ALEXANDER MURAVYEV
St Petersburg State University, Russian Federation, and
IZA, Germany

I Z A
World of Labor
Evidence-based policy making

Employment protection legislation in transition and emerging markets

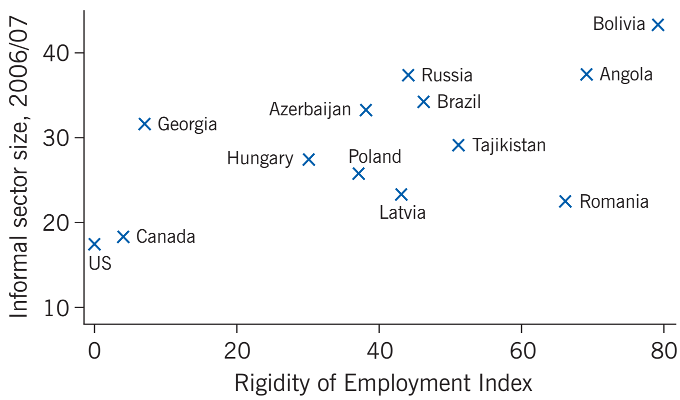
Although market failures mean employment protection is necessary, excessive protection can be counterproductive

Keywords: employment protection, unemployment, informality, transition and emerging economies

ELEVATOR PITCH

Employment protection legislation aims to shield employees against unfair dismissal and earning reductions at the time of job loss. Theory suggests that employment protection stabilizes employment over cyclical upturns and downturns without necessarily increasing general unemployment. However, recent evidence from transition and emerging economies shows that employment protection legislation tends to raise unemployment among disadvantaged groups, particularly youth, and may increase informal work. Employment protection policies thus require careful consideration of their unintended effects.

Informal sector growth and employment rigidity



Source: Based on Figure 1.

KEY FINDINGS

Pros

- Employment protection legislation can remedy some labor market failures.
- Introducing stricter legislation can stabilize employment and unemployment over the business cycle.
- Employment spells can be lengthened and workers' earnings stabilized by introducing employment protection.

Cons

- If too intrusive, employment protection legislation can increase unemployment among vulnerable groups, especially youth.
- Experience shows that excessive protection can cause longer unemployment spells.
- Labor market institutions with strict legislation may lead to higher informal employment.

AUTHOR'S MAIN MESSAGE

Employment protection can contribute to job and earnings stability and smooth employment in downturns. But experience from transition and developing economies shows that excessive protection can be counterproductive, with the means subverting the ends. Policies need to weigh these undesirable outcomes against the intended outcomes.

MOTIVATION

Employment protection legislation is a key part of labor market institutions and policies throughout the world. Its main goal is to protect employees against unfair dismissals and earnings reductions at the time of job loss. Together with other measures, such as unemployment benefits, it provides labor market security beyond a particular job or employer.

Employment protection legislation

Employment protection legislation is commonly defined to encompass regulations governing hiring and firing.

Hiring rules cover such areas as duration of employment contracts, set-asides for disadvantaged groups, and probation periods.

Firing rules include such topics as dismissal for cause, mass layoffs, and severance payments.

Some definitions restrict employment protection to hiring and firing costs, while others also include working hours, health and safety, and worker representation rights.

To what extent employment protection legislation achieves its stated goals and whether it has side effects are controversial issues. Theory does not unambiguously predict the effect of employment protection legislation on the labor market and the economy in general.

Evaluation of the overall effect is thus an empirical issue. For several reasons, this is a nontrivial task. First, institutions, including employment protection legislation, are hard to measure. Second, they change slowly within any country. Third, they can interact with other institutions in numerous ways. According to one leading labor economist, "Priors aside, the problem of determining how institutions affect outcomes is difficult. One difficulty is the large number of possible configurations of institutions relative to the number of cross-country observations on which to assess their impact on outcomes" [1].

The problem is particularly acute in empirical studies from high-income countries, which due to better availability of data dominate the literature. In this respect, the experience of emerging and transition economies, many of which have introduced comprehensive institutional reforms in recent decades, can be particularly instructive. Indeed, developing and transition economies "present an exciting venue for studying the impact of regulatory reforms, including of labor reforms. A number of countries, especially in Eastern Europe, have recently undergone significant reforms to make labor regulation more flexible...These reforms are larger in magnitude than any reforms in developed countries" [2].

This paper sheds light on expected benefits and potential shortcomings of employment protection legislation, drawing on recent experience of emerging and transition economies.

DISCUSSION OF PROS AND CONS

Employment protection legislation is among the most controversial and complex labor market institutions. It is usually introduced with the economic aim of increasing employment and the social aim of ensuring decent work. But its effects on employment, productivity, and welfare remain theoretically ambiguous, requiring clarification through empirical studies.

The effects predicted by economic theory

Deviations from the competitive model of the labor market, the so-called market failures, provide the main economic rationale for statutory employment protection (see **Labor market failures**).

> **Labor market failures**
>
> Market failures, including in the labor market, occur when the market mechanism fails to deliver a socially efficient and equitable allocation of scarce resources.
>
> The best example in the context of the labor market is monopsony, when dominant employers (for example, in an industry or in a region) use their buying power to drive wages below the level that would have occurred in a competitive environment. Other causes of labor market failures include, for example, imperfect information and discrimination.
>
> They may lead to misallocation of resources, welfare losses for society and social problems.

For example, employment protection can be a remedy from underinvestment in human capital by firms and workers. The problem is that firms may be reluctant to invest in workers' skills, as the workers can be poached after conclusion of the professional training by another company. Similarly, workers may underinvest, especially in firm-specific skills, as they face the risk of termination of the employment relationship and, as a consequence, the loss of their investments. With employment protection, both sides expect the employment relationship to be lasting and therefore have stronger incentives to invest in firm-specific skills that may be of little value outside of the firm and the sector.

While employment protection can remedy some market failures, some unintended side-effects may be undesirable. For example, by raising firing costs, employment protection reduces not only a firm's inclination to lay off workers but also its willingness to hire new ones. When making a hiring decision, a firm considers the potential future costs of worker dismissal. Therefore, it might decide to hire fewer workers than if firing costs were zero. Employment protection may also reduce worker effort. Indeed, absenteeism may even be more likely among protected workers, as more recent studies suggest.

Some theoretical models predict that employment protection legislation will lead to segmentation of the labor market into workers with a protected job (insiders) and the unemployed or workers with temporary or fixed-term contracts (outsiders). This second group faces greater difficulties than they might otherwise in finding protected jobs because of the reduced willingness of firms to hire.

In emerging and transition economies, this kind of duality emerges between the formal and informal sectors (see **Informality in the labor market**). In a simulation for Brazil, policies that reduce the cost of formal jobs (such as lower hiring and firing costs) not only increase employment in the formal sector and reduce employment in the informal one, but also reduce unemployment and inequality [3].

Informality in the labor market

Informality in the labor market encompasses income-generating activities of waged workers or the self-employed that are not reported to the tax authorities.

As this definition is difficult to operationalize, informality is often associated with job characteristics (unskilled workers, those in marginal jobs, the self-employed, domestic and family workers, and workers in small firms with up to five employees) as well as with the non-compliance to the state in terms of labor laws and social security systems (wage workers and the self-employed non-compliant with, or without access to, the social security system or pension system).

The overall effect of employment protection legislation on the labor market and economy in general is hard to predict based on existing theory. The only prediction that seems certain is that stricter legislation leads to reduced employee turnover (longer job tenures and unemployment spells) and smooths swings in employment and unemployment over the business cycle. In addition, some theoretical models suggest that employment protection legislation affects the composition of the employed and the unemployed.

But theory is more ambiguous regarding the effect on general unemployment and wages. For example, when workers can “buy out” their jobs by accepting a lower starting wage, employment and unemployment might show little response to employment protection legislation. All in all, theory suggests that employment protection reduces some distortions at the cost of introducing or increasing others. The overall effect is therefore an empirical issue.

Empirical evidence

The empirical evidence on employment protection legislation comes from three types of studies: cross-country studies based on aggregate data, cross-country studies based on disaggregate data, and single-country studies based on micro-data. Studies based on cross-country data are the main source of evidence about how changes in labor law affect the labor market and the economy, including in transition and emerging economies.

Cross-country studies for transition and emerging market economies

For reasons of data availability and quality, the empirical evidence from emerging and transition economies is fairly limited. A key reference paper pools data from 85 developed, transition, and developing countries [4]. The focus is on the regulation of labor markets through laws affecting employment, collective relations, and social security. The paper presents a new methodology to quantify dozens of provisions in labor law into a set of easily interpretable indicators (subsequently used in the World Bank's Doing Business project). The principal finding is that stricter regulation of labor is associated with lower labor force participation and higher unemployment, especially among young workers. There is also some evidence that more stringent regulations are associated with a larger unofficial economy, although this seems to stem mostly from collective relations laws.

Another study [5] deals explicitly with developing economies and measures the costs of employment protection legislation using a different technique from that used in [4]. The study constructs indicators of the direct cost of complying with labor laws (measured as a fraction of average monthly wages) for different types of regulation. These indicators can be compared not only across countries and over time, but also against each other. The principal conclusion of the empirical analysis is that regulation "reduces labor market flexibility, reduces the employment of marginal workers, and generates inequality in the larger society."

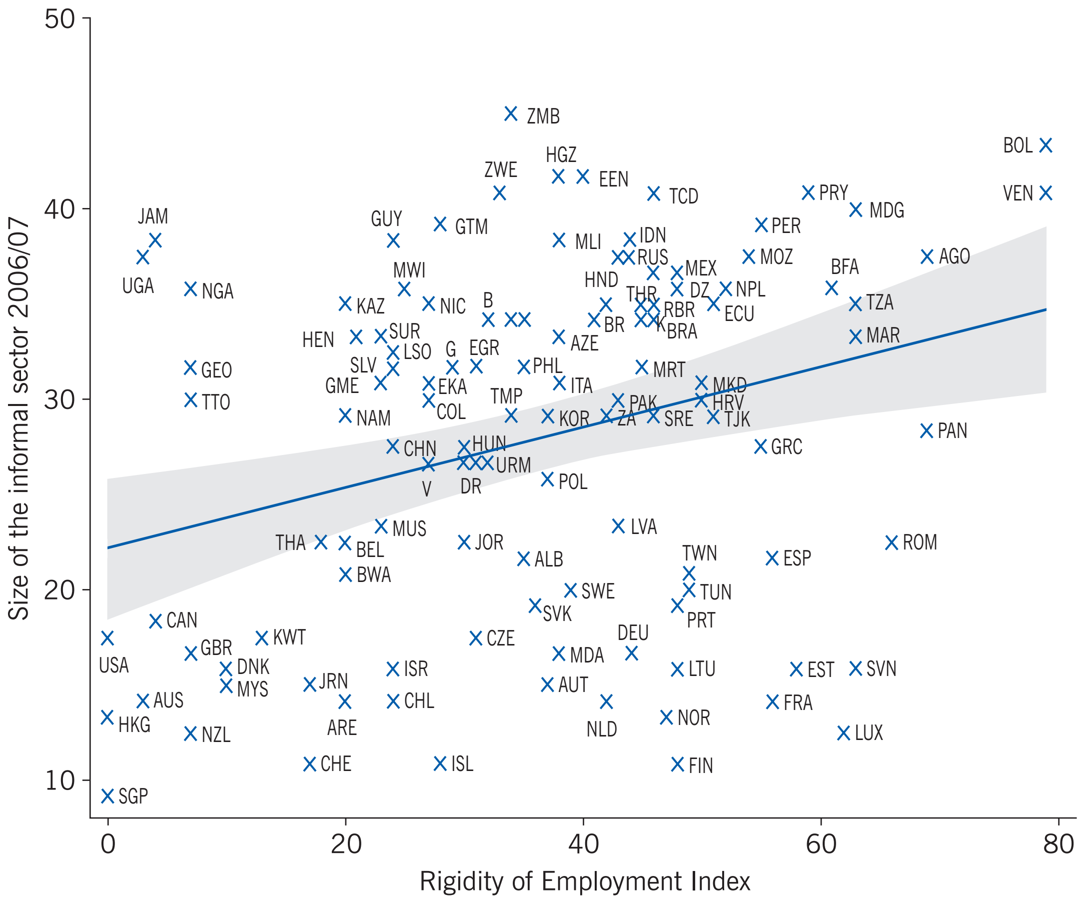
A comprehensive survey of the employment law literature published between 2004 and 2009, with an emphasis on developing and transition economies, employs statistical analysis to assess the link between labor law, measured by the rigidity of employment index published by Doing Business, and labor market outcomes [2]. The sample covers more than 100 countries, including major transition and emerging economies. The principal finding is that more rigid regulations are associated with a larger informal sector and higher unemployment .

A more recent and comprehensive study of the role of labor market institutions in transition economies uses a unique dataset that covers the majority of transition economies, including countries of Central and Eastern Europe, South-Eastern Europe, and most of the successor states of the Soviet Union [6]. It examines labor market outcomes and institutions, including employment protection legislation, and macroeconomic controls from the early to late periods of transition in those economies (from 1995 to 2008).

The data suggest large differences in labor market institutions and outcomes, both across the three geographical regions and over time, with liberalization of labor markets being a clear trend. The econometric evidence shows the importance of labor market institutions in the determination of labor market outcomes and is in line with the argument that deregulation of labor markets improves their performance. Although the study finds that not all institutions and policies matter, for those that do there is a robust negative effect of stricter employment protection on employment and a significant positive impact on youth unemployment, though not necessarily to the same extent.

A related paper studies how labor market institutions, including employment protection legislation, affect informal employment in transition and Latin American countries [7]. The data cover 52 countries observed in 1999, 2003, and 2007, with a total of more than 100 observations. In line with the literature that identifies labor market regulation as an important driver of informality, a key finding of the econometric analysis is that a more regulated labor market is associated with a larger informal economy (see also Figure 1). The result is particularly strong for the transition economies in the sample.

Figure 1. How informality grows with rigid employment protection



Source: Djankov, S., and R. Ramalho. "Employment laws in developing countries." *Journal of Comparative Economics* 37:1 (2009): 3–13 [2]. Reprinted with permission from the Association for Comparative Economic Studies.

I Z A
World of Labor

Single-country studies for transition and emerging market economies

Brazil. An important within-country study based on disaggregated data investigates the link between the evolution of the Brazilian labor market over 1990–2000 and two far-reaching reforms of the late 1980s, a trade reform and the adoption of a new constitution [8]. The trade reform substantially reduced barriers to international trade, while the constitutional reform of 1988 increased regulation of the labor market by raising overtime costs, increasing the penalty for firing workers, and relaxing restrictions on union activity. There was a substantial rise in informal employment over the period—as high as 10 percentage points in metropolitan areas.

The study takes advantage of a detailed and extensive dataset to analyze worker flows across dozens of industries. The statistical analysis suggests little role for trade liberalization in the increase in informality but finds that 30-40% of the rise in informality can be explained by increased regulation of labor due to the constitutional reform, including regulations influencing firing costs. The effect works primarily through reductions in the job-finding rate in the formal sector as opposed to increased separation rates, the focus of most studies.

India. A study examining the role of employment protection in explaining manufacturing performance in Indian states over 1958–1992 takes advantage of state-level variations in the stringency of employment protection [9]. Although the Industrial Disputes Act of 1947 regulating industrial relations for formal manufacturing firms (but not small informal firms) was passed at the central level, the national Constitution gave state governments the right to amend the act.

The study classified the amendments, 113 in all, as pro-worker, pro-employer, or neutral. The econometric analysis shows that pro-worker amendments at the state level resulted in lower output, employment, investment, and productivity in the formal manufacturing sector and in higher output in the informal sector, which was not covered by the regulation. Pro-worker labor regulation was shown to contribute to an increase in urban poverty.

Russian Federation. Russia is known for its relatively stringent labor regulations (at least those covering permanent employment contracts), but weak enforcement. Moreover, law enforcement varies widely across regions, cities, and segments of firms and over time, creating substantial de facto variation in the stringency of labor regulations despite apparent uniformity in the laws. This feature is exploited in a study that uses unique data on regional variation in enforcement of employment protection legislation to investigate how labor regulation affects labor market outcomes, such as employment and unemployment rates among the general population, women, and youth [10].

The data cover 80 regions over six years, with 480 observations overall. The analysis suggests that interregional differences in enforcement have a statistically significant impact on regional economies and labor markets. In particular, effective enforcement tended to suppress employment and increase unemployment, affecting women, youth, and other disadvantaged groups first. Intended to protect vulnerable groups, employment protection seems to have had the opposite effect.

Georgia. Until 2006, Georgia retained the labor code adopted during the Soviet era, with a few changes and amendments. It provided a modest level of worker protection, close to the OECD average. Then in 2006, the government of President Mikheil Saakashvili overhauled the labor law, simplifying dismissal procedures (verbal notification was sufficient), reducing severance pay, making it more difficult to reinstate workers, and making it substantially easier to lay off large numbers of workers at once [11].

From close to the OECD average, Georgia's employment protections fell to the levels in the US and the UK, which are among the lowest in the developed world. The reform might have gone too far, however, eliciting criticism from the International Labor Organization and the EU (which Georgia aspires to join) for excessively strengthening the position of employers and undermining the rights of employees.

Implications of the findings on transition and emerging market economies

Several commonalities emerge from this review of the evidence for transition and emerging market economies.

- First, stricter regulation of labor causes higher unemployment among young workers.
- Second, such regulation is also associated with a larger incidence of informal employment. Both of these findings are consistent with segmentation models of the labor market.
- Third, many studies also find detrimental effects of employment protection legislation on labor force participation, employment, and unemployment in the general population.

In view of this evidence, it is not surprising that the dominant trend has been the easing of employment protections, especially in countries with traditionally strict legislation. Most countries that have recently reformed their employment protection legislation have relaxed dismissal provisions.

LIMITATIONS AND GAPS

Measurement and modeling issues complicate interpretation of the empirical evidence of employment protection's effect on the labor market. Indicators of employment protection can be based on a direct calculation of employer costs, quantification of legal provisions, or subjective estimates of the stringency of regulation. The three methods do not yield the same estimates of the stringency of labor laws—or the same answers on the effect of employment protection on the economy.

Advances in measurement may shed more light on how different elements of employment protection legislation (such as regulations pertaining to permanent contracts, temporary contracts, and collective dismissals) affect labor markets. Better measurement can help particularly in assessing the balancing of all elements of employment protection legislation as opposed to partial reforms that relax a particular set of legal provisions.

On the modeling side, infrequent and small changes in institutions, including employment protection legislation, constitute a serious problem for empirical research. Most of the empirical evidence of the effects of employment protection legislation still comes from high-income countries, where there is relatively little variation in key institutional variables, especially over time. Data from other countries are important to building a more comprehensive picture of how employment protections affect labor market outcomes and the economy at large.

Interpreting the evidence is also complicated by incomplete enforcement: sometimes the rigidity exists only on paper, with the most stringent regulations applied selectively or not at all.

Finally, there is still a lack of evidence on how employment protection legislation interacts with other labor market institutions, such as unemployment insurance and collective bargaining.

SUMMARY AND POLICY ADVICE

All countries have some form of employment protection legislation related to job security and decent work. The goal is to protect employees against unfair dismissal as well as against fluctuations in earnings that occur at the time of job loss.

Theory suggests, however, that stringent employment protection legislation may have important side effects on the labor market that need to be considered. In particular, while legislation protects insiders (those already in formal and permanent employment), it may worsen the prospects of outsiders, such as young workers who are just entering the labor market.

The empirical evidence confirms some of the risks associated with stringent employment protection legislation, although the evidence is far from conclusive. Recent studies based on data for transition and emerging market economies, which are characterized by large variation in labor market institutions and outcomes, provide additional support to the idea that the costs of employment protection legislation may be substantial, particularly for women, youth, and other vulnerable groups. Especially important, excessive regulation of the labor market increases informal employment—usually low-quality, unprotected jobs. It is not surprising, then, that most countries that have reformed employment protection in recent years have relaxed dismissal provisions.

Policies for employment protection require careful examination of the tradeoffs between intended and unintended effects. Stricter regulation of labor causes higher unemployment among young workers and is associated with a higher incidence of informal employment. It can also be detrimental to labor force participation, employment, and unemployment in the general population.

Acknowledgments

The author thanks an anonymous referee and the IZA World of Labor editors for many helpful suggestions on earlier drafts.

Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

REFERENCES

Further reading

Cazes, S., S. Khatiwada, and M. Malo. "Employment protection and industrial relations: Recent trends and labour market impacts." In: *World of Work Report 2012: Better Jobs for a Better Economy*. Geneva: International Labour Office, International Institute for Labour Studies, 2012; pp. 35–58.

Skedinger, P. *Employment Protection Legislation: Evolution, Effects, Winners and Losers*. Cheltenham, UK: Edward Elgar, 2010.

Key references

[1] Freeman, R. *Labor Market Institutions without Blinders: The Debate over Flexibility and Labor Market Performance*. NBER Working Paper 11286. Cambridge, MA, 2004.

[2] Djankov, S., and R. Ramalho. "Employment laws in developing countries." *Journal of Comparative Economics* 37:1 (2009): 3–13.

[3] Bosch, M., and J. Esteban-Pretel. "Job creation and job destruction in the presence of informal markets." *Journal of Development Economics* 98:2 (2012): 270–286.

[4] Botero, J., S. Djankov, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer. "The regulation of labor." *Quarterly Journal of Economics* 119:3 (2004): 1339–1382.

[5] Heckman, J., and C. Pages. *Law and Employment: Lessons from Latin America and the Caribbean*. Chicago: University of Chicago Press, 2004.

[6] Lehmann, H., and A. Muravyev. "Labour market institutions and labour market performance: What can we learn from transition countries?" *Economics of Transition* 20:2 (2012): 235–269.

[7] Lehmann, H., and A. Muravyev, A. "Labor market institutions and informality in transition and Latin American countries." In: Pages, C., J. Rigolini, and D. Robalino (eds). *Social Insurance and Labor Markets: How to Protect Workers while Creating Good Jobs*. Oxford: Oxford University Press, forthcoming 2014.

[8] Bosch, M., E. Goñi-Pacchioni, and W. Maloney. "Trade Liberalization, Labor Reforms and Formal–informal Employment Dynamics." *Labour Economics* 19:5 (2012): 653–667.

[9] Besley, T., and R. Burgess. "Can labor regulation hinder economic performance? Evidence from India." *Quarterly Journal of Economics* 119:1 (2004): 91–134.

[10] Gimpelson, V., R. Kapelyushnikov, and A. Lukyanova. "Employment protection legislation in Russia: Regional enforcement and labor market outcomes." *Comparative Economic Studies* 52:4 (2010): 611–636.

[11] Muravyev, A. "The evolution of the regulation of labour in the USSR, the CIS and the Baltic States, 1985–2009." *Europe-Asia Studies* (Forthcoming 2014).

The full reference list for this article is available from the IZA World of Labor website (http://wol.iza.org/articles/employment-protection-legislation-and-labor-market-outcomes-in-transition-and-emerging-market-economies).