

ILO Research Department

EMPLOYMENT PROTECTION LEGISLATION TO PROMOTE QUALITY JOB CREATION

An effective system of Employment Protection Legislation (EPL) must balance, among other things, the needs of workers for income and job security with employers' need to adjust the workforce in an increasingly dynamic world of work. Indeed, rather than debating the benefits of more versus less EPL, more attention should be paid to the correct design of EPL, its interaction with other benefits, and its implementation and effective enforcement.

Key findings

The review of existing studies as well as new findings from a novel policy compendium of labour market reforms undertaken in recent years shows that:

- There is no direct link between the level of stringency of EPL and the aggregate employment rate
- The global financial and economic crisis that first erupted in 2008 has led to an increased focus by governments on reforms of labour legislation
- Deregulatory EPL reforms increase unemployment in the short run when implemented during crises

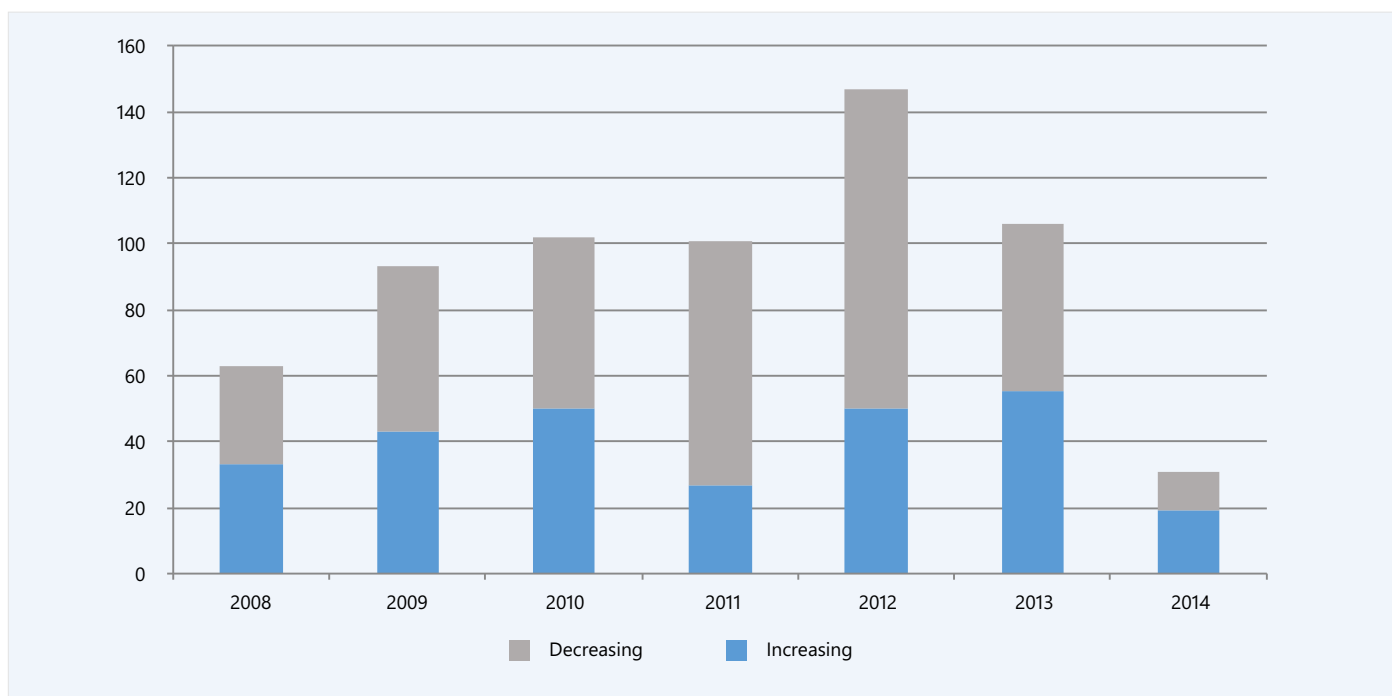
Research question

This Research Brief presents the main findings of the article "Drivers and effects of labour market reforms: Evidence from a novel policy compendium", published in the *IZA Journal of Labor Policy*.¹ Reforms of labour legislation have been amongst the most widely spread policy interventions used by governments in recent years. In developed economies, labour market legislation reforms have been perceived as useful instruments for sustaining employment levels in times of rising unemployment rates and limited public resources. In developing economies, the attention towards labour market legislation has mostly concerned the need to protect workers against

shocks in labour demand resulting from fluctuations in international trade and GDP growth. In both cases, policy interventions have differed with respect to their (i) motivation (e.g. enhancing competitiveness or kick-starting job creation); (ii) direction (e.g. increasing or decreasing protection); and (iii) area of intervention (e.g. permanent or temporary workers, collective bargaining). This variation raises questions about the determinants of labour market reforms as well as about the effectiveness of these reforms in achieving their objectives.

1 The paper is available at the following link:
<http://izajolp.springeropen.com/articles/10.1186/s40173-016-0071-z>

Figure 1. Number of EPL reforms implemented globally by direction of change



Source: Adascalitei and Pignatti Morano (2016).

What works

In order to fill this gap, a novel compendium of labour market reforms was built that covers 110 advanced and developing economies between 2008 and 2014 – see box 1 for the methodology and definitions used to compile the compendium. A descriptive analysis based on the data in the compendium shows that reform intensity has increased during the first phase of the global financial and economic crisis, reaching a peak in 2012². Between 2012 and 2014 the average number of reforms passed annually decreased, matching levels that characterized the pre-crisis period. Moreover, the majority of reforms have decreased existing levels of regulation – although large disparities are registered across geographical regions and policy subdomains. Reforms of permanent contracts have been at the centre of the attention of policymakers in developed economies, while governments in developing economies have primarily reformed collective bargaining institutions. Finally, the majority of reforms have been of a permanent (rather than temporary) nature.

Drawing on the compendium of labour market reforms, the purpose of the paper is twofold. First, it seeks to explain determinants underpinning the reforms. The results of the analysis show that high and increasing unemployment rates have positively affected the probability of adopting labour market reforms – thus confirming the hypothesis

that crises act as catalysts of reforms. At the same time, the reform intensity is positively associated with the simultaneous implementation of fiscal consolidation measures (especially in developed economies) as well as the presence of a fixed exchange rate regime (given the more limited room for monetary policies). Second, the paper examines the short-term effects of these labour market reforms on unemployment rates. In the baseline specification, the results indicate no effects of either a reduction or an increase in labour market regulation on changes in unemployment. However, when analysing the effects of reforms at different points of the business cycle, the results reveal that labour market reforms that tend to reduce protection increase the unemployment rate in the short run when these reforms are implemented during crises – while no statistically significant effect is present if they are implemented during periods of economic stability or expansion. These findings are in line with those obtained by a number of recent studies that have examined the short-term impact of structural reforms. However, these studies have focussed until now only on advanced economies. In particular, deregulatory labour market reforms – by facilitating the firing procedures – tend to generate an increase in unemployment in the short run when they are implemented during crises (IMF, 2016; OECD, 2016).

These novel results complement the findings of the rich empirical literature that has examined the general equilibrium effects of EPL on labour market performances. Indeed, the majority of these studies found that on average the degree of stringency of EPL has no effect on the aggregate level of employment in the long run (ILO, 2015). One caveat in this respect refers

² Reform here refers to a single change in the legislation – rather than a full-fledged policy intervention. If a single policy package introduces several changes in the legislation, these are included, analysed and counted separately. See box 1 for details.

Box 1. The compendium of labour market reforms: A methodological note

In order to track reform efforts in the area of labour legislation, a novel policy compendium has been constructed covering 110 countries between 2008 and 2014. Importantly, and given the numerous obstacles to assessing in each specific case the relative importance of the changes to the legislation introduced, a choice has been made to decompose every reform into its different components and then to classify them separately in the compendium – therefore avoiding any assessment of their separate importance. In this sense, “reform” refers to a single change in the legislation – rather than a full-fledged policy intervention. If a single policy package introduces several changes in the legislation, these are included, analysed and counted separately. For instance, the 2012 labour market reform in Spain corresponds to 18 separate entries in the compendium.

The methodology used to compile and code the data follows previous work in this field, while being adapted to the wider geographical coverage (i.e. developed and developing economies) and the narrower area of research interest (i.e. employment protection). In particular, the main sources of information are represented by the ILO employment protection legislation database (EPLex) and the ILO database of national labour, social security and related human rights legislation (NATLEX). These are the two most comprehensive inventories of labour legislation with a global coverage, presenting detailed and comparable information on the state of labour legislation in both developed and developing countries. The information collected from the ILO databases is complemented and crosschecked with the data available in the EU Commission database on labour market reforms (LABREF), the social reforms database of the Fondazione Rodolfo De Benedetti (fRDB) and IZA as well as national and international reports.

A number of caveats apply to this approach. For instance, the compendium does not track secondary or administrative regulation. In this respect, the assessment made for the compendium is based uniquely on the interpretation of legislative text of each reform. However, issues of implementation and enforcement are equally critical in measuring the underlying impact and direction of a policy change. Moreover, these issues are likely to differ substantially between developed and developing countries – with enforcement being generally weaker in the latter – as well as between systems of common and civil law given the different importance of judicial cases in the two systems. In this respect, the research does not substitute or supersede the role and the comments of the ILO supervisory mechanism nor the reference that should be made to International Labour Standards.

In this respect, the present exercise does not aim to replace nor challenge the insights from traditional indicators of EPL – see ILO (2016) for a novel contribution in this respect. In particular, higher counts for a particular country or policy subdomain do not necessarily reflect that more extensive or effective policies are being adopted by governments. For instance, a gradualist reform approach would be incorrectly interpreted as a sign of policy activism compared to an abrupt single change to the legislation. Similarly, policy reversals could inflate the number of interventions registered in the compendium. In order to partially deal with these problems, the compendium introduces dummies to code labour market reforms along several dimensions. In particular, for each reform it is noted (i) the direction of the intervention (i.e. increasing or decreasing legislation); (ii) its temporal horizon (i.e. temporary measure or permanent change in the legislation); and (iii) its coverage/target group as a share of the eligible population (i.e. complete reforms targeting the majority of the eligible population or two-tier reforms applying only to a subgroup).

to economies characterised by an overly restrictive or overly flexible system of EPL, which can generate an inappropriate framework of incentives (e.g. in terms of risk-sharing between employers and employees) and can therefore result into lower employment levels (ILO, 2012).

Policy considerations

In the aftermath of the global financial crisis, the policy debate on the merits of changes in EPL has intensified as many countries opted for adjustment strategies that included extensive labour market reforms. Based on the most recent evidence, policy-makers should consider, among other things, several dimensions when reforming EPL systems:

Ensure design of EPL is appropriate

The dichotomy between more versus less regulation is largely misplaced, as the literature generally shows no effect of EPL regulations on aggregate employment (and unemployment) rates. Instead, the policy focus should move to promoting good regulations that improve the overall job security without hampering employment creation. For example, in the Netherlands the 2014 Work and Social Security Act sought to make legislation over dismissals more predictable. Under the previous system, employers could at their choice decide to turn to the court to terminate an employment contract or rather seek permission from the Dutch Labour Authorities. In an effort to rationalise the system and make dismissals' procedures more predictable, the new legislation has established that (i) terminations of contracts for economic reasons or long-term disability have to be dealt by the Dutch Labour Authorities; while (ii) dismissals for all other reasons need the approval of the court.

Further reading

Adascalitei, D. and Pignatti Morano, C. (2016) "Drivers and effects of labour market reforms: Evidence from a novel policy compendium", in *IZA Journal of Labor Policy* 5:15.

ILO 2012. *World of Work Report 2012: Better jobs for a better economy*. ILO, Geneva.

—. 2015. *World Employment and Social Outlook 2015: The changing nature of jobs*. ILO, Geneva.

—. 2016. *Employment Protection Legislation: New Approaches to Measuring the Institution*. ILO, Geneva.

IMF 2016. *World Economic Outlook 2016: Too Slow for Too Long*. IMF, Washington DC.

OECD 2016. *OECD Employment Outlook 2016*. OECD, Paris.

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Quality of jobs is a central consideration

EPL should not prevent the emergence of new forms of work, but rather promote their correct use. For example, the 2012 Spanish labour market reform limited the maximum duration of temporary contracts to 24 months and introduced tax benefits for employers that convert fixed-term contracts into permanent contracts. Similarly, the presumption of dependent employment has been introduced for formally self-employed individuals in Portugal during the recent crisis in an effort to limit the misuse of this form of employment relation (e.g. for fiscal reasons). Under the new legislation, the burden of proving that the individual is indeed self-employed (rather than an employee) has been moved to the employer. At the same time, self-employed individuals have been granted access to social security and a clear definition of self-employment was introduced in the legislation.

Take into consideration policy complementarity and interactions

The effectiveness of a system of EPL largely depends on its interaction with other areas of policy intervention. Even a well-designed system of EPL is indeed unlikely to be fully effective if adequate links with other policy areas are not developed. For instance, activation policies will help workers transition from declining to expanding industries and in this way reduce unemployment spells. Similarly, adequate income support during periods of unemployment can mitigate the negative impact on living standards. Well developed and accessible policies in these two areas can then be linked with a more flexible system of EPL – as is the case in Denmark. Indeed, workers moving to unemployment will be adequately assisted and helped in finding a new job. Finally, EPL systems should be designed also in accordance with the applicable system of collective bargaining in order to ensure an adequate balance between wage and employment adjustment.