

Employment Protection: The Costs and Benefits of Greater Job Security

How protected are jobs?

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and costs of employment
protection?**

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Introduction

Deregulating labour markets – for example making it easier for firms to hire and fire employees – is at the heart of the employment debate in many OECD countries. Laws on firing or layoffs and other employment protection regulations are thought by many to be a key factor in generating labour market “rigidity”, as well as one reason for the large differences in labour market performance among OECD countries, notably between the United States and some of the larger European countries.

The key point is how to reconcile the demand for flexibility in the labour market expressed by firms with the demand for job security expressed by workers. Less strict rules about hiring and firing may make it easier for employers to hire workers, thus improving the job prospects of new entrants to the work force such as young people, or women returning after time off to raise a family. At the same time, easing restrictions can also make people who already have jobs worry more about the risk of losing them.

The role of employment protection legislation in achieving flexible labour markets while maintaining adequate social protection is one theme of the reassessment of the OECD Jobs Strategy called for by OECD employment ministers in 2003 and due to be completed in 2006.

But to assess whether and how to reform employment protection legislation, it is crucial to understand what job protection is supposed to achieve and whether more efficient substitutes are available to achieve similar policy goals. This Policy Brief summarises recent OECD work on the role of employment protection legislation as part of a wide menu of policy instruments available to governments to influence domestic labour markets. ■

How protected are jobs?

Employment protection regulations refer to the rules that govern hiring and firing decisions, such as the duration of work contracts, conditions of dismissal and severance. These regulations can be provided through legislation, collective bargaining agreements or judicial practices and court interpretations of legislative and contractual provisions.

The OECD has developed an index to measure the *strictness* of employment protection legislation (EPL) and how it has changed since the end of the 1980s. The overall strictness of employment protection legislation varies widely among OECD countries, with greater job protection in southern European countries, Mexico and Turkey, and less protection in English-speaking countries (see Chart 1).

The index is broken down into three components: regulations governing the terms and conditions of permanent contracts in case of individual dismissals; additional provisions in the face of mass layoffs; and regulations governing the possibility of hiring on temporary contracts. In general, differences in the strictness of regulations covering temporary employment are the key element in explaining differences in the level of employment protection between OECD countries.

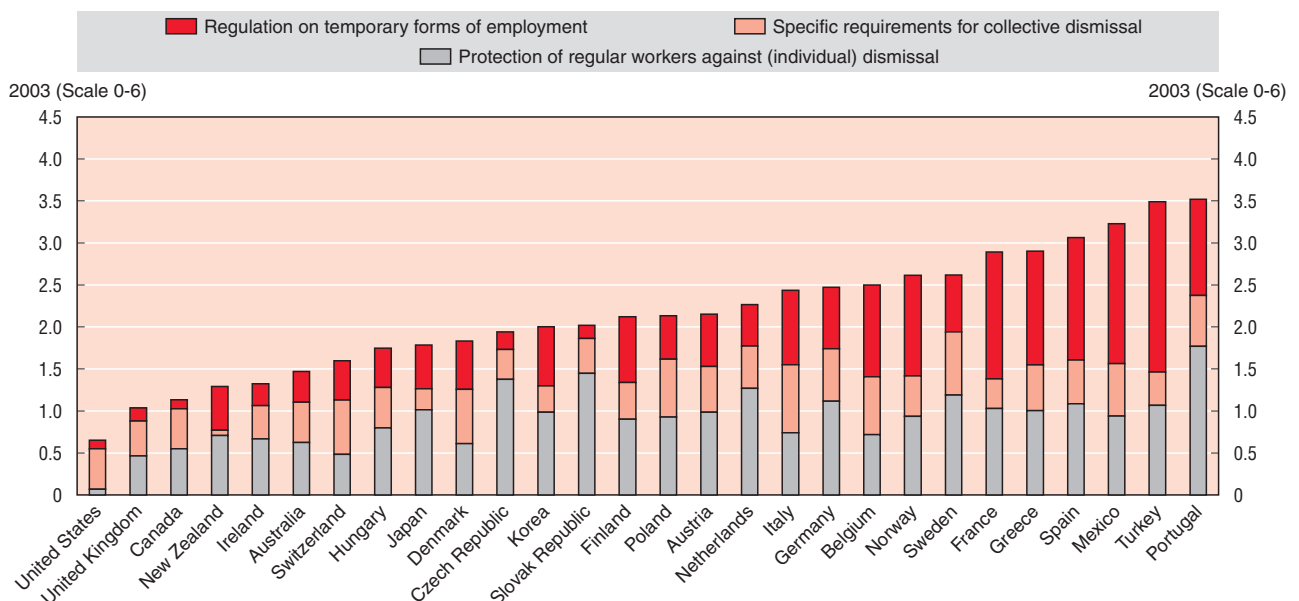
Although wide differences persist in the degree of strictness of employment protection legislation, there is evidence of convergence between countries over the past two decades. This process is mainly driven by an easing of regulation in the countries where it was relatively strict at the end of the 1980s. In most cases, reforms made it easier to employ people in *temporary* jobs, while leaving existing provisions for *permanent* contracts practically unaltered. ■

What are the benefits and costs of employment protection?

Legislation covering dismissal as well as provisions regulating the use of fixed-term contracts and temporary work agencies can all be described as restrictions placed on the ability of the employer to adjust the workforce and to control labour costs. Higher employment protection tends to reduce firings during economic downturns and thus increases job stability. This is likely to promote workers' effort and willingness to be trained, which may have positive implications for aggregate employment and economic efficiency.

However, higher employment protection may also diminish firms' ability to cope with a rapidly changing environment driven by globalisation, new technology

Chart 1. The overall summary index of employment protection legislation strictness in 2003 and its three main components



Source: OECD Employment Outlook 2004.

and organisational change. In addition, the strictness of employment protection legislation affects hiring decisions in periods of rising demand; indeed, when deciding whether to hire new workers on permanent contracts, firms take into account the likely costs of laying people off in the future. This may make it more difficult for jobseekers to find a job, thus exerting upward pressure on long-term unemployment.

The fact that employment protection legislation protects existing jobs stands out in OECD work to test the various effects of such protection. Take the case of Portugal and the United States, which have similar unemployment rates but different levels of employment protection. In Portugal, where the legislation is rather strict, the proportion of workers who become unemployed is five times lower than in the United States, the least regulated country. But when it comes to finding a new job, the chances of re-employment are higher for a jobless worker in the United States than in Portugal. More than one third of Portuguese unemployed are jobless for one year or longer, compared with only 10% in the United States. Obviously, other components of the institutional setting (e.g. unemployment insurance systems) also contribute to these contrasting pictures. Nevertheless, more comprehensive international comparisons lend support to the view that stricter employment protection legislation reduces the risk of layoff but also makes the hedge between non-employment and employment more difficult to jump over.

Strict employment protection rules may also be a factor behind the rise in the use of temporary contracts observed in many OECD countries in recent years. The high cost of dismissing people on permanent contracts may constitute an incentive for employers to use a series of temporary contracts rather than converting them to permanent contracts. Certain workers may thus be trapped in situations where they move between temporary work and unemployment, with little chance of getting a permanent job and building a career. ■

Who benefits from and who pays for more protected jobs?

Since employment protection legislation tends to reduce both dismissals and hiring, its overall impact on aggregate unemployment is unclear, both in economic theory and in the empirical evidence. This notwithstanding, the effects of employment protection legislation are different for different groups. For

instance, first-time entrants (mainly young people), and re-entrants (mainly women who are more likely than men to move between employment and inactivity, in particular when seeking to balance the competing demands of work and family life) are more likely to be affected by reduced hiring opportunities while being less in a position to benefit from fewer dismissals. And indeed, empirical evidence suggests that strict employment protection legislation may reduce the employment rate of both youth and prime-age women.

The picture is less clear for older workers and the low-skilled. Indeed, empirical evidence suggests that for these groups the reduction in hiring rates resulting from strict employment protection might be compensated by a decrease in dismissals associated with employment protection legislation. In the case of older workers, the cost of firing someone who has been with the company for many years is very high, so employers tend to retain these employees. And employment protection legislation may not have much effect on hiring decisions since many older workers are close to retirement age – thus the likely cost of having to lay them off in future is not a major concern for prospective employers. For the low-skilled, the story is quite different. They tend to be employed in low-productivity jobs and are, therefore, more likely to be negatively affected by adverse economic developments that reduce labour demand. So employment protection regulations may play a particularly important role for unskilled workers with permanent or regular contracts, by limiting layoffs in periods of weak economic growth. The flip-side may be an over-representation of unskilled workers in temporary work.

In fact, the evidence suggests that differences in the strictness of employment protection legislation between permanent and temporary jobs may be an important element in explaining the recent rise in the incidence of temporary work for the low-skilled, as well as for young people in many OECD countries. This is all the more important as temporary work tends to weaken job attachment, with detrimental effects on training and human capital formation, which is especially important for the employability of youth, and low-skilled workers.

Overall, those already in the core labour market, mainly men aged 25-54, appear to benefit from the job stability induced by strict employment protection legislation, both in terms of employment prospects and the likelihood of holding a permanent job. In addition, their position may be further strengthened by the upward pressure they can exert on wages once they

are employed, at the expense of those at the margin of the labour market, particularly the unemployed and those on temporary contracts who are often excluded from wage negotiations. ■

How can EPL contribute to labour market security?

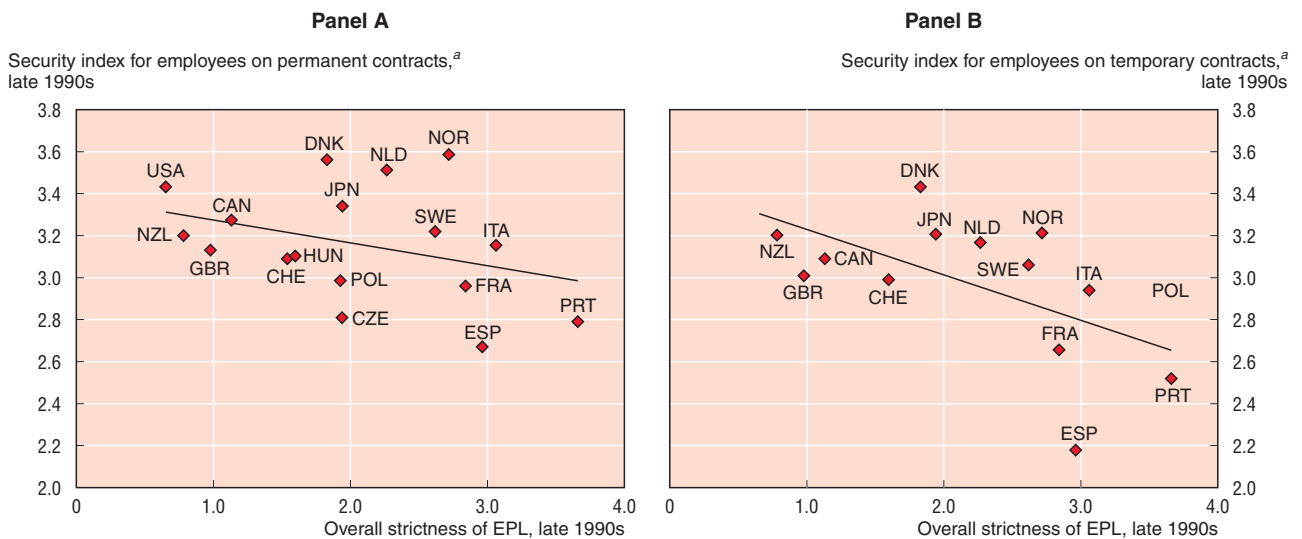
There are several dimensions to the concept of labour market security: stability in employment, the opportunity to find a new job quickly after a spell of unemployment or inactivity, and finally income security for those who are working or are looking for work. Employment protection legislation seems to contribute mainly to the first of these dimensions, namely the stability of employment relationships. The other side of the medal is that job protection also tends to prolong the average spell of unemployment, thus contributing to one form of labour market insecurity. Indeed, at first glance, there is no evidence that workers feel more secure about their job in countries where they are more protected against lay-offs (see Chart 2). Strikingly, not only does more stringent employment protection make temporary workers feel less secure but it seems to have a similar effect on the very workers that it is meant to protect. All in all, the rationale

for protecting jobs rather than focussing on protecting the workers themselves throughout their working lives, including potential periods of unemployment, is not obvious.

Obliging employers to give severance pay and notice periods before laying people off plays an insurance role in guaranteeing a smoother income stream in the event of job loss. But there are other ways of protecting workers. In addition to helping people find new jobs, public employment services and the unemployment benefit system can be more efficient than employment protection legislation in providing adequate income security for the jobless as they can take into account individual situations. One of the major drawbacks of severance pay systems is that they do not consider individual characteristics that are bound to play a key role in determining the degree of income protection needed. For instance, severance payments may not be sufficient for individuals who are at high risk of long-term unemployment, while individuals with more secure labour market status, such as highly-educated workers, may be overcompensated.

This does not mean that employment protection has no role to play. Dismissals have a cost for society, not just the individual, and from the point of view of economic efficiency and welfare, it is important that each

Chart 2. No evidence that stringent EPL makes workers feel more secure about their job



a) Average answer, by country, to the following question from ISSP “Do you worry about the possibilities of losing your job?” – Scale from 1 (I worry a great deal) to 4 (I don’t worry at all).
Source: OECD Employment Outlook 2004.

of the concerned parties, particularly employers, takes this cost into account. The social value of a job may be higher than its private value, reflecting the fact that the government uses payroll or income taxes to finance unemployment benefits as well as public goods such as education or healthcare. A job may thus be unproductive for an employer, while still generating value for society. As a result, left to their own devices, market forces may lead to more layoffs than are desirable from the point of view of collective welfare. Taxing dismissals could thus increase overall economic efficiency.

One way of doing this is by Experience-Rating, as in the United States. This implicates employers' social responsibility more directly in the system by linking employers' social security contributions to the firm's dismissal history and using the funds collected to cover, at least in part, the cost of unemployment payments for the displaced workers. Since its introduction, experience rating in the United States has been shown to have the positive effect of shifting workers from high-turnover firms to employers who offer more stable jobs, thus reducing the number of people temporarily unemployed because they are moving from one job to another.

The Austrian government has recently tried a different way of spreading the cost burden of job losses. Since 2003, employers have had to contribute 1.54% of the payroll to an account calculated individually for each employee, from the first day of employment until contract termination. If the employee changes job, the balance of his/her severance account is carried over to the next employer. In the case of dismissal, an employee can choose to withdraw funds from the account or to save the entitlements built up during the employment period towards a future pension. From the employer's standpoint, this new system suppresses the specific monetary cost of a dismissal, although it may increase labour costs in general. From the employee's standpoint, it reduces the cost of job mobility because workers do not lose the balance of their severance account when taking a new job.

Another way to foster labour market security while maintaining a sufficiently mobile labour force is to use active labour market policies to make it easier for people out of work to return to employment. Denmark is a good example of a country that has chosen to combine a high level of expenditure on active labour market policies, particularly on policies to get the unemployed back into work, with generous unemployment insurance benefits and *moderate*

employment protection legislation, the so-called "Flexicurity" approach. The Danish system is the result of several reforms, started in 1994, and its main feature is the obligation for all unemployed people to take part in programmes to help them get back to work, including private and public job training, training in job search, and targeted education with support from the public employment services. Initially these "active" options were only available after a period during which workers simply received unemployment benefits. This "passive" period has been progressively shortened and now the active options start on the first day of unemployment. The system has been very effective in guaranteeing employment security and maintaining high employment rates, while ensuring sufficient labour market dynamism. However, it is extremely costly, with the active and passive measures overall absorbing 5% of Danish gross domestic product (GDP). And while activation and support during a spell of unemployment may enhance labour market security, the latter might also require a preventive approach, that is acting before jobs are actually lost. ■

Improving skills for more secure jobs?

Investing in human capital is key to improving employment prospects and job security over the longer term. In OECD countries, unemployment rates of workers with less than upper secondary education are twice as high as those of the highly-educated. In any case, whatever a person's level of initial education before entering the labour market, it is no longer enough to carry a person right through his/her working life, due to the rapid pace of change and demand for new qualifications. On average, OECD estimates suggest that a 10% increase in the time spent by an adult on education or training is associated with a) an increase in the probability of participating in the labour market of almost 0.4 percentage point, and b) a fall in the probability of being unemployed of almost 0.2 percentage point.

Incentives for training and learning new skills are particularly important within a strategy of global reform to make the labour market more responsive to change. Workers who receive training during their career are in a better position in the event of lay-off, since they are more successful in searching for a new job. This is particularly true for relatively old and/or low-educated workers. In fact, for a worker aged 35 years or more, the probability of finding a new job within two years after lay-off is estimated to be 8 percentage points

How to design efficient training policies?

Efficient financial incentives must not cover total costs but be a matched contribution. What counts when an individual or an employer is deciding whether to invest in training is the difference between expected benefits and costs, at the margin. Consider for instance the fiscal treatment of training expenditures made by enterprises. Certain countries, such as Austria and Luxembourg, allow employers to deduct more than the actual cost of training (between 110% and 120%) from their turnover when determining taxable income, implying a reduction of marginal costs of between 10% and 20% of total expenditure. The low percentage of the effective subsidy ensures that firms always have important resources for training at stake and that public money does not subsidise a large amount of investment that would have been done anyway in the absence of the subsidy. Moreover, to avoid any burden on the public budget, it is always possible to finance the tax credit with a specific corporate levy independent of training expenditure, as is done in many countries to support specific training funds.

Effective policy packages must increase individual benefits from training, by fostering the portability of skills. By fostering the portability of skills and transparency in the signalling of learning outcomes, trained workers can better price themselves into jobs. Many countries have introduced standardised competence-based qualification systems, where workers are measured by their ability to perform particular tasks, and can thus acquire qualifications without having to attend a special course. Yet much remains to be done to ensure that these mechanisms function correctly.

greater if he/she took some training in the year before job loss. This difference widens to 10 percentage points in the case of workers with upper secondary education or less.

Providing training to workers is therefore likely to be an effective way of enhancing their labour market security. But employers and workers tend to underinvest in training, because of imperfections in labour, capital and training markets. Policy action is required to tackle these market failures. However, when deciding lifelong learning policies, special care must be taken to avoid an excessive burden for the public budget and “deadweight losses” – that is, subsidising employers and workers for an investment that they would have made anyway. ■

Conclusion

Overall, employment protection legislation can be seen as one component of a comprehensive strategy to insure workers against labour market risks, which would also rely on well-designed unemployment insurance benefits, effective activation policies, make work pay policies, and support to investment in human capital throughout the working life. Such a policy mix may help guarantee sufficient dynamism in the labour market, while ensuring adequate employment security among workers.

The precise balance between the different policy planks depends on country circumstances and

institutions. In Denmark, the combination of some employment protection provisions with active labour market policies (mostly based on training) and effective re-employment services aimed at enhancing hiring prospects, has contributed to a better functioning of the labour market. However, other countries seem to have achieved similar improvements in labour market performance by reducing both employment protection and unemployment benefits, with little recourse to active labour market policies. As part of the reassessment of the OECD Jobs Strategy, further work will be carried out to shed light on the interactions between these policy planks, and how different combinations of policies might achieve similar employment outcomes. ■

For further information

For further information on the OECD’s work on employment protection legislation and training, please contact:

Andrea Bassanini,
tel.: (+33 1) 45 24 90 32;
e-mail: Andrea.Bassanini@oecd.org

Glenda Quintini,
tel.: (+33 1) 45 24 91 94;
e-mail: Glenda.Quintini@oecd.org

Anne Saint-Martin,
tel.: (+33 1) 45 24 85 90;
e-mail: Anne.Saint-Martin@oecd.org

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Where to contact us?

FRANCE

OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD BERLIN Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail:
berlin.contact@oecd.org
Internet:
www.oecd.org/deutschland

JAPAN

OECD TOKYO Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail:
mexico.contact@oecd.org
Internet:
www.oecdemexico.org.mx

UNITED STATES

OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
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