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On the evasion of employment protection legislation ☆

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ABSTRACT

This paper analyzes how the option to evade employment protection legislation impacts on unemployment. Using a stylized model, it is established that the level of unemployment is non-monotonous in the degree of strictness with which employment protection legislation is enforced. Considering just cause and social criteria requirements for three regulatory regimes representative of a large number of industrialized countries, we find that different regimes generate different dismissal decisions only if the regimes are strictly enforced. In contrast, unemployment rates may differ across regimes even in the case of weak enforcement. Additionally, we find that it may be worse for the economy to weakly enforce harmful regulations than to strictly enforce them.

1. Introduction

1.1. Motivation and results

The aim of the law is to control behavior, and it may succeed in doing so because of the threat of sanctioning. It may thus be argued that the law puts a price on legal and illegal behavior, respectively (Cooter, 1984), where the price for non-compliance does not always deter potential offenders. The fact that some individuals act in breach of their legal obligations has been considered, for instance, with regard to crimes in general (see, e.g., Becker, 1968), the payment of tax obligations (see, e.g., Allingham and Sandmo, 1972), and environmental law (see, e.g., Friesen, 2003). In contrast, the literature on employment protection legislation (EPL) has usually taken it for granted that firms' compliance with employment protection law is perfect, or has included EPL merely in the form of firing costs.

This paper analyzes how the possibility of evading EPL impacts on unemployment in different regulatory regimes. In our analysis, we consider a simple dynamic model with a pool of potential employees, who show either a high or a low level of productivity. Firms cannot ascertain an individual's productivity type before hiring, but become informed in the course of production. In contrast to many studies dealing with EPL, employment protection in our analysis is not viewed as a black box which imposes some firing costs, as is standard in the literature. Instead, we treat employment protection as restricting dismissal decisions by firms, namely, whether dismissals require good cause and whether, in the case of a redundancy, the employer is restricted with respect to the choice of the employee to be dismissed. As a consequence, in our set up there are dismissals which are in compliance with the law and therefore do not impose any firing costs, in contrast to the standard treatment in the literature. The framework used not only allows for this context dependence but also makes firing costs, if they arise, more concrete. For instance, it may be that the firm would like to dismiss a low-productivity worker while keeping a high-productivity worker, and that EPL prescribes that a high-productivity worker will have to be released instead. In that case, the effect on the firm's profit is a function of the difference in productivity levels. The setup we use is designed to allow us to focus on these aspects. Firms start out with two employees in the first period but, due to an exogenous drop in demand, reduce this number to one in the second period. At the dismissal stage, if firms can choose between the two employees, they will prefer to dismiss a low-productivity employee. Moreover, firms may wish to dismiss both employees at this stage if

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both employees are of the low-productivity type. After that, they would hire a new worker, as such behavior entails a positive probability that the newly hired worker is of the high-productivity type. However, EPL might restrict firms by disallowing certain dismissals. To what extent firms' dismissal decisions are restricted depends on the regime of employment protection considered. We take three different regimes into account here. In the first regime, regime *I*, firms are free to dismiss employees of their choosing, i.e., there is neither a requirement for dismissals to be with good cause nor guidelines stating which employees can be dismissed. In the second regime, regime *II*, firms can choose freely between employees but can dismiss only if there are (operational) reasons to reduce the workforce. Finally, the third regime, regime *III*, not only requires good cause for dismissals in the first place, but also intervenes in the choice of employees, who are made redundant according to the application of social criteria. The three regimes we study are representative of many jurisdictions. We will elaborate on this in the next subsection after having stated the key results of this contribution.

Our central findings can be summarized and explained as follows. The three regimes considered yield different dismissal decisions only given sufficiently strict enforcement of EPL, where the strictness of enforcement is taken to be the level of the expected sanction for noncompliance with EPL. For intermediate levels of strictness, we find that the unemployment rate in regimes *II* and *III* differs, although the regimes no longer result in different dismissal decisions. The impact of the regime on the level of unemployment is due to the fact that firms subject to regime *III* bear the expected sanction when neglecting social criteria in the event of redundancies, which reduces expected profits and thus the number of firms in equilibrium. Finally, if enforcement is rather weak, dismissal decisions are not at all affected by the regime applicable and the level of unemployment in the three regimes will converge in the limit, as intuition would suggest. This study also shows that the unemployment rate is non-monotonous in the strictness of EPL enforcement. When lowering the strictness of EPL enforcement, there are intervals for the expected sanction for evading EPL in which the change effects an increase in the unemployment rate, and other intervals where the unemployment rate decreases as a consequence of the decrease in the expected sanction. Accordingly, increasing the strictness of EPL enforcement may harm employees. This may be the case if the increase in the expected sanction for evading EPL is not sufficient to achieve a change in firms' dismissal decisions, but only impacts on the level of expected profits, resulting in a higher unemployment rate. Our analysis also yields the observation that weaker enforcement of employment protection does not necessarily imply that the effects of EPL on unemployment will be lessened. The last finding, which is in contrast to Caballero et al. (2004), who find that labor regulations have weaker effects in countries where enforcement is weak, can be explained by the use of an example. With strict employment protection, regime *III* in our setting, firms which fulfill the good cause requirement may be forced to dismiss a high-productivity worker instead of a low-productivity worker due to binding social criteria. There is a level of the expected sanction for evading EPL at which the benefit of evading this provision is just equal to the expected costs. If the strictness of enforcement falls below this level, all firms will rather dismiss a low-productivity worker instead of a high-productivity one, even if they have to incur the fine. As a consequence, more low-productivity workers are dismissed and their share among job seekers increases. This latter effect causes the expected profits of newly entering firms to decrease so that fewer positions are offered, while incumbent firms experience only a marginal gain from disobeying employment protection. This implies a higher unemployment rate as fewer positions are offered. In fact, there are external effects resulting from the decision to evade the EPL provision which are not taken into account by the individual firm. The unemployment rate after the decrease in the strictness of enforcement then surpasses the level before the decrease.

1.2. Cross-country comparison of employment protection legislation

EPL restricts the employer's freedom to reduce the workforce of a firm.[1] However, most jurisdictions allow for dismissals justified by operational reasons like a decrease in a company's sales, although very often requirements exist that workers be given notice or severance payments be made (see, e.g., OECD, 2004). The following discussion focuses on two main aspects: first, whether or not employers are free to dismiss workers without good cause, where good cause may be given by referring to operational reasons; and second, whether or not, in the event of dismissals for operational reasons, the employer is restricted with respect to the choice of which workers to dismiss. Following the delineation of employment protection regulations by the OECD (1999, 2004), the corresponding rules can be interpreted as one item of the regulations concerning individual dismissals of workers with a regular contract, namely the definition of justified versus unfair dismissals.[2] Our cross-country comparison outlines the regulations in the United States (US), the United Kingdom (UK), and Germany.[3]

In contrast to the US, the other two countries apply regulations that allow dismissals only for cause, given some probationary period has elapsed (see, e.g., European Commission, 2006). In contrast, employment contracts in the US are generally at will, which allows employers to terminate the employment relationship with or without cause. The main exceptions to the at-will doctrine are established either by collective agreements, statutes which provide workers with protection against discrimination, or exemptions originating from case law, in particular the implied contract, the good faith and the public policy exceptions (International Labour Organization, ILO, 2010). With regard to collective agreements, the number of union members in the US was equal to only 12.4% of employed wage and salary workers in 2008 (Bureau of Labor Statistics, 2009). Discriminating terminations of employment contracts are effectively forbidden for workers engaging in organized activities, older workers, and workers with a disability, and also if based on national origin, race, and sex, according to the Equal Employment Opportunity principles (OECD, 2004). The exemptions originating from case law refer to specific situations where it is argued that either a long-term contract has been implicitly promised to the worker, a termination is to be classified as unfair treatment, or termination conflicts with public policy (for a more detailed description see, e.g., MacLeod and Nakavachara, 2007). Nevertheless, the US is considered to be a country with very limited employment protection regulations, which is also reflected in the position it occupies in cross-country rankings (see OECD, 2004). For the purpose of our endeavor, it can be asserted that the employer's freedom to dismiss an employee is mostly unrestricted as, first, no cause must be stated, and second, in the case of dismissals for operational reasons, the employer is free to choose with respect to which worker to lay off.

In the two European countries considered here, the UK and Germany, specific employment protection laws can be found in each jurisdiction. In the UK, the most important statute governing the termination of employment contracts is the Employment Rights Act 1996 (ERA) (see International Labour Organization, ILO, 2010). The ERA states that dismissals are only allowed for cause, that is, the termination must not be viewed as unfair (Sec. 94(1) and Sec. 98(2)

[1] This section follows Baumann, (2010).

[2] Commonly, in the event of collective dismissals, additional regulations apply; see, e.g., OECD (2004).

[3] The information is based mainly on the Termination of Employment Digest, a database provided by the International Labour Organization (International Labour Organization, ILO, 2010).