A Partial Defence of Job-Security Provisions

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MANY ECONOMISTS ARE CONVINCED that the lack of labour-market flexibility is the root cause of poor employment performance in many countries. The idea that any institutional or legal features likely to inhibit adjustment in the labour market (referred to here as "Job-Security Provisions" or JSPs) are undesirable has become part of every economist's Book of Truths. This deeply rooted belief, however, appears to be more an act of faith than an economic fact.

Economists' dislike of JSPs is based upon simple theoretical reasoning: JSPs reduce lay-offs during downturns and among shrinking firms, because firms must pay the high penalties associated with JSPs. However, JSPs can also reduce hiring and employment during upswings and among growing firms, because of the uncertainty inevitably associated with business activity and because of firms' fears of a change in luck that accompanies such uncertainty. Firms are reluctant to hire more workers now if they fear that a future downturn will necessitate costly lay-offs.

Though such economic reasoning is in itself perfectly correct, it has unclear empirical predictions. The question of whether the costs associated with JSPs (reduced hiring during good times) outweigh their benefits (reduced lay-offs during downturns), and the even deeper question of whether reduced lay-offs really are a good thing, are both primarily empirical. Over the last decade, the OECD has been leading a crowd of international organisations in search of convincing empirical evidence against JSPs. But despite their efforts, empirical evidence has so far been inconclusive.

If JSPs are to be suspected of being an important obstacle to economic success, the first question to be asked is: are JSPs a decisive factor in a country's labour-market performance? Can we, beyond a reasonable doubt, establish JSPs as a sure ticket to high unemployment, while increased labour-market flexibility would be the sure path toward full employment? The answer to that question is: definitely not. Geographic and historical evidence points to the contrary. If JSPs hurt countries, the wounds they inflict are hardly lethal. In fact, JSPs do not hurt economies, because they often do not prevent labour markets from adjusting.

Competing Theories

The effects of JSPs on labour markets and on economies in general are manifold. Key to both proponents' and opponents' attitudes toward JSPs, however, is their evaluation of the effect of JSPs on labour-market turnover. Proponents of JSPs insist that the ultimate goal of JSPs is not to prevent job destruction, but rather to reduce the uncertainty for workers who would otherwise face the possibility of lay-off. When faced with costs of laying off workers, firms are more likely to absorb temporary shocks by hoarding labour rather than by letting workers go. Employers will prefer to have workers sitting idle or underproductive—performing tasks the employer would normally subcontract, such as maintenance—rather than paying the cost of JSPs. This has two major advantages. First, it is generally accepted that firms exhibit less aversion toward risk and have fewer financial constraints than individuals. It therefore makes economic sense to have firms carry a larger share of the uncertainty associated with business activity. Second, a more stable workforce means less waste of human capital. Though a highly mobile workforce has some advantages, too much mobility has its costs. When workers are let go because of a temporary downturn, they start looking for jobs elsewhere. The risk for the employer, and for the economy at large, is to lose all the firm-specific knowledge these workers have accumulated while working at their previous job. For proponents of JSPs, less labour turnover helps workers and the economy.

Opponents to JSPs argue that reduced labour-market turnover hurts the economy. When faced with stiff penalties associated with lay-offs, firms might reduce hiring in the first place. Furthermore, some economists even question the idea that reducing lay-offs is a desirable goal. In their mind, JSPs would inhibit the necessary and desirable labour re-allocation between successful and failing businesses. Opponents of JSPs often point to low unemployment rates in the United States and much higher rates in Europe as evidence confirming the view that JSPs produce rigid labour markets and, as a result, higher unemployment.

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North American and European economies are so different that it is almost impossible to measure the impact of JSPs on the economy in isolation of everything else. Differences in product markets, as opposed to differences in labour markets, might be the main source of difference in economic performance between Europe and the United States. The widely accepted view that the costs associated with JSPs are significant is based largely on shaky evidence. There is no clear link between economic performance and JSPs, as well as evidence showing that,

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even under stringent JSPs, firms can adjust their labour force in a rather efficient way.

Historical Evidence

How can we measure the impact of JSPs on economic performance? Measuring the number of jobs created can be misleading, since Europe and the United States face very different demographic situations. Creating hundreds of thousands of jobs when your working-age population is booming is certainly a less impressive achievement than doing so with a stagnant population. Looking at employment-to-population ratios or at labour-force participation rates could also be misleading since these figures are greatly influenced by social and cultural differences between countries. Finally, looking at growth of per capita income would probably favour Europe, if only because European countries had some catching-up to do with the United States in terms of economic development.

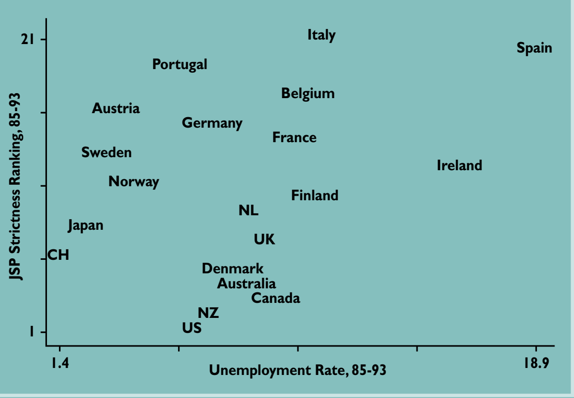
In the end, the best indicator remains the ability for economies to provide jobs to those who want to work—the unemployment rate. Since JSPs can only affect economies through the labour market, it is sensible to look first at the unemployment rate, despite the fact that measures of unemployment rates can be biased. Indeed, the direction of the bias is unclear and is, in any event, likely to be small. The more generous European system might give incentives to workers to remain attached to the labour force when they would drop out of it in the United States, thus overstating European unemployment. However, high unemployment often discourages workers from job search and to drop out of the labour force, thus understating European unemployment.

The argument pointing toward JSPs as a leading cause of high European unemployment is historically inconsistent. If JSPs explain the poor European labour-market performance over the last two decades, how are they compatible with its remarkable success in the 1960s and early 1970s, as shown in Figure 1? Most of the institutional factors which are now blamed for Europe's lack of labour-market flexibility were established in the immediate aftermath of the Second World War. Yet for decades, European labour markets unquestionably outperformed the totally unregulated US market.

More convincing is the fact that the time-path of labour-market regulation on both continents is wrong if we want an empirical argument against JSPs. Ever since they set up their generous social systems (which not only include JSPs, but also generous UI and welfare systems), most European countries have been pulling back toward less regulated labour markets, while the completely unregulated US market has become more regulated. After the Second World War, most European countries set up many institutions regulating labour markets: the principle of the need for a just cause to dismiss a worker; the principle of advance notice before lay-offs; the principle of severance payments to workers who are laid off; and finally, severe restrictions on part-time and temporary work. In the 1960s, several European countries increased these protections by requiring employers to consult and notify works councils before mass lay-offs. Ever since, most European countries have been reducing the strength of these protections by reducing the amount of firm-paid severance payments, reducing the time lag between notification and lay-offs, or by relaxing regulations on part-time and temporary work. In contrast, the previously unregulated US market has moved in the opposite direction. As examples of increased regulation in the US over this period, one can note the fact that US courts have increasingly upheld the principle of the need of a just cause for dismissal; the large body of anti-discrimination laws; the development of health and safety rules in the workplace; and finally, the introduction of experience-rated unemployment insurance. In most US states, unlike any other industrialised country, unemployment insurance is experience rated—the more an individual firm uses the UI system by creating lay-offs, the more it must pay into it.

FIGURE 1
Unemployment in the United States and in Europe

FIGURE 2
Unemployment and Strictness of JSP



The US labour market is still unquestionably less regulated than the labour markets in most European countries. Yet it started performing better while becoming increasingly regulated. At the same time, the deregulating European markets were stalling. The historical dynamics are wrong if one wants to blame JSPs for the poor performance of European labour markets.

Geographic Evidence

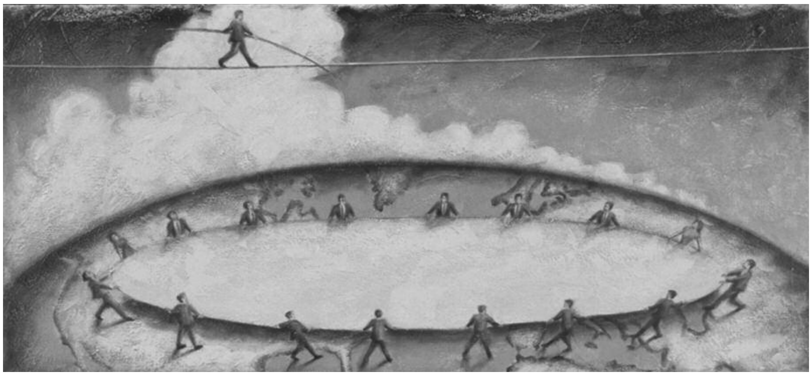
The conventional view of an unregulated and successful North America set against a regulated and failing Europe is wrong. Over the last 15 years, some heavily regulated European countries—Austria and Germany, for example—succeeded in keeping well-performing labour markets, while in North America the unregulated Canadian labour market performed dreadfully. But the geographic evidence goes deeper than simply showing that there are exceptions to the rule.

Figure 2 illustrates the relation between labour-market performance in OECD countries and the strictness of their JSPs. The vertical axis shows the OECD's ranking of countries according to the strictness of their JSPs between 1985 and 1993. Countries higher up the vertical scale have the strictest job-security provisions. The horizontal axis shows each country's average unemployment rate from 1985 to 1993.

It is clear from Figure 2 that the harshness of a country's JSPs has absolutely no predictive power for a country's labour-market performance (with probably the exception of Spain). As noted previously, the geographic evidence goes deeper than simply showing that there are exceptions to the rule that unregulated labour markets perform well while regulated ones do poorly. The geographic evidence simply shows that there is no relationship at all between JSPs and labour-market performance. Unregulated markets are no guarantee of success, and active regulation does not guarantee failure.

Firm-Level Evidence

Historical and geographic evidence provide some answers to the first question: if JSPs hurt, the magnitude of their influence on a country's economic fate is very small. To put it bluntly, this simple evidence does not justify the international obsession that economists have developed against JSPs. Obviously some countries are doing the right thing, while others are not, and what they are doing right has nothing to do with JSPs. It would be much more productive for economists to figure out what these important "things" are, rather than focusing on institutional details which are at best an annoyance.



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The Belgian labour market helps to demonstrate that JSPs do not prevent markets from functioning properly. Belgium ranked 17th out of 21 OECD countries for the strictness of its JSPs, yet it appears to adjust faster than the US labour market. The secret of that surprising result lies in three words: Short-Time Compensation. The existence of a successful system of unemployment insurance for workers working *short* hours (as opposed to being unemployed, working *zero* hours) has transformed the Belgian labour market from one adjusting through employment (the number of workers) into one adjusting through working time (average hours per worker). With Short-Time Compensation, workers have their working hours reduced by 25% (from 40 to 30 hours, for example), are eligible for 25% of the unemployment insurance benefits they would have received, if they were laid off completely and thus unemployed. The resulting new system actually appears to outperform the so-called "flexible" US system.

When faced with a decline in total hours to be worked, the typical US firm reduces employment quickly and sharply. Working time—average hours per worker—is left almost untouched. In Belgium, a firm confronting the same reduction in demand reduces employment at a much slower pace. In the meantime, the Belgian firm is able to sizably reduce working time, since workers are more willing to accept working fewer hours because of the existence of Short-Time Compensation. This remarkable result is achieved because of the simultaneous presence of two sources of rigidities in the Belgian labour market. Without Short-Time Compensation, most workers would not accept the cuts in working time; without the costs associated with the dismissal of workers, firms might elect not to resort to cutting hours.

Katherine Abraham of the University of Maryland and Susan Houseman of the Upjohn Institute, among others, have confirmed this result showing similar patterns in Germany. Rather than being less flexible than the US labour market, European labour markets are simply flexible in ways which differ from the US style of flexibility.

A second set of evidence on the extent to which JSPs hurt firms can be found in two independent studies of lay-off practices in European countries. The first study looks at the Netherlands; the second concentrates on Belgium. Both countries are well known for having strict JSPs. The first study finds that, in the Netherlands, a sizeable share of all lay-offs in the economy originates from growing firms. The second study finds that, in Belgium, lay-offs are positively correlated with employment growth in the firm—the more firms grow, the more they fire workers.

These results indicate that in both countries firms make extensive use of on-the-job sorting of workers. Firms hire workers, and then see whether they fit the job. This is definitely not the attitude of an employer allegedly paralysed by fear of JSPs. If employers really felt constrained by JSPs, they would try to sort workers as much as possible before they hire them (and with the high level of unemployment in these two countries, this is definitely an easy task). They would then hire workers only if those workers were sure to fit. Obviously, this is not the way Belgian and Dutch firms operate.

Why JSPs Are Harmless

JSPs do not hurt the functioning of economies because they do not significantly hinder labour-market adjustment processes. In regards to their economic harmlessness, three points are worth emphasising.

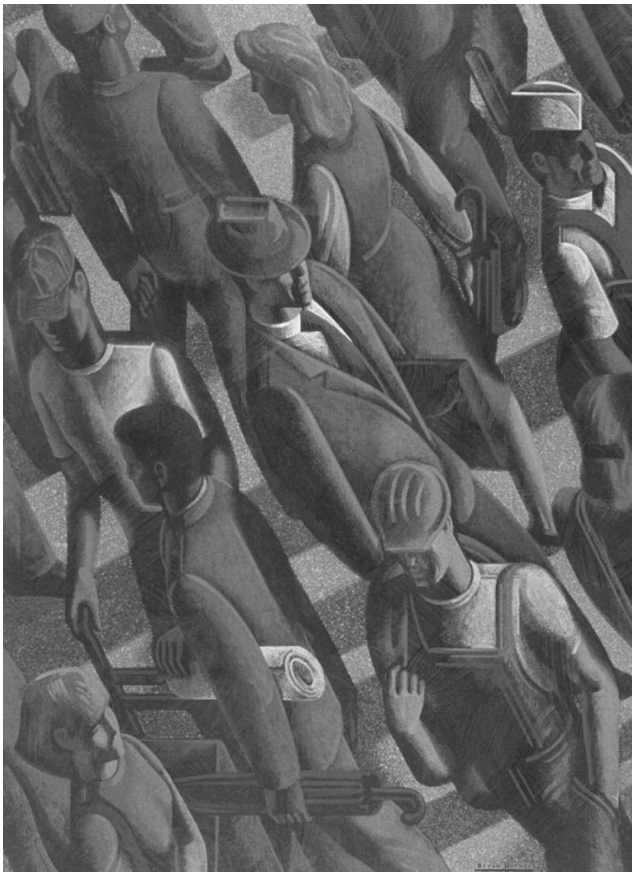
First, it is important to consider the combined effect of JSPs and Short-Time Compensation. Economists know that introducing an imperfection in an otherwise totally free market will lead to inferior economic performance. However, economic theory has no clear prediction on what will happen to that market's performance if a second imperfection is introduced. It is certainly possible that both imperfections will offset each other, resulting in better economic performance for the market with two imperfections than the market with only one of them. The analysis of the joint impact of JSPs and Short-Time Compensation is a perfect illustration of this point. The joint introduction of two imperfections in a labour market leads to a new system which performs quite well.

Labour markets in most industrialised countries are very complex, being the result of the interaction of dozens of institutions, laws and regulations, all of which interact with each other and influence the way the market works. Together, they bring labour markets toward equilibria and ways of functioning which can differ radically across countries, but cannot easily be classified as being "better" or "worse". Studying the impact of JSPs on labour markets in isolation of everything else does not make any sense, and the empirical evidence confirms that.

The case of JSPs and Short-Time Compensation is merely one example. Other institutional and legal features whose interaction with JSPs are unclear include labour courts, publicly provided health insurance, public pension funds, and works councils.

Second, in democracies, penalties associated with laws and regulations are limited. Laws and regulations are often plagued with scores of loopholes and exceptions, and laws are often not even enforced. In short, estimating whether a law truly has "teeth" is not a simple task.

In the case at hand, two types of firms are more likely to be hurt by JSPs. The first type are firms which need to hire workers in a world where information about a worker's true ability is limited. Despite a careful screening and selection process, a firm might discover that the worker it has selected does not fit the job and that it needs to let him or her go. The second type are shrinking firms which need to shed as much labour as they can to salvage what they can of their activities. In both cases, most JSPs provide enormous loopholes; probationary periods in the former case, and bankruptcy in the latter. Most often, when firms hire a new worker,



they are allowed to fire that worker at will anytime during the first six months of employment, sometimes the first year. Hiring and lay-off practices in Belgium and the Netherlands show that employers use that opportunity extensively.

Third, the penalty for governments trying to impose excessively stringent JSPs is that firms will not pay a penny; they will simply go bankrupt. Shrinking or dying firms will often not even need to go bankrupt. Indeed, most countries with severe JSPs also have other institutional features which, in the end, reward shrinking firms rather than taxing them. For a long time, government's favourite reward for a failing firm was some form of direct state aid. Now that these have been severely curtailed by the European Union, governments have turned toward other tools: early retirement and extensive use of the disability insurance system.

Complex Solutions

If JSP policies and regulations are costly to administer, if laws are costly to enforce, why should any country use them to reach a result that free markets would naturally produce on their own? Little evidence exists on the benefits associated with JSPs. These benefits are not hard to measure and evaluate, but economists have simply been so busy looking for evidence on the costs of JSPs that few of them looked at the benefits. Yet, there is not much need for tests and measures here. All economists have to do is to look at the profound attachment hundreds of millions of people—not just a privileged few—in Europe and recently in South Korea show for these institutions. Ordinary people hate risks, and there are enormous social benefits to be reaped from reducing people's economic risks.

Countries and economies are very complex organisations. Studying one aspect of these organisations—here the unemployment insurance system, there dismissals laws, or there again, the welfare system—in isolation of everything else does not make any sense. One of the lessons we have learned from recent medical advances is that to cure serious illnesses, you often need several types of medication. We will not cure the disease that affects labour markets in many industrialised countries simply by eradicating JSPs from our economic systems. The solutions to our problems are undoubtedly much more complex. ◆