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Article

New empirical findings on the labour market effects of employment protection

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DICE REPORTS¹

NEW EMPIRICAL FINDINGS ON THE LABOUR MARKET EFFECTS OF EMPLOYMENT PROTECTION

The links between employment protection (regulations concerning hiring and firing) and the performance of the labour market have occasioned extensive debate. At issue is the question whether excessively strict employment protection is a major contributor to the persistently high unemployment experienced in many European countries since the 1980s. Some argue that employment protection, by raising firms' firing costs, acts as a deterrent against hiring new workers and that, moreover, it constitutes an extra source of bargaining power for the protected employees (insiders), resulting in higher wages. On the other hand there are those who argue that employment protection reduces the inflow into unemployment. They add that it creates stable employment relationships which favour the introduction of new technologies as well as the reorganisation of working practices and enhances investment in training and skill formation. In their view, the rise in productivity compensates for higher firing costs.

New empirical findings

Until recently, empirical research had not provided a clear-cut answer to the question raised above. The major reason is that most of the cross-country research had used data on employment protection at one point in time (that is the late 1980s).² Therefore, institutional changes could not be measured. Moreover, the number of individual indica-

tors for measuring the overall strictness of employment protection was too small. Meanwhile the OECD has gathered new information which it presented in 1999.³ It extends prior research in two ways: First, it presents new data describing employment protection in the late 1990s and makes them comparable to data of the late 1980s. Secondly, it provides a new, much richer data base. It identifies those aspects of employment protection (e.g. procedural requirements, notification periods or severance pay) that are most important for reassessing the relationship between employment protection and labour market performance.

According to the OECD, employment protection refers to both, regulations concerning hiring (e.g. rules favouring disadvantaged groups, conditions for giving temporary or fixed-term contracts, training requirements) and firing (e.g. redundancy procedures, mandated notification periods and severance payments, special requirements for collective dismissals and short-time work schemes). Various institutional arrangements can provide employment protection: the private market, labour legislation, collective bargaining agreements, and court interpretations of legislative and contractual provisions. The OECD has compiled information on 22 indicators for 27 countries. Twelve indicators refer to the strictness of dismissal regulation for regular and permanent workers. Six indicators refer to the regulation of fixed-term contracts and temporary agency work. Four indicators measure the strictness of collective dismissal regulation. These 22 indicators provide the inputs for the construction of cardinal summary indicators of employment protection strictness.

Does employment protection raise overall unemployment?

Easing employment protection ...

There is significant variation in employment protection, both with respect to the overall level of strictness and with respect to the relative emphasis placed on different components of regulation. The Southern European countries stand out for having relatively strict employment protection, along with

¹ DICE = Database of Institutional Comparison in Europe.

² M. Emerson (1988), Regulation or De-regulation of the Labour Market: Policy Regimes for the Recruitment and Dismissal of Employees in Industrialised Countries, *European Economic Review*, April, 775–817; G. Bertola (1990), Job Security, Employment and Wages, *European Economic Review*, June, 851–886; D. Grubb and W. Wells (1993), Employment Regulation and Patterns of Work in EC Countries, *OECD Economic Studies* No. 21, Winter, 7–58; OECD (1994), *The OECD Jobs Study*, Evidence and Explanations, Part II, Paris.

³ OECD (1999), *Employment Outlook 1999*, Chapter 2, Paris.

Strictness of Employment Protection^{a)}

Country						Overall strictness		
	Regular employment		Temporary employment		Collective dismissals	Version 1 ^{b)}		Version 2 ^{c)}
	Late 1980s	Late 1990s	Late 1980s	Late 1990s	Late 1990s	Late 1980s	Late 1990s	Late 1990s
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Austria	2.6	2.6	1.8	1.8	3.3	2.2	2.2	2.3
Belgium	1.5	1.5	4.6	2.8	4.1	3.1	2.1	2.5
Denmark	1.6	1.6	2.6	0.9	3.1	2.1	1.2	1.5
Finland	2.7	2.1	1.9	1.9	2.4	2.3	2.0	2.1
France	2.3	2.3	3.1	3.6	2.1	2.7	3.0	2.8
Germany	2.7	2.8	3.8	2.3	3.1	3.2	2.5	2.6
Greece	2.5	2.4	4.8	4.8	3.3	3.6	3.6	3.5
Ireland	1.6	1.6	0.3	0.3	2.1	0.9	0.9	1.1
Italy	2.8	2.8	5.4	3.8	4.1	4.1	3.3	3.4
Netherlands	3.1	3.1	2.4	1.2	2.8	2.7	2.1	2.2
Portugal	4.8	4.3	3.4	3.0	3.6	4.1	3.7	3.7
Spain	3.9	2.6	3.5	3.5	3.1	3.7	3.1	3.1
Sweden	2.8	2.8	4.1	1.6	4.5	3.5	2.2	2.6
United Kingdom	0.8	0.8	0.3	0.3	2.9	0.5	0.5	0.9
Japan	2.7	2.7	..	2.1	1.5	..	2.4	2.3
Switzerland	1.2	1.2	0.9	0.9	3.9	1.0	1.0	1.5
United States	0.2	0.2	0.3	0.3	2.9	0.2	0.2	0.7
Canada	0.9	0.9	0.3	0.3	3.4	0.6	0.6	1.1
Australia	1.0	1.0	0.9	0.9	2.6	0.9	0.9	1.2
New Zealand	..	1.7	..	0.4	0.4	..	1.0	0.9

.. = Data not available. – ^{a)} The scores can range from 0 to 6, with higher values representing stricter regulation. – ^{b)} Average of indicators for regular contracts and temporary contracts. – ^{c)} Weighted average of indicators for regular contracts, temporary contracts and collective dismissals.

Source: OECD, Employment Outlook 1999.

Deregulation of fixed-term contracts has positive employment effects

France, Germany and Sweden. On the other extreme, regulation is least restrictive in the United States, the United Kingdom, New Zealand, Canada and Ireland (see Table, column 8).

Between the 1980s and the late 1990s, there was some easing of employment protection in nine countries, unchanged strictness in eight countries, and a tightening of restrictions in one country, France (Table, columns 6 and 7). Reduction in the overall strictness of employment protection was – as a rule – not due to an easing in regular contracts. In fact, there was a considerable continuity of employment protection in this area. The only exceptions were Finland, Portugal and Spain which significantly eased employment protection for permanent workers (Table, columns 1 and 2).

... encourages temporary work

In order to enhance workforce flexibility, countries may choose other options. They can reduce employers' termination costs by facilitating the use of fixed-term contracts with a specific termination date and by recourse to workers hired from temporary work agencies. In general, there will not be advance notices or severance pay in these cases, and it will usually be difficult for employees to file an unfair

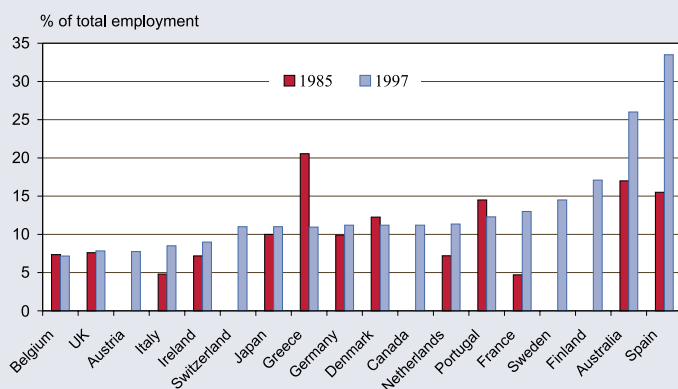
dismissal claim. Many countries eased regulations regarding fixed-term contracts and temporary work agencies. In particular, Italy, Greece, Spain and Sweden have allowed employment of temporary workers provided by temporary work agencies. Restrictions on fixed-term contracts were eased in Germany, Italy, Austria, Belgium, Finland, the Netherlands. Portugal and Sweden, but tightened in France and Spain. Taking both options together, Sweden, Denmark, Italy, Belgium, Germany, and the Netherlands have moved furthest in the direction of easier use of temporary work contracts (Table, columns 3 and 4).

The deregulation regarding fixed-term contracts and temporary work agencies has encouraged the evolution of temporary employment contracts. As a consequence, temporary work has become an important component of employment growth in many OECD countries since the mid 1980s. Yet in most OECD countries less than 15% of employees are in temporary work. Exceptions are Finland, Australia and especially Spain (see Figure).

Employment protection of insiders only

Regarding the effect of employment protection on labour market performance, the OECD draws

TEMPORARY EMPLOYMENT, 1985 - 97



Source: OECD, Economic Outlook, June 1999, p. 146.

some interesting conclusions. A cross-country comparison suggests that employment protection has little or no effect on overall unemployment. It may, however, influence its demographic composition. In countries where employment protection is stricter, unemployment tends to be lower for prime-age men, but higher for younger workers and, perhaps, prime-age women.

lower turnover in the labour market, with both jobs and unemployment spells tending to last longer. Fewer workers experience unemployment in any one year in countries with stricter employment protection, but those becoming unemployed have a greater probability of remaining unemployed for a year or more.

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Concerning the employment effects, employment protection strictness tends to reduce the employment-to-population ratio for the working-age population. This negative association holds true for youth and prime-age women, but reverses for prime-age men, consistent with the hypothesis that employment security protects the jobs of “insiders” and reduces the employment chances of “outsiders”. Stricter employment protection is associated with

Strict employment protection helps prime-age men, but hurts women and youths