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Employment protection reforms, employment and the incidence of temporary jobs in Europe: 1996–2001 ☆

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ABSTRACT

This paper uses longitudinal data on individuals from the European Community Household Panel over the 1996–2001 period to investigate the impact of reforms of employment protection systems in nine countries on the incidence of employment and of temporary jobs for wage and salary workers. Important features of the research design include the use of individual fixed effects models as well as the inclusion of country-specific trends in the dependent variable. A robust finding is that policies making it easier to create temporary jobs on average raise the likelihood that wage and salary workers will be in temporary jobs. This effect is felt primarily when the regional unemployment rate is relatively high. However, there is no evidence that such reforms raise employment. Thus, these reforms, while touted as a way of jump-starting individuals' careers in the job market, appear rather to encourage a substitution of temporary for permanent work.

1. Introduction

A considerable volume of economic research has been devoted over the last two decades to explaining and suggesting remedies for the stubbornly high unemployment rates in a number of European countries. Among the suggested policy remedies for reducing joblessness is the relaxation of systems of employment protection by reducing the mandated costs to firms of firing workers. Some have argued that such reforms encourage job creation by reducing future downsizing costs or the costs of firing unproductive workers; however, the reforms may also raise the number of employee discharges, potentially undoing the reforms' effects on unemployment (OECD, 2004). While some reforms lower the costs of firing workers from permanent jobs, most reforms in recent years have been directed at easing restrictions on the use of temporary employment contracts. These reforms presumably reflect a desire to maintain protections for workers in permanent jobs while giving firms an incentive to create new, temporary jobs, which may ultimately become permanent.[1] However, such policies may instead encourage firms to substitute temporary for permanent jobs, and, if so, the overall exit rate from jobs may increase. The resulting higher turnover may even lead to higher equilibrium unemployment than before (Blanchard and Landier, 2002; Cahuc and Postel-Vinay, 2002). Moreover, temporary jobs are known to pay less, offer less training, and be less satisfying than regular jobs (Booth et al., 2002b; Kahn, 2007). Thus, reforms that encourage the creation of temporary jobs may not lower unemployment and also may not unambiguously raise employed workers' utility (Blanchard and Landier, 2002; Cahuc and Postel-Vinay, 2002).

This paper studies the effects of employment protection system reforms in nine European countries during the 1996–2001 period. The countries are Belgium, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain and the United Kingdom. During the post-1990 period, the most common reform of employment protection laws (EPL) among these and other OECD countries has been to relax

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[1] Evidence on the question of whether temporary jobs are stepping stones to permanent jobs is mixed. See Booth et al. (2002b), Autor and Houseman (2005), and Ichino et al. (2005).

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restrictions on the use of temporary contracts. For example, in some cases, firms were allowed to renew their temporary employment contracts additional times. This type of reform may be the easiest to accomplish politically since it leaves intact any basic protections on permanent employment (Brügemann, 2007). However, as shown below, there were also some reforms in which protections on permanent jobs were relaxed as well as some where protections on permanent jobs or restrictions on temporary jobs were increased. This diversity of change will provide us with some useful variation in order to estimate the impact of these reforms.

To examine the effects of EPL reforms, I use longitudinal data from the European Community Household Panel (ECHP) for the nine countries mentioned above. Microdata are helpful in estimating the impact of reforms since they allow one to control for composition effects. For example, groups in the labor force that typically work disproportionately in temporary jobs such as the young, women or immigrants may be increasing their labor force share at the same time as reforms are being enacted. If so, then macroeconomic comparisons of the incidence of temporary jobs before and after reforms may confound these compositional effects with the true effects of the reforms. In addition, previous theoretical and empirical research suggests that the impact of employment protection on the incidence of temporary jobs will be felt disproportionately by the young, women, immigrants, and the less skilled (Kahn, 2006, 2007). Having microdata will allow one to test these hypotheses as well.

The longitudinal nature of the ECHP sharpens one's tests of the impact of the reforms. Specifically, by estimating individual fixed effects models, one can observe outcomes for the same individual in an environment without and one with labor market reforms. Such a research design can alleviate possible biases due to non-random changes in the composition of the population at the time of the reforms, even controlling for its measured characteristics. For example, new cohorts of women may have different attitudes toward temporary work (compared to previous cohorts) around the time of reforms. Again, the incidence of temporary work among women may be changing for these compositional reasons rather than due to the reforms. However, by observing the same worker over time, we can provide a more valid test. Of course, individuals' attitudes may be changing at the time of reforms, making even the fixed effects approach suspect. I will address such concerns by including country-specific trends in some models. Moreover, this design can in principle at least partially account for the potential endogeneity of reforms. For example, to the extent that reforms reducing workers' protection become more politically viable during expanding labor markets (a possible outcome in political economy models of reforms such as those of Saint-Paul (2002) and Brügemann (2007)), failure to control for country trends may lead us to mistakenly credit reforms for creating jobs.

On the effect of temporary job reforms, I find that not controlling for country-specific trends, making it easier to create temporary jobs does not affect employment but raises the incidence of such jobs among the employed; these findings hold up even controlling for country-specific trends. Thus, making it easier to create temporary jobs does appear to cause a greater relative incidence of such jobs, although the lack of a positive aggregate employment effect of such reforms suggests that firms are induced to substitute temporary for permanent jobs. Moreover, the positive effects of liberalizing temporary employment reforms on the relative incidence of temporary employment are primarily observed at high unemployment. I pose a model for the impact of such reforms that attributes such a result to two factors. First, in the model, the gain to hiring a worker directly into a temporary rather than a permanent job stems from the firm's right to weed out unproductive workers at low cost under a temporary contract. The value of this option is greater when average productivity is low, i.e., when unemployment is high. Second, the unemployment insurance (UI) system in effect subsidizes the temporary employment strategy, and this subsidy is greater during periods of high than low unemployment.

Regarding permanent protection reforms, I find that, not controlling for country-specific trends, reducing restrictions on firing workers from permanent jobs appears to raise employment and to raise the incidence of permanent work among the employed, as the reforms were intended to do. However, these effects become small and insignificant on average when I control for country-specific trends. The impact of controlling for country-specific trends suggests that countries are most likely to enact reforms liberalizing their permanent job protection regulations when the incidence of employment and permanent employment is rising.

2. Recent research on the impact of reforms in employment protection systems

Theoretical research on the impact of reforms of employment protection mandates suggests that making it easier to create temporary jobs raises their relative incidence but has ambiguous effects on overall unemployment. The ambiguity is due to the opposing factors of lowered cost of offering jobs on the one hand and a higher exit rate from employment on the other hand (Blanchard and Landier, 2002; Cahuc and Postel-Vinay, 2002). Lowering of firing costs from permanent jobs also has theoretically ambiguous effects on employment and permanent employment: on the one hand, again such reforms lower the cost of offering permanent jobs; on the other hand, they make it easier to fire workers from permanent jobs, lowering employment and the relative incidence of permanent jobs (Bertola, 1999; Garibaldi and Violante, 2005).

On the empirical side, several authors have estimated the impact of recent reforms in employment protection systems in Europe or Latin America, with most analyses focusing on a specific country.[2] In some of these cases, reforms were targeted at subgroups in the labor force, providing researchers with a natural experiment in which outcomes can be compared across subgroups. For example, the Spanish reforms of 1997 reduced dismissal costs for permanent jobs for workers under 30 years old and for those over 45 years old but not for those ages 30–44 (Kugler et al., 2005). Similarly, in Colombia in 1990, dismissal costs were lowered for jobs in the formal sector but not for the informal sector (Kugler, 1999). Going in the opposite direction (i.e., increasing employment protection), the UK in 1999 lowered the probation period during which workers may not sue for unfair dismissal from two years to one year (Marinescu, 2007). And, Italian reforms of 1990 raised unjust dismissal costs for small firms but not for larger firms (Kugler and Pica, 2008). In other cases, reforms were enacted uniformly across the economy. For example, Blanchard and Landier (2002) study the effect of France's policy in the 1990s of lowering costs of firing workers from temporary jobs on transitions to permanent work; and Boeri and Garibaldi (2007) study the effects on employment and productivity of Italy's late 1990s reforms which made it easier for firms to create temporary jobs.

In each of these cases, the reforms were correlated with the expected changes in labor market outcomes, suggesting a policy impact. For example, in the non-targeted reforms (i.e. which applied to all employers and workers), transitions from temporary to permanent employment in France fell in the 1990s after firing costs from temporary jobs were lowered (Blanchard and Landier, 2002); and in Italy, temporary employment grew in the late 1990s after passage of reforms making it easier to create temporary jobs (Boeri and Garibaldi, 2007). Among the targeted reforms (i.e. those that applied to a subset of firms or workers), shortening the probationary period in the UK was associated with a decrease in the firing hazard for workers with up to two years of tenure relative to those with more

[2] As discussed below, the OECD (2004) performed a cross-country analysis of EPL reforms.