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**Article**

## Employment protection

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## Employment protection

### Policymakers need to find the right balance between protecting workers and promoting efficient resource allocation and productivity growth

Keywords: regulations on hirings and firings, employment protection legislation (EPL), labor mobility, reallocation of resources, productivity growth

#### ELEVATOR PITCH

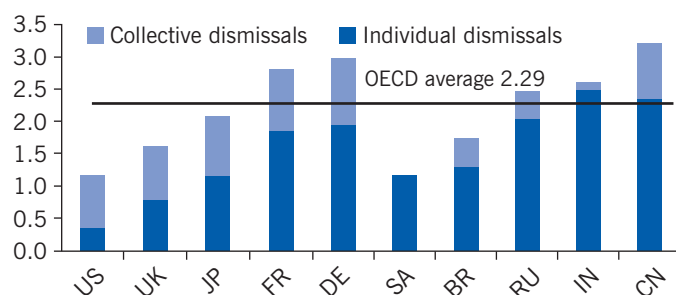
Laws on hiring and firing are intended to protect workers from unfair behavior by employers, to counter imperfections in financial markets that limit workers' ability to insure themselves against job loss, and to preserve firm-specific human capital. But by imposing costs on firms' adaptation to changes in demand and technology, employment protection legislation may reduce not only job destruction but also job creation, hindering the efficient allocation of labor and productivity growth.

#### KEY FINDINGS

##### Pros

- ⊕ Employment protection legislation can be justified by the need to protect workers from arbitrary actions by employers.
- ⊕ Imperfections in financial markets limit the possibilities for workers to insure themselves against dismissal. Employment protection legislation provides such insurance.
- ⊕ Employment protection legislation can promote long-lasting work relationships that encourage workers' commitment to a firm and the firm's investment in human capital.
- ⊕ In countries lacking unemployment benefits, severance pay can sustain job search by dismissed workers and improve job matching.

#### Protection of permanent workers against dismissals, 2013



Note: Scale 0–6: 0=least stringent; 6=most stringent.

Source: Based on Figure 1.



##### Cons

- ⊖ By raising labor adjustment costs, stringent employment protection reduces job creation as well as job destruction and weakens firms' ability to exploit new technologies and markets.
- ⊖ Stringent employment protection reduces the ability of economies to redirect labor resources to the most productive uses.
- ⊖ Liberalizing temporary contracts while retaining stringent regulation of permanent contracts contributes to labor market segmentation.
- ⊖ In many developing and emerging economies, stringent employment protection is weakly enforced, and many workers in the informal sector are unprotected.

#### AUTHOR'S MAIN MESSAGE

Studies suggest that stringent employment protection legislation hinders the effectiveness of labor market flows and the allocation of labor to the most productive jobs, harming productivity and growth. In general, workers benefit from a more efficient allocation of labor, through higher real wages and better career progression, but some displaced workers may suffer longer unemployment spells and lower real wages in their new jobs. Employment protection reform should be part of a comprehensive package that promotes better allocation of labor and adaptability in the labor market but also provides safety nets for the unemployed and effective re-employment services.

## MOTIVATION

All countries have laws and regulations governing the hiring and firing of workers under different types of labor contracts. Such employment protection legislation varies widely, both in its legal provisions and in its enforcement. Economists and policymakers have long debated the effects of employment protection legislation on the behavior of workers and firms. Policy intervention is clearly justified by the need to protect workers from arbitrary actions and from imperfections in financial markets that limit their ability to insure themselves against the risk of dismissal. There could also be efficiency considerations, to the extent that hiring and firing regulations promote long-lasting relationships that encourage firms' investment in human capital [1]. However, by preventing firms from responding swiftly to changes in demand and technology, stringent employment protection legislation can hinder labor mobility, the optimal allocation of labor to its most effective uses, and ultimately productivity growth. Therefore, governments have to strike a balance between worker protection and labor market flexibility.

## DISCUSSION OF PROS AND CONS

### How do countries compare in employment protection?

Employment protection legislation has been assessed across countries and over time. Many studies have focused on the legal provisions affecting hiring and firing workers under different types of contracts, but fewer have also taken enforcement into account [2]. The Organisation for Economic Co-operation and Development (OECD) has compiled a widely used set of indicators that quantify the costs and procedures involved in dismissing individuals or groups of workers and in hiring workers on fixed-term or temporary work agency contracts. The OECD indicators of employment protection reveal different underlying approaches to protecting workers against unfair dismissal.

#### OECD indicators of employment protection legislation

Employment protection legislation for workers on regular contracts focuses on the conditions for terminating employment, including required notification and involvement of third parties (such as courts, labor inspectorates, and workers' councils); notice periods and severance pay; the conditions under which it is permissible to lay off an employee; and the repercussions if a dismissal is found to be unfair. Most countries have additional provisions for collective dismissals. Employment protection also provides a regulatory framework for fixed-term and temporary work agency contracts, the types of work for which these contracts are allowed, and requirements for agency workers to receive the same pay and conditions as equivalent workers.

Employment protection can be specified in legislation, collective agreements, or individual employment contracts. In practice, it also depends on the interpretation of rules by courts or tribunals and the effectiveness of enforcement. With a few exceptions, information on enforcement is generally scattered, so analysis of the cross-country quantitative measures of the stringency of employment protection is limited to studying the mandatory legislative restrictions governing recruitment and dismissal.

OECD. *Employment Outlook*. Paris: OECD Publishing, 2013.

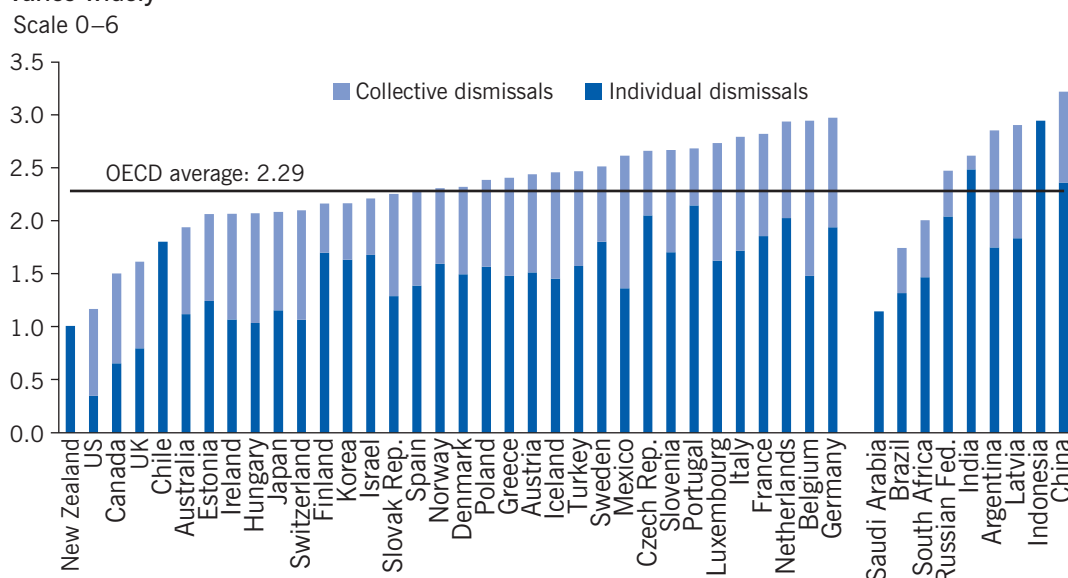
### Different approaches to firing regulations

Some countries define unfair dismissal very narrowly, but workers are usually compensated whether termination is fair or wrongful. In another group of countries, ordinary compensation tends to be low or zero, but unfair dismissal is broadly defined, and compensation for unfair dismissal is high. Moreover, with the main exception of some emerging market economies, there seems to be a greater consensus among policymakers that collective dismissals bring about greater negative externalities and are in need of stricter protection. Thus, the cross-country variation in the stringency of regulation on collective dismissals is smaller than that of individual dismissals.

The US stands out as the least regulated country based on indicators for dismissals of individual workers on permanent contracts. Most other English-speaking, common-law countries (New Zealand, Canada, and the UK), as well as Hungary, also have fairly unrestrictive individual dismissal regulations. By contrast, regulations for the Czech Republic, Portugal, France, the Netherlands, and Germany, are far stricter than the OECD average. Some key emerging economies, including China, India, Indonesia, and the Russian Federation, also have strict regulations, although enforcement in these countries tends to be weak.

With the main exception of some emerging market economies, most countries grant additional protection for collective dismissals, which are assumed to involve greater social costs. These additional regulations tend to be more restrictive in countries with lighter constraints on individual dismissals (see Figure 1). The additional protection against collective dismissals is generally granted whether terminations are wrongful or fair.

Figure 1. Protection of permanent workers against individual and collective dismissal varies widely



Notes: Data refer to 2013 for OECD countries and Latvia and 2012 for other countries. The height of the bar represents the value of the overall indicator on a scale of least stringent (0) to most stringent (6).

Source: OECD. *Employment Outlook*. Paris: OECD Publishing, 2013 [2]; data for Israel, <http://dx.doi.org/10.1787/888932315602>.

Among the OECD countries, Germany, Belgium, and the Netherlands have the most stringent restrictions overall on individual and collective dismissals according to the OECD indicators, with France and Italy not far behind despite recent reforms. Among all countries considered, China has the tightest regulations, with overall regulations of regular workers also far above the OECD average in Argentina and Indonesia. At the bottom of the distribution, New Zealand and Saudi Arabia have more lax regulations than the US. Canada, the UK, and Brazil also have relatively light regulations.

In many countries a significant share of employees are not covered by the protections granted to open-ended contracts, either because they are employed under atypical contracts or because they are in the informal economy. The share of employees on fixed-term contracts, for example, was just 12% for the OECD average in 2011, but was more than 25% in Poland and Spain. Many young people are hired on fixed-term contracts; the OECD average in 2011 revealed one-quarter of employees aged 15–24, although the share was as high as 40% in the EU. In the emerging economies, the informal sector accounts for about 30% of total employment in China rising to more than 50% in Mexico and more than 80% in India in the second decade of the 2000s. Moreover, in countries with rigid regulations on permanent contracts, the hiring and firing of temporary workers accounts for a large majority of gross worker flows. For example, in France, 78% of hires and 71% of separations (dismissals and voluntary quits) in 2011 were due to the start or end of fixed-term contracts.

As there are so many different types of atypical contracts, collecting standardized information on their regulations is difficult. The OECD indicators cover only certain aspects of regulations for standard fixed-term and temporary work agency contracts. The indicators of the strictness of the regulation of temporary contracts measure how easily firms can resort to these alternative types of contract to meet their need for flexibility, and ease the constraints imposed by regulations on regular, open-ended contracts.

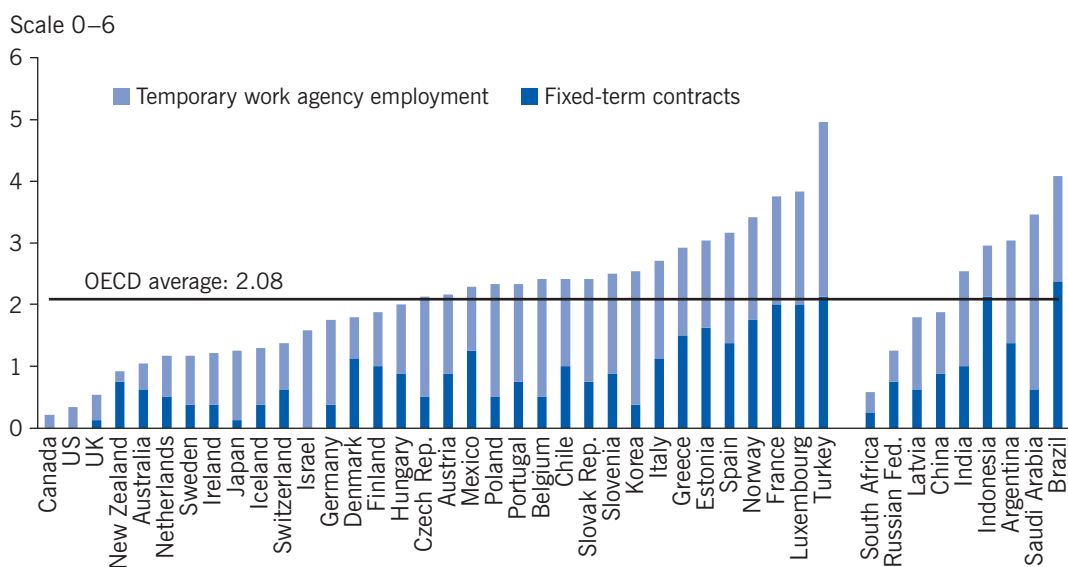
There is a positive correlation between the stringency of regulation on temporary contracts and that of employment protection against individual dismissals. Canada, the US, the UK, and South Africa have the lightest regulations on temporary contracts, while Turkey and Brazil stand out as having more stringent regulations (see Figure 2).

### **Striking a balance between protecting workers and facilitating efficient labor allocation**

One of the main channels through which employment protection legislation can affect firms' and workers' behavior and economic performance is its impact on labor mobility and the efficiency of labor allocation. Theoretical labor market models suggest that if firing costs are positive, the optimal firm strategy is to reduce both job creation and job destruction, resulting in an ambiguous effect on average employment levels [3]. By inhibiting the ability of firms to adapt their workforce to changes in labor demand and technological progress, employment protection legislation could slow growth in productivity at the firm level. At the same time, higher adjustment costs could also slow the reallocation of resources from declining industries and firms to expanding ones, with negative implications for aggregate economic and labor market outcomes.

A key factor determining the impact of employment protection legislation on economic performance is how much workforce adjustments within and across firms and sectors drive

Figure 2. Regulation of temporary contracts also varies widely



Notes: Data refer to 2013 for OECD countries and Latvia and to 2012 for other countries. The height of the bar represents the value of the overall indicator on a scale of least stringent (0) to most stringent (6).

Source: OECD. *Employment Outlook*. Paris: OECD Publishing, 2013 [2]; data for Israel, <http://dx.doi.org/10.1787/888932315602>.

growth in productivity at the aggregate level. A large body of empirical evidence strongly supports what economist Joseph Schumpeter called “creative destruction.” New firms enter the market with innovative products and processes and create new jobs, displacing unprofitable incumbent firms, which exit the market, destroying jobs. Incumbent firms are also engaged in a continuous process of adapting their workforces in response to new products and processes and changes in markets and competitive forces. This continuous process of firm entry, exit, and adaptation, accompanied by the reallocation of resources from declining to expanding businesses, contributes to technological progress, productivity, and output growth. The impact of employment protection legislation on productivity performance depends on the extent to which firms are exposed to demand and technology shocks.

In theory, the potential inefficiencies in the optimal allocation of labor generated by employment protection legislation can be offset by wage adjustments, private payments, and the design of efficient contracts. In practice, however, wage-setting mechanisms and financial market imperfections tend to weaken these offsetting mechanisms, as does uncertainty about future firm performance. Regardless, the potential impact of regulations on firms’ performance and productivity growth should be balanced out against the need to protect workers from unfair behavior by employers. In addition, especially in sectors where technological progress proceeds fairly predictably, employment protection legislation, by promoting job stability, can encourage workers’ commitment and investment in firm-specific human capital, with a positive impact on productivity.

By affecting both hiring and firing, employment protection legislation tends to have a disproportionate effect on new entrants to the labor market, as well as on workers (such as women) who re-enter after a period of inactivity. This unequal effect is enhanced when

more rigid regulations on permanent contracts are combined with less stringent regulations on temporary and other forms of atypical contracts, as has occurred in some European countries as well as Japan and Korea. Many young workers and those with intermittent careers risk being trapped in temporary contracts, with considerable difficulty moving on to more stable contracts with better career prospects.

## **What is the impact of employment protection on employment and labor mobility?**

### ***Employment protection and employment and unemployment levels***

Many empirical studies have assessed the impact of employment protection on the labor market and broader economic outcomes. The early literature focused on the potential impact on aggregate employment and unemployment, generally relying on cross-country time-series data [4]. Unsurprisingly, given what theory predicts, the empirical evidence is not clear-cut: some studies found no significant effects of employment protection on employment or unemployment outcomes, while others, including the seminal paper on the subject [5], found that stricter regulations reduce employment and increase unemployment. More recently, several studies have exploited the fact that certain employment protection reforms targeted specific groups of workers or firms or were undertaken at different times in different states or regions, thereby generating quasi-natural experiments. These studies typically found small, but often significant, negative effects of stricter employment protection rules on aggregate employment.

There is also some evidence in aggregate cross-country time-series studies that employment protection slows employment adjustment to economic shocks. Other studies have found slower rates of adjustment of productivity to long-term levels in countries with stricter employment protection. Similarly, recent OECD work exploiting the differential effects of dismissal restrictions on employment across industries or types of firm found that these regulations reduce employment resilience to output shocks [6].

### ***Employment protection and labor reallocation***

In line with the theoretical predictions, there is more consistent evidence for the impact of employment protection on job and worker flows. One strand of this empirical literature identifies the possible impact of employment protection by focusing on regulatory reforms or on the differential treatment of workers or firms within countries [7]. For example, one study found that the adoption of stricter wrongful-discharge protection norms by state courts in the US, which took place at different times, had a negative effect on firm entry rates and job flows [8]. Another study exploiting the exemption of small Italian firms from job security provisions confirms that larger firms had lower job turnover and job destruction than exempted smaller firms. Large negative effects on large firms were found in an analysis looking at the impact on hirings of a recent reform of dismissal costs in Turkey that applied differently to small and large firms. However, a few microstudies found no effect of dismissal regulations on job or worker flows, and this could be attributed to the small economic importance of these specific exemptions. It is difficult to generalize the results from these country case studies, because of considerable variation in the nature and extent of the reforms and in underlying labor market and economic conditions in each country.

A second strand of the empirical literature uses cross-country data sets, analyzing either aggregate data or comparable cross-country microdata [9]. Some studies used industry-level data for several countries, exploiting the fact that differences in the frequency and intensity of fluctuations in demand and changes in technology for different industries create different needs to adjust the workforce. Consistently, the studies found a stronger negative effect of employment protection on job and worker flows in industries that require greater workforce adjustments for reasons stemming from demand or technology. Moreover, there is some evidence that more restrictive regulations tend to curb direct shifts of workers from one job to another, which plays a major role in reallocating labor to the most productive uses.

### ***What are the links between employment protection and productivity?***

Given the well-established empirical links between employment protection and labor mobility and, in turn, between labor mobility and productivity, the next obvious question is whether there is also evidence of an effect of employment protection on productivity. While the evidence from country case studies is inconclusive [6], recent cross-country studies have found evidence of a consistent negative effect on productivity. A study that exploited differences across US states in the timing of stricter job security provisions also found a positive effect on capital investment and a negative effect on productivity growth. Evidence from studies of several Spanish labor market reforms implemented in the past 20 years also suggests that the gap between restrictions on open-ended contracts and those on temporary ones depresses productivity growth. More generally, cross-country time-series evidence suggests that productivity growth has been slower in countries that weakened regulations on temporary contracts while maintaining stringent restrictions on regular ones [10].

### ***Do workers benefit from more flexible job security provisions?***

While there is ample evidence of the importance of labor reallocation for productivity growth and, in turn, of the impact of employment protection on the size and overall efficiency of labor reallocation, what about the impact of greater labor mobility on the workers directly affected? As stressed above, not all labor mobility promotes productivity growth. For example, an OECD study suggests that when labor mobility is achieved mainly through the use of temporary contracts, leaving workers on permanent contracts largely untouched, the result is often a weaker accumulation of firm-specific human capital and weaker firm-level productivity growth [9]. Even more importantly, while some workers benefit from better job opportunities, others suffer substantive losses in post-displacement earnings and working conditions.

The OECD study also finds that the wage premia for job changes are positive and significant in two-thirds of OECD countries. There is also some evidence that unemployed workers and workers with limited attachment to employment, benefit from a more dynamic labor market [11]. But how does employment protection affect the impact of labor mobility on workers? While strict employment protection appears to have no sizable effect on the average wage premium for a job change, it has substantially larger negative effects on the wage premium for voluntary separations and on the wage penalty at re-employment for involuntary separations [9].



These results suggest that, overall, employment protection reforms aimed at easing hirings and separations and reducing their cost by promoting greater worker mobility tend to create more job opportunities for employed workers who want to search for better jobs. In general, workers tend to benefit from a more dynamic labor market that ensures better matches between their skills and employers' needs and from the fact that their wages will also reflect the productivity-enhancing effects of efficient labor reallocation. However, not all workers benefit from a dynamic labor market. Displaced workers tend to suffer substantive losses in post-displacement earnings and working conditions. Policies to facilitate their re-integration into employment should be a key component of an overall reform package that aims to strengthen efficiency in the allocation of labor while also considering the equity implications.

### ***Employment protection and labor market segmentation***

Reforms of employment protection legislation should also take into account the potential distributional effects. To enable firms to respond more flexibly to technological change and fluctuations in demand, many advanced economies and some emerging market economies have liberalized temporary contracts while leaving more rigid regulations in place on permanent contracts. This liberalization “at the margin” has increased dualism in the labor market. Workers on temporary contracts tend to bear the brunt of labor market adjustments, while workers on permanent contracts enjoy greater protection and job stability.

The empirical evidence, while limited, agrees that reforms at the margin have increased the probability of workers being in fixed-term contracts, especially young workers and low-skill and immigrant workers. Spain provides a good example of this. When Spain liberalized fixed-term contracts in the early 1980s without changing dismissal costs for regular contracts, fixed-term contracts expanded while permanent contracts shrank. Moreover, the large regulatory gap between permanent and temporary employment keeps transition rates across these two types of contracts low. Workers tend to become trapped in fixed-term contracts, often going from temporary contract, to unemployment, and back to temporary contract.

Finally, several studies find that the difference in the cost of adjusting the stock of workers on different types of contract explains both the share of workers on fixed-term contracts and the greater volatility of these contracts. A recent study finds that in Italy (before the 2012 labor reform), where employment protection was much stronger for firms with more than 15 employees, firms wanting to expand beyond this threshold substituted temporary workers for permanent workers, to the detriment of overall firm productivity [12].

## **LIMITATIONS AND GAPS**

Despite progress in assessing the effect of employment protection on labor market and productivity outcomes, much remains to be done on how to measure the stringency of employment protection and its impact. Most indicators focus on the regulations themselves, even though enforcement is often weak and applies differently across workers, sectors, and types of firm.

Stringent but weakly enforced regulations create different types of distortion, with major effects on both workers and firms. More work is needed to assess enforcement issues and the impact of employment protection legislation on job flows and productivity at the firm level using the same empirical framework and comparable data sets. In addition, studies need to explore the interaction between employment protection and other labor market policies and regulations—from promoting flexibility within firms to promoting the quick re-integration of displaced workers into the labor market.

## SUMMARY AND POLICY ADVICE

Through employment protection legislation and regulations, governments can strongly influence labor market adaptability. The design and enforcement of employment protection legislation can affect turnover in the labor market, which, in turn, can have significant effects on productivity growth.

The debate on the appropriate set of laws and regulations affecting the hiring and firing of workers has become more urgent following the global financial crisis, as several (mainly European) countries have sought to enhance their competitiveness by easing employment protection provisions for workers. But the debate needs to be informed by more hard evidence on both the impact of employment protection legislation on labor market and economic outcomes and on different groups of workers and firms.

Recent empirical evidence has focused on the impact of employment protection on labor market dynamics and, ultimately, on productivity and worker welfare. The evidence shows that employment protection legislation significantly affects labor market flows, which in turn significantly affect productivity growth. The evidence also shows that while many workers benefit from a more dynamic labor market through higher real wages and better careers, some displaced workers lose out because of longer spells of unemployment and lower real wages in post-displacement jobs.

Reform of employment protection legislation should not be conducted piecemeal but should be part of a comprehensive reform package to promote greater adaptability of the labor market and better allocation of labor. Measures should include an adequate safety-net, backed up by effective re-employment services, to assist displaced workers in finding new jobs that pay well and lead to stable job opportunities.

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## Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

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