand, *European Economic Review*, 45, 533-552.
- [13] Hall Robert, 2004, Measuring factor adjustment costs, *Quarterly Journal of Economics*, 899-927
- [14] Hamermesh, Daniel S. and Gerard A. Pfann, 1996, Adjustment costs in factor demand, *Journal of Economic Literature*, Vol XXXIV, 1264-1292.
- [15] Hamermesh, Daniel S., 1989, Labour demand and the structure of adjustment costs, *American Economic Review*, Vol 79, no4.
- [16] Hamermesh, Daniel S., 1993, Labor demand, Princeton University Press.
- [17] Judd Kenneth J., 1998, Numerical Methods in Economics, MIT Press.
- [18] King Robert G. and Julia K. Thomas, 2003, "Partial adjustment without apology", NBER Working Paper N. 9946
- [19] Kramarz, Francis, Michaud Marie-Laure, 2004, The shape of hiring and separation costs, 2004, IZA Discussion Paper 1170.
- [20] Mankiw, Gregory, 1985, Small Menu costs and large business cycles: A macroeconomic model of monopoly, *Quarterly Journal of Economics*, Vol 100, May.
- [21] Nickell S.J. and Wadhvani S., 1991, Employment determination in British Industry: Investigations using micro-data, *Review of Economic Studies* 58, 955-969.

- [22] Nilsen Oivind Anti, Salvanes Kjell and Fabio Schiantarelli, 2003, Employment changes, the structure of adjustment costs, and plant size, mimeo
- [23] OECD , 2005, OECD Factbook 2005.
- [24] Pfann G.A. and F.C. Palm, 1993, Asymmetric Adjustment costs in non-linear labour demand models for the Netherlands and U.K. manufacturing sectors, *Review of Economic Studies*, 60, 397-412.
- [25] Rotemberg, Julio and Michael Woodford, 1997, “An Optimization-Based Econometric Framework for the Evaluation of Monetary Policy,” NBER, Technical Working paper 223, 1998.
- [26] Sargent, Thomas, 1978, 'Estimation of dynamic labor demand schedules under rational expectations', *Journal of Political Economy*, december, 86, 1009-10044.
- [27] Shapiro, Matthew D, 1986. The Dynamic Demand for Capital and Labor, *The Quarterly Journal of Economics*, vol. 101(3), 513-42.
- [28] Tauchen, George, 1986, 'Finite State Markov chain Approximations to univariate and vector autoregressions', *Economics Letters*, Vol 20 , p. 177-181.
- [29] Tillmann Peter, 2005, Inflation Dynamics in Europe: The Role of Employment Adjustment Costs, mimeo.
- [30] Varejao Jose and Pedro Portugal, 2003, Employment dynamics and the structure of labor adjustment costs, Banco de Portugal Working paper 12-03.

9 Appendix

I. Relaxing the labour input assumption¹⁷

Throughout the paper it is assumed that labour input into production is identical to the number of employees, i.e. implicitly hours remain fixed, i.e. when small firms adjust labour input, they have to adjust in number of employees. For instance a firm with 10 employees when faced with a negative demand shock has the option to either do nothing (i.e. remain with 10 employees) or reduce employment (and hence labour input into production) with minimum 1 employee. As the paper shows, this induces stickiness. The estimated model fits the data quite well. But what if firms could adjust downward (and upward) more smoothly labour input into production, i.e. assume 10 employees could be adjusted by the firm into labour input into production of 9.1 or 9.2 or.. 9.9 employees without adjustment cost, but with reduced pay. For instance imagine a 7% drop in demand and the firm reduces labour input into production to 9.3 (and its wage bill would become W9.3 rather than W10). This reduction of labour input to 9.3 would be equivalent to the following interpretation. The firm would still have 10 employees (i.e. face no adjustment costs) but would accommodate the negative demand shock by letting the 10th employee work only for 30% of 40 hours per week or by letting all 10 employees work for 7% less hours and 7% less pay ! Whereas the assumption of the equality of the employment level with the labour input is likely too strict in the model in the paper, in this other model presented here it is likely too loose, given that a 7% reduction for a 7% reduced pay is not that likely and increasing labour input will generally also not be costless. So the truth should somewhere lie in the middle. Note that in terms of adjustment in numbers of employees, a 7% negative demand shock will have the same implications for the stickiness of the employment level ! In the case of the model in the paper, the shock is too small to fire 1 employee, and so the firm remains at 10 employees. In the case of the more flexible labour input the firm also remains at 10 employees, but simply reduces working hours with 7%, so labour input becomes 9.3, employment stays at 10. So the stickiness of the employment level is not affected. However the estimates of the adjustment costs could be affected.

¹⁷This section was inspired by an anonymous referee.

A model that incorporates that idea was reestimated for group 1 (the group for which such flexibility would be most relevant) to test how much on the one hand the adjustment cost and on the other hand the frequency of non-adjustment (in terms of numbers of employees level) would be affected.

The assumptions of that model are identical to the model in the paper with two exceptions. First a firm with x employees can adjust downwards (without adjustment costs) up to an labour input level of $(x-1)+0.1$ (e.g. from 15 to 14.1) in steps of 0.1 with reduced pay (i.e. instead of W15 , W14.1) and can adjust upwards (without adjustment costs) from $(x-1)+0.1$ to x with increased pay (but no overtime pay). Otherwise said, 10 employees can costlessly adjust labour input in the set $\{9.1,9.2,\dots,10\}$, 11 employees can adjust costlessly labour input in the set $\{10.1, 10.2, 10.3, \dots,11\}$. E.g. in the new model the firm does not incur adjustment costs when adjusting its labour input in the following fashion $\{ 9.5 9.2 9.7 9.9 10 9.1 9.4\}$, but will incur adjustment costs when adjusting e.g. from 9.4 to 10.4 (i.e. in the first case it has 10 employees in the second 11 employees).¹⁸

The results are as following. The structural parameters of production and demand hardly change. The adjustment cost parameters do change significantly however. However they remain very low and imply similar order of magnitudes of costs. Whereas hiring cost of hiring 1 employee was 0.5% it is now 0.1%. The costs of hiring 5 employees was 0.5% it is now 1.7%. The costs of firing one employees was 0.4%, it is now 0.1%, similarly the cost of firing 5 employees was 0.4% and is now 0.1%. There is a clear reduction in the adjustment costs up or down of 1 employee. The intuition for this result is as follows. The firm can now adjust labour input without incurring adjustment costs (e.g. where a firm with 10 employees could simply produce with a labour input of 10 the firm can now produce with labour input of 9.1,9.2,9.3 etc. up to 10). This induces the firm to remain with its number of employees and adjust labour input (costlessly) rather than number of employees (which induces adjustment costs) whenever it can. Clearly, for larger shocks the firm still cannot avoid to hire and fire at least one employee. To match the non-adjustment frequency in the data, with this additional flexibility of labour input, the adjustment costs of hiring and firing 1 employees must be lower.^{19,20}

¹⁸One has to obviously bound the costless flexibility of labour input somewhere. In this exercise the boundaries for each employment level have been chosen relatively wide to provide a good test of the relaxation of the labour input assumption.

Table 6 Structural Parameters Adjustment Costs (with relaxed labour input assumption)

Size classes	H^f	H^l	H^c	F^f	F^l	F^c
Class 1 [10,15[	0.0015 **	-0.002	0.001*	0.0003	0.0006	-0.0001

** Significant at 10% level * Significant at 5% level

What happens to the frequency of non-adjustment when adjustment costs are set to zero in this model? Very similar results to table 5 are obtained. When removing adjustment costs, the non-adjustment frequency would drop to 25 (whereas it was 27 in the model in the paper). One can conclude that relaxing the strict labour input assumption in the paper does not seem to alter the results dramatically.

Table 7 Frequency of non-adjustment: estimated model versus data

Size classes	Data	Est. Model	Est. model $F^f, F^l, F^c, H^f, H^l, H^c = 0$
Class 1 [10,15[	40.4	37	25

II. Construction of the dataset

The dataset was constructed using the AMADEUS database. This database contains balance sheet statement and profit and loss accounts of European firms. First all French manufacturing firms were selected. From this

¹⁹There is another way of confirming the same idea. When simulating the model with relaxed labour input with the parameter estimates of the original (non-relaxed) model for group 1 (i.e. those of table 3 and 4), the frequency of non-adjustment should increase. Indeed it does. The frequency of non-adjustment jumps to 55% (from 40%). The firm now simply uses the additional costless flexibility in labour input to not adjust its number of employees.

²⁰An interesting example of a firm that has tried to avoid hiring and firing by adapting a flexible working hours mechanism through using a work-time account is the car maker BMW. BMW states that "Based on the principle of varying working hours according to workload, the balance on a work time account can range between plus or minus 200 hours, which can be evened out over the course of several years." Interestingly it confirms the finding here that additional flexibility at the hours level induces more stickyness at the employment level and that there is a clear trade-off. "The virtually unlimited accounting period allows more uniform development of the size of the workforce. It also helps to reduce costs in manufacturing operations, above all by eliminating personnel costs for surplus staff. Cost savings are also achieved with regard to the recruitment and layoff of staff and – due to marginal fluctuation – through lower training costs." (BMW, Flexible working hours at the BMW group.)

selection, firms with complete data on employment, profit, sales and capital stock for 9 years were kept. To make sure that the selected firms were truly plants and not headquarters without a physical plant, firms that had more than 50% of fixed assets under a different form as tangible assets (i.e financial fixed assets, which are equity in other firms) were dropped. Firms were also dropped if they had a large outlier observation in the 9 year period. The outliers were defined as a growth rate of more than 200% in employment in a given year, a growth rate of sales more than 200% in a given year. Further, firms which employment grew more than 60% over the whole period were removed. This last criterion is done as the model in the paper has a long run stationary employment level of the firm as it solution. This paper is therefore not able to say anything on the relationship between long run firm growth and adjustment costs. This would imply a different type of analysis.

European Central Bank Working Paper Series

For a complete list of Working Papers published by the ECB, please visit the ECB's website (<http://www.ecb.int>)

- 594 "The euro's trade effects" by R. Baldwin, comments by J. A. Frankel and J. Melitz, March 2006
- 595 "Trends and cycles in the euro area: how much heterogeneity and should we worry about it?" by D. Giannone and L. Reichlin, comments by B. E. Sørensen and M. McCarthy, March 2006.
- 596 "The effects of EMU on structural reforms in labour and product markets" by R. Duval and J. Elmeskov, comments by S. Nickell and J. F. Jimeno, March 2006.
- 597 "Price setting and inflation persistence: did EMU matter?" by I. Angeloni, L. Aucremanne, M. Ciccarelli, comments by W. T. Dickens and T. Yates, March 2006.
- 598 "The impact of the euro on financial markets" by L. Cappiello, P. Hördahl, A. Kadareja and S. Manganeli, comments by X. Vives and B. Gerard, March 2006.
- 599 "What effects is EMU having on the euro area and its Member Countries? An overview" by F. P. Mongelli and J. L. Vega, March 2006.
- 600 "A speed limit monetary policy rule for the euro area" by L. Stracca, April 2006.
- 601 "Excess burden and the cost of inefficiency in public services provision" by A. Afonso and V. Gaspar, April 2006.
- 602 "Job flow dynamics and firing restrictions: evidence from Europe" by J. Messina and G. Vallanti, April 2006.
- 603 "Estimating multi-country VAR models" by F. Canova and M. Ciccarelli, April 2006.
- 604 "A dynamic model of settlement" by T. Koepl, C. Monnet and T. Temzelides, April 2006.
- 605 "(Un)Predictability and macroeconomic stability" by A. D'Agostino, D. Giannone and P. Surico, April 2006.
- 606 "Measuring the importance of the uniform nonsynchronization hypothesis" by D. A. Dias, C. Robalo Marques and J. M. C. Santos Silva, April 2006.
- 607 "Price setting behaviour in the Netherlands: results of a survey" by M. Hoeberichts and A. Stokman, April 2006.
- 608 "How does information affect the comovement between interest rates and exchange rates?" by M. Sánchez, April 2006.
- 609 "The elusive welfare economics of price stability as a monetary policy objective: why New Keynesian central bankers should validate core inflation" by W. H. Buiter, April 2006.

- 610 “Real-time model uncertainty in the United States: the Fed from 1996-2003” by R. J. Tetlow and B. Ironside, April 2006.
- 611 “Monetary policy, determinacy, and learnability in the open economy” by J. Bullard and E. Schaling, April 2006.
- 612 “Optimal fiscal and monetary policy in a medium-scale macroeconomic model” by S. Schmitt-Grohé and M. Uribe, April 2006.
- 613 “Welfare-based monetary policy rules in an estimated DSGE model of the US economy” by M. Juillard, P. Karam, D. Laxton and P. Pesenti, April 2006.
- 614 “Expenditure switching vs. real exchange rate stabilization: competing objectives for exchange rate policy” by M. B. Devereux and C. Engel, April 2006.
- 615 “Quantitative goals for monetary policy” by A. Fatás, I. Mihov and A. K. Rose, April 2006.
- 616 “Global financial transmission of monetary policy shocks” by M. Ehrmann and M. Fratzscher, April 2006.
- 617 “New survey evidence on the pricing behaviour of Luxembourg firms” by P. Lünemann and T. Y. Mathä, May 2006.
- 618 “The patterns and determinants of price setting in the Belgian industry” by D. Cornille and M. Dossche, May 2006.
- 619 “Cyclical inflation divergence and different labor market institutions in the EMU” by A. Campolmi and E. Faia, May 2006.
- 620 “Does fiscal policy matter for the trade account? A panel cointegration study” by K. Funke and C. Nickel, May 2006.
- 621 “Assessing predetermined expectations in the standard sticky-price model: a Bayesian approach” by P. Welz, May 2006.
- 622 “Short-term forecasts of euro area real GDP growth: an assessment of real-time performance based on vintage data” by M. Diron, May 2006.
- 623 “Human capital, the structure of production, and growth” by A. Ciccone and E. Papaioannou, May 2006.
- 624 “Foreign reserves management subject to a policy objective” by J. Coche, M. Koivu, K. Nyholm and V. Poikonen, May 2006.
- 625 “Sectoral explanations of employment in Europe: the role of services” by A. D’Agostino, R. Serafini and M. Ward-Warmedinger, May 2006.
- 626 “Financial integration, international portfolio choice and the European Monetary Union” by R. A. De Santis and B. Gérard, May 2006.

- 627 “Euro area banking sector integration: using hierarchical cluster analysis techniques” by C. Kok Sørensen, J. M. Puigvert Gutiérrez, May 2006.
- 628 “Long-run money demand in the new EU Member States with exchange rate effects” by C. Dreger, H.-E. Reimers and B. Roffia, May 2006.
- 629 “A market microstructure analysis of foreign exchange intervention” by P. Vitale, May 2006.
- 630 “Implications of monetary union for catching-up member states” by M. Sánchez, May 2006.
- 631 “Which news moves the euro area bond market?” by M. Andersson, L. J. Hansen and S. Sebastyén, May 2006.
- 632 “Does information help recovering structural shocks from past observations?” by D. Giannone and L. Reichlin, May 2006.
- 633 “Nowcasting GDP and inflation: the real-time informational content of macroeconomic data releases” by D. Giannone, L. Reichlin and D. H. Small, May 2006.
- 634 “Expenditure reform in industrialised countries: a case study approach” by S. Hauptmeier, M. Heipertz and L. Schuknecht, May 2006.
- 635 “Identifying the role of labor markets for monetary policy in an estimated DSGE model” by K. Christoffel, K. Kuester and T. Linzert, June 2006.
- 636 “Exchange rate stabilization in developed and underdeveloped capital markets” by V. Chmelarova and G. Schnabl, June 2006.
- 637 “Transparency, expectations, and forecasts” by A. Bauer, R. Eisenbeis, D. Waggoner and T. Zha, June 2006.
- 638 “Detecting and predicting forecast breakdowns” by R. Giacomini and B. Rossi, June 2006.
- 639 “Optimal monetary policy with uncertainty about financial frictions” by R. Moessner, June 2006.
- 640 “Employment stickiness in small manufacturing firms” by P. Vermeulen, June 2006.

ISSN 1561081-0



9 771561 081005