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Unemployment duration and job-match quality in urban China: The dynamic impact of 2008 Labor Contract Law

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ABSTRACT

We assess the dynamic impact of employment protection legislation in transition economies. We use the Chinese 2008 Labor Contract Law to identify the effects of employment protection on job-finding rates and subsequent job-match quality, in relation to the duration of workers' past unemployment. The causal effects are estimated in a sharp regression-discontinuity design, allowing for workers' unobserved characteristics to jointly underlie their sequential and multidimensional outcomes in labor markets. Even though the law protracts unemployment duration in the short run, once an individual succeeds in finding a job, it improves job-match quality including better job security, higher wages and higher likelihood of receiving social insurance. However, where there is equal unemployment duration, migrants have lower job-finding rates and worse job-match quality than locals. Men have lower job-finding rates but better job-match quality than women. Future research should use longer panel data to evaluate long-term effects on labor markets.

1. Introduction

The socialist system in 1980s and 90s labor markets in urban China privileged urban residents (those with urban household registration, *Hukou*) by assigning permanent jobs in state or collective sectors and prohibiting job mobility. Consequently, this is referred to as the “iron rice bowl” period. To reduce the inefficiency caused by *de facto* lifetime jobs, a labor law permitting short-term contracts, regulation of employment relations and minimum working conditions took effect in 1995 together with the restructuring of the state and collective sectors. Between 1995 and 2000, 31.6 million and 16.5 million workers were laid off from the state and collective sectors, respectively, equaling a quarter of the 1995 urban labor force.¹ Draconian labor retrenchment caused unemployment of an average 19 months, suppressing wages by 16% for this unemployment period, especially affecting women (Knight and Li, 2006). Urban labor markets also became less formalized as it was common for employers to re-hire the laid-off workers on an informal basis (Cai *et al.*, 2008). According to Friedman and Lee (2010), only half of enterprises had signed contracts with employees by 2007 and this proportion was much lower for non-state sectors (20%) and migrant workers (12.5%).

The low contract rate, especially in the non-state sectors (less than 20%), together with the fact that more than 60% of contracts were short-term (less than one year), were also reflected in a survey of 31,000 employees across 7 provinces, conducted by the National People's Congress of China in April 2005.² Meanwhile, rural-to-urban migrant workers rarely had social insurance. In Lu and Song (2006) survey in Tianjin which is only about 100 km from the capital city, few migrants had medical insurance (14.3%), pensions (8.6%) or unemployment insurance (7.3%) in contrast with high insurance coverage among urban workers – 68.2%, 63.8% and 51.8%. Consequently, loss of formalization and limited protection of workers have become salient in urban labor markets (Park and Cai, 2011).

The Chinese government enforced the new Labor Contract Law (LCL) from January 1st, 2008 to halt the trend towards informalization of the urban labor market (Gallagher *et al.*, 2013). Policy was to institutionalize labor conflict resolution and ease labor relations (Gallagher and Dong, 2011) through legislation and arbitration (Friedman and Lee, 2010). There are two primary goals underlying the passage of the law: to protect workers' rights by mandating labor contracts and by regulating contract amendment, conversion and termination. This causes Chinese

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¹ Authors' calculation based on data from China Statistical Yearbook (2001) published by the National Bureau of Statistics (NBS).

² The report is accessible at http://www.npc.gov.cn/npc/zq/2005-12/29/content_343899.htm (in Chinese, accessed 29 January 2016).

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employment protection legislation (EPL) to be the 3rd strictest among the OECD countries (Gallagher et al., 2013). Secondly, the LCL is dedicated to improvement of employees' social protection. As reviewed by Freeman (2010), EPL for developed (typically OECD) countries has tilted market outcomes towards incumbent workers without a clear aggregate influence on employment, while the impact in developing countries remains ambiguous and highly sensitive to country-specific contexts (e.g., the tightness of labor markets and strength/enforcement of EPL). Using the 2008 EPL in China, this paper aims to offer a *dynamic* and *causal* assessment of the implementation of LCL on workers' labor market outcomes, depending on their past unemployment duration. These outcomes are job-finding rates and subsequent job-match quality including job security, wages and the likelihood of obtaining employer-provided social insurance.

The present study contributes to the literature in the following three ways. First, it adds to the studies on the ambiguous wellbeing consequences of EPL on employees' employment transitions and social protection³ by identifying unemployment duration-dependent impact in developing countries undergoing extensive socio-economic transformation. Salvatori (2010) and Freeman (2010) provide recent cross-country examination by using the European Community Household Survey and empirical evidence in developing countries, respectively. It would be of considerable interest to see new evidence from urban China where rapid economic growth, quick recovery from financial crisis, inconsistency in law-implementation, heterogeneous employer responses and segregated domestic labor markets offer an ideal environment for assessment of the varied impact of EPL on employees' wellbeing. It is also worth noting time-varying employment effects, as pointed out by Chen and Funke (2009) theoretical model. There have been different outcomes in unemployment duration since the enactment of the law. Both employers and employees' behavior and the macroeconomic environment change over time, and this is especially apparent during the economic downturn covered by our sample period.⁴ The role of the LCL in formalizing labor markets has also weakened over time as noted in official reports.⁵ Nevertheless, the aforementioned empirical studies have described the situation using descriptive statistics or case studies, or estimated (static) average treatment effects separately for different labor outcomes. The dynamic and complex role of the LCL remains unclear.

Second, this paper further highlights heterogeneity of dynamic causality among various labor market outcomes. It distinguishes between the overall and compositional impact of the LCL on labor market transitions and outcomes – the differences (or discrimination, if any) between urban local workers and rural-to-urban migrants, and between males and females.

Third, this study makes a methodological advance in accordance with a rich dataset. It exploits a panel dataset covering individual urban and migrant workers in 15 cities from coastal to western China with individual employment history as long as a decade (2000–2009) and as many as four job transitions. As suggested in Giles et al. (2012), household surveys with individual employment histories can better facilitate the estimation of employment effects because the aggregated data clouded micro heterogeneity and firm surveys covered only those which survived the 2008–2009 crisis excluding those who might have been most affected by structural shocks. We anchor dynamic endogeneity during the individual's sequential job search and match to a non-parametric joint

distribution. Based on this, we identify the unemployment duration-dependent causal impact of LCL by using a sharp regression discontinuity design embedded in joint duration and multi-equation mixed models including simultaneously the probability of finding employment (i.e., unemployment hazard) and three critical dimensions of post-unemployment job-match quality, namely job security in terms of employment hazard rates, wage level and the likelihood of coverage by employer-provided social insurance schemes.

The remainder of this paper proceeds as follows. The next section reviews articles in the LCL pertaining to this paper and the existing literature on the impact of LCL. Section 3 describes the dataset and provides exploratory analysis. Section 4 spells out the model. Section 5 discusses results and finally, Section 6 concludes.

2. Review of new Labor Contract Law and its consequences in urban labor markets

For appointments after January 1st, 2008, the articles of LCL relating to the first primary goal include: mandatory contracts for all kinds of labor; specified probationary periods of 1–6 months according to the length of the contract and entitlement to a single probationary period from the same employer. This restriction is intended to prevent employers exploiting workers by extending probation periods and then terminating the employment. For both incumbent and new workers, those on temporary one-year contracts will be able to convert their contracts to permanent ones and those who have worked for the employer for a decade or completed two consecutive fixed-term contracts will be automatically offered open-ended contracts. Severance pay is required unless the employee refuses to renew the contract; this payment, for lawfully terminated contracts, is as much as 12 times the employer's monthly salary during his/her period of employment or 12 times 300% of the local average monthly salary, and is doubled for unlawfully terminated contracts, which makes labor reallocation much more costly than before. The employer is required to submit layoff plans to the labor administrative department explaining the situation to the labor union or to all employees 30 days in advance if dismissing more than 20 persons or over 10% of the total workforce. This introduces high fixed firing costs as well as social insurance. To realize the second primary goal, the LCL stipulates that a contract must specify social insurance arrangements and this applies to both incumbent and new workers whenever a contract is signed.

The strict employment protection articles in the LCL may incur “adaptive” incentives for both employers and employees, resulting in mixed or sometimes unintended labor market outcomes. On the labor demand side, empirical studies in developed countries show that EPL brings real costs to firms via labor and financial channels. In Italy, a rise in dismissal costs induced capital deepening in terms of an increase in the capital-labor ratio and a decline in total productivity in small firms relative to larger ones (Cingano et al., 2016). In European countries, stringent EPL reduces firms' investment, especially when financial markets are also imperfect (Calcagnini et al., 2014). Firm-level data in 21 OECD countries over the period 1985–2007 show that costly adjustment of labor force under EPL pushes up firms' operating leverage and crowds out financial leverage (especially among firms with high labor turnover) (Simintzi et al., 2015); tighter EPL dampens corporate takeovers and impedes layoffs (Dessaint et al., 2017), but raises long-term unemployment (2–5 years after the EPL) (Holt and Hendrickson, 2017). Based on data from 26 OECD countries over the same period, Olney (2013) shows that EPL also discourages FDI from multinationals. At the same time, however, EPL can also bring about positive effects via firms' adjustments to the law. Even though multinational firms perform less radical innovation in high EPL countries, more incremental innovation through worker motivation would drive positive impact of EPL on overall innovation (Griffith and Macartney, 2014). Firms in South Korea responded to EPL for temporary workers in 2007 by reducing temporary contracts and partially substituting permanent and other unprotected temporary

³ For example, individuals' unemployment duration under unemployment insurance could be ambiguous, depending on individual heterogeneity (Tatsiramos and van Ours, 2014). There could also be different short- and long-term effects on employment and different wage effects depending on firms' heterogeneity, which is to be reviewed empirically in Section 2 and theoretically in Footnote 17.

⁴ For example, Knight and Li (2006) find a positive association between past unemployment duration and post-unemployment wages by using data from 2000.

⁵ According to the National Migrant Workers Report published annually by the NBS since 2009, the national average contract rate for migrant workers has remained around 42% since the enactment of the LCL (2008–2013) with diminution of permanent contracts and insurance-coverage.

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