



The effects of employment protection: Learning from variable enforcement

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Abstract

Employment protection legislation (EPL) is not enforced uniformly across the board. There are a number of exemptions to the coverage of these provisions: firms below a given threshold scale and workers with temporary contracts are not subject to the most restrictive provisions. This within-country variation in enforcement allows us to make inferences on the impact of EPL which go beyond the usual cross-country approach. In this paper we develop a simple model which explains why these exemptions are in place to start with. Then we empirically assess the effects of EPL on dismissal probabilities and on the equilibrium size distribution of firms. Our results are in line with the predictions of the theoretical model. Workers under permanent contracts in firms with less restrictive EPL are more likely to be dismissed. However, there is no effect of the exemption threshold on the growth of firms.

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1. Introduction

The purpose of this paper is threefold (i) to extend standard models of employment protection legislation (EPL) allowing for disciplinary as well as economic dismissals, (ii) to explain why EPL is typically not enforced in the case of small units and (iii) to provide new evidence on the relationship between strictness of EPL and job loss as well as EPL thresholds and growth of firms.

Unlike previous studies drawing on cross-country variation, in this paper inferences are made by exploiting the *within*-country variation in the enforcement of EPL. Regulations on dismissals typically allow for a threshold scale (generally defined in terms of the number of employees) below which the most restrictive EPL provisions (e.g., the compulsory reintegration in case of unjustified dismissal) are not enforced, the legal procedures for firings are eased, or severance payments are diminished. In this paper we develop a simple theoretical model to illustrate the rationale for these exemptions, and use this discontinuity in regulations (as well as the divide between fixed-term and permanent contracts) to infer the effects of EPL within a double-difference approach.

The vast *theoretical* literature on EPL does not take into account that legal restrictions to dismissals affect both economic and disciplinary dismissals. In an efficiency wage environment à la Shapiro and Stiglitz (1984), this observation is very important because the likelihood of disciplinary layoffs deters workers from shirking, whilst the probability of economic layoffs affects positively the efficiency wage the employer has to pay in order to induce workers not to shirk. This is because a higher risk of being dismissed per any given level of effort reduces the penalty associated with the fact of being caught shirking. Hence, insofar as EPL negatively affects disciplinary layoffs, it increases the efficiency wage; when EPL instead acts mainly on economic layoffs, it reduces the efficiency wage. As monitoring effectiveness is decreasing in firms' size, this simple intuition explains the presence of threshold plant levels below which EPL is only mildly enforced. It would just make it too costly for small units to operate.

The vast *empirical* literature on EPL (surveyed in OECD, 1999, 2004) typically uses a cross-country approach in assessing the effects of EPL on labour markets. However, cross-country (and often pair-wise) correlations of indicators of the strictness of EPL with measures of labour market performance cannot disentangle the effects of EPL per se from the effects of EPL when interacted with other institutions. Previous work—i.e., Bertola and Rogerson (1997), and Layard and Nickell (1999)—suggests that the effects of EPL on labour market performance interact with other institutional features, such as wage compression induced by collective bargaining, unemployment benefits and statutory minimum wages or the effects of early retirement and “soft” landing schemes. In a cross-country and multivariate regression framework it is not possible to take into account all of the relevant institutional interactions, owing to the few degrees of freedom available (there are no time-series for many institutions), and measurement problems, which are particularly serious having mainly to do with ordinal measures (country rankings) of institutions, developed out of qualitative information on regulations. In this paper—as in Garibaldi et al. (2004) and Kugler and Pica

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