



How does employment protection legislation influence hiring and firing decisions by the smallest firms?



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HIGHLIGHTS

- We examine the impact of employment protection on hiring and firing decisions by the smallest firms (0–4 employees).
- Strict employment protection legislation (EPL) is negatively related to both hiring and firing decisions.
- Strict EPL is, therefore, negatively related to labour mobility among the smallest firms.

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ABSTRACT

This paper examines the impact of employment protection legislation (EPL) on hiring decisions by own-account workers and firing decisions by very small firms (one to four employees). Using data from the EU-15 countries, our results show that the strictness of employment protection legislation is negatively related to both these types of decisions, and hence, to labour mobility among the smallest firms. This new evidence may be useful for governments aiming to create a more enabling macro-environment for employment and productivity growth.

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1. Introduction

The global economy faces a threatening downward spiral as a result of the financial and economic crisis of 2008. In some European economies, the problem is strongly exacerbated by a substantial increase in unemployment rates and a decrease in competitiveness. Therefore, the challenge is not just to start and strengthen the economic resurgence, but also to ensure this recovery is accompanied by employment and productivity growth. In this respect, there is near consensus among academics and

policymakers that entrepreneurship is a major driver of economic growth, job creation, and competitiveness in global markets. Consequently, any successful strategy to get out of the jobs crisis should recognize entrepreneurship as a key element.¹ There is a heated debate in Europe, however, about the role of labour market regulation (Millán et al., 2012; Román et al., 2011, 2013). On the one hand, strong employment protection is good for employees as it protects their rights. Hence, in environments with strong employment protection, the number of job dismissals is likely to

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¹ The key role of entrepreneurship as a major driver of economic growth, job creation, and competitiveness in global markets has been well documented in academic publications (see Van Praag and Versloot, 2007 for a comprehensive survey) and policy reports (see, for instance, the new *Europe 2020 strategy*).

be lower. On the other hand, it may not be so good for unemployed individuals since the risk for entrepreneurs of hiring an employee is bigger: if it turns out the new employee does not perform as well as expected, or if the firm is forced to downsize due to external circumstances, the costs of dismissing the employee are relatively high. This increased risk of hiring employees related to strong employment protection may make entrepreneurs more cautious to take on employees. And in an environment where the entrepreneur's risk of hiring people is higher, the number of new jobs created is also likely to be lower. So, while strong employment protection may be good for individuals *having* a job (the 'insiders'), it may not be so good for individuals *looking for* a job (the 'outsiders'). This paradox is known as the insider–outsider problem of employment protection (see Lindbeck and Snower, 2001 for a survey).

Strict employment protection may thus lower the levels of both hiring and firing of employees. This, in turn, may cause levels of labour mobility – the movement of workers between firms – to be lower as well. As labour mobility between firms is an important source of knowledge spillovers, and thereby of productivity growth (Stephan, 1996; Breschi and Lissoni, 2001; Cooper, 2001; Power and Lundmark, 2004), the impact of Employment Protection Legislation (henceforth EPL) on hiring and firing decisions is an important topic of investigation.² In this paper we empirically investigate if and to what extent strict EPL (i) prevents the hiring of employees by own-account workers; and (ii) hampers the firing of employees by employers of very small firms (one to four employees). We focus on the smallest firm category because EPL disproportionately affects the smallest firms, as in these firms the hiring and firing costs are bigger relative to total labour costs. In other words, small firms suffer a scale disadvantage when EPL is high. Moreover, in small firms there is less flexibility to accommodate a poorly performing worker towards a different occupation within the firm (Parker, 2007, p. 704). Hence, the impact of EPL on hiring and firing decisions, and hence on the level of labour mobility, is expected to be especially strong for (very) small firms. In our empirical analysis, random effects logit models are applied to individual level data drawn from the European Community Household Panel for the EU-15 countries. The individual level data are complemented by a macro level indicator reflecting the strictness of employment protection, developed by OECD.

2. State of the art

The literature on the determinants of job creation by the self-employed remains rather limited: see, for example, Carroll et al. (2000) and Mathur (2010) for the US; Westhead and Cowling (1995), Burke et al. (2000, 2002, 2009), Cowling et al. (2004) and Henley (2005) for the UK; and Congregado et al. (2010) for the EU-15. As regards job dismissals by the group of employers, the literature only adopted tangential approaches to the phenomenon by means of survival analysis: see, for instance, Millán et al. (forthcoming) for the EU-15. To the best of our knowledge, an analysis of the impact of the strictness of employment protection on the individual decisions of (i) own-account workers to hire employees; and (ii) employers to fire employees, does not exist to date. This is the research gap we are aiming to fill in the current paper.

² Although a positive impact on productivity growth may be associated with lower employment levels (as the same output can be produced with fewer workers), empirical evidence points in the opposite direction: regions that achieve productivity growth often also achieve employment growth because the market volume increases as a result of increased competitiveness (Fritsch, 2008).

3. Methods

3.1. Data

We use data from the European Community Household Panel (henceforth ECHP) covering the period 1994–2001.³ The ECHP, designed and coordinated by Eurostat, is a standardized multi-purpose annual longitudinal survey carried out at the level of the EU-15.⁴ Additional details on the ECHP data can be found in Peracchi (2002).

3.2. Sample

Two different samples are used in this analysis where, as usual, persons younger than 18 and older than 65, workers in the agricultural industries and those individuals working part-time are excluded. Our first sample includes individuals who are own-account workers for some particular period and then either change their labour force status to employers employing between one and four employees or remain as own-account workers at a later period. This dataset yields 8380 observations (3324 individuals) of which 1201 (14.3%) refer to transitions to employer. Our second sample includes individuals who are employers employing between one and four employees for some particular period and then either change their labour force status to own-account workers or remain as employers at a later period. This second dataset yields 6912 observations (2911 individuals) of which 945 (13.7%) refer to transitions to own-account worker.⁵

3.3. Estimation methods

We use random effects binary logit models that control for unobserved heterogeneity across individuals. Models that control for unobserved heterogeneity across countries are used as robustness checks (not shown for brevity, but available on request). Both approaches yield similar results. Furthermore, both these approaches show no major changes relative to simple pooled regressions (also not shown). This suggests that, even if some unobserved heterogeneity may exist, it does not affect our estimates.

3.4. Measures

3.4.1. Dependent variables (data source: ECHP)

Transitions from own-account worker to employer (one to four employees): The dependent variable is a discrete variable that equals 1 for individuals who are own-account workers in period t and become employers in a firm with one to four employees in period $t + 1$. Note that such a transition implies hiring of new employees. It equals 0 for individuals who remain as own-account workers in periods t and $t + 1$.

Transitions from employer (one to four employees) to own-account worker: The dependent variable is a discrete variable that equals 1 for individuals who are employers in a firm of one to four employees in period t and become own-account workers in period $t + 1$. Note that such a transition may imply firing of employees. It equals 0 for individuals who remain as employers in periods t and $t + 1$.

³ The ECHP data are used with the permission of Eurostat (contract ECHP/2006/09 held with the Universidad de Huelva).

⁴ France, Luxembourg and Sweden were excluded from our analysis because these countries presented missing values for several relevant variables.

⁵ The exclusion of those employers employing more than four employees reduces the number of transitions from own-account worker to employer with 133 observations. Similarly, the number of transitions from employer to own-account worker is reduced with 149 observations. As a robustness check, we also estimated our models using data of all employer sizes. Results are qualitatively the same as presented in Table 2, and are available on request.

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