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Labor Market Regulations: Job Security versus Labor Flexibility

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In a nutshell

- *Labor laws aim to protect workers and increase labor market efficiency.*
- *However, over-protective labor regulations may result in higher informality and unemployment, as well as in hurting outsiders (usually women and young workers).*
- *A balanced approach between flexibility in the labor market and security of workers is needed.*
- *Reforming social protection schemes and the introduction of unemployment insurance would protect workers rather than jobs and lead to more efficient labor markets.*

There is increasing evidence that over-protective labor regulations have negative implications that offset the benefits associated with such provisions. Over-protective regulations in hiring and firing lead to rigidity in employment and lead to firms' inability to adjust during downturns. Job creation is a major bottleneck for most MENA countries where the growing labor force and the shrinking public sector leading to high youth unemployment. Absorbing the growing numbers of new entrants to the labor markets requires that private firms are able and willing to generate employment opportunities at a much faster rate. Increasing the flexibility of labor market regulations is central to reducing the incentives for employers to hire workers informally with no employment security, as well as to ensure that employers are not discouraged from creating jobs or resort to using more capital-intensive technologies to get round rigid employment laws. The growth of formal private sector job creation is key for inclusive economic growth.

Indeed the challenge for policymakers is to provide regulations that protect vulnerable workers but at the same time provide the needed flexibility in the labor market that do not deter employers from hiring workers. Hence, there is a need to have a balanced approach between security and flexibility, (Angel-Urdinola and Kuddo, 2010). This balanced approach

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need to reduce the cost of job creation but also provide workers with earnings security. In other words, the aim of policymakers should be to protect workers' earnings rather than jobs.

In order for MENA countries to introduce more flexible labor regulations, a prerequisite is ensuring that vulnerable workers have social safety nets to fall onto if they become unemployed. For many MENA (non-GCC) countries, this leads to huge fiscal burden. However, with the reduction of public sector employment, governments should direct their public spending toward financing safety nets that reach and protect vulnerable workers. The challenge for governments is to design instruments of social protection that can accomplish their intended objectives while minimizing the associated inefficiencies. At the same time, the introduction of active labor market policies that provide the required training are paramount to lift the unemployed out of poverty and insert them into productive employment.

What are labor regulations?

Labor markets, like many markets, if left on their own might deliver efficient outcomes but not equitable ones. As a result, governments resort to labor market interventions in the form of regulations and laws. Labor laws regulate interactions between workers and employers. They provide the rules and codes of conduct for employees and employers. For example, labor laws set the conditions for firing workers and the associated costs involving notice requirements and severance payments. They also govern collective bargaining and strike actions. Hence, labor market regulations have major implications on the functioning of labor markets, affecting the levels of employment and unemployment.

In general, labor laws aim to protect workers and increase labor market efficiency. Yet, governments' regulations of labor markets are a highly contested issue. Some economists disagree on the role and impact of labor regulations. They believe that regulated labor markets only protect insiders (i.e., those already employed), whilst others maintain that regulations are required to protect vulnerable workers. Even when it comes to employment protection legislations, those measures concerning hiring and firing of workers, there is a debate on whether they protect workers or restrict employment.

There are many forms of labor market regulations. Governments use those regulations to protect workers against risk in the labor market, such as employment risk and/or earnings risk. Hence, for example, minimum wages are introduced to provide minimum adequate earnings for the most vulnerable group of workers. Similarly, employment protection laws are used to protect existing jobs by restricting the ability of firms to lay off employees at will and/or to provide them with unemployment insurance if they lose their jobs. Clearly, the effects of labor market regulations depend on compliance and enforcement of those regulations.

Most MENA countries, excluding GCC, have 'overprotective' labor regulations, in particular concerning firing workers: they tend to have high firing costs involving notice requirements, severance payments, and fines for terminating redundant workers. In a way, this is not surprising since labor laws in MENA countries stem from their social contracts, which are grounded on a preference for the state rather than for markets in welfare provision, social services and in determining economic priorities as well as for redistribution and equity in economic and social policy, (Angel-Urdinola and Kuddo, 2010).

According to Doing Business in 2010 by the World Bank, looking at the rigidity of hiring and firing of workers in MENA, MENA (non-GCC) ranks the most rigid region in redundancy index (43.3) and third from top in difficulty of hiring index (32.8) where those indices range from 0 to 100, with higher values indicating more rigid regulations. Although labor markets in MENA are heavily regulated, many workers in MENA remain largely unprotected. Labor laws tend to be binding only in the public sector and in the relatively small private formal sector. But, some argue that it is in fact the stricter labor regulations and employment protection legislations that lead to large informal sectors. This raises an important question, namely whether less-protective labor regulations lead to less informality.

Do more flexible labor regulations lead to less informality?

There are several channels through which over-protective employment laws can impact formal-informal employment. First, job security regulations that require employers to provide mandated benefits such as maternity leave, holiday pay, or sick leave for incumbent workers, increase employers costs and hence reduce their capacity to hire more formal workers. Secondly, employment protection regulations that protect jobs of current workers by requiring severance payment, and notifying third parties such as labor authorities, increase the firing costs for workers who respond by hiring fewer workers formally and less reluctant to hiring inexperienced workers they cannot lay off. At the same time, more protective employment regulations and provisions make informal employment more attractive and worth queuing for, hence increasing unemployment and prolonging unemployment durations. Thus, overall, those regulations reduce demand for protected labor, while increasing supply for protected employment, resulting in higher informality and unemployment.

Focusing on the case of Egypt, where a new labor law (Law 12 of 2003) was passed with the goal of increasing flexibility in hiring/firing in private sector and in state-owned enterprises, provides a good case study to answer this question. Basically, the law came into effect in early 2004 and is comprised of 257 articles that address all the legal aspects regulating the labor market by providing comprehensive guidelines for the recruitment, hiring, compensation, and termination of employees. The labor law allows employers to issue definite duration contracts and renew contracts for an indefinite number of times and to lay off workers for economic reasons, subject to payment of severance pay. Hence, this law is seen to provide more flexibility in hiring and firing.

Examining the impact of the law on workers who were employed informally without contracts, shows that the change in law has had a positive impact on formalization of labor employment in Egypt and has reduced informal work that is non-contracted as formal private sector employers became more willing to hire workers formally after the passage of the law. The passage of the new labor law did increase the probability of transitioning to formal employment for non-contractual workers employed in formal firms by about 3-3.5 percentage points, or the equivalent of at least a fifth of informal workers in formal firms (Wahba and Assaad, 2015). This suggests that more flexible labor regulations increase formal employment and reduce informalization. However, the changes in employment protection regulations do not have the same effects on all types of workers. They tend to favor insiders mainly, prime-age males, who are already employed. Thus, the evidence suggests that the 2003 law has impacted insiders (those already employed), but had no effect on those young first-time entrants to the labor market (outsiders) (Wahba, 2009).

Do employment protection laws increase unemployment?

Another example of the impact of employment protection laws is the Palestinian Labor Law passed in 2000 which increased the severance payment to older workers, especially in the West Bank, resulting in a substantial increase in the cost of dismissing workers. The evidence suggests that there is an association between the introduction of the 2000 Palestinian Labor Law and longer unemployment duration among youth. (Sayre et al (2010)) The increase in the firing costs make employers less likely to hire new workers. These findings support those on Egypt suggesting that high firing costs reduce formal jobs and hence increase unemployment and informalization.

Evidence from other regions

Although the effect of regulations is not that strong for developed countries, overall the studies for developing countries tend to show negative effects of heavy regulations of labor. Cross-country studies on labor regulations in developing countries find that countries with stricter labor regulations have lower labor force participation, higher unemployment, especially of the young, and a larger informal sector. An interesting study by Lafontaine and Sivadasan (2008), in order to control for the different types of firms operating in different countries, use data for the same firm (an international fast-food chain) producing the same product across more than 2,500 outlets in 43 countries. They find that stringent employment protection laws reduce a firm's ability to adjust labor to the desired level in response to demand or productivity shocks.

Similarly, a collection of 11 studies on the effect of labor regulation on employment in Latin America conclude that job security regulations promote inequality among demographic groups as insiders gain while outsiders, especially the young, lose. In Brazil, the findings show that stricter enforcement of labor regulations constrains firm size and reduces employment. In Colombia, the reduction in job security costs have brought about a 1.3 to 1.7 percentage points decline in unemployment, again pointing to the negative impact of high firing costs.

Comparing labor regulations in China and India, it is argued that China's labor reforms and flexible labor market were instrumental for its rapid industrial growth and employment. On the other hand, India's averseness to reform its rigid labor laws has significantly dampened the positive impacts of industrial deregulation in the formal sector (Boeri et al., 2008). Indeed, recently, many developing countries introduced labor market reforms to enhance productivity, accelerate employment generation and improve economic performance as overly protective employment laws are seen to be associated with lower job creation, and productivity growth.

Conclusion and policy recommendations

There is a need to have a balanced approach between workers' security and labor market flexibility. Reforming employment protection laws should be accompanied by social protection reforms. It is important to have a well-designed unemployment insurance scheme that offers sufficient protection to workers while benefitting from a more flexible labor market. Moreover, there is a desperate need for a responsible social protection program that insures the unemployed, the poor and the vulnerable. It is only through inclusive growth that Sustainable Development can be reached rather than continue being a goal.

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