Chapter 3 : Labour market reform: towards more efficient regulation

Main Findings

- Countries faced with the twin challenge of low employment growth (chapter 1) and stabilizing fiscal positions (chapter 2), have turned increasingly towards amending labour market institutions, notably regulations regarding the hiring and firing of workers is often seen as a way to spur job creation. In particular, the most recent evidence indicates that:
    - Further decentralization of collective bargaining and in some cases, restrictions on bargaining. In fact, 26 out of the 40 countries where the data on bargaining coverage is available have had a decline in the coverage rate between 2000/01 and 2008/09. Some of the decline is part of the broader trend that was already taking place before the crisis, while many others were accelerated by the financial and economic crisis;
    - Easing of dismissal procedures in labour legislation (particularly for collective dismissals) and general weakening of employment protection. It is estimated that in 51 countries out of 128 (equal to 40 per cent of countries) industrial relations institutions have been reformed, while in 43 countries out of 128 (34 per cent) workers' representation rights have been modified in the recent years;
    - 51 countries out of 128 (equal to 40 per cent) have changed the legislation over dismissal procedures by mainly modifying the regulation of severance payments and notice periods. This trend is particularly visible in the European Union, where changes in dismissal procedures occurred in 24 out of 27 countries;
    - Moreover, in 63 per cent of the 128 countries with available information, governments unilaterally implemented anti-crisis measures without formal agreement or approval from the social partners.
- As these trends show, in an attempt to tackle high unemployment and spur job creation, there is a general move towards decentralization and deregulation. But the empirical evidence on the link between EPL and employment outcomes is far from being conclusive and similar is the story with the link between collective bargaining and labour market outcomes. In particular, this chapter illustrates that:
    - There is a non-linear relationship between EPL and employment. More importantly, from low levels of regulation to an average level of 2.1 in case of the OECD countries, employment increases as the EPL gets more stringent;
    - Similarly, highest employment rates are found in either a fully decentralized (but organized) bargaining and in fully centralized bargaining systems. Even though the

recent trend has been towards decentralization, actually disorganized decentralization is much worse than an intermediate level of bargaining;

- Likewise, the relationship between private sector investment and stringency of EPL is also non-linear. In fact, there is a positive relationship between the two variables until the EPL score of 2.7, which is slightly above the average level of strictness among the OECD countries. Beyond 2.7, the relationship between the two is negative;
- Finally, there is a weak negative correlation between EPL stringency and social well-being, and this holds for both developed and emerging economies. However, higher collective bargaining coverage is generally associated with higher social well-being.

- As the empirical evidence shows, there is little support in the data for a linear approach when it comes to the interaction between labour market institutions and labour market performance. Policy debate has been too focussed on "less regulation vs. more regulation" instead of "efficient regulation" – that is, a collectively negotiated level of employment protection that would ensure job quality and satisfaction without preventing economic efficiency and employment growth.

Introduction

As chapter 1 documented, job creation remains tepid at best and job quality has deteriorated. Not surprisingly, a key issue at the centre of these trends is labour market regulation. As countries are faced with the twin challenge of low growth and seemingly insurmountable debt burden (see chapter 2 for more), deregulating the labour market is seen as a way to spur job creation and growth. This is particularly the case in the European economies, as countries in the region continue to languish in the aftermath of the financial and economic crisis. Furthermore, the crisis has accelerated the longer-term trend towards decentralization of collective bargaining. Some of these efforts, however, may be counterproductive and exacerbate labour market duality which could dampen the medium-term prospects regarding income generation and productivity, not to mention raising considerable equity concerns and individual well-being. There is a need to learn from the experience of countries that have espoused the path to "efficient regulation" rather than "deregulation".

In particular, this chapter analyses the developments in labour market institutions such as employment protection legislation (EPL) and collective bargaining and their economic, labour market and social implications. Section A provides an overview of EPL and collective bargaining with a focus on their theoretical links with macroeconomic performance and labour market outcomes. Moreover, it includes an overview of recent changes in EPL and collective bargaining – covering over 128 countries where qualitative data is available in terms of legislative changes. For 43 countries, the chapter provides an update to the quantitative data on EPL available based on OECD methodology and ILO sources. Section B assesses the impact of these changes across countries by exploiting the

quantitative data on EPL to identify any causal links with employment, macroeconomic performance, and general well-being. Section C concludes by providing a new strategy based on efficient regulation, supported by concrete examples where countries have managed to achieve a balance between employment protection and firms' ability to withstand economic downturns.

A. Labour market institutions: Overview

Employment protection legislation (EPL)

Employment protection legislation is one of the many labour market institutions in a country designed to give employees protection from the fluctuations in earned income, which normally occur when the employee loses his job, individually or collectively. Generally speaking, EPL imposes restrictions on firms' ability to fire employees, while it also regulates the use of temporary workers. However, there are exemptions to EPL, which usually depend on the size of the firm. A well-functioning EPL, which balances the need to provide income security to workers and allow firms' to adjust employment (hours and/or jobs) based on fluctuations in aggregate demand, is an important determinant of a country's ability to weather an economic downturn. Economic theory says that EPL has a direct impact on allocation of labour, but since internationally comparable quantitative measures of EPL have numerous problems (see Box 3.1 for more), labour market impact of EPL remains mostly an empirical question (Bertola, Boeri, and Cazes, 2000).

EPL has three main pillars: i) regular employment (permanent or open-ended contacts), ii) temporary employment, and iii) collective dismissals. Within regular employment, legislation addresses procedural inconveniences (administrative and legal), notice periods and severance pay, and difficulty in hiring or dismissing employees. Severance pay is a direct cost of dismissals for employers, and it is usually defined as a number of wage days (or months) per seniority year. In terms of difficulty of dismissals, the legislation usually covers the definition used for 'just cause' for dismissal – valid reasons include, firm's economic situation (loss in revenues, looming bankruptcy) and personal circumstances of the employee (disciplinary misconduct or neglect of work). When a firm cannot show that there were valid reasons for a dismissal, then the dismissal can be declared 'without just cause.'

The second pillar of employment protection is legislation covering temporary employment. Regulation for temporary employment mostly deals with the length of contracts, and is usually designed to give firms flexibility in adjusting employment during economic fluctuations. In order to prevent excessive use of temporary contracts, there are laws governing their use, the chief among which is the regulation that stipulates the reasons for which a firm can hire workers on temporary contracts. For example, temporary contracts are generally accepted for seasonal works, and also for employing specific groups of workers such as young people and new entrants to the labour market (Skedinger, 2010). The primary restriction an employer faces is the length of time for which it can keep an employee on a temporary contract.

Finally, the third pillar of EPL is regulation governing collective dismissals, which tend to be subjected to stringent restrictions. The definition of collective dismissal depends on the number of employees

concerned and it tends to vary among countries. Collective dismissals have broader economic and social consequences hence regulation is meant to strike a right balance between the socio-economic costs and the need for employer to adjust employment. The restrictions put in place for employers include, mandatory consultations with union or worker's organization, approval from the public administration office, in some cases higher severance pay than individual dismissals, and mandatory steps to help the laid-off employees find new employment through job-placement services and training (Skedinger, 2010).

Box 3.1: Employment protection legislation and the quest for a satisfactory indicator

Measuring employment protection is a difficult task and depends very much on the data availability. Some quantitative aspects can be easily computed, such as the number of months' notice required for individual dismissal and severance pay. But other aspects, such as the interpretation of the definition of "just cause" for termination, are more difficult to measure precisely. In order to carry out international comparisons of employment protection regimes, various summary indicators have been computed by academics and international organizations[1] to describe the "strictness" of employment protection legislation in each country. But comparable datasets remain scarce: the OECD for example has developed such a methodology and compiled synthetic EPL indicators ranging from (0 to 6), with 6 being the most stringent legislation.

Since the OECD index covers mostly industrialized countries (recently there has been attempts to include large emerging and developing economies), international organisations such as the World Bank or the Fraser Institute have developed other indicators. The "employing workers index" which is part of the Doing Business Indicator published by the World Bank Group has been however subject to strong criticism. As highlighted by the ILO, this indicator suffered from a number of both conceptual and methodological flaws; in particular it relies on a simplistic "regulations are costs" perspective (Berg and Cazes, 2008). While trying to influence policy changes in a country is a novel goal, doing it based on a narrow and unbalanced view of the labour market could lead to misleading and unfair policy recommendations with disastrous consequences.

Another limitation of those EPL indexes relates to the omission of enforcement procedures: they are *de jure* indicators, based on the provision of legislation in place, such as labour codes, employment protection acts, and other types of laws. Yet, there are several important indications that asymmetries across countries (and over time) in the degree of enforcement of labour legislation maybe more marked than differences in regulations per se. Enforcement plays a crucial role in the functioning of labour markets, notably in determining labour market flows such as job losses and inflows into unemployment (Bertola, Boeri and Cazes, 2000).

In case of developing and emerging economies, the presence of large informal sector makes it difficult for the EPL indicator to be very meaningful. Moreover, most of the low and middle income countries generally provide *de jure* greater employment protection than the average for the OECD but this is mainly because the legislation is usually the only protection available for workers and in that, it covers only formal workers. Meanwhile, since enforcement of EPL is even more of a challenge in developing countries, formal workers are afforded little protection in practice. This gap in protection remains one of the key challenges facing policymakers in developing and emerging economies.

Since all indexes of EPL are essentially comparative evaluation of labour laws, by their design they include elements of subjectivity (Skedinger, 2010). One way to get around the problem of this subjectivity is by not looking at EPL indexes in isolation but by examining the links with other institutions features (Bertola et al, 2000). By employing a rather nuanced approach, there can be a better understanding of EPL and its impact on labour market outcomes.

The empirical evidence on the effects of EPL can be divided into the following three categories: i) cross-country studies using aggregate data; ii) cross-country studies using disaggregate data; and iii) within country studies using disaggregate data (Figure 3.1). Most commonly found empirical evidence is of the first type but in the last few years there has been a notable shift towards using disaggregated data and also there is increasingly more reliance on within country evidence. However, irrespective of the methodology used, there is a general consensus that the impact of EPL on employment/unemployment levels is rather mixed. But in terms of distribution, there is clear evidence that vulnerable groups such as the youth and women are negatively affected by EPL.

[1] For example: Bertola (1985); OECD (1994, 1999), and Holzmann et al.

Figure 3.1: Empirical evidence on the effects of employment protection legislation (EPL)

Cross-country studies using aggregate data	Cross-country studies using disaggregate data	Within country studies using mostly disaggregate data
• Mixed and rather small effects on aggregate levels of employment/ unemployment • Negative effects on vulnerable groups, especially youth • Hump-shaped relationship between EPL and growth	• Mixed effects on aggregate levels of employment/ unemployment • Reduced employee turnover (job creation/ destruction) • Negative effects on productivity • Weak/ negative connection between EPL and perceived job security	• Mixed and rather small effects on aggregate levels of employment/ unemployment • Reduced employee turnover (job creation/ destruction) • Negative effects on productivity • Increased worker absenteeism

Note: Disaggregated data refers to disaggregation by industry and firms, and most recently by individuals. The summary is based on over 100 studies conducted since 1990.

Within the cross-country studies using aggregate data, some studies find that employment declines and unemployment increase with the strictness of EPL (for e.g., Blanchard and Wolfers, 2000; Botero et. al, 2004; Feldmann, 2003, 2009; Heckman and Pagés-Serra, 2000; Nickell, 1997; and Lazear, 1990), while other studies show that there is no effect at all or that employment increases (for e.g., Allard and Lindert, 2007; Baccaro and Rei, 2007; Cazes and Nesporova, 2007; Garibaldi and Violante, 2005; and Griffith et al. 2007). Meanwhile, studies in this stream of literature show that there is a hump shaped relationship between EPL and growth, that is, an increase in EPL from a low level leads to increased GDP per capita, but a reduction occurs with a high level of protection (Skedinger, 2010).

But there are several problems with cross-country studies with aggregate data: first, there are measurement problems with the indices of EPL; OECD's EPL index is the most commonly used but it had very few observations over time until 2006, it's only recently that the data has gotten more extensive. Second, self-constructed indices – used by several studies – have comparability problems. Third, the problem of reverse causality is persistent across several studies (it is difficult to separate whether unemployment levels is affecting the stringency of EPL or vice versa). Given these weaknesses, one of the main strengths of cross-country studies based on aggregate data is that they tend to capture general equilibrium effects which are not possible with disaggregated data without

heroic assumptions. However, the advantage of studies that use disaggregated data is that they tease out effects that could be hidden in aggregate data (Skedinger, 2010).

Cross-country studies that use data disaggregated by industry, region and size indicate that there is a measurable negative impact on job reallocation (job creation and destruction) but it varies by industry (Caballero et al, 2004; Gomez-Salvador et al., 2004; Haltiwanger et al., 2006; Messina and Vallanti, 2007). When disaggregating by contract type, job creation and destruction is much higher for temporary than for open-ended contracts. For example, among large firms in Spain, it is 5 to 7 times higher (Garcia-Serrano, 1998; Amuedo-Dorantes and Malo, 2008), but job creation and destruction move together for both type of contracts across the business cycle.

Meanwhile, some studies also show that there is a negative impact on productivity (see for e.g. Bassanini et al, 2009). However, these results vary considerably by industries and it is practically impossible to aggregate at the national level. Also there are studies that cast doubt on the negative impact on productivity by showing that stronger EPL increases patents at the industry level (Acharya et al, 2009). The advantage of using disaggregated data is that the problem of reverse causality is less severe and similarly, the likelihood of omitted variable bias entering into the estimates is relatively low. However, one clear disadvantage is that the results depend crucially on the choice of industries (Skedinger, 2010).

Besides the cross-country studies, there are several within country studies that have exploited the fact that in some countries EPL were more/less stringent for small firms but for large firms they remained the same (Skedinger, 2010). In other words, there were partial labour market reforms, which in turn provide treatment and control groups. Besides the natural experiment, one of the main advantages of within country studies is that it controls for country specific conditions that cross-country studies cannot do. Findings from this group of studies indicate that EPL decreases flows in the labour market, but the effects on employment levels is mixed. Meanwhile, studies show that there is a negative impact on worker's productivity as measured by absenteeism and sickness absence.

A majority of studies on EPL argue that the effects of EPL are stronger when wages cannot be adjusted downwards to compensate for the increases costs due to the legislation (Skedinger, 2010). This depends on collective bargaining framework prevalent in a country, in particular, whether it is centralized or decentralized. Also, for example, if insiders have strong bargaining power then the likelihood of the employer shifting the cost of EPL to employees is minimal. Hence, it is vital to examine the effects of EPL in relation to the collective bargaining framework and other labour market institutions prevalent in a country (Boeri and Van ours, 2007; Boeri, Bertola and Cazes, 2000).

Collective bargaining

Collective bargaining is a process of negotiation between employer and workers that determine employment relationship, in particular, wages, working time and working standards (Hayter, 2011). It is unlike EPL, which is a government regulation. By design, collective bargaining entails a process of joint decision making where work-related issues between employer and workers are addressed in a

consensual manner. Collective bargaining occurs at several levels: inter-sectoral (or national), sectoral and firm level (Table 3.1). But the most prevalent type in Europe and other industrialized economies is the sectoral level bargaining while the least prevalent type is the firm level bargaining. Since wages and working time are important components of economic production, collective bargaining over these factors has a direct impact on labour market and macroeconomic performance.

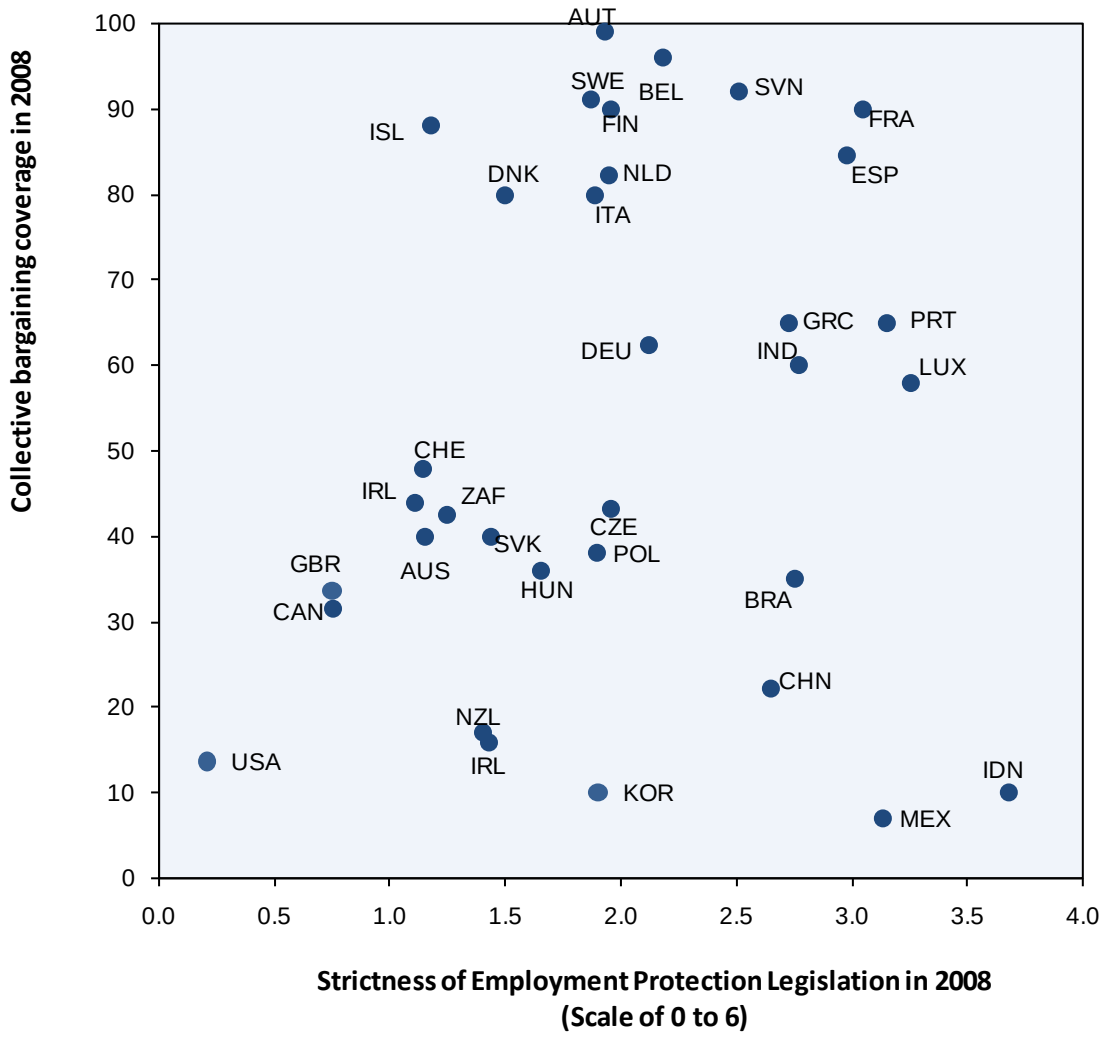
Table 3.1 : Collective bargaining over wages

	Inter-sectoral level	Sectoral level	Firm level		Inter-sectoral level	Sectoral level	Firm level
Australia	.	XXX	X	Latvia	.	.	XXX
Austria	.	XXX	X	Lithuania	.	.	XXX
Belgium	XXX	X	X	Luxembourg	.	XX	XX
Brazil		XXX	X	Malaysia	.	.	XXX
Bulgaria	.	XXX	X	Malta	.	.	XXX
Canada	.	.	XXX	Mexico	.	.	XXX
Chile	.	.	XXX	Netherlands	.	XXX	X
China	.	.	XXX	New Zealand	.	.	XXX
Cyprus	.	XXX	X	Norway	XX	XX	X
Czech Republic	.	XXX	X	Philippines	.	.	XXX
Denmark	XX	XX	X	Poland	.	.	XXX
Estonia	.	.	XXX	Portugal	.	XXX	X
Finland	XX	XX	X	Romania	.	XXX	X
France	.	X	XXX	Russia	X	XX	X
Germany	.	XXX	X	Singapore	.	.	XXX
Greece	X	XXX	X	Slovakia	.	.	XXX
Hungary	.	XXX	X	Slovenia	X	XXX	.
India	.	XXX	X	South Africa	.	XXX	.
Indonesia	.	.	XXX	Spain	.	XXX	X
Ireland	XXX	X	X	Sweden	.	XXX	X
Israel	.	XXX	X	Switzerland	.	XXX	X
Italy	.	XXX	X	Turkey	.	.	XXX
Japan	.	.	XXX	UK	.	X	XXX
Korea	.	.	XXX	USA	.	.	XXX

Note: X = existing level of wage bargaining, XX = important, but not dominant level of wage bargaining; XXX = dominant level of wage bargaining.
Source: IILS based on EIRO and national sources.

In most advanced economies, the strength of EPL tends to be highly correlated with other labour market institutions, but in the case of developing and emerging economies, strictness of EPL is associated with low coverage of collective bargaining (see Figure 3.2). For example, in the lower right hand corner in figure 3.2 are Brazil, China, Indonesia, and Mexico – countries that have very high strictness of EPL but low collective bargaining coverage. If these countries are excluded from the chart, there is a positive relationship between the coverage rate and strictness of EPL, with countries such as Ireland and the US at the lower end, while countries such as France and Spain at the higher end.

Figure 3.2: Collective bargaining coverage and strictness of employment protection legislation (EPL)



Source: IILS based on data from the OECD and ICTWSS.

There is a considerable literature on the links between the degree of centralization of collective bargaining and macroeconomic performance. In particular, examining the 1970s and the 1980s, Bruno and Sachs (1985) find a positive association between centralization and positive macroeconomic performance as measured by lower inflation and/or lower unemployment rate. The rationale for this empirical result primarily lies in the fact that firms tend to internalize externalities when bargaining takes place at a centralized level (for e.g., national level). However, Calmfors and Driffil (1988) have questioned this linear association by providing empirical evidence that there is a hump-shaped relationship between centralization of collective bargaining and macroeconomic performance. In other words, the best macroeconomic results are obtained for full centralization (at national level) and full decentralization (at firm level), and the worst results are associated with intermediate levels of centralization (at sectoral level).

Following the postulation that there is a hump-shaped relationship between collective bargaining and macroeconomic performance, academic research and policy recommendations have been dominated by either supporting or rejecting this result (Driffill, 2006). However, in the last decade, economic research (mainly theoretical) has evolved towards analysing the impact of collective bargaining depending on the type of shock and on supporting decentralized collective bargaining, while industrial relations research (mainly empirical) has focused on the effects on wage inequality.

On the one hand, macroeconomic results differ according to the type of shocks, on the other hand, full centralization provides a better adaptation to generalized shocks to an economy but it does not provide an optimal answer when the economy is affected by sector or industry specific shocks and adjustments in relative prices are required. This shows that besides the design of collective bargaining, the interactions of different types of shocks are pertinent in understanding macroeconomic results. Meanwhile, examining aggregate macroeconomic results could hide distributional impact of collective bargaining. For example, according to the OECD (2004), an intermediate level of centralization and coordination increases the relative wage of older workers (55-64) and women.

More recently, the economic literature in this discipline has focussed on other characteristics of collective bargaining and their role in creating nominal wage rigidities. For example, duration of collective agreements, when they cover relatively long periods, increase nominal wage rigidities. This in turn leads to higher persistence of unemployment rate deviations from its structural rate (Blanchard and Galí, 2010).

Meanwhile, studies have shown that among advanced economies, coverage and centralization of collective bargaining play a role in reducing wage inequality but the size of these effects is rather debatable (see, for e.g. Wallerstein, 1999, and Golden and Londregan, 2006). In case of developing economies, empirical evidence shows that unions reduce overall wage dispersion in the labour market (Hayter and Weinberg, 2011). Within country studies corroborate these findings – they show that centralized wage bargaining reduces wage dispersions (Kahn, 1998).

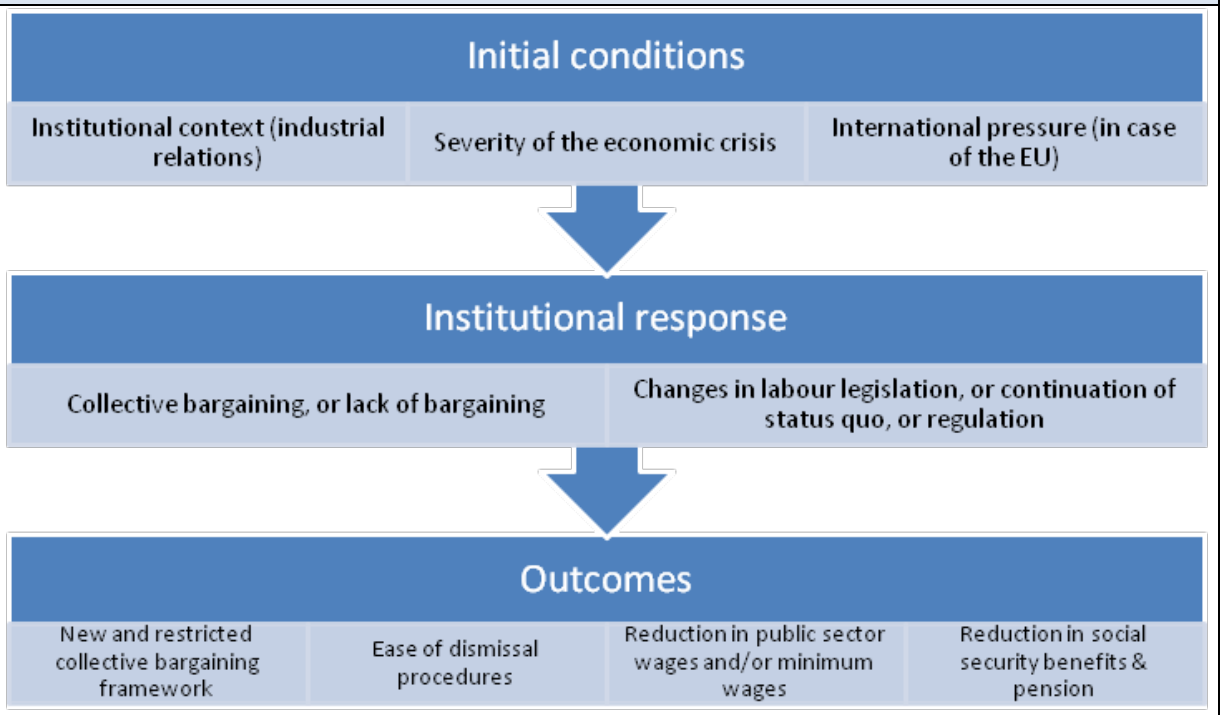
To sum up the empirical evidence on collective bargaining, since the 1990s there is a trend in Western economies towards decentralization. Moreover, the discussions over design of collective bargaining has moved away from virtues of centralization to the virtues of firm-level bargaining. Not surprisingly, the period of decentralization is also associated with a general increase in wage inequality (Hayter and Weinberg, 2011). Despite this clear association, as next sub section shows, the recent financial and economic crisis has further accelerated the move towards decentralization.

Changes in EPL and collective bargaining as a response to the financial and economic crisis, 2008-09/10

In order to understand the changes in employment protection and collective bargaining in the last few years, it is key to look at the initial conditions that countries were faced with (Figure 3.3). First, the existing industrial relation and collective bargaining framework played an important role in determining how countries responded to the crisis. For example, in countries where collective bargaining was relatively strong (as measured by coverage rate and union density), the response to the crisis included extensive consultations with social partners. Second, the severity

of the crisis differed across countries and that played an important role in countries' response. Furthermore, the debt overhang exacerbated the response in many troubled economies. Third, international pressures, most notably in the European Union have played an important role in steering some countries toward further deregulation of their labour markets.

Figure 3.3: Understanding collective bargaining and labour market regulation during the financial and economic crisis



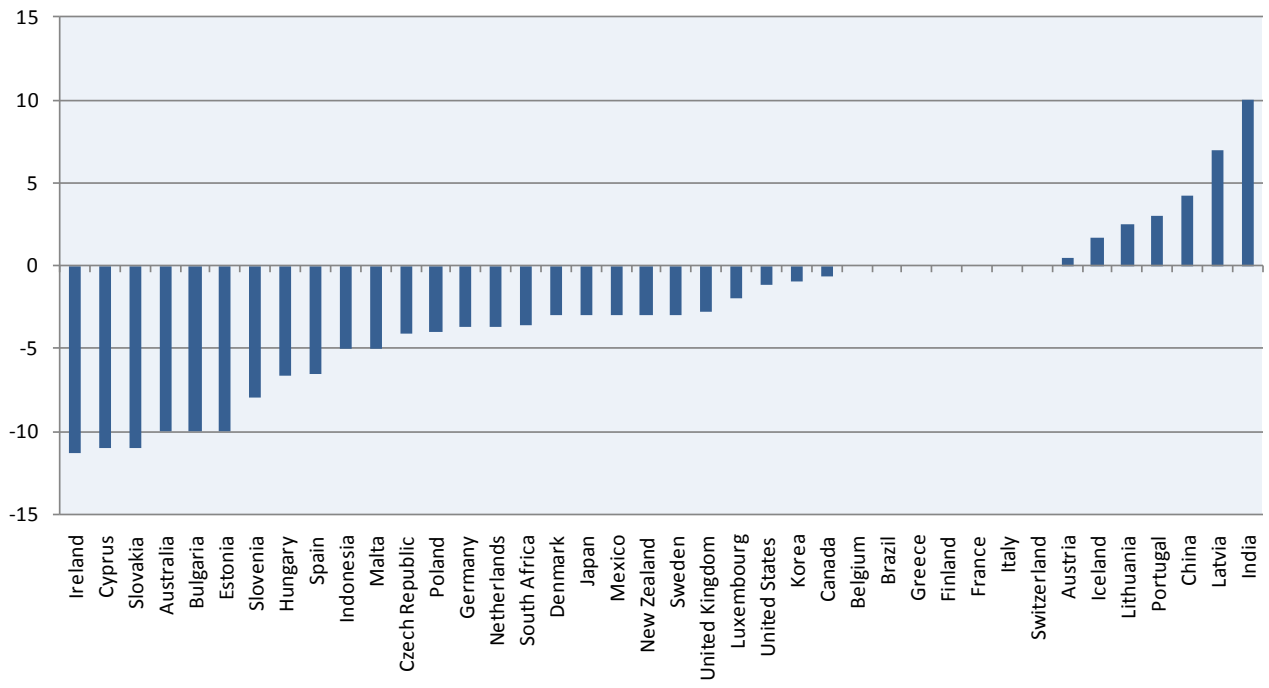
Given the initial conditions, the institutional response has greatly varied across countries. Some countries relied on collective bargaining to design labour market and social policies to respond to the crisis, while others did not. Indeed, industrial relations have been under severe strains during the economic crisis, since collective bargaining and social partnership have often been regarded as an impediment to the correct functioning of the economy. It is estimated that in 51 countries out of 128 (equal to 40 per cent of countries) industrial relations institutions have been reformed, while in 43 countries out of 128 (34 per cent) workers' representation rights have been modified in the recent years. Moreover, in 63 per cent of the 128 countries with available information, governments unilaterally implemented anti-crisis measures without formal agreement or approval from the social partners (see Table 3.2 and Table 3.3 for more on G20 and EU 27 countries).

The changes to collective bargaining rights have been in the form of: changes in regulation governing industrial relations, changes in worker's representation, and changes in bargaining agenda. Moreover, 26 out of the 40 countries where the data on bargaining coverage is available have had a decline in the coverage rate between 2000/01 and 2008/09 (Figure 3.4). Some of the decline is part

of the broader trend that was already taking place before the crisis, while many others were accelerated by the financial and economic crisis.

Furthermore, there have been changes in dismissal procedures as part of labour market reform in several countries. This has taken the form of changes: in severance payments, in notice period, and in the legislation governing collective dismissal for economic reasons. It is estimated that 51 countries out of 128 (equal to 40 per cent) have changed the legislation over dismissal procedures by mainly modifying the regulation of severance payments and notice periods. This trend is particularly relevant in the European Union, where changes in dismissal procedures occurred in 24 out of 27 countries (see Table 3.2 and Table 3.3 for more on G20 and EU 27 countries).

Figure 3.4: Change in collective bargaining coverage between 2000/01 and 2008/09



Source: IILS calculations based ICTWSS Database.

Note: The 2000/01 data for Bulgaria, Brazil, Cyprus, Indonesia, Korea, Lithuania, Latvia, Malta, Mexico, Portugal and South Africa refers to either 2002 or 2003. Similarly, the 2008/09 data for Australia, Denmark, Estonia, Finland, and New Zealand refers to 2007 data. Definition of coverage: employees covered by wage bargaining agreements as a proportion of all wage and salary earners in employment with the right to bargaining, expressed as percentage, adjusted for the possibility that some sectors or occupations are excluded from the right to bargain (removing such groups from the employment count before dividing the number of covered employees over the total number of dependent workers in employment WSEE; see Traxler, 1994).

Table 3.2: Changes in collective bargaining and employment protection across the G20 countries

	Changes in collective bargaining rights				Changes in dismissal procedures			
	Collective bargaining used as a means to respond to crisis	Changes in industrial relations' regulation	Changes in workers' representation	Changes in the bargaining agenda	Changes in severance payments	Changes in notice period	Changes in the legislation of collective dismissal for economic reasons	Other changes in dismissal legislation
Argentina	No	No	No	No	No	No	No	No
Australia	No	Yes	Yes	No	Yes	Yes	No	No
Brazil	Yes	No	No	No	No	No	No	Yes
Canada	No	No	No	No	No	No	Pending	No
China	No	No	No	No	No	No	Yes	No
France	No	No	Yes	No	Yes	No	No	Yes
Germany	Yes	No	No	No	No	No	No	No
India	Yes	No	No	No	No	No	No	No
Indonesia	No	Pending	No	No	No	No	No	No
Italy	Yes	Yes	Yes	Yes	No	No	No	Yes
Japan	Yes	No	No	No	No	No	No	No
Mexico	No	No	No	No	No	No	No	No
Russia	No	No	No	No	No	No	Yes	Yes
Saudi Arabia	No	No	No	No	No	No	No	No
South Africa	Yes	No	No	No	No	No	No	No
South Korea	Yes	Yes	Yes	No	Yes	Yes	No	No
Turkey	No	No	No	No	No	No	No	No
United Kingdom	No	Yes	No	No	Pending	Pending	Pending	Yes
United States	No	No	No	No	No	No	No	No

Source: IILS based on ILO Dialogue, EIRO, and national sources.

Table 3.3: Changes in collective bargaining and employment protection across the EU27 countries

	Changes in collective bargaining rights				Changes in dismissal procedures			
	Collective bargaining used as a means to respond to crisis	Changes in industrial relations' regulation	Changes in workers' representation	Changes in the bargaining agenda	Changes in severance payments	Changes in notice period	Changes in the legislation of collective dismissal for economic	Other changes in dismissal legislation
Austria	Yes	No	No	No	Yes	No	No	Yes
Belgium	Yes	No	Yes	No	Yes	Yes	Yes	No
Bulgaria	Yes	No	No	No	No	No	No	Yes
Cyprus	Yes	Pending	No	No	No	No	No	No
Czech Republic	Yes	No	No	No	Pending	No	No	Yes
Denmark	Yes	Yes	No	No	Yes	No	No	No
Estonia	Yes	No	Yes	No	Yes	No	Yes	Yes
Finland	Yes	Yes	Yes	No	No	No	No	No
France	No	No	Yes	No	Yes	No	No	Yes
Germany	Yes	No	No	No	No	No	No	No
Greece	No	Yes	No	No	Yes	Yes	Yes	No
Hungary	No	Yes	Yes	No	Yes	No	No	Yes
Ireland	No	Pending	Yes	No	No	No	Yes	Yes
Italy	Yes	Yes	Yes	Yes	No	No	No	Yes
Latvia	No	Yes	No	No	No	Yes	Yes	Yes
Lithuania	Yes	Yes	Yes	No	Yes	Yes	No	Yes
Luxembourg	No	No	No	No	No	No	No	No
Malta	No	No	Yes	No	No	No	No	Yes
Netherlands	Yes	No	Yes	No	Yes	No	No	Yes
Poland	No	No	No	No	No	No	No	No
Portugal	No	Yes	No	No	Pending	Pending	No	Yes
Romania	No	Yes	Yes	No	Yes	Yes	No	Yes
Slovakia	No	Yes	Yes	No	Yes	No	No	No
Slovenia	No	Yes	No	No	No	No	No	No
Spain	Yes	Yes	No	No	Yes	Yes	Yes	Yes
Sweden	Yes	Yes	No	No	No	No	No	Yes
United Kingdom	No	Yes	No	No	Pending	Pending	Pending	Yes

Source: IILS based on ILO Dialogue, EIRO, and national sources.

B. Labour regulations: Employment, macroeconomic performance and well-being

1. Labour market impact

There is a non-linear relationship between the strictness of labour legislation and employment rate…

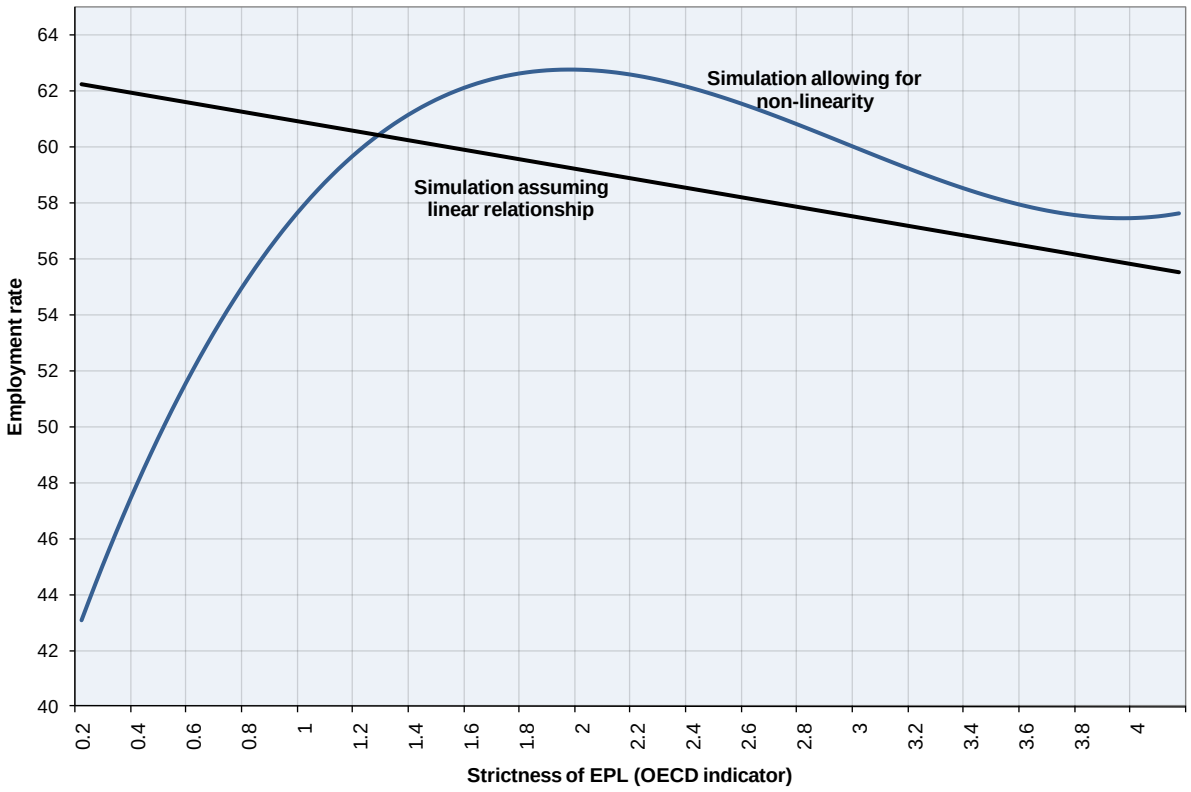
As Section A pointed out, a gamut of past studies on employment protection legislation (EPL) find either no impact or a negative impact on aggregate employment rate. This could be because of the fact that most studies look at the link between EPL and employment without disaggregating by gender or age group. However, some studies that look at the impact on employment disaggregated by gender and age group find differential impact of EPL on employment. In particular, Bassanini and Duval (2006) find no impact of EPL on male employment but a negative impact on female

employment. Furthermore, the authors identify a positive relationship between EPL and the employment of older workers (male and female) but a negative or zero impact for younger workers. Indeed, the simulations conducted for this chapter suggests that there is a non-linear relationship between EPL and employment rate.

First, as in the case of most past studies, allowing for a linear relationship between EPL and employment rate suggests that going from the lowest value for EPL (for e.g. the US) to the highest value (for e.g. Portugal), the employment rate decreases from 62 per cent to 55 per cent (Figure 3.5). Note that this is not a huge difference considering the difference in strictness between countries with an EPL score close to 0 to countries with a score close to 5.

Second, when the simulations assume a non-linear relationship between EPL and employment, it seems that the negative impact of EPL on employment kicks in only above the mean strictness of around 2.1 (one the OECD Scale). Before 2.1, as EPL strictness increases, employment rate also increases – in particular, it increases from 43 per cent to 63 per cent between the EPL scores of 0.2 to 2.1 (Figure 3.5). This simple exercise shows that the impact of EPL on aggregate employment rate is far from being a linear negative relationship. In fact, at very low levels of employment protection, increases in EPL stringency are associated with a higher employment rate. Similarly, for countries with above average strictness of EPL, a less stringent regulation is related to increases in employment. Hence, the debate has been wrongly focussed on “less regulation vs more regulation” while it is about “efficient regulation” – a level of strictness that maximizes employment.

Figure 3.5: Impact of EPL on aggregate employment rate: simulation using data for 27 countries



Notes: Simulations are based on fixed-effects estimations on the employment rate. See Appendix.

Meanwhile, in the last few years, several countries have moved towards deregulating their labour market…

[*To be developed using updated using the most recent EPL data comparable to the OECD index, constructed by the ILO Employment Analysis Dept*.]

…which has not had the expected impact on employment and job creation

To be developed according to the following guidelines:

- One of the key features of the labour market adjustment observed over the last decades and which intensified with the job crisis of 2008 in many OECD countries (but not only) has been the disproportionate effect of job losses among "atypical" forms of employment, in particular fixed-terms contracts, leading to labour market dualism. While a lot of empirical work has looked at the role of EPL on the quantity of jobs, less attention has been devoted to the quality of employment.

- This section addresses both dimensions: it provides cross-country evidence for a wide range of countries (enlarged OECD ones) on the impact of EPL reforms on LM outcomes such as

the employment or unemployment levels, but also on the extent to which labour market segmentation increased.

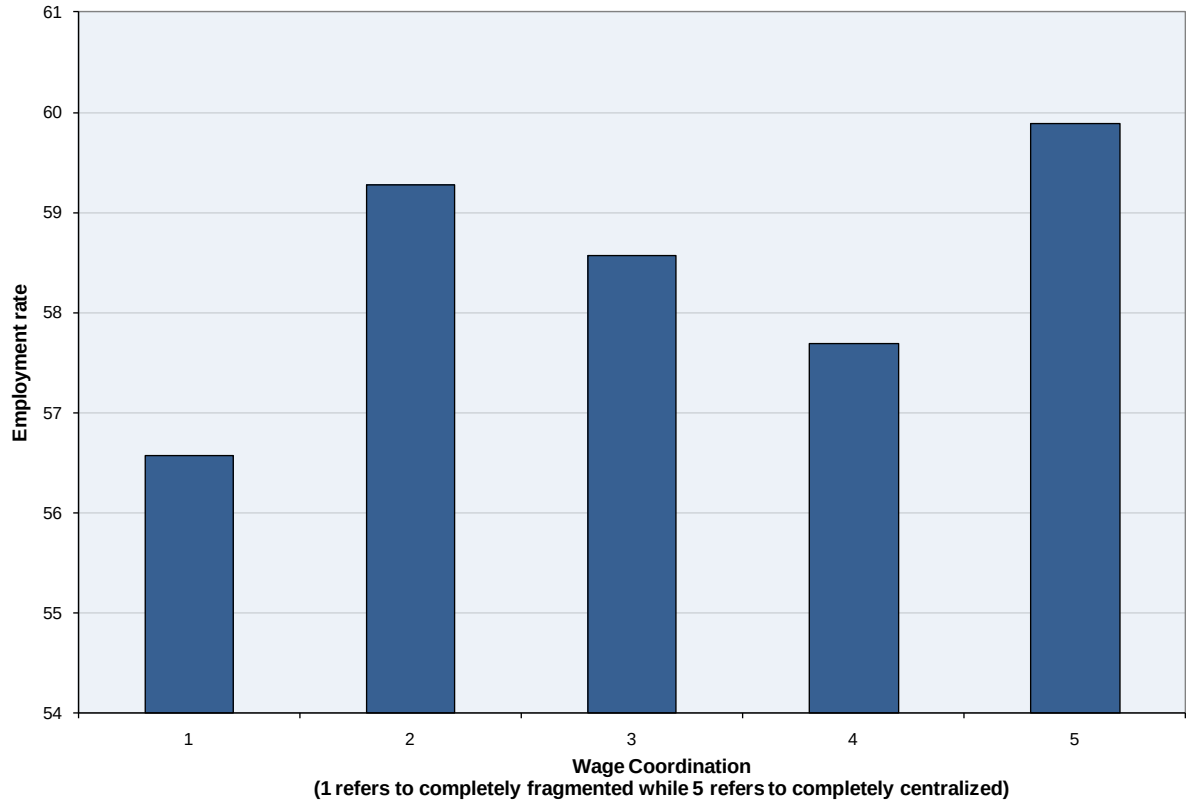
- The cross-country analysis (about 35 countries) will regress respectively the employment rates, unemployment rates, youth unemployment rates, as well as the share of permanent employment on a set of explanatory and control variables (EPL indexes and UB benefit, CB coverage, minimum wages etc.). Furthermore, the period before and after the crisis will also be compared.

- For the EU countries, the analysis will go a bit more in depth in terms of the quality aspect and job satisfaction (for example in terms of job stability and involuntary reason for being in fixed term contracts). Some policy recommendation in terms of LM reforms will be provided, in particular regarding exit strategies from labour market segmentation: for example, in Europe the "single contract" has been presented as an option to solve the insider-outsider question.

Similarly, the relationship between collective bargaining and employment rate is also non-linear…

As section A showed, there has been a general move towards decentralization of collective bargaining and the financial and economic crisis hastened this trend. The primary rationale behind this is that a more centralized level of bargaining has a negative impact on aggregate employment while a decentralized level of bargaining has a positive impact. In fact, simulations following the same guidelines as before show that the level of coordination over wage-setting is non-linear (as the well-known results obtained by Calmfors and Driffill, 1988) (Figure 3.6). The lowest employment rate is associated with a coordination value of 1, which stands for not only full decentralization but also fragmentation (i.e. disorganized decentralization meaning that negotiations over wages is not only at firm level but also without any coordination). For coordination values of 2 to 5, there is a U-shaped relationship between employment and bargaining. In other words, the highest employment rates occur in a fully decentralized but organized bargaining system (score of 2), and in a totally centralized bargaining system (score of 5). Meanwhile, in intermediate level of coordination, there is a relatively lower employment. To sum up, not all decentralization in bargaining has a favourable impact on employment. In fact, disorganized decentralization has a negative impact on employment and is associated with even worse results than intermediate levels of coordination.

Figure 3.6: Coordination of wage bargaining and its impact on employment rate



Notes: Simulations are based on fixed-effects estimations on the employment rate. See Appendix.

2. Impact on macroeconomic performance

As with the relationship between EPL and employment rate, the impact of EPL on private sector investment is also non-linear…

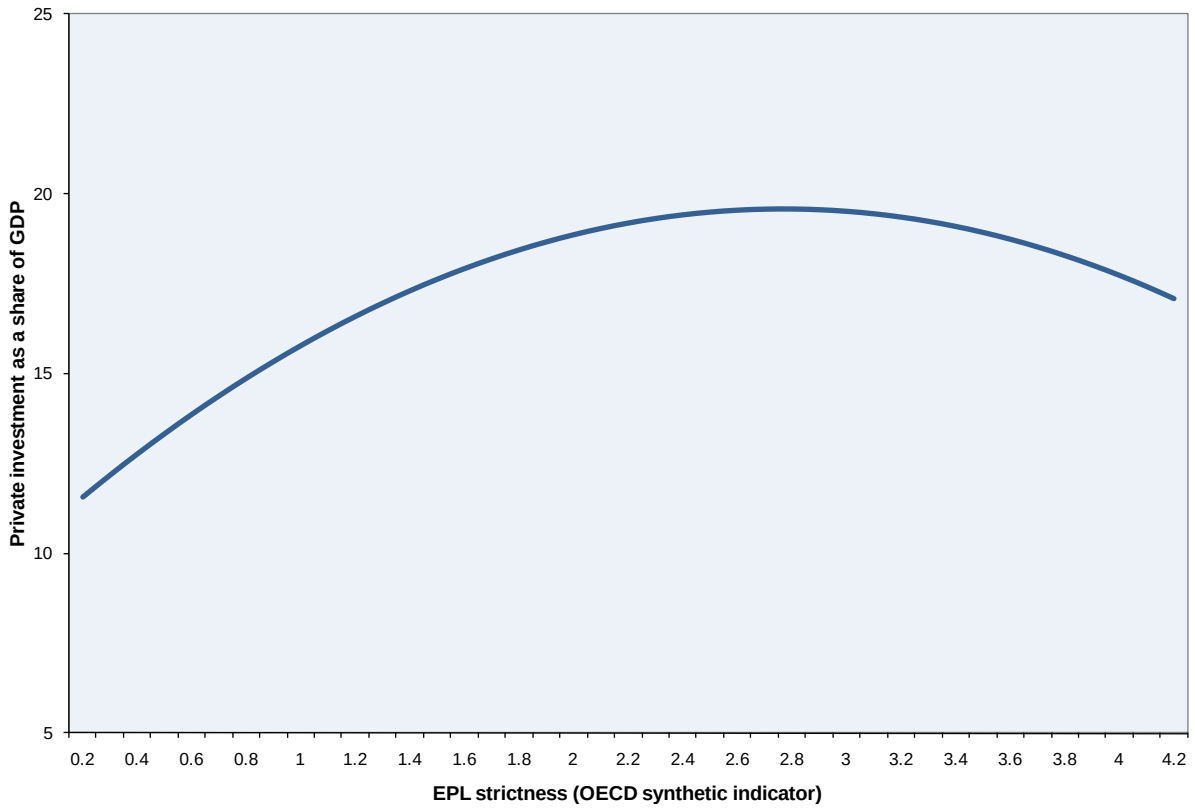
As Section A showed, most studies that examine the relationship between EPL and macroeconomic performance tend to use GDP growth as the dependent variable. While it is a fairly straightforward indicator of macroeconomic performance, it is difficult to tease out the relationship between EPL and GDP growth. Not surprisingly, most studies find no or insignificant relationship between the two variables. In this chapter, a novel approach is employed by looking at the link between EPL and private business investment (i.e., private sector gross fixed capital formation as a percent of GDP). The impact on investment stems from the fact that decision regarding allocation of capital, besides labour, is also dependent on labour market regulation.

The impact of EPL on investment could be either positive or negative. First, strictness of EPL might discourage businesses to expand production, resulting in a lower aggregate investment. Second, in industries where labour and capital are complementary factors of production, the impact of EPL on employment and investment would be in the same direction (either positive or negative depending

on the employment intensity). Third, a relatively strict EPL might discourage the use of labour and encourage firms to adopt capital intensive technologies, therefore increasing aggregate investment. In sum, all this points to the fact the net effect of EPL on investment is far from linear and simplistic.

Indeed, Figure 3.7 shows a hump-shaped relationship between private sector investment and strictness of EPL. There is a positive relationship between the two variables until the EPL score of 2.7, which is slightly above the average level of strictness among the OECD countries. Beyond 2.7, the relationship between the two is negative. This is consistent with the relationship between EPL and employment rate presented in sub-section 1. Meanwhile, in case of developing and emerging countries, there are not enough data points to carry out simulations but simple correlations show that there is a positive relationship between EPL and private sector investment.

Figure 3.7: Impact of EPL on private sector gross fixed capital formation in developed countries



Notes: Simulations are based on fixed-effects estimations on the employment rate. See Appendix.

3. Impact on general social well-being

While stricter EPL is not necessarily associated with more satisfied workers…

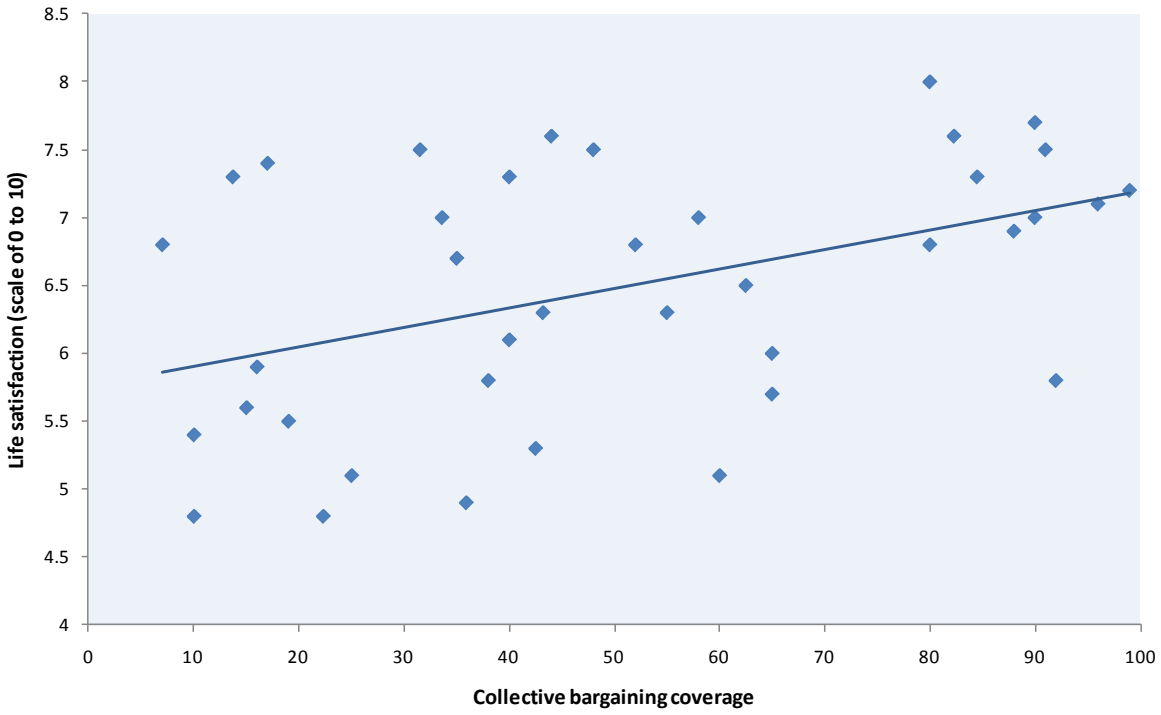
Previous studies have tried to examine the link between employment protection and perceived job security and psychological well-being, but the results have been largely inconclusive. Conventional wisdom says that perceived security increases with stricter regulation as the risk of being fired gets

reduced (Skedinger, 2010). However, studies have shown that in fact permanent employees and the ones in temporary jobs feel more insecure with stricter EPL (see: Böckerman, 2004; Clark and Postel-Vinay, 2009); although this might be because the survey responses captured perceived labour market security instead of job security. Moreover, this could stem from the so called "locking-in effect" where permanent employees feel like they cannot leave their current job because they perceive the likelihood of finding a new job to be low. Generally speaking a more stringent employment protection does not lead to increased security, quite the contrary. Empirical analysis of data on well-being and EPL corroborates these earlier studies. In fact, there is a weak negative correlation between EPL stringency and social well-being, and this holds for both developed and emerging economies.

…countries with higher collective bargaining coverage report higher well-being among workers

On the contrary, higher collective bargaining coverage is generally associated with higher well-being (Figure 3.8). While there are notable exceptions to this rule – for e.g. New Zealand with the CB ratio of 17 and the mean life satisfaction index of 7.4 and the US with the CB ratio of 13.7 and the mean life satisfaction index of 7.3 – the relationship is positive across all income groups. There are no previous studies that have looked at the relationship between subjective well-being and collective bargaining so it is difficult to identify any kind of causal links between the two variables. However, collective bargaining coverage rate could be capturing the existence of democratic institutions in a country, which is generally linked with higher life satisfaction and happiness. Collective bargaining after all refers to negotiation between employer and workers that determine employment relationship – it is a fundamentally democratic institution.

Figure 3.8: Relationship between life satisfaction and collective bargaining



Note: The date refers to 40 countries, including emerging economies for 2008. Source: IILS based on World Gallup Poll and ILO Dialogue & ICTWSS.

C. Policy considerations

As this chapter has shown, while there have been very few cases of significant overhauls in employment protection legislations (EPL), there have been several marginal changes which are likely to have an enormous impact on labour market and macroeconomic outcomes for years to come. For example, 40 per cent of the countries have changed legislation over dismissal procedures by mainly modifying the regulation governing severance payments and notice period, which is particularly the case in the European Union, where changes in dismissal procedures occurred in 24 out of 27 countries. Meanwhile, collective bargaining over reforms during the crisis years has also taken a back seat. In particular, in over 60 per cent of the countries, anti-crisis measures were put in place without agreement or approval from social partners. Furthermore, there has been a general trend towards decentralization (both organized and disorganized), and also collective bargaining coverage has been reduced. In sum, there has been an alarming trend towards "deregulation and decentralization" but for a better labour market and macroeconomic performance, there is a need for a labour market that is governed by "efficient regulation" – a set of rules that balances employment and labour market security.

1. Employment protection that maximizes labour outcomes while providing employment and labour market security

First, labour market regulation did not cause the financial and economic crisis of 2008-09; among the main culprits, some include: lack of adequate financial regulation and oversight, loose monetary policy, and unbridled risk-taking in the financial sector. Despite this piece of economic history, there seems to be a consensus among policy circles that labour market regulation ought to be relaxed to reduce unemployment and spur job creation. In case of the EU, since both the monetary and fiscal policies now are effectively under the pejorative of the European Commission, countries in the region have a smaller set of policy choices, including labour market regulation, to tackle the elevated unemployment rates. But deregulation of the labour market is very unlikely to have the desired outcome. Indeed, as this chapter has shown, the evidence on the link between employment protection legislation (EPL) and labour market outcomes is far from linear. If anything, up to an average stringency of EPL, there is a positive impact on employment. Similar is the story with macroeconomic outcome measured by gross fixed capital formation in the private sector.

Deregulation clearly is not the answer and some countries seem to be more cognizant of this than others and have put in place measures to strengthen employment protection while ensuring desired labour market outcomes. In case of developing and emerging economies, China has recently put in place a new regulation for dismissals stemming from economic reasons (See Box 3.2 for more). Among the advanced economies, Denmark has reformed its system of severance payments by putting in place both the extension of coverage and duration (see Box 3.2 for more). These case studies show that there is a need to strike the right balance between employment protection and ability to respond to the crisis, but the slippery-slope on the path of deregulation is not the answer to high unemployment.

Box 3.2: Reinforcing employment protection in times of crisis: case of China and Denmark

Denmark has represented during the decade preceding the crisis an example of successful reconciliation between employment security and flexibility. This model has come under severe strains during the recent years. After having reached the minimum level of 3.3 per cent in 2008, unemployment rate more than doubled during the crisis. This was the result of a GDP contraction by 5.2 per cent in 2009. Facing these challenges, the government and the social partners decided to reinforce the mechanisms of employment protection in cases of dismissals. From a legislative point of view, severance payments have been introduced for blue collar workers, while the procedures to be followed in cases of mass layoffs have been reinforced (Consolidated Act No. 291 of 2010). Social partners also played a role in guaranteeing employment security. The 2010 national collective agreement in the manufacturing industry extended the right to severance payments to hourly paid employees with a minimum of 3 years of seniority. At the same time, maternity and paternity leaves have been extended by 2 weeks. The joint actions undertaken by the government and the social partners avoided the dismantlement of the Danish system of employment protection and prevented the workers to unevenly bear the consequences of the recession.

In *China*, the financial and economic crisis did not interrupt the national trend of economic boom. Nonetheless, it definitely hampered it: GDP growth dropped by 33 per cent in 2009 and unemployment rate increased in both 2008 and 2009 after a period of continuous reduction. It is in this context that the State Council decided to reinforce in 2009 the legislation over collective dismissals for economic reasons. Given the average big size of Chinese companies, the regulation over collective dismissal has always represented a central topic in employment protection legislation in the country and a traditional source of flexibility for the employers. According to the new legislation, any employer planning to dismiss more than 20 employees or more than 10% of the work force has to consult workers' representatives one month in advance. Moreover, the employer is now required to submit to the local public administration a social plan presenting the agreed redundancy regulations and the measures to help dismissed workers finding new jobs.

2. Strengthening industrial relations and collective bargaining for better labour market and macroeconomic outcomes

Another victim to the financial and economic crisis has been collective bargaining. In particular, because of the crisis, the long-term trend towards decentralization and fragmentation has further accelerated. As it is the case with EPL, collective bargaining mechanism did not cause the financial and economic crisis. In fact, their existence is indicative of democratic traditions prevalent in a country, and they represent a potentially powerful tool for achieving policy coordination across the economy. As the empirical evidence in this chapter shows, there is a U-shaped relationship between coordination over wage bargaining and employment rate. Also, countries with higher collective bargaining coverage are also the ones with higher social well-being.

In the last few years, the countries that have achieved the best labour market and macroeconomic results have been the ones that opted for a balance between reinforcing collective bargaining institutions and the need to allow for a certain degree of adjustment to macroeconomic shocks. Indeed, among the developing and emerging countries, South Africa provides an excellent example of a country that brought together social partners to design and implement police responses to the financial and economic crisis (see Box 3.3 for more). Likewise, among the advanced economies, Australia provides an example of a country that successfully managed to balance the need to reinforce industry and national level wage bargaining and ability to respond to the financial and economic crisis (see Box 3.3 for more).

Box 3.3: Strengthening of industrial relations and collective bargaining during the crisis: case of Australia and South Africa

In Australia, the crisis interrupted a long period of sustained economic growth. GDP growth rate dropped from an average of 3.4 per cent between 2002 and 2008 to 1.3 per cent in 2008. Similarly, unemployment increased in 2009 for the first time since 2001. In this macroeconomic context the social partners and the national government decided to structurally reform the system of industrial relations with the approval of the Fair Work Act in 2009. The overall objective of the reform was to provide for industrial relations that are "fair to the employees and flexible for business". Under the new legislation, employers are legally required to conclude company level agreements if the majority of workers ask to do so. Moreover, if the national industrial relations' institution believes that employees in a particular company are low paid, then employers may be required to participate in industry-wide bargaining. Finally, workers gain greater bargaining power at the enterprise level: if one employee in the company belongs to a trade union, the union has the right to be involved in the negotiations. At the same time however, the Fair Work Act removes arbitration for the resolution of workplace disputes and encourages their informal settlement.

South Africa has been particularly hit by the global financial and economic crisis. After a decade of economic growth, GDP declined by 1.8 per cent in 2009. Similarly, unemployment rate started increasing in 2008 after having continuously declined since 2003. Following the long-standing national tradition of tripartist policy making, the government and the social partners decided to develop a coordinated response to the crisis in the national economic and labour council NEDLAC. Consultations started in October 2008 and resulted in the "Framework for South Africa's response to the international economic crisis" in February 2009. This national framework agreement identified six priorities along which the response to the crisis should have been developed: investment in public infrastructure, macroeconomic policy, industrial and trade policy, employment and social measures, global coordination and social partnership. As a result of these policy measures, the South African economy rapidly recovered and GDP grew by more than 3 per cent in 2011.

Appendix

This appendix provides the background to the empirical analysis used in Section B of this chapter. First, it is important to note that the attempt here is not to provide a causal impact of EPL stringency and collective bargaining on different dependent variables used in the analysis (such as, employment rate, investment rate, social well-being). The regressions are used to understand how EPL and collective bargaining are associated with these broader measures of employment and macroeconomic performance.

Table A1 provides the list of countries included for the empirical analysis (note that for Section A, a broader selection of countries are used as it relies largely on qualitative data). In terms of estimation, the chapter employs fixed effects model, where fixed effects correspond to countries. According to the standard specification with country specific effects, the relationship between labour market performance and labour market institutions can be written as (Lazear, 1990; Addison and Teixeira, 2003; Bassanini and Duval, 2006):

$$y_{it} = \alpha_t + \beta_i + \sum_j X_{ijt}\, b_j + e_{it}$$

Where y denotes the labour market outcome (employment rate), X is the set of explanatory and control variables, and α and β are time and country specific fixed effects. All regressions are shown in Table A2. The definitions of dependent variables used in the analysis are:

- *Employment rate*: the share of employment with respect to the population. The source is the Labour Force Survey of each country or such comparable surveys.

- *Investment rate*: Private sector gross fixed capital formation as a share of GDP. The source is UN National accounts.

- *Well-being*: aggregate subjective variable provided by Gallup World Poll.

Explanatory variables include the following:

- *Stringency of EPL*: This is the synthetic indicator provided by the OECD on EPL strictness. The rank goes from 0 to 5, where 0 means the least strict EPL and 5 the strictest one.

- *Wage bargaining coordination:* ranges from 1 to 5, comes from the ICTWSS database and has 5 values:[2]

    - 5 = economy-wide bargaining, based on a) enforceable agreements between the central organisations of unions and employers affecting the entire economy or entire private sector, or on b) government imposition of a wage schedule, freeze, or ceiling.

    - 4 = mixed industry and economy-wide bargaining: a) central organisations negotiate non-enforceable central agreements (guidelines) and/or b) key unions and employers associations set pattern for the entire economy.

    - 3 = industry bargaining with no or irregular pattern setting, limited involvement of central organizations, and limited freedoms for company bargaining.

    - 2 = mixed or alternating industry- and firm level bargaining, with weak enforceability of industry agreements

    - 1 = none of the above, fragmented bargaining, mostly at company level.

Both variables have been introduced in the regressions in levels, squared and cubed. The rationale was to capture non-linearity in the association between these variables and the employment rate or the investment rate.

[To be included: Tables A1 and A2].

[2] Database on Institutional Characteristics of Trade Unions, Wage Setting, State Intervention and Social Pacts (ICTWSS), produced by Jelle Visser at the AIAS (University of Amsterdam): http://www.uva.aias.net/207.

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