The Cost of Firing and the Speed of Hiring: Separation Costs in a Discrete Efficiency Wage Model

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Abstract

Using a representative, forward looking firm in capital and labor decisions, this paper introduces separation costs into a discrete, dynamic, efficiency wage model in order to determine the effect of separation costs on both steady state unemployment rates and the hiring process following a negative productivity shock. This paper builds on the general equilibrium models of Burnside, Eichenbaum, and Fisher (2000), Alexopoulos (2003), and Alexopoulos (2004), which correct for empirical shortcomings in the original Shapiro and Stiglitz (1984) model. I compute equilibrium dynamics in order to investigate the impact of separation costs during a recession. I find higher separation costs cause higher steady states rates of unemployment and sclerosis of labor dynamics both in separations and hirings following a recession. My findings are applicable to comparisons of labor dynamics both in Europe versus the U.S. and in the U.S. over time. These findings provide a better understanding of the dynamics of post recession unemployment rates. I am also able to capture the larger role of hiring rates over separation rates in labor dynamics from Hall (2005) and Shimer (2005) by distinguishing between workers separated due non-cyclical reasons and those who are part of mass layoffs in a recession.