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# Employment protection and incentives: Severance pay vs. procedural inconvenience<sup>☆</sup>



Kyota Eguchi

Chuo University, Faculty of Commerce, 742-1, Higashinakano, Hachioji, Tokyo 192-0393, Japan

### ARTICLE INFO

#### Article history:

Received 15 April 2012

Revised 19 May 2014

Available online 16 September 2014

#### JEL classification:

J64

J65

K31

#### Keywords:

Worker incentives

Search friction

Commitment

### ABSTRACT

**Eguchi, Kyota**—Employment protection and incentives: Severance pay vs. procedural inconvenience

I consider the effects of employment protection (EP) on worker incentives in the labor market with search friction, where EP is categorized into severance pay (SP) and procedural inconvenience (PI). When firms cannot distinguish shirkers, EP seems to negatively affect worker incentives, because shirkers are unlikely to be fired. However, EP can have a positive effect on worker incentives because diligent workers are protected by EP. It is shown that the positive effect can dominate the negative one when EP is moderate. In particular, PI tends to improve the unemployment rate and welfare, while SP has a somewhat unclear effect. *J. Japanese Int. Economies* **34** (2014) 272–290. Chuo University, Faculty of Commerce, 742-1, Higashinakano, Hachioji, Tokyo 192-0393, Japan.

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<sup>☆</sup> An earlier version of this paper was presented at the 2009 Far Eastern and South Asian Meeting of the Econometric Society at the University of Tokyo and the 2008 annual autumn meeting of the Japanese Economic Association at Kinki University. I am grateful to two anonymous referees, Ryo Kambayashi, Ryoichi Imai, Masaru Sasaki, Hideshi Itoh, Takashi Shimizu, and the seminar participants at the Search Theory Workshop, the Law and Economics Workshop, Tohoku University, Nihon University, the Contract Theory Workshop, Nanzan University, and Tokei-kenkyu-kai. This research was partially supported by Grant-in-Aid for Scientific Research from the Japanese Ministry of Education, and the Japan Securities Scholarship Foundation. Any error, if present, is entirely mine.

E-mail address: [eguchi@tamacc.chuo-u.ac.jp](mailto:eguchi@tamacc.chuo-u.ac.jp)

## 1. Introduction

This study examines the effects of employment protection (EP) on worker incentives in the labor market with search friction. OECD Employment Protection Indicators have shown that OECD countries have various rules of EP and degrees of EP strictness, and many researchers have drawn significant attention to the association of EP with economic performances. While numerous studies have focused on the effects of EP, relatively fewer studies have been conducted on the effects of EP on worker incentives. Worker incentives, however, are crucial for macroeconomic and corporate performances, and thus, the issue in this article should be considered.

There are negative and positive effects of EP on the worker incentives. Regarding negative effects, the efficiency wage model, in which threat of dismissal is a driving force in worker incentives, suggests that if EP deters firms from firing shirkers, EP has a *disincentive effect*. In the real world, however, even diligent workers who contribute to a firm's success can be fired because of unfavorable business conditions. If workers are easily fired regardless of their contribution, they are discouraged from working hard for their firms. Thus, credible job security can encourage workers, and therefore, EP has a positive *commitment effect* on worker incentives. Accordingly, the effect of EP on worker incentives is complicated. This study considers the effects of EP when all fired workers, including shirkers, are protected by EP.

In this article, to analyze various rules of EP, I categorize EP into severance pay (SP) and procedural inconvenience (PI), which includes providing sufficient advance notice or negotiating with unions. Although both SP and PI increase firms' firing costs, SP is a monetary transfer from firms to fired workers, whereas PI leads to a transaction cost. In that regard, it seems that SP is a better option than PI, because SP is not socially wasteful. However, SP may seriously damage worker incentives, because SP can benefit shirkers as well. This study also focuses on the difference between SP and PI.

While the disincentive effect of EP has often been realized, the commitment effect has been given less serious consideration except in some recent studies regarding skill formation. [Suedekum and Ruedemann \(2003\)](#) and [Belot et al. \(2007\)](#) indicate that introducing SP as a type of EP induces workers to make a human investment, because firms can promise workers the benefit of skill formation through SP. [Booth and Zoega \(2003\)](#) point out that firing policies tend to be excessively implemented, because firms are not concerned with human capital lost when workers quit and move to other industries. These studies show that if credible job security is provided, workers can receive compensation for their costs of skill formation, and thus, skill formation is promoted.<sup>1</sup>

Although these previous studies generated insightful results, they were limited to analyses in partial equilibrium models. Even if the effect of EP is beneficial in partial equilibrium analyses, this may not be true for general equilibrium analyses. Thus, as shown in a recent study by [Demougin and Helm \(2011\)](#) in which they analyzed an incentive problem in the search model, it is crucial to consider the effect of EP on worker incentives from the perspective of general search equilibrium analyses.

To analyze whether the disincentive effect overrides the commitment effect, we must consider whether shirkers are protected by EP, especially whether they are eligible for SP. When EP provides benefits for only diligent employees, a negative effect on worker incentives from EP is unlikely. This is because if firms can verify shirkers, the shirkers do not have EP. [Fella \(2000\)](#) considers this situation with an efficiency wage model and shows that a positive effect is generated by SP.

[Galdon-Sanchez and Guell \(2003\)](#) analyze a different situation: shirkers are not protected by EP in principle, but third parties are unable to distinguish shirkers. In their model, firms can fire workers for their "shirking behavior" even if they do not shirk, and fired workers may not receive SP because of firms' selfish behavior. When firms' moral hazard is pervasive, firms can avoid incurring SP, and firing can be excessively implemented. Therefore, regulations that inhibit firms from easily firing workers provide a positive effect.

[Fella \(2000\)](#) considers a situation in which diligent workers are protected by EP, but shirkers are not. [Galdon-Sanchez and Guell \(2003\)](#) focus on a firm's moral hazard in which workers cannot receive

<sup>1</sup> Some studies are focused on the commitment effect of unions. [Booth and Chatterji \(1998\)](#) show that unions' bargaining power enhances skill formation and improves social welfare. [Eguchi \(2002\)](#) also points out the significance of unions as commitment devices for job security. [Piccirilli \(2010\)](#) analyzes the effect of employment protection when unions can commit future wages.

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