Reduction of Employment Protection in OECD Countries: Its Driving Forces

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Introduction

In a globalised world structural change is essential if countries want to preserve their competitive edge and reduce their unemployment. A major obstacle to structural change is employment protection. According to the OECD, the summary indicator of the strictness of employment protection (EPL) is relatively high in continental European countries with the exception of Switzerland and Denmark, and relatively low in English-speaking countries.

A reduction in the strictness of EPL, which would increase the flexibility of labour markets, is generally resisted by incumbent workers. In order to overcome this resistance, the European Commission has proposed enhancing income security by providing higher unemployment benefits. According to this "flexicurity" strategy, flexibility is supported by generous income security. Workers will accept a reduction in the strictness of EPL more easily if they receive higher unemployment benefits during periods of unemployment.

As the "flexicurity" strategy is very popular in Europe (European Commission 2006, chapter 2) it is of interest to know whether the generosity of unemployment benefits has been associated with less employment protection in OECD countries in the past. There are few studies which have analysed this relationship empirically. Boeri et al. (2003 and 2006) investigate the relationship between the generosity of unemployment benefits and the level of EPL strictness. In a cross-section for one year they find a negative relation between the two schemes.

Our approach is different. We want to find out whether changes in the strictness of EPL over time can be explained by changes in the generosity of unemployment benefits. We include 26 OECD countries and consider the period from 1985 to 2003. Apart from the generosity of unemployment benefits we also control for other determinants. They relate to the activation of the unemployed, the power of unions, the strength of government, trust and unemployment.

During the last two decades some European countries have reduced the strictness of their EPL. Governments, however, have pursued a highly selective approach. They have left existing provisions for permanent contracts practically unaltered (with the exception of Spain) and relaxed only EPL for temporary jobs (Figure). However, the latter reforms have not been implemented in all OECD countries but only in some countries. These countries are Belgium, Denmark, Germany, Greece, Italy, the Netherlands and Sweden. In these countries firms' use of temporary forms of employment has been eased considerably. The most prevalent path of reform involved facilitating the use of fixed-term contracts and/or hiring workers from temporary work agencies.

Determinants of employment protection

According to the literature, interest groups, politicians (including the government), political institutions and social values have to be taken into account when analysing the political economy of EPL reforms. In the following we shall discuss some key ideas from the literature. As we will show, the predictions found in the literature on the determinants

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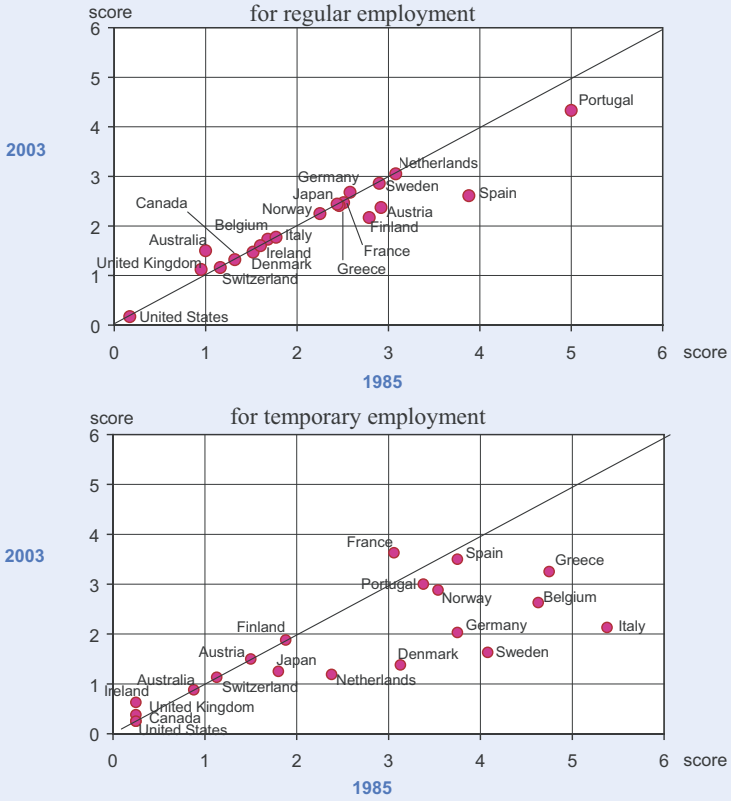
Figure



A high score means high EPL strictness and vice versa.

1985 data are lacking for the Czech Republic, Hungary, Korea, New Zealand, Poland and Slovakia.
The score for Italy refers to 1989 instead of 1985.

Source: OECD, http://www.oecd.org/dataoecd/1/5/39069225.xls.

of employment protection are often contradictory. We will focus on the political power of incumbent employees to resist EPL reforms, the counterbalancing factors of compensating transfers and of a strong government, and the role of trust in implementing EPL reforms.

The main interest group relevant for EPL reforms are the incumbent employees and their unions who want to protect their jobs by a strict EPL. When the amount of rents – i.e. the difference between the employees wage and the unemployment benefits an individual would receive if unemployed – is high, workers will organize themselves better and are more determined to oppose EPL reforms. While workers fear being negatively affected by a reduction in the strictness of employment protection, the unemployed stand to benefit. Their chances of finding a job would increase. But workers have a higher propensity to dominate political decisions. They are politically better organized than the unemployed (Fernandez and Rodrik 1992, 1146).

We hypothesize that the resistance of incumbent workers to EPL reforms will be higher for EPL reforms for permanent jobs and lower for EPL reforms for temporary jobs ("reforms at the margin"). This is because incumbent workers are not directly affected by the latter reforms, and potentially they are made better off. They can earn higher wages because labour market tightness increases due to the higher demand for temporary jobs. And if they lose their job they will benefit from the increased job finding opportunities of the unemployed (Saint-Paul 2000, 227–53). The resistance to EPL reforms at the margin will, however, not be negligible. Incumbent workers may recognise that two-tier systems could perhaps be used as an intermediate step towards a complete EPL reform that they are not in favour of. Reforms at the margin gradually build up a stock of workers with temporary contracts. These workers have different interests than those who hold a fixed contract. They can be used as a "political constituency" to support subsequent reforms of core labour market EPL that the government from the beginning may have intended to achieve (Saint-Paul 1996, chapter 11; Dewatripont and Roland 1992). The power of incumbent workers and their unions to resist EPL reforms cannot be easily measured. In this article we use union density as a proxy.

Policy-makers in favour of lower EPL strictness can overcome insider resistance to EPL reforms by offering compensating transfers to those who do not benefit from the reform. Lower dismissal protection may be less worrying to insiders if unemployment benefits become more generous. Activating the unemployed, which increases their re-employment chances, may also reduce the resistance of incumbent workers to EPL reforms. According to Roland (2002), governments should follow a long-term reli-

able policy of providing compensating transfers in order to be able to secure the political acceptance of EPL reforms by the losers. In this paper we measure the compensating transfers by the generosity of unemployment benefits. We use expenditure on active labour market policies as an indicator for the activation of the unemployed.

The stronger a government the easier it is for the government to implement policy change. Strength of government is related to the number of independent branches of government (executive and legislative branches), the party composition of these branches, the role of the "judiciary" and "sub-federal entities" as players in the political system, etc. If the characteristics of the political system constrain the commitment of government to political change – as indicated by our "Political Constraints Index" – it will be difficult for governments to overcome resistance of incumbent workers to EPL. Broad coalition governments, for example, are considered to be an obstacle to EPL reform. They tend to paralyse decision-making, due to the hold-up power of the workers' wings in the Social Democratic parties (Alesina and Drazen 1992).

So far the literature – as summarized above – has overlooked that the power of incumbent workers and the strength of government may be determined by more fundamental factors, like the prevailing social values. In recent studies the importance of trust has been addressed in this context (see, for example, Algan and Cahuc 2006). Trust ("can people be trusted?"), however, is a general category. It may refer to different groups of persons. With respect to the power of employees, trust can be associated with positive attitudes towards social co-operation. Strong trust may help to overcome collective action problems, thereby sustaining labour unions and fostering resistance to EPL reforms. With respect to workers' perception of employers, trust may lead to a different form of behaviour. If workers think that they are treated fairly by employers, they are less likely to demand employment protection. And if the people trust politicians, governments are in a stronger position to implement EPL reforms.

Finally EPL reforms might be influenced by the development of unemployment. A rise in unemployment may result in incumbent workers being more determined to protect their jobs. The unemployed, however, will be more strongly in favour of EPL reforms, which might create more employment opportunities for them. And governments may become more committed to increasing labour market flexibility.

As we have shown, the theoretical arguments do not give clear guidance on the effects of our determinants on changes in employment protection. Empirical research can, however, help to identify the driving forces of EPL reforms.

Data

Our dependent variables are the OECD summary indicators of EPL strictness for the period 1985 to 2003. We use three indicators: the overall EPL indicator (version 1), the EPL indicator for regular employment and the EPL indicator for temporary employment (OECD 2004, chapter 2).

The determinants of EPL are from different sources:

- The union density data are from the OECD (Union Density Database) and Visser (2006). The "adjusted" union membership data define union membership as a proportion of wage and salary earners in employment.
- Unemployment benefits are taken from the OECD. The OECD summary measure of benefit entitlements is defined as the average of the gross unemployment benefit replacement rates for two earnings levels, three family situations and three durations of unemployment (OECD Tax-Benefit Models).
- Public expenditure for active labour market policy as a percentage of GDP (OECD Labour Market Database) is used as a proxy for the activation of the unemployed. The purpose of active labour market policies is to provide active assistance to the unemployed, which will improve their chances of obtaining work. This indicator, however, does not capture all aspects of activation like counselling, placement of the unemployed, benefit sanctions, etc. Unfortunately other panel data are not available.
- As our measure of the constraints on policy change that governments are facing we use the "Policy Constraints Index V" of Henisz (2000) and Wharton School (2006). It measures the extent to which a change in the preferences of any one actor of the political system leads to a change in government policy.
- The indicator "trust" is taken from the World Values Survey. It refers to the percentage of the

population that thinks most people can be trusted. The following question was asked: "Generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?"

- Unemployment is measured by the standardised unemployment rate as a percentage of the total labour force (OECD 2007).

Table 1

Descriptive statistics

Variable	Observations	Mean	Standard deviation	Minimum	Maximum
Overall EPL (score)	215	2.11	1.058	0.21	4.19
EPL for temporary employment (score)	215	2.09	1.476	0.25	5.38
EPL for regular employment (score)	215	2.14	0.963	0.17	5.00
OECD summary measure of unemployment-benefits (%)	215	28.8	12.918	3.0	65.0
Log of OECD summary measure of unemployment-benefits	215	3.23	0.551	1.10	4.17
Trust (%)	135	38.5	14.188	9.8	64.8
Unemployment (%)	206	7.7	3.753	1.6	19.6
Policy Constraints Index V (score)	213	0.77	0.093	0.33	0.89
Public expenditure for active labour market policy (% of GDP)	208	0.79	0.501	0.12	2.83
Union density (%)	186	38.3	21.228	8.1	83.9

Estimation approach

Our panel of countries allows us to estimate a model with country and year fixed effects. One advantage of including country fixed effects is that they control for unobserved country specific variables that are constant over time and influence both employment protection and our explanatory variables. In particular, without these country indicators one may not discover that higher benefits are associated with less protection. This is because unobserved variables such as the political preferences of voters may lead to both higher benefits and high protection. Unobserved or unmeasured left-leaning preferences of voters may make it appear that high benefits are associated with high protection. Country fixed effects control for these political preferences of voters. They control for the average level of protection and benefits and allow for an examination of the effect of changes in benefits on changes in protection.

Thus we estimate the following equation:

$$y_{it} = \beta x_{it} + \mu_i + \gamma_t + \varepsilon_{it} ,$$

where μ_i is a country fixed effect and γ_t a year fixed effect. We estimate this model for three different measures of employment protection legislation y_{it}. The x_{it} vector includes the generosity of unemployment benefits, public expenditure for active labour market policies, union density, policy constraints and a measure of trust and unemployment. We put the unemployment benefits measurement in logs because we expect that the effect of benefits on employment protection legislation is declining at the margin. We cluster all standard errors by country.

Results

Table 1 gives the descriptive statistics for the data. We use in our analysis bi-annual data over the period 1985 to 2003. The overall employment protection index ranges from 0.21 (United States over the entire time period) to 4.19 (Portugal in the late 1980s). The protection indices for temporary work and regular work show similar ranges. They range from 0.25 in the United States, Ireland and the UK to 5.38 in Italy for temporary employment and from 0.17 (United States) to 5.00 (Portugal) for regular employment. The average EPL index is slightly lower for temporary work than the one for regular work. The summary measure of the unemployment benefits, which is defined as the gross replacement rate, has a mean of 29 percent. It ranges from 3 percent in Italy (1989) to 65 percent in Denmark. There are pronounced differences in trust. In Portugal only 9.8 percent of the population trusted other persons, whereas in Norway a high of 64.8 percent trust each other. The lowest unemployment rate was achieved in Sweden (1.6 percent), the highest in Poland (19.6 percent). The Political Constraints Index V ranges from a minimum of 0.33 in Italy to a maximum of 0.89 in Belgium. Whereas the United States only spent 0.12 percent of GDP on active labour market policy, Sweden reached the maximum with 2.83 percent. Union density was lowest in France (8.1 percent) and highest in Sweden (83.9 percent).

Table 2

Determinants of overall EPL

Log of OECD summary measure of unemployment-benefits	-0.233 (0.140)	-0.280** (0.101)	– 0.187** (0.086)	– 0.181 (0.111)	– 0.203** (0.097)
Trust		– 0.020** (0.008)	– 0.020*** (0.007)	– 0.021*** (0.006)	– 0.020*** (0.007)
Unemployment			– 0.029 (0.018)	– 0.03 (0.018)	– 0.03 (0.021)
Policy Constraints Index V			1.517*** (0.217)	1.537*** (0.246)	1.722*** (0.275)
Public expenditure for active labour market policy (% of GDP)				0.035 (0.142)	0.114 (0.164)
Union density					– 0.015 (0.014)
Constant	3.023*** (0.428)	3.642*** (0.426)	2.557*** (0.402)	2.524*** (0.500)	2.642*** (0.561)
Observations	215	135	132	130	114
R^2	0.9497	0.9594	0.9653	0.9652	0.9666
Note: Robust standard errors in brackets. * means significant at the 10% level, ** at the 5% level, and *** at the 1% level. Year and country effects included but not reported.					

Next we move to our estimation results. The dependent variable in Table 2 is the overall employment protection index. The point estimate on the unemployment benefits measure is negative and statistically significant in three of the five specifications. We also estimated these regressions without country fixed effects (not reported). We found that in the regressions that do not include country fixed effects the unemployment benefits measure has a positive sign. The fact that the inclusion of country indicators changes the sign on the unemployment benefits measure from positive to negative, shows that there are country-specific variables which cause some countries to have above average rates of both unemployment benefits and employment protection and others below average rates.

In Table 2, the estimates on the unemployment benefit measure imply that a one percent increase in benefits leads to an increase of between 0.0018 and 0.0028 points in the employment protection measure. An alternative interpretation is that (given the mean

Table 3

Determinants of EPL for temporary employment

Log of OECD summary measure of unemployment-benefits	-0.409 (0.331)	– 0.571** (0.241)	– 0.365* (0.213)	– 0.328 (0.268)	– 0.378 (0.228)
Trust		– 0.037** (0.014)	– 0.038*** (0.013)	– 0.039*** (0.012)	– 0.040*** (0.013)
Unemployment			– 0.062 (0.040)	– 0.065 (0.042)	– 0.079* (0.044)
Policy Constraints Index V			3.316*** (0.480)	3.390*** (0.553)	3.463*** (0.561)
Public expenditure for active labour market policy (% of GDP)				0.104 (0.288)	0.126 (0.325)
Union density					0.013 (0.026)
Constant	3.650*** (1.022)	5.104*** (0.909)	2.673** (0.996)	2.471* (1.217)	2.861* (0.993)
Observations	215	135	132	130	114
R^2	0.9088	0.9186	0.9325	0.9301	0.9395
Note: Robust standard errors in brackets. * means significant at the 10% level, ** at the 5% level, and *** at the 1% level. Year and country effects included but not reported.					

Table 4

Determinants of EPL for regular employment

Log of OECD summary measure of unemployment-benefits	– 0.063 (0.081)	0.003 (0.050)	– 0.017 (0.062)	– 0.043 (0.078)	– 0.034 (0.067)
Trust		-0.002 (0.004)	– 0.003 (0.005)	– 0.003 (0.005)	0.0002 (0.004)
Unemployment			0.003 (0.013)	0.005 (0.013)	0.02 (0.019)
Policy Constraints Index V			– 0.289 (0.287)	– 0.326 (0.308)	– 0.025 (0.274)
Public expenditure for active labour market policy (% of GDP)				– 0.039 (0.073)	0.099 (0.101)
Union density					– 0.044 (0.026)
Constant	2.412*** (0.262)	2.198*** (0.207)	2.462*** (0.412)	2.602*** (0.484)	3.460*** (0.985)
Observations	215	135	132	130	114
R^2	0.9707	0.9727	0.9725	0.9727	0.973

Note: Robust standard errors in brackets. * means significant at the 10% level, ** at the 5% level, and *** at the 1% level. Year and country effects included but not reported.

employment protection measure is 2.11) a one point increase in the benefits leads to a 0.09 and 0.13 point increase in employment protection. These findings suggest that, quantitatively, the correlation between unemployment benefits and employment protection is weak.

Among our other control variables only trust and policy constraints are statistically significant. All specifications in Table 2 show that higher levels of trust lead to less employment protection and that this effect is statistically significant at conventional levels. This suggests that trust is a substitute for regulation. One possible interpretation of this finding is that when workers trust that they are treated fairly by employers, they are less likely to demand employment protection. Another interpretation is that when workers trust politicians and believe in their ability to take care of them it will be easier for governments to convince workers about the necessity of reducing the strictness of EPL. We also find that fewer policy constraints are negatively correlated with employment protection. This suggests that countries with governments that are less subject to checks and balances and that are not paralysed by conflicting parties in coalition governments are more likely to soften employment protection. Our results do not indicate any significant influence of unemployment, public expenditure on active labour market policy and union density on employment protection.

Table 3 uses employment protection for temporary work as the dependent variable. Here the coefficients on the measure of unemployment benefits, trust and policy constraints almost double in size, and the point estimates that were statistically significant in Table 2 remain so in Table 3. These results show that providing higher unemployment benefits, a higher level of trust and low policy constraints are especially beneficial for implementing EPL reforms at the margin. Higher unemployment benefits may increase the support of their recipients. In addition providing compensation transfers seems to be quite effective in overcoming incumbent workers' resistance to EPL reforms of temporary work. This may be so because liberalising temporary work is confronted with less resistance from insiders than the reduction in the strictness of EPL for regular work. Trust too has a positive impact. And for governments that are facing policy constraints, it is easier to overcome the resistance to EPL reforms at the margin.

In contrast to Table 3, Table 4 shows that our time-varying covariates do a poor job explaining employment protection for regular work. In part this is the case because there is less variation in the regular work employment protection measure within a country, than for the temporary work measure. Many countries have lowered employment protection for temporary work while implementing few changes for permanent work. However, it may also reflect the possibility that policy makers are more willing to increase unemployment benefits in exchange for less protection for temporary work, but not for regular work. The results of Table 4 imply that our findings

in Table 2 are due to the fact that two-tier reforms of EPL have taken place in Europe as shown by the results of Table 3.

Conclusion

Our analysis has shown that changes in the strictness of EPL over time can be explained by the generosity of unemployment benefits. Lower dismissal protection seems to be less worrying to workers if unemployment benefits become more generous. This result is in line with previous empirical research. In addition, our disaggregated analysis has shown that this effect is mainly driven by the temporary component of employment protection. While we find significant effects of unemployment benefits on temporary employment protection, we were not able to detect such effects for permanent contracts. This implies that generous employment benefits reduce the resistance to EPL reforms only "at the margin".

Generosity of unemployment benefits, however, is not the only determinant of reducing EPL strictness. Our analysis has revealed that a high level of trust and low policy constraints have also been beneficial for implementing EPL reforms in OECD countries. Thus, generous unemployment benefits in combination with a high level of trust and low policy constraints can explain the liberalisation process of temporary work in OECD countries.

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