Should Governments Mandate Job Security?

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OVER THE LAST 20 YEARS, economies have had to deal with a lot of change. There have been rapid improvements in information technologies, and free-trade agreements between countries have led to an expansion of international trade. There have also been changes in the scope and form of government intervention in the economy as a result of changing attitudes about the appropriate role of government, changing defence needs, and the need to deal with public debts and deficits.

Although change tends to be associated with the innovations that drive economic growth and is therefore generally considered beneficial, rapid change can also create insecurity. In particular, the change of recent years appears to have brought increased feelings of job insecurity. Workers who believed their jobs were secure have found themselves laid off as a result of the so-called downsizing by firms and governments. Furthermore, since unemployment rates have risen in almost all OECD countries over the last three decades, the unemployed may find themselves competing with a larger number of people for a new job than would have been the case for workers in similar situations 30 years ago.

Whether the seeming increase in the rate of economic change in recent years is part of a long-term trend or just a temporary phenomenon remains an open question. It is clear, however, that job security is a major concern of workers in many western economies today. In response to this concern, governments have introduced policies designed to discourage firms from laying off workers by increasing the costs of lay-offs. These policies take two main forms. First, there are laws that require firms to pay a worker who is laid off without cause a specified amount of severance pay related to that worker's number of years of service. Second, there are laws requiring that firms give a certain amount of advance notice before laying off a worker. An example of this is the 1988 *Worker Adjustment and Retraining Notification Act (WARN)* in the United States (popularly called the "plant-closing" law). This requires firms to provide 60 days advance notice of plant closures or lay-offs that would displace 50 or more workers.

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Although the concern for job security that has motivated such laws is real, it is not clear whether many of the policies enacted to promote job security are actually desirable. In this article, I consider some of the reasons why government-mandated job security may be undesirable. Before considering the specific context of job-security policies, however, it is useful to briefly present a general set of criteria by which government economic policies can be evaluated.

Reasons for Government Intervention

The two principal criteria that economists use to assess public policies are "efficiency" and "equity". Efficiency concerns how well the available resources in the economy are harnessed to provide the things that people desire. This does not refer only to produced goods and services, but also to less tangible goods such as leisure time, a clean environment, and safe working conditions for employees. A policy change is said to be efficient if it allows—in principle—every member of the economy to be made better off in terms of his or her own values. What "in principle" means here is that the total benefits to those who are made better off by the policy exceeds the total costs to those who are made worse off. If the benefits of a policy exceed the costs in this way, it would be possible—in principle—for the winners to compensate the losers financially so that the combination of the policy and the appropriate compensations would make every member of the economy better off.

In practice, however, such compensations are never made and as a result most policy initiatives involve both winners and losers. Because of this, efficiency alone is not a sufficient criterion

for assessing policies. We must also consider how consumption of the broadly defined outcomes of economic activity are distributed among the members of the economy when assessed against a value judgement of what constitutes an equitable distribution. Typically, policies to promote equity involve a redistribution from rich to poor. The most obvious example of such a policy is a tax-and-transfer system in which governments impose taxes that raise more money from the rich than the poor and then use part of this revenue to provide a social safety net.

Equity and efficiency are often conflicting goals. A policy designed to improve efficiency may have undesirable effects on equity if the principal beneficiaries are among the wealthier members of society. Similarly, policies designed to enhance equity may reduce efficiency. The two criteria for judging a policy can therefore be stated as:

- Will the policy improve economic efficiency without causing too great a reduction in equity?
- Will the policy produce greater equity without causing too great a loss of efficiency?

Of course, these criteria depend on the value judgements of what is equitable and what constitutes "too great" a loss in efficiency or equity, but they do present a way of organising the arguments for and against any particular policy. In the remainder of this article, I use the criteria of efficiency and equity to assess government-mandated job security.

Job Security and Efficiency

Job insecurity is a result of the continuous turnover in the labour market. Some jobs are disappearing, resulting in lay-offs, and new jobs are being created and thus generating new positions. This turnover is itself the result of change in the economy. Firms are continuously faced with changes in the demand for their products and in their production costs. As a result, some firms find it profitable to expand while others find the need to scale back.

Some of this change is perhaps the result of government policy, but most of it is outside government's control: changing weather patterns produce large swings in agricultural production from year to year; firms are always developing new products and processes for producing existing products; because of fads or changing social attitudes, consumers' preferences are always shifting away from some products and toward others.

Therefore, when governments intervene in labour markets to increase the costs to firms of laying off workers, they do not reduce the speed of economic change that is the root cause of insecurity. Rather, they affect the way in which firms can react to the economic change. Thus, governments affect the extent to which the insecurity that is the inevitable result of change is shared between workers and the owners of firms. To consider the effect on efficiency of these job-security policies, we need to first consider the ways in which an individual firm can respond to the sorts of changes that could potentially result in lay-offs. We then need to see how the job-security policies might change this behaviour.

When governments intervene in labour markets to prevent lay-offs, they do not reduce the speed of economic change that is the root cause of insecurity.

Consider a firm that is faced with a downturn in the demand for its product. There are a number of ways such a firm can respond. First, it can reduce the size of its workforce, either by laying off workers or by not replacing workers who quit. Second, it can reduce the total number of labour hours, but not the total number of workers by employing each existing worker for fewer hours each week. Third, it can retain its staff at full wages and just absorb the downturn itself as reduced profits. The period of the downturn can be used to re-organise its operations and retrain its workers to perform new tasks or use new equipment. Finally, it can do any combination of the above. The actual method chosen to adjust to a downturn in demand depends on three things.

First, the best option for the workers and firm depends on the particular circumstances of all individuals involved. For instance, a large firm with many plants in different locations or in different industries is likely to be better placed to allow its profits to fluctuate across the business cycle than are individual workers who depend on their jobs at that firm to provide the bulk of their income. Alternatively, if the firm is a small, highly indebted owner-operated company seeking to establish itself in an industry, and if its workers are in a labour market where unemployment is relatively low and good jobs easy to find, then the workers may well be in a better position than their employer to absorb the downturn.

Second, the optimal response of a firm to a downturn depends on whether the downturn is perceived as temporary or permanent. If a firm lays off some of its workers, they may respond by searching for and finding alternative employment elsewhere. If the downturn turns out to be temporary and the firm now seeks to bring its workforce back to its original size, it may face considerable hiring and training costs for the new employees who are unfamiliar with the particular circumstances of that firm. With temporary downturns, then, it may be beneficial for a firm to retain as much of its workforce as possible in order to avoid these hiring and training costs.

Finally, the nature of the particular firm and the conditions of the labour market each determine whether it is better for workers to share the costs of the downturn by each reducing the number of hours worked ("hours adjustment") than to lay off some group of the workers ("employment adjustment"). In some firms, all that matters is the total number of hours worked. It makes no difference to the firm's profits whether it has 120 workers each working 30 hours per week or 90 workers each working 40 hours per week. In other firms, there may be costs associated with the total number of workers employed, independent of how many hours each works. In the first case, there is no cost to the firm from using hours adjustment rather than laying off workers. In that case, as long as workers prefer hours adjustment, that is the more efficient option. In the second case, the firm has a clear preference for employment adjustment. Hours adjustment is efficient only if the benefits to workers exceed the cost to the firm.

It is not automatic, however, that workers prefer the security of hours adjustment to employment adjustment. In a workplace where workers are in similar circumstances and desire security over future income, workers are likely to prefer the relative security of hours adjustment. There is a higher chance that they will have their income reduced by a small amount through being employed for fewer hours, but a lower chance that they will lose their job completely by being laid off. Consider, however, a workplace comprising both older workers who have family commitments and little job mobility, and younger workers with fewer commitments and greater opportunities elsewhere in the labour market. In such a workplace, the cost of lay-off to the younger workers is relatively low and the cost of hours adjustment to the older workers relatively high. Accordingly, employment adjustment may well be the more efficient outcome, even if there are no costs to the firm for using hours adjustment.

The optimal way for a firm to adjust to change differs across firms and depends on several different things known only to the workers and firm in each workplace.

Furthermore, we do see each of the methods of adjustment being voluntarily employed by firms to some extent. For instance, it has often been noted that output in the United States falls by far more than does labour input during recessions. Most economists attribute this to the fact that firms indulge in what is termed "labour hoarding". This means that a firm will choose to retain workers during a recession even though it does not have work for them. This is the case, even though the United States have comparatively few laws mandating job security. A likely explanation for labour hoarding is that it occurs at firms where the downturn is perceived as temporary. The firms are therefore seeking to avoid future hiring and retraining costs. Although hours adjustment is less common in the United States than in Europe, it does occur, particularly through adjustments in the number of overtime hours that firms ask their employees to work.

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An Efficiency Role for Mandated Job Security?

In this environment where the circumstances of every firm are different, and where every method of adjusting to downturns is both feasible and occasionally adopted in the right circumstances, what is the effect of government policies mandating job security? Obviously, policies mandating a particular level of severance pay or requiring advance notice of lay-offs increase the cost to the firm of using the lay-off option. This increases the incentive for the firm to use hours adjustment or to absorb the downturn itself.

For the purposes of illustration, suppose that circumstances are such that it is more efficient for a firm to absorb a downturn itself or to use hours adjustment, but that, in the absence of government mandates, the firm would use lay-offs. In such a case, it would clearly enhance efficiency if a policy such as mandatory notice or mandated severance pay were to induce the firm to move to the more efficient policy. But why would such a situation arise? It is always possible for firms and workers to write provisions for severance pay or advanced notice of lay-off into their labour contracts. If it would be efficient for the contracts to contain such provisions, the benefits to the workers would exceed the cost to the firm. With an appropriate adjustment to the contract wage, such a contract would be better for all parties than a contract not containing those provisions. To suggest that it would enhance efficiency to *impose* job security on firms is to suggest that workers and firms are incapable of negotiating contracts in their own interest.

Instead, the likely effect of job-security legislation is to reduce efficiency by inducing firms not to use lay-offs as the means of adjustment even in those situations where employment adjustment would be optimal. Job-security legislation often seeks to minimise such costs by identifying situations where restrictions on lay-offs would be particularly costly, and exempting firms from the legislation in those circumstances. For instance, the mandatory-notice *WARN* act in the United States recognises that small firms are less able to absorb the costs of a downturn than are larger firms, and so it exempted small firms from the provisions of the act.

It is not possible, however, for legislation to anticipate the situations that might arise in every particular workplace and to write clauses dealing with every special case. It is likely, therefore, that job-security legislation has the effect of preventing lay-offs in circumstances where such lay-offs would be the optimal way of adjusting to a downturn. The real danger here is not so much that firms would be made to bear too much of the cost of a downturn, but that firms will be reluctant to expand employment even when times are good, in anticipation of the fact that job-security legislation will make it too expensive to lay off workers in any subsequent downturn. There is a danger that job-security legislation will result in less entrepreneurship and an economy that is less able to respond to changes as they occur. It is also possible that disincentives to hire created by mandated job security could result in increased unemployment rates.

It would be unfair, however, to dismiss job-security legislation on this basis. Those who advocate such legislation do not do so on the basis that it is likely to enhance the efficiency of labour-market contracts. Rather, the legislation is intended primarily to protect those workers most at risk of lay-off from the insecurity associated with economic change. Job-security legislation is designed primarily to promote equity rather than efficiency. The question we must address, therefore, is whether the efficiency costs are so great as to outweigh any equity benefits.

The available evidence on the costs of job-security policies is very mixed. In part this is due to the inherent difficulty of analysing labour-market data. Labour markets are complex social institutions that are not well understood by economists. Workplaces are social as well as economic institutions in which social customs matter. Also, even in times of job insecurity, most workers spend long periods of time with a single employer. Therefore, relationships between buyers and sellers in the labour market tend to be longer and more personal than in other markets. As a result, labour markets are likely to evolve slowly in

response to external factors such as job-security legislation. This inevitably makes it very difficult to ascertain the effects of such laws, and leaves room for a considerable range of interpretations of the available evidence.

For instance, some economists have attributed the high and persistent unemployment rates in Europe, compared to the United States, in part to the fact that European countries have much more stringent job-security legislation than do the United States. Others dispute this finding. Some economists also question whether job-security laws do significantly reduce the ability of firms to respond to changing circumstances. Katherine Abraham of the University of Maryland and Susan Houseman of the Upjohn Institute have done a comparative study of a few key industries comparing Germany, which has very strong job-security legislation, and the United States, which do not. Their analysis shows that, in response to a decline in demand, German firms were able to reduce their total labour input by about the same proportion as US firms, except that German firms were more likely to do so by reducing the average hours worked by each employee rather than by laying off workers. In contrast, the US firms responded to the reduction in demand by laying off workers but holding hours worked per worker roughly constant. This evidence is certainly encouraging, but it only tells part of the story. The fact that firms are able to reduce their total labour input even without laying off workers does not necessarily imply that there are no associated costs to the firms or for their workers. The work of Abraham and Houseman does suggest, however, that the worst fears of opponents of job-security legislation about the effect of such policies may be misplaced.

Job Security and Equity

The main conclusion of the previous section is that, although there are good theoretical reasons for thinking that it might be costly to the economy for the government to mandate job security, there is not convincing evidence that those costs are great. On the other hand, there is no doubt that job insecurity causes stress to workers, particularly for those who find themselves laid off. Mandated job security is a redistributive policy designed to increase the welfare of workers. If we cannot be sure that job-security policies are creating significant efficiency costs, but we do know that job insecurity is causing considerable stress to workers, is there not a clear argument in favour of job-security policies? There are two reasons for rejecting this argument.

The first is that there is no guarantee that mandating job security will actually increase the welfare of the workers it is designed to protect. Employment contracts are the result of some combination of formal bargaining between workers and employers and the market pressures. If workers have a lot of bargaining strength, then any labour contract is likely to be favourable for workers in terms of offering high wages and desirable conditions such as job security. When workers have less bargaining strength, they will be unable to negotiate so favourable a contract. The amount of bargaining power held by workers depends on a number of factors including the strength of the union, if it is a unionised workplace, the degree to which labour laws favour collective bargaining, and the level of unemployment. If the government then mandates job security, it does not change these factors determining the relative bargaining strength of workers and employers—it simply restricts the nature of the contracts that workers and employers can negotiate. There is therefore no reason to expect that mandated job security will result in better contracts for workers who are at risk of being laid off. Instead, we might expect to see contracts offering lower wages or other benefits in exchange for the mandated job security as the total compensation package continues to reflect the factors determining the bargaining power of workers. In such cases, the contracts may be better in the sense of embodying more job security, but they will also be worse in the sense of embodying lower wages.

The second reason why mandated job-security policies may not succeed in promoting equity is that, whether or not these policies do improve the well-being of those they are designed to help—employed workers who run the risk of being laid off from their current job—there is another group of workers who are likely to be hurt by mandated job security—currently unemployed workers.

If job-security policies are successful in reducing the number of workers leaving jobs to either leave the workforce or become unemployed each month, then it must also reduce the number of new employees hired. This may be because new firms are more reluctant to expand if they know that it will be difficult for them to cut back again in the future. It may also be because firms that avoid lay-offs during a downturn have no need to take on new workers in a subsequent upturn. Whatever the exact mechanism, the fact is that countries with high rates of job destruction also have high rates of job creation.

Now, consider the effect that lower levels of hiring will have on unemployed workers. In particular, imagine two different hypothetical economies, one with mandated job security and one without. In the former economy, the job-security laws result in a low level of lay-offs and a correspondingly low level of new jobs. In the economy without such laws, the number of lay-offs is higher but so is the number of new jobs. To highlight the effect of labour-market turnover on equity, imagine that none of the possible costs to workers of mandated job security that we have discussed so far apply. Specifically, imagine that mandated job security has no effect on the unemployment rate, wage rate or other benefits received by

employed workers. In this world, mandated job security will unambiguously make employed workers better off: they receive the same wages and benefits, and have a lower probability of being laid off in the future. But now consider the effect on unemployed workers. Because there is lower turnover in the labour market in the economy with mandated job security, there are fewer opportunities for an unemployed worker to find a job. As a result, it takes longer for the average unemployed worker to find a job in the economy with job security than in the one without. Unemployed workers have therefore been made unambiguously worse off by the job-security legislation.

Therefore, if job-security legislation is actually effective at reducing the number of lay-offs in the economy, it also reduces the number of new jobs. But the latter implies that unemployed workers must wait longer and search harder before they are re-absorbed into the workforce. Thus, while mandated job security may be beneficial for those workers who are currently employed, its effect on labour-market turnover implies that it is harmful to those workers who are currently unemployed.

An Equity Role for Mandated Job Security?

If mandated job security does have this effect, there are very serious implications for the desirability of such policies. A large number of studies have shown that there are considerable social costs resulting from unemployment. These costs are particularly severe in the case of long-term unemployment. They range from health costs, to the loss of skills by workers who are out of work for long periods of time, to the effects on income inequality if a small number of workers are out of work for a long period of time rather than a larger number of workers experiencing short spells of unemployment.

The possibility that government-mandated job security could increase the average duration of unemployment and hence dramatically increase the social costs of unemployment is the strongest argument against job-security legislation. Even if such legislation benefits the people it is intended to help and comes at little or no efficiency cost, it may in fact constitute one of the most inequitable policies the government can devise by helping relatively fortunate workers at the expense of the least fortunate members of society—the long-term unemployed.

The available data suggest that job-security legislation does affect the average duration of unemployment. Countries with strong job-security laws tend to have lower lay-off rates than those without such laws. This is exactly what we would expect: if job security laws do not actually reduce the lay-off rate, then the whole debate about their desirability is empty—they are simply having no effect. More important, the data also show a strong correlation between the lay-off and hiring rates in a number of OECD countries. Furthermore, those countries with active job-security laws and hence lower lay-off rates also have higher expected durations of unemployment. A much larger fraction of their labour forces have been unemployed for more than 12 months than in countries without strong job-security legislation.

The comparison between Canada and Belgium is particularly revealing. Both countries are small open economies that are part of a much larger trading bloc, but Belgium has very strong job-security laws while Canada's are weak. During the first four years of this decade, Belgian unemployment rates were consistently lower than Canada's. Despite this, OECD data show that the average duration of unemployment in Belgium was about 12 months compared to only 4 months in Canada. Furthermore, well over 50% of the unemployed workers in Belgium in those years had been unemployed for more than 12 months while in Canada fewer than 10% had been.

Of course, simple correlations like these do not prove that it is job-security legislation that has *caused* the high unemployment duration and high incidence of long-term unemployment in those countries with stringent job-security laws. The data do suggest, however, that such a causal relationship is a strong possibility.

Is Mandated Job Security Desirable?

By the very nature of labour markets, it is difficult to infer from the available data the precise long-term effects of labour-market policies. At the same time, the stakes for such policies are very high indeed. For most people, the wage or salary received from a single job constitutes a very large proportion of their income. This is particularly true for those with lower incomes. As a result, small changes in labour markets that may appear minor in the aggregate can have substantial impacts on particular individuals.

The debate about the merits of mandated job security illustrates the difficulties of constructing labour-market policies. The effects of job security laws are not well understood, but their potential impacts are considerable. There are three main arguments for why job-security legislation may be undesirable: first, the legislation may have a substantial efficiency cost that will outweigh any equity benefits; second, it may not succeed in benefitting the people it is intended to help—employed workers who face the insecurity of possible lay off in the future; third, it may considerably worsen equity by reducing the job-finding prospects of unemployed workers and thus increasing the social costs of long-term unemployment.

Although economic theory suggests that the first two potential effects of job-security legislation are likely to be present, there is very little evidence in the data for them. An absence of evidence for such effects is not the same thing as saying that there is convincing evidence that they are not present: the inherent difficulty in drawing conclusions from labour-market data means that there will always be considerable uncertainty about any effect.

The third argument against job-security legislation is much stronger as it suggests that the legislation reduces both efficiency and equity. It therefore does not depend on the relative size of costs and benefits. Furthermore, the available data do point in the direction of supporting this argument, however, there is room for doubt in interpreting this evidence.

What policies should governments therefore adopt regarding job security? Given the degree of ambiguity as to the effects of mandated job security, it would be prudent for them to take a "first do no harm" approach. There is a very real possibility that job-security legislation could reduce the opportunities for unemployed workers to rejoin the workforce and hence lead to an increase in the social costs of unemployment. This suggests that, on balance, the risks of doing considerable harm quite likely outweigh any benefits that might come from such legislation. ◆