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# Job protection laws and agency problems under asymmetric information

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## Abstract

Under symmetric information, a job protection law which says that a principal who has hired an agent today must also employ him tomorrow can only reduce the two parties' total surplus. The law restricts the principal's possibilities to maximize her profit, which equals the total surplus, because she leaves no rent to the agent. However, under asymmetric information, a principal must leave a rent to her agent, and hence profit maximization is no longer equivalent to surplus maximization. Therefore, a job protection law can increase the expected total surplus by restricting the principal's possibilities to inefficiently reduce the agent's rent.

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## 1. Introduction

In most European countries, permanent employment relationships that are protected by job security legislation are the regular case. This paper offers a principal–agent theoretic perspective on employment protection laws. It is quite obvious that job security is a precious good. However, why is the government needed to legislate employment protection? If a permanent relationship between an employer and an employee is beneficial,

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say because the employee is risk-averse or needs incentives to invest in firm-specific skills, then the two parties could deliberately write a labor contract that guarantees job security to the employee. How can a job protection law increase welfare over and above the level that can be reached by private contracting? After all, it is merely a restriction on the class of contracts that the two parties may write.<sup>1</sup>

In general, restrictions on the class of contracts that private parties may write can be desirable in the presence of externalities. For instance, welfare can be increased if cartel contracts are prohibited, because such contracts have negative externalities on the consumers, who are not contractual parties. But why should insecure or fixed-term employment contracts be prohibited? A possible reason is that permanent employment relationships have positive external effects that the contractual parties do not internalize.<sup>2</sup> However, in what follows I will not consider any such externalities and instead only focus on the gains from trade that accrue to the employer and the employee.

The main result of the analysis will be that state-mandated employment protection can strictly increase the expected surplus that an employer and an employee together can generate. This will be demonstrated in a simple principal–agent model that does not rely on risk-aversion, incomplete contracts, search frictions, wealth constraints, or limited commitment abilities. Instead, the result will follow immediately from the presence of asymmetric information, which of course is the cornerstone of the principal–agent theory. Under symmetric information, the employer can extract the full gains from trade with the employee. Hence, a law that restricts the class of feasible contracts will reduce not only the employer's profit, but at the same time the total surplus generated in the employment relationship. In contrast, under asymmetric information the employer must leave an information rent to the employee. This means that the employer's profit is no longer equal to the two parties' total surplus. A job protection law may then decrease the employer's profit but simultaneously increase the total surplus, because it limits the possibilities of the employer to inefficiently dismiss the employee in order to reduce the information rent.<sup>3</sup>

Hence, the present paper illustrates that mandatory employment protection (i.e., a restriction on the class of admissible labor contracts) can be welfare-enhancing, even

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<sup>1</sup> In the present paper, job protection legislation means that an employer who hires an employee today is not allowed to dismiss him tomorrow; i.e., the law imposes prohibitive firing costs. This is to be distinguished from severance payments, which in theory can trivially be undone by the parties, as has been discussed by Lazear (1990).

<sup>2</sup> For instance, more mobility could mean that people care less about their neighbors and imply more criminality. Less job security could negatively affect the housing market and the public health system. The fact that job insecurity is health-damaging has e.g. been confirmed by D'Souza et al. (2003), who find a more than threefold increase in odds for depression and anxiety, and a more than twofold increase for physical health problems.

<sup>3</sup> It is a standard result that in agency models with asymmetric information the first best is not achieved because the principal implements trade in too few states of the world. This 'downward distortion' for all but the best type is induced because trade is more attractive for a good-type agent who has to be deterred from mimicking a bad type.

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