



European
Research Area

EUROPEAN POLICY BRIEF



**Employment protection, productivity,
wages and jobs in Europe**

*An EU-funded collaborative
project involving eight
organisations across Europe*

16/2/13

INTRODUCTION

**Context – the importance of
employment protection
legislation**

Employment protection legislation (EPL) provides a right to job security that is highly valued by employees. At the same time, EPL brings costs to business in the form of reduced flexibility, which can be revealed via lower total factor productivity (TFP) growth. There may therefore be a trade-off between employment stabilisation and undesirable productive inefficiency. Welfare issues associated with EPL are also of policy relevance, in particular in countries with marked two-tier labour markets. In the light of the current recession, while high EPL protects permanent workers from losing their jobs, it may damage employment prospects of young people and other disadvantaged groups of workers not likely to be covered by EPL.

**The measurement of the
impact of EPL on growth of
TPF, real wages and
employment**

The aim of the research is to provide measures of the impact of EPL on TFP growth, and also on real wage and employment growth. One of the main contributions from our research is that EPL's productivity, wage and employment effects can be interpreted within a conventional labour supply and demand framework. The project therefore provides the basis for an evaluation of this important policy. The methodology is to use panel statistical methods based on industry-country-time datapoints. While EPL is a national policy and cannot vary by industry, the research follows insights

that suggest that EPL bears more heavily on industries with low labour turnover, and which cannot rely much on “natural wastage”.

KEY OBSERVATIONS

EPL reduces both TFP and wage growth, leaving employment broadly unchanged

The research finds that where EPL bites, TFP tends to fall, which is interpreted as reflecting business costs of implementing EPL. At the same time, we find that wage growth also tends to fall, and so employment growth is not affected significantly. Nevertheless, EPL appears also to raise hours worked per person employed, which implies outsider groups (e.g., young workers) may be excluded. EPL effects are less pronounced in services than manufacturing, but in both sectors benefits must at least equal costs, since overall employment is maintained.

The fall in TFP growth is considerable, about -0.5% annually, which can be compared to overall annual average growth of 1.5%. At the same time, the research also finds that EPL is associated with reduced real wage growth (about -0.25% annually, relative to a sample average annual increase of 2.4%), which can be interpreted as reflecting the compensating wage differential associated with job security.

Whether the reduction in wage growth is sufficient to compensate for reduced productivity can be simply judged in the paper’s framework from employment growth, which is not reduced significantly in industries affected by EPL. Thus, the benefit of job security provided by EPL appears broadly to be paid for by the workers themselves.

Service sector industries are less affected by EPL than manufacturing

The paper also finds differences in the impact of EPL between sectors. First, EPL reduces TFP more in manufacturing than services. This result is according to expectations since manufacturing has naturally lower labour turnover rates than services, and hence cannot rely as much on “natural wastage” to accommodate EPL. To some extent, therefore, EPL may represent a problem for manufacturing. However, wages also fall more in manufacturing than services, leaving employment again not much affected, so the challenge to manufacturing might be more apparent than real.

Large-firm dominated industries are more affected by EPL than small-firm

Furthermore, TFP growth is reduced by EPL more in large-firm dominated industries than small. In this sense, EPL can be seen as bearing harder on the larger firms. Again, real wage growth falls to reflect the benefits of the extra job security, with this fall being more marked in the large firm sector, and apparently preserving employment. In sum, employment - and thus profitability - appears to be preserved in the face of EPL at the overall level,

Hours worked per employee increases with EPL, implying adverse distributional effects

and also in manufacturing, and in the large-firm dominated sectors.

A problematic result is in the distribution of the benefits of EPL. The results point to EPL increasing hours worked per employee, which is to be expected since EPL raises the costs of hiring and firing. While hours worked per employee decline at about -0.24% annually for the sample as a whole, this decline is halved in EPL-affected industries, primarily manufacturing industries, and large-firm dominated industries. Presumably, outsider groups such as young workers without experience have less of a chance of finding jobs in these industries. The effect of EPL on prospects of outsider groups is a topic worth pursuing in future research.

KEY POLICY MESSAGES

There are trade-offs in the costs of EPL so reforms of the labour market need to progress with caution

The question for policy-makers is how strict the country's EPL should be. EPL inevitably restricts the employer's "right to fire", which clearly has advantages for incumbent employees, but also brings possible disadvantages in terms of less business adaptability. Strict EPL might also result in fewer job opportunities for those entering the labour force (outsiders) since businesses respond to the risk and uncertainty imposed by restrictions on the right to fire by behaving more cautiously in their hiring, even in good times

Strict EPL has costs in terms of lower TFP growth, but the lower TFP is accompanied by lower real wage growth, so that employment growth is left unaffected. The workers, in a sense, bear the cost of their improved job security by accepting lower wages. Importantly, since employment growth is unaffected by EPL, business profitability is also maintained. The policy implication is that EPL can be as strict as in Austria (top quartile), or as weak as in Denmark (bottom quartile), and this difference will not matter for jobs. However, this conclusion may be too simplistic since it ignores dynamic impacts. Lower TFP leads to lower standards of living in the long run, and this reduced competitiveness is likely to reduce future employment growth.

Overall, the policy recommendation is for caution. Reforms of the labour market need to be assessed in conjunction with other features of the institutional environment. The result that strict EPL appears to have no significant adverse effects on overall employment is only possible because wages are flexible downwards. Freely flexible wages are thus a necessary

concomitant of stricter EPL, and policy makers might not want such flexibility. The research also reveals possible distributional disadvantages from EPL. Specifically, hours per worker increase with the strictness of EPL, implying that job opportunities become less equally shared. It might be that employers indeed become more cautious in their hiring when EPL is strict, and hence evaluation of the costs versus the benefits of EPL also must take account these adverse distributional aspects.

Project paper

Ana Rincon-Aznar and W. S. Siebert (2012) 'Employment protection, productivity, wages and jobs in Europe'. INDICSER Discussion Paper 36, www.indicser.com

RESEARCH PARAMETERS

Aims and methodology of the project

The objective of the INDICSER project is to develop indicators which provide information on the performance of service sectors in the EU. At the heart of the project are concerns that such indicators should be valid in terms of concepts, measurement methods and feasibility, but should also have value in terms of their usefulness for policy. Therefore the approach adopted is to include both an EU-wide application of existing concepts and develop and experiment with new concepts. This will be carried out within an overall coherent structural framework designed to provide information on the key determinants of growth and productivity.

The indicators are divided into two broad areas: market services, whose performance is crucial to growth in the EU relative to its competitors; and non-market services, mostly government-run, where it is important that taxpayers can assess how far public spending is effective, as well as non-market services' contribution to the economy. For market services the project will construct indicators that describe trends in growth and productivity in service sectors and indicators that are useful in analysing determinants of growth, such as innovation, ICT, intangible capital, competitive environment and foreign presence.

In view of the global financial crisis, financial services will be covered in greater detail with new output measures developed and applied to a large set of EU countries. For non-market services much of the analysis will focus on indicators for health and education, where significant new research is required on both the conceptual framework and practical implementation. Finally, the project will also develop experimental indicators which might be useful in the future, covering insurance, collective services, distributive trades and research sector output.

PROJECT IDENTITY

Co-ordinator

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Funding Scheme

FP7 Socio-economic Sciences and the Humanities
Research area: Indicators for the European service sector (SSH-2009-6.2.1.)
Topic: Improved ways of measuring both the potential for and impact of policies
Collaborative Project (small or medium-scale focused research project)

Duration

1 January 2010 – 31 December 2012 (36 months)

EU Contribution

€ 2,350,000

Website

www.indicser.com

For more information

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Further reading

Bassanini, A. L. Nunziata and D. Venn (2009), "Job Protection Legislation and Productivity Growth in OECD Countries", *Economic Policy*, 24:352-402.

Bentolila and Bertola (1990), "Firing Costs and Labour Demand: How bad is Eurosclerosis?", *The Review of Economic Studies*, Vol. 57, No. , July 1990, pp. 381-402.

Summers, L, (1989), "The simple economics of mandated benefits", *American Economic Review*, 79: 177-83.