Comment on Skedinger: Employment consequences of employment protection legislation

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Per Skedinger has written a useful survey of the empirical literature on the employment consequences of legislated labour turnover costs – an area where empirical research is quite complicated and the results difficult to evaluate. To put the paper in context I will, to begin with, make a distinction between three types of labour turnover costs:

- Resource costs, such as costs associated with the search for workers, the scrutiny of applicants and training costs.
- Labour turnover costs caused by the market powers of employees with permanent job contracts, i.e. insiders on the labour market. These employees are able to create very high, indeed even prohibitive, hiring costs for firms that want to hire individuals willing to work at wages below those received by already employed workers – a basic background to the insider-outsider divide in the labour market.
- Labour turnover costs caused by legislation on employment protection, such as compulsory notification of lay-offs, rules against dismissal "without cause", severance pay, seniority regulations (such as last-in first-out rules), etc.

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Skedinger's paper is confined to the last type of labour turnover costs. This means, in fact, that he asks whether legislated labour turnover costs are so important relative to other types of labour turnover costs that they have identifiable effects on the employment situation. One difficulty of identifying such effects is that the other types of labour turnover costs may not be independent of legislated costs; different types of labour turnover costs may either be substitutes or complements to each other. There are also problems of identification, since there may be reverse causation in the sense that the employment situation may induce governments to change the rules of job protection. As in other surveys of empirical studies, there are also well-known problems of generalizing from a number of partly conflicting empirical studies; one reason is the difficulty to evaluate the relative *quality* of each of the studies.

I will organize my discussion in terms of different (although partly overlapping) *theoretical predictions* of the effects of legislated labour-turnover costs. I confine myself to five predictions.

1. Legislated labour turnover costs would be expected to result in reduced employee turnover. We would therefore expect that the flows into and out of unemployment are reduced, which would be reflected in a combination of longer average job tenure and longer average unemployment duration for individuals.

Both cross-country aggregate studies and within-country studies deal with these issues and the results are broadly consistent with the predictions. Are there any welfare implications of this result? There is probably general agreement among observers that longer unemployment duration is welfare-reducing. In contrast, it is not obvious how we should look upon longer average job tenure from a welfare point of view. Some observers may argue that it is welfare-increasing since it reflects increased job security, while others may argue that long job tenure, at least when it is the result of last-in-first-out rules, often reflects a reluctance among individuals to move to other, more suitable jobs (since they would then lose seniority).

2. *The insider-outsider divide* in the labour market would be expected to be accentuated by higher legislated labour turnover costs for workers

with permanent employment contracts (labour-market insiders). One reason is that the insiders may use their increased market powers to push up real wages, since wage formation in the real world does not take place in atomistically competitive labour markets.

Both studies based on cross-country aggregate data and studies relying on within-country data address these issues. The results are basically consistent with these hypotheses. While the job prospects for older workers tend to be boosted by such policies, the main losers are young people and probably also women and non-European immigrants. Skedinger also reports an empirical study of his own according to which stiffer job-security legislation for permanently employed workers results in an increase in “involuntary” temporary employment, in the sense that individuals who would prefer permanent contracts have to settle for temporary employment. One interpretation is that such legislation induces firms to offer more temporary job contracts at the expense of permanent job contracts – a predicted consequence that is consistent with a previous empirical study by another author. Moreover, a number of authors studying within-country data have found that reforms that make it easier for firms to hire workers on a temporary contract also tend to boost the market powers of insiders, and therefore increase the opportunity for these to push up their wages. This counteracts the direct positive employment effects of firms’ increased interest in hiring workers on temporary contracts.

3. Higher labour turnover costs would be expected to reduce labour market dynamics in the sense of *less reallocation* of labour across production sectors and firms.

The results of both within-country studies and recent studies based on cross-country disaggregate data are broadly consistent with this hypothesis. While some of these studies refer to job-to-job flows, others refer to employment inflows and outflows. Some within-country studies also suggest that the effects on employment dynamics are greater for small than for large firms.

- Legislated job protection would be expected to prolong (stabilize) both high aggregate employment and high aggregate unemployment, hence to contribute to employment and unemployment persistence.

It is mainly cross-country aggregate studies that have dealt with this issue. Skedinger finds that the studies in his sample tend to be consistent with these hypotheses. He reports that "stringent legislation seems to dampen the unemployment-increasing effects in the short term in case of macroeconomic shocks, but prolongs the period required for unemployment to return to the previous level".

- Theory and intuition predict ambiguous effects on the *average level* of aggregate employment and unemployment over the business cycle, since both aggregate hiring and aggregate firing would be expected to fall.

From his survey Skedinger concludes: "It seems difficult to substantiate that there is a robust relationship between employment protection and aggregate employment or unemployment". Presumably, this characterization is based on the observation that nine of the surveyed studies based on cross-country aggregate data report adverse employment effects while seven studies report either no statistically significant effects at all or positive effects – and that studies based on disaggregate cross-country data and within-country date give similar results. However, on close inspection of the studies, we also find that while nine aggregate cross-country studies give negative effects, only two give positive effects (five studies not revealing any significant effects at all). Similarly, five within-country studies give negative effects but only one study gives positive effects (three studies reporting no significant effects at all). Only one reported study using disaggregate cross-country data deals with the issue and this study reports negative effects on aggregate employment.

Thus, as an alternative, or complement, to Skedinger's agnostic characterization of the results of the surveyed empirical studies, we may say that it is more likely that the effects on average aggregate employment are negative than that they are positive. Naturally, I then assume that the quality of the studies with negative effects is not analytically inferior to that of the other studies.

In my own writings on these issues, I have argued that it is not enough to look at the consequences of job-security legislation for *average* employment (or average unemployment) over the business cycle, or over several business cycles. I have suggested that the *social* implications of legislated job protection differ depending on the macroeconomic situation. Employment inertia (persistence) generated by high legislated job protection may be regarded as a social advantage when aggregate unemployment is initially low, as it was in European countries in the 1950s and 1960s. High employment is then stabilized. However, such inertia may be regarded as a social disadvantage if unemployment is initially high, as has been the case from the early 1980s in most countries in Western Europe, in particular if there is great uncertainty about the future macroeconomic situation (Lindbeck 1993, 1996). In this situation, it is instead high unemployment that is being stabilized. Since long-term unemployment may be regarded as a particularly serious social problem, it is reasonable to assert that the welfare costs of an increased persistence of high aggregate unemployment during a deep recession are larger than the welfare gains of the delay of the rise in aggregate unemployment in the case of unemployment-creating shocks in booms. This illustrates how an institutional feature – in this case job-security legislation – that may be favourable from a social point of view under certain circumstances may become a serious social problem under other circumstances. I have suggested that these mechanisms may help explain why the gradually more rigorous job-security legislation in Europe in the 1960s and the early 1970s was not a serious social problem, but did become a social problem after the large unemployment-creating macroeconomic shocks in the 1980s.[1]

References

Lindbeck, A. (1993), Unemployment and Macroeconomics, MIT Press, Cambridge MA.

Lindbeck, A. (1996), The West European employment problem, Weltwirtschaftliches Archiev 132, 609-637.

[1] Ljungqvist and Sargent (1998) have suggested a somewhat similar hypothesis, although they refer to microeconomic (structural) rather than macroeconomic shocks.

Ljungqvist, L. and Sargent, T. (1998), The European unemployment dilemma, Journal of Political Economy 106(3), 514-550.