Introduction

Employment protection – the set of rules governing hiring and terminating employees – is a key feature of any country’s labor market. What types of contracts will be permitted between employers and employees? Under what conditions can the relationship be terminated? What are the requirements for providing advance notice? What are the obligations of the employer regarding severance or termination payments? These are important questions for policy-makers in addressing the trade-offs between labor market flexibility and the economic security of employed workers.

Employment protection practices in any country are determined by a mix of cultural norms, collective bargaining, and legislation. This primer note focuses on the statutory regulations affecting employment protection. It provides a basic overview of the policy options and a summary of what is known about their impacts on workers and on the labor market. It also addresses the institutional and political aspects of employment protection.

The note is based on international experience, both in terms of hiring and termination regulations and evidence on their labor market impacts.¹

In the end, policy-makers must grapple with two overarching issues: How much protection will be provided to workers against the uncertainties of job loss? What is the balance between providing this protection inside the firm through job security rules or outside the firm through social protection instruments such as state unemployment benefits and re-employment programs?

Background

In traditional and informal economies, employers and workers are engaged on an “at will” basis – in other words, as long as both want to be party to the relationship. In more formal economies, explicit regulations determine what contractual arrangements are acceptable between employers and workers and what is acceptable regarding the termination of those arrangements. These regulations are usually stipulated through a Labor Code or another piece of employment legislation. Employment protection arrangements can also be included in collective agreements, in enterprise personnel policies, or in individual contracts. However, these generally cannot undercut any statutory regulations.

Employment protection legislation – also referred to as job security rules – can cover a long list of items:

- what kinds of contracts are permitted;
- any special rules favoring certain groups in hiring;

¹ The primary background piece for this note is Betcherman, Luinstra, and Ogawa (2001).
I occupational standards;
I the conditions under which workers can be terminated;
I requirements for severance and advance notice of termination;
I redundancy procedures; and
I special rules for mass layoffs.

Economists and some policy-makers often characterize employment protection arrangements along a “rigidity/flexibility” continuum. However, those emphasizing the protective nature of job security rules are more likely to consider the continuum as “protective/deregulated.”

There is considerable variation in terms of where countries fit on the spectrum illustrated in Box 1. An important determinant is the national legal and cultural tradition. In countries with Anglo-Saxon heritage where common law principles prevail, statutory regulation plays a smaller role in directly providing employment protection than it does in countries with civil law principles (e.g., French or Spanish tradition) or in countries that have or recently had planned economies. Developing countries often follow the traditions of the countries that colonized them. However, even where very strong job security provisions exist “on paper,” their application “on the ground” may be limited because of weak enforcement and large informal sectors.

Employment protection rules enhance job security for employees in two ways: by restricting the ability of employers to hire workers on an explicitly non-permanent basis and/or by restricting employer freedom to terminate workers. The general idea, in either case, is to make dismissal costly to the employer.

Controversies surround sharp differences of opinion about the costs and benefits of these employment protection policies. One perspective sees restrictions on non-permanent hiring and on employer dismissal rights as providing important social protection for workers. An opposing view emphasizes the fact that these regulations raise the cost of labor and thus discourage job creation and favor more privileged “insiders” (Freeman 1993). These different views very often clash when countries are considering reforms to their labor laws. Accordingly, the political economy aspects of employment protection cannot be ignored.

In the end, good labor market policy must get beyond these ideological positions. How the labor market is regulated can have potentially significant effects on the rates of job creation and destruction; levels of employment and unemployment; productivity, wages, and profits; and the degree of social protection and justice afforded workers. The magnitude of these effects depends on the degree of protection provided, the level of compliance, and the reach of the formal sector. Later in this note, we summarize the findings of empirical studies into these effects.

**Employment protection regulations**

**Hiring**

The most important issue on the hiring side concerns the rules for non-standard workers – i.e., workers who are contracted for a temporary or fixed duration. Where these forms of employment are restricted, employers are legally obliged to offer workers indeterminate contracts with the statutory job security (and attendant costs) these contracts afford. On the other hand, employers have complete flexibility to terminate fixed-term (at term end) or temporary agency employees. Restrictions on these forms of contracts usually pertain
to the types of work (e.g., occupations), the number of renewals, and the maximum duration allowed.

Table 1 summarizes the statutory rules in these areas for a set of countries selected to illustrate the range of approaches and to offer some geographical variation.\(^2\) The table demonstrates the considerable variation that exists and approximately orders the countries from most to least protective. During the 1990s, at least in developed countries, there generally was a loosening of restrictions on non-standard contracting.

### Table 1: Legal Arrangements for Fixed-Term Contracts and Temporary Agency Work in Selected Countries

<table>
<thead>
<tr>
<th></th>
<th>Fixed-Term Contracts</th>
<th>Temporary Agency Work</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ethiopia</strong></td>
<td>Permitted only in the following cases:</td>
<td>Licenses for private employment agencies are required from regional or national authorities, depending on scope of activities.</td>
</tr>
<tr>
<td></td>
<td>• specified piece work;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• temporary replacement of absent worker;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• urgent work to prevent damage or disaster to life or property;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• work relating to the industry but performed at irregular intervals;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• seasonal work.</td>
<td></td>
</tr>
<tr>
<td><strong>Chile</strong></td>
<td>Maximum duration one year after which the contract becomes one of indeterminate duration.</td>
<td></td>
</tr>
<tr>
<td><strong>Czech Republic</strong></td>
<td>Not allowed for:</td>
<td>No restriction</td>
</tr>
<tr>
<td></td>
<td>• graduates of university-level schools or specialist apprentice schools hired for work that corresponds to their qualifications;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• adolescents;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• employees under collective bargaining agreement; or disabled persons</td>
<td></td>
</tr>
<tr>
<td><strong>Spain</strong></td>
<td>Permitted for various reasons (e.g., specific projects; temporary replacements; training contracts; production eventualities; special categories of workers; long-term unemployed)</td>
<td>Allowed for justifiable cases</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>• &lt; 1 year duration without restriction</td>
<td>Restricted to specific occupations</td>
</tr>
<tr>
<td></td>
<td>• up to 3 years for particular types of workers</td>
<td></td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td>• Widely possible without justification</td>
<td>Generally approved except for construction</td>
</tr>
<tr>
<td></td>
<td>• Maximum number of 4 contracts/24 months (no limits in justified cases)</td>
<td></td>
</tr>
<tr>
<td><strong>United States</strong></td>
<td>No restrictions</td>
<td>No restrictions</td>
</tr>
</tbody>
</table>

*Source: Betcherman, Luinstra, and Ogawa (2001)*

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**Termination**

The key policy issue here concerns how difficult and/or costly it is for employers to terminate indeterminate employees for *economic* reasons.\(^3\) Restrictions can take various forms including: what is considered to be a justifiable reason for termination; severance obligations upon termination; advance notice requirements; and necessary administrative procedures for laying off work-

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\(^2\) Selected labor legislation provisions, covering employment protection as well as other aspects of labor regulation, have been compiled for 17 countries in the annex of Betcherman, Luinstra, and Ogawa (2001). HOT-LINK.

\(^3\) “Economic” reasons include business-related causes for termination (e.g., shrinking markets, increasing competitiveness, etc.). This class of terminations stand in contrast to dismissals for “non-economic” reasons such as discrimination, union organizing, or job performance.
There may also be special requirements in the case of mass layoffs.

Table 2 provides examples of statutory arrangements regarding what are legally acceptable reasons for economic dismissals; what severance requirements exist; and what advance notice is required for the same set of countries included in Table 1. Again countries are approximately ordered from most to least protective. During the past decade or so, there has been no clear trend in regulating dismissals in developed countries: some have strengthened protections, others have eased them, but in most cases arrangements have remained relatively stable. In some developing countries – including many in Latin America – job security rules have been scaled back.

**Labor market impacts of employment protection regulations**

These regulations on hiring and termination are often hotly debated not only because they define the job...
security of employees but because they have potentially important implications for economic and labor market performance. Unfortunately, these aggregate effects too often are not adequately considered when policy-makers are considering labor market reforms. Empirical research shows that employment protection arrangements can have impacts on employment and labor market dynamics (e.g., turnover, job creation/destruction, response to shocks, etc.). They also can affect the forms of employment, the labor market situation of different types of workers, and the size of the informal sector.  

Table 3 summarizes the research findings. The largest body of evidence concerns the experience of developed countries. There has been less empirical analysis in developing and transition countries. However, some recent studies have assessed the labor market impacts of employment protection regulations in Latin America (Heckman and Pages 2000) and Eastern Europe (Riboud et al. 2002). At any rate, it is clear that much more empirical research is required in developing countries in order to see whether the impacts of job security rules are affected by large informal sectors, weak compliance, and other factors that distinguish labor markets in developing countries from those in developed economies.

The impacts on employment and unemployment levels are modest and, in the case of unemployment, often statistically insignificant. This suggests that the negative aggregate effect of these rules is less than many economists assume. However, the empirical findings are much stronger for the dynamic effects – on labor turnover and job tenure, job creation and destruction, and unemployment duration – and on the types of jobs created. More flexible employment arrangements are likely to facilitate adjustment to macroeconomic shocks. Overall, rules to protect job security increase the number of stable jobs but at the price of more long-term unemployment and non-participation in the labor force and less opportunity for regular employment in the formal sector. This increases the vulnerability of certain groups of workers including women and youth, and the unskilled or poorly educated who are less likely to get these jobs. Many of these workers, then, will be

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4 There are various methodological and data issues that researchers must confront in this field. For a summary, see Betcherman, Luinstra, and Ogawa (2001) — HOTLINK.

5 Exceptions are Freeman (1993) and Lindauer (1999).
relegated to being either out of the labor force or in the informal sector. This has to be weighed against weaker job protection rules that do not discourage formal sector job creation but provide a lower level of protection in these jobs.

**Enforcement and dispute resolution**

Reform of employment protection laws should not ignore enforcement and dispute resolution. In many developing and transition countries, these features are weak and, as a result, hamper the effectiveness of labor market regulations.

Enforcement is a longstanding concern in most developing countries. Informal sectors, largely outside the reach of inspectors, are large – often representing a significant share, if not the majority, of the labor force. Developing countries typically do not allocate a lot of resources to enforce labor market regulations, even to police the most visible employers (e.g., the public sector). For this reason, it is important for the regulatory framework to be realistic so that self-compliance will be high and the enforcement challenge moderated. That does not mean that labor codes should have no protections for employees but rather that they should accord with good business practices in the specific national context.

Many types of labor regulations are enforced through inspections, as well as by responding to complaints. Both approaches apply, for example, to occupational health and safety. The hiring and termination rules that are the subject of this note are enforced through complaint procedures. For example, where employees believe that employers have violated hiring or dismissal obligations, efficient and fair dispute-resolution procedures are required. This can happen in various ways: labor/management enterprise committees; government arbitrators; and labor or civil courts. There has not been rigorous evaluation of the effectiveness of these approaches. However, a good rule of thumb is to resolve as many disputes as possible through pre-judicial procedures. In fact, many developed countries are relying increasingly on alternative dispute resolution which emphasizes fact-finding, mediation, and conciliation as opposed to binding decisions made by government inspectors, arbitrators, or judges. While these approaches can reduce the number of complaints that cannot be resolved by the parties, there is still a need for judicial review and a court option.

**International conventions**

Drafters of labor legislation should consider relevant international conventions. These are adopted at the International Labour Organisation (ILO), the specialized United Nations agency responsible for promoting labor rights and decent working conditions. The ILO has a tripartite structure in which representatives of workers and employers participate on an equal basis with government officials. Once the tripartite assembly adopts a Convention, national governments (usually legislatures) have the option of ratifying the Convention. If they choose to ratify it, national governments are obliged to incorporate the principles of the Convention into national law and practice and to submit periodic reports to the ILO. Conventions are designed to be universal in that all states should be able to implement them regardless of their level of economic development or their particular social, political, or economic system.

Termination of Employment Convention (No. 158) obliges ratifying states to meet various standards for dismissal, including termination for economic reasons:

- In cases of termination for economic/structural reasons, employers must (a) notify workers representatives; (b) allow for consultation with workers on measures to limit layoffs, mitigate impacts, retrain workers, and find alternative employment; and (c) notify government authorities of planned terminations;
- Notice of termination or compensation in lieu thereof must be given “in a reasonable period,” except in cases of serious misconduct;
- Terminated workers are entitled to “(a) severance allowance or other separation benefits, the amount of which shall be based inter alia on length of service and the level of wages, and paid directly by the employer or by a fund constituted by employers’ contributions; or (b) benefits from unemployment insurance or assistance or other forms of social security, such as old-age or invalidity benefits, under the normal conditions to

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6 Many developed countries are increasingly experimenting with enterprise “self-compliance” plans that are endorsed by governments. For a discussion, see Betcherman, Luinstra, and Ogawa (2001). HOTLINK.
which such benefits are subject; or (c) a combination of such allowance and benefits;” and
- Casual, fixed-term, and probationary workers can be excluded from these provisions.

Private Employment Agencies Convention (No. 181) obliges ratifying states to provide certain protections for workers employed by private employment agencies and establishes standards for regulating these agencies:

- Agencies should not deny freedom of association and collective bargaining rights; they should not abuse child or migrant workers and they should adopt equal opportunity and anti-discrimination practices;
- Agencies should not charge fees of workers (except with government permission);
- States should ensure that temporary agency workers have adequate protection in terms of rights, conditions and work (e.g., access to training, maternity leave, minimum wages, etc.);
- States can restrict the operation of temporary employment agencies in specific sectors; and
- Certain types of temporary agency work can be exempted from the standards established in the Convention.

Again, governments are not obliged to ratify these conventions – they represent the ILO members’ agreement on appropriate standards. However, once a government has ratified a convention, it is obliged to implement it. The ILO receives regular reports on the implementation of ratified conventions but does not have genuine enforceability powers.

**Conclusion**

There are valid reasons why countries want to ensure that there is some job security provided for workers and that labor markets are more than just “spot” markets. In formal labor markets, the major policy lever for providing job security is through regulations that restrict short-term contracting and make it difficult or costly for employers to terminate regular employees for economic or business-related reasons. This is a complex and controversial policy issue because job security legislation can affect labor market performance and benefit certain classes of workers while reducing opportunities for others.

Countries that are considering reforms to employment protection regulations must address various issues. First are the likely labor market impacts of different regulatory options. To the extent that the findings from developed countries can be generalized to developing countries, we know that stricter employment protection regulations will indeed make jobs more secure but with apparent costs: more long-term unemployment and less opportunity for regular employment in the formal sector. This latter cost is likely to disproportionately affect vulnerable groups of workers including women and youth, and the unskilled or poorly educated. However, country characteristics such as the structure of the economy, the size of the informal sector, and enforcement effort can affect what the labor market impacts will be.

Second, political economy is a key aspect of labor market regulation. There are always winners and losers when labor market regulations are reformed and, because the employment impacts hit especially close to home, changes will be hotly contested. When policymakers are considering reform options, they must communicate the aggregate benefits clearly; they must understand who will benefit and who will not; and they may have to compensate the losers.

Third, policymakers need to consider job security regulations in conjunction with other policy options that provide protection for workers – in particular, the collective bargaining framework and programs for unemployed workers. Where collective bargaining is well developed and has a wide reach, appropriate job security arrangements can be negotiated between employers and workers (with labor law providing a basic minimum). Similarly, unemployment benefits and effective active labor market programs can help workers manage the risks of unemployment and, as such, can be substitutes for strong employment protection regulation.

Finally, policymakers must recognize that labor regulation is only one part of the broader economic policy framework. Its interaction with the regulation of product markets, macroeconomic policy, and the business investment climate will determine overall labor market performance.
Annotated bibliography


Background paper for this primer. Expands on topics discussed here, including collective bargaining, enforcement, and dispute resolution. LINK


Compares the “distortionist” (World Bank) versus “interventionist” (International Labor Organization) views of labor market regulation. Concludes that both overstate their claims. Efficiency losses are not as major as alleged by the former view, but neither are the social gains of consultation as large as is maintained by the latter view. Proposes new model of labor market policies and interventions to support economic reform.


Documents high job security provisions in Latin American labor regulation. Shows substantial impact on level (lower) and distribution of employment (more unequal).


One of the few survey papers that considers labor market regulation with the context of developing countries and poverty reduction. Concludes that regulatory reforms are likely to only make a modest difference in job creation.


Survey of employment protection legislation (EPL) in OECD countries and changes over the last decade. Evaluates the relationship between strictness of EPL and labor market performance. Finds little relationship to overall unemployment. Finds that stricter EPL may be associated with the following: increasing employment levels of prime-age males; lower employment levels for women and youth; expansion of self-employment; lower job turnover; more stable jobs; and longer spells of unemployment.


Evaluates the labor market institutions of EU accession countries, compares them to those of Western European and other OECD countries, and discusses the impact of macro and structural reform on the labor market compared to institutional changes. Finds that while economic reform had the most impact on labor market outcomes, relatively inflexible labor market institutions contributed to low employment creation, a rising proportion of long-term unemployed, specific patterns of labor-force participation and growth in the informal economy.