3 Hiring and Firing Workers

During the Industrial Revolution in Britain, women received one-third to one-half the wage of men. One scholar of that period writes: "Employers did not offer a living wage to the female since they assumed that she was dependent upon a household headed by a male and therefore did not depend only on her wages for subsistence."[1] About one hundred years later, in 1882, a factory inspector describes employment relations in Russia: "The owner is an absolute sovereign. He is not tied by any law, and often applies and interprets existing legal regulations at his own discretion. The workers must obey him."[2] A third example comes from Zimbabwe, where, before independence in 1980, Africans did not benefit from minimum-wage legislation, were discriminated against in appointments to skilled jobs, and were barred from training programs.[3] Regulation can change that.

Employment law protects workers from arbitrary, unfair, or discriminatory actions by their employers. Regulations—from mandatory minimum wage to premiums for overtime work to grounds for dismissal to severance pay—have been introduced as a response to apparent market failures. The failures range from the exploitation of workers in one-company towns to discrimination on the basis of gender, race, or age to the suffering of the unemployed in the Great Depression and in the transition of formerly socialist economies.

More recent concern for social justice, particularly in developing countries, led the International Labor Organization to establish a set of fundamental principles and rights at work. They include the freedom of association, the right to collective bargaining, the elimination of forced labor, the abolition of child labor, and the elimination of discrimination in hiring and work practices.[4] They constitute the minimum regulation necessary for the effective functioning of labor markets.[5] Every country needs to adopt and enforce them.

However, if regulation in other aspects of the employment relation is too rigid, it lowers labor force participation, increases unemployment, and forces workers into the informal economy. Economic analysis shows that if the average Latin American country were to reduce its employment protection to the level found in the United States, estimated total employment would rise by almost six percentage points.[6] In some countries, the negative effects of rigid employment regulation are even larger. A 10 percent increase in dismissal costs in Peru is associated with an estimated increase in long-term unemployment of 11 percent,[7] and in India and Zimbabwe of about 20 percent.[8]

Disadvantaged groups are hurt the most. Evidence from Argentina, Chile, Colombia, France, the Russian Federation, Spain, and Tunisia shows that new entrants into the labor market—women and youths—suffer disproportionately the consequences of reduced employment opportunities.[9] As a result, many women and teenagers either remain unemployed or find employment in the informal economy. In Côte d'Ivoire, 73.3 percent of informal employees are women; in Uganda, 80.5 percent; in Peru, 57.5 percent.[10] Cross-country analyses suggest that if Mozambique were to reduce its labor regulations to the level found in Zambia, the share of informal employment might drop by as much as 13.5 percentage points, and the share of informal

employment of women might drop by 18 percentage points.[11]

Rigid employment regulation is associated with more poverty in developing countries. A study of India suggests that, between 1958 and 1990, poverty in West Bengal, the Indian state with the highest labor protection, increased by 10 percent as employment opportunities were denied to poor people.[12] Almost 2 million urban poor people would have found jobs in West Bengal if the state government had not passed stricter regulation on dismissals and work hours. In contrast, the government of Andra Pradesh, another Indian state, made employment regulation more flexible in the 1980s: 1.8 million urban poor found jobs in manufacturing and service companies in the next decade.

Improving the flexibility of employment law while maintaining fundamental workers' rights requires several reforms. Among them, introducing part-time and fixed-term employment contracts, reducing the minimum wage for young workers, and allowing for shifting the work time between periods of slow demand and peak times have proven successful in several countries. Other possible reforms for countries with greater administrative capacity include providing unemployment benefits to workers in times of low demand (short-time compensation) and using a negative income tax in place of a minimum wage.

What Is Employment Regulation?

Employment regulation is one of four bodies of labor law:

- Employment regulation
- Social security laws
- Industrial relations
- Workplace safety.

This chapter is limited to employment regulation. Next year's report will provide analysis of social security laws, and the report in the year after will study industrial relations and workplace safety regulation.

Employment regulation governs the individual employment contract, including flexibility of hiring through part-time and fixed-term contracts; and conditions of employment, including maximum number of hours in a work week, premiums for overtime work, paid annual leave, and a minimum wage. It also governs flexibility of firing, including grounds for dismissal, notification rules for dismissal, priority rules for dismissal, and severance pay.

Social security laws govern the social response to needs and conditions that have a significant impact on workers' quality of life, such as old age, disability, death, unemployment, and maternity. Social security laws are present in developed countries but still nascent elsewhere.[13]

Industrial-relations laws regulate the bargaining, adoption, and enforcement of collective agreements; the organization of trade unions; and industrial action by workers and employers.

Workplace safety covers the working environment and training of workers for the use of machinery and equipment, as well as the regulation of production processes or materials that are hazardous to workers' health. Workplace safety regulation has beneficial effects for both workers and businesses.[14]

Employment regulation is fairly new, established after World War II in many advanced economies. In the aftermath of the 1973 oil shock, many developed countries tightened employment laws, especially in the area of collective dismissals. Since then, regulation has been continually undergoing reform—every developed country except the United States has made major revisions to its labor regulation since 1990. In May 2003, the German government announced reforms to reduce unemployment. The main proposals would make dismissals easier and reduce the time unemployed people are allowed to receive benefits. The reform will also make fixed-term contracts more attractive to small-business owners.

Flexibility of Hiring

The first area of employment regulation addressed in this chapter is hiring by means of part-time and fixed-term contracts. Part-time contracts have proven popular in recent reforms. Employees who value flexible work schedules—especially younger people continuing their education, women with children, and older people who work to supplement

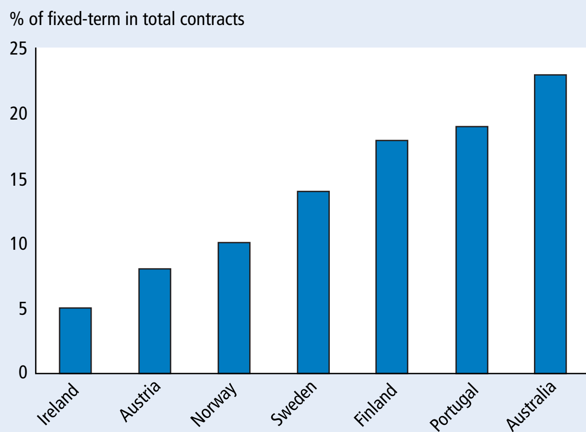


Figure 3.1
Use of Fixed-Term Labor Contracts

Source: OECD 1999.

their income—have been the main beneficiaries. By mid-2003 every country in the *Doing Business* sample allowed part-time contracts. Some countries—including France, Japan, Namibia, and Romania—exempt part-time employment from carrying the mandatory benefits of full-time workers. Part-time contracts are also easier to terminate. These two features make it attractive for businesses to hire part-time workers. In many OECD countries, where data on labor contracts are available, roughly a quarter of the workforce has part-time jobs: the Netherlands (30 percent), Australia (27 percent), Norway (27 percent), Switzerland (26 percent), New Zealand (24 percent), and the United Kingdom (23 percent).[15] In Australia, teenagers make up a large share of the part-time workforce, working under so-called casual contracts.

Fixed-term contracts ease the entry for new employees. They were established in France in 1979, to be used for the replacement of employees on leave, temporary increases in activity, and seasonal activities, as well as in contracts for disadvantaged groups such as youths and women.[16] By 1999, 10 percent of the workforce in France had such contracts. Spain adopted revisions to its labor code in the mid-1980s to allow for part-time and fixed-term contracts; by 1999, almost 30 percent of workers, primarily first-time entrants in the labor market, had such contracts. The 1996 revision of the labor code in Tunisia introduced fixed-term contracts, and by 2001 about 15 percent of the labor force had them.[17] Other countries with high rates of fixed-term contracts are Australia, Finland, Portugal, and Sweden (figure 3.1).

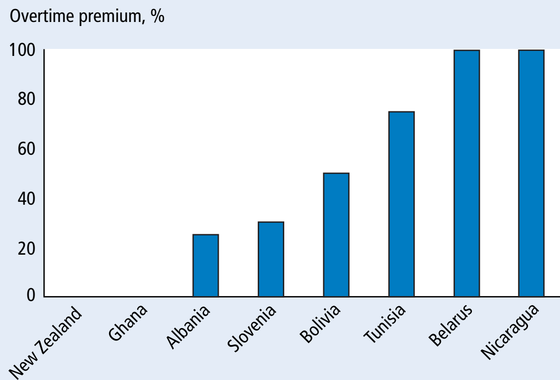
Many countries allow fixed-term contracts only for specific tasks. This is true for most Latin American countries—such as Argentina, Bolivia, Brazil, Guatemala, Mexico, Panama, Uruguay, and Venezuela—and for southern Europe—France, Greece, Italy, Portugal, and Spain. Chile, Japan, Mexico, and Sweden limit the duration of fixed-term contracts to one year, but many former socialist countries allow fixed-term contracts of up to five years. Poland does not regulate the duration of fixed-term contracts. Nor do Australia, New Zealand, South Africa, the United Kingdom, or Zambia.

Conditions of Employment

The legal provisions for conditions of employment cover flexibility in working time requirements, mandatory payment for non–working days (including paid annual leave and holidays), and minimum-wage legislation. In countries with a common-law tradition, substantial aspects of the employment relation are left to the individual agreement between the worker and manager.

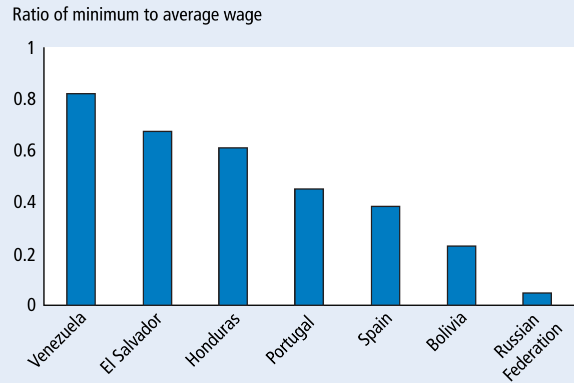
Kenya, Oman, Singapore, Slovenia, Thailand, and the United States, among others, impose no regulation regarding daily rest. However, it is legislated at a minimum of 14 hours in Chile, Colombia, Ethiopia, Panama, and Syria. With the exception of New Zealand, all countries regulate the number of work hours. Botswana, Chile, Costa Rica, Ireland, Malaysia, Morocco, and Vietnam all allow a 48-hour workweek. France has the shortest workweek, at 35 hours, followed by Denmark, with 37 hours. Night work is generally allowed in most countries, except Albania, Belarus, Mozambique, Norway, Turkey, and Uruguay. Work on holidays is not subject to any regulation in Denmark, Hong Kong (China), Latvia, Malaysia, Singapore, and Tunisia. However, holiday work is strictly regulated in countries with a German legal tradition, including Austria, Germany, and Switzerland.

Figure 3.2
Premiums for Overtime Work—from Nothing to Double



Source: Doing Business database.

Figure 3.3
How High Is the Minimum Wage



Source: Maloney and Nunez 2000.

In cyclical or seasonal industries, overtime work is often used. Burkina Faso, Cameroon, Jamaica, Hong Kong (China), New Zealand, Spain, and the United Kingdom do not have regulations on a premium for overtime work. Chad, Italy, and Mali require a 10 percent premium over wages paid for work in normal hours. Bangladesh, Belarus, India, Mexico, Nicaragua, Pakistan, Uruguay, and Uzbekistan mandate up to double pay for overtime work (figure 3.2). Some Central European countries recently revised employment regulation to allow managers to shift work time from periods of slow demand to peak periods. In Poland, such shifts must balance out within six months; in Hungary, within a year. Such reforms eliminate the uncertainty of spending longer hours at work for employees, while reducing the costs of unpredictable or cyclical demand—and overtime pay—for businesses.

The United States leaves it to individual or collective worker contracts to agree on the number of days of paid annual leave. In all other countries, the duration of annual leave is subject to regulation. The most generous annual leave is mandated in Sierra Leone (39 days), followed by Congo Republic (35 days); Ethiopia (33 days); Chad, Côte d'Ivoire, and Niger (32 days); and Burkina Faso, Egypt, Finland, Nicaragua, and Yemen (30 days).

Several OECD countries—Austria, Denmark, Finland, Italy, Norway, Sweden, and Switzerland—have no mandatory minimum wage. In some countries, like Austria, this is the result of a long social partnership among labor unions, business associations, and the government. Regulation would be redundant. In countries that regulate minimum wages, the ratio of minimum to average wages varies from 0.82 in Venezuela to 0.05 in the Russian Federation (figure 3.3). If this ratio is high, businesses are unwilling to hire less experienced workers, discriminating against youths or mothers returning after maternity leave, who have been out of the workforce for some time. One promising reform is to enforce a lower minimum wage for younger workers, as established in Chile in 1989, generating a significant increase in job opportunities for recent graduates. The introduction of similar apprentice wage laws was a common reform in other Latin American countries in the 1990s.[18]

Flexibility of Firing

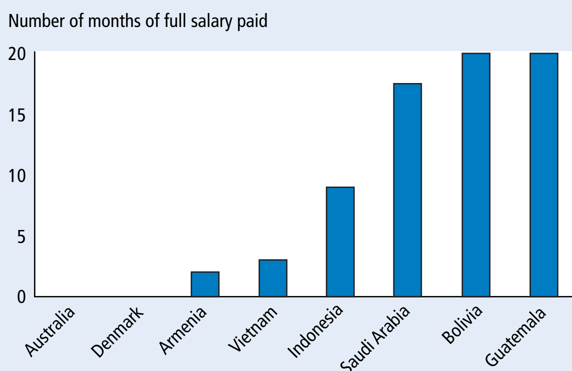
Flexibility of firing encompasses grounds for dismissal, procedures for dismissal, notice periods, and severance payments. The rules on grounds for dismissal vary from "contract at will"—as in Ghana, Israel, and the United Kingdom, where the employment relation may be terminated by either party at any time—to allowing termination of contracts under a narrow list of "fair" causes such as redundancy—as in France—to not considering

redundancy as a fair cause for dismissal—as in Bolivia, the Republic of Korea (before 1998), and Portugal. The 1998 reforms of employment regulation in the Republic of Korea allowed for dismissal on the grounds of redundancy or economic restructuring.

The procedures for dismissal often require notification or even approval by unions, workers councils, the public employment service, a labor inspector, or a judge. Some countries also mandate retraining and reassignment to another job in the enterprise—and establish priority rules for dismissal or re-employment of redundant workers. In Tunisia, companies must notify the labor inspector of planned dismissals in writing one month ahead, indicating the reasons and the workers affected. The inspector may propose alternatives to layoffs. If these proposals are not accepted by the employer, the case goes to the regional tripartite committee comprised of the labor inspector, the employer organization, and the labor union. The committee decides by a majority vote (if the inspector and union reject the proposal, no dismissal is possible). It may also suggest retraining, reduced hours, or early retirement. Only 14 percent of dismissals end up being accepted. As a result, annual layoffs are less than 1 percent of the workforce, compared with more than 10 percent in the average OECD country.

Even if employers are permitted to dismiss workers, regulations may impose notice periods and severance payments (figure 3.4). In Croatia, employers need to give workers three months' advance notice and pay six monthly salaries in severance for employees with tenure in the business of more than 20 years.

Figure 3.4
Severance Payments—from Nothing to 20 Months' Pay



Source: Doing Business database.

Often workers feel unjustly dismissed or may not receive sufficient compensation. One recourse is to file a lawsuit against their employers. In many countries, such disputes are handled by specialized labor courts or tribunals. Until recently, representatives of employee and employer organizations frequently sat on the jury, alongside professional judges. This practice has often led to protracted judicial procedures and difficulties in reaching compromise. In Brazil, prior to 1999, an equal number of representatives from labor unions and business associations served as judges on the Labor Conciliation Board, the regional labor courts, and the supreme labor court. The average labor dispute took almost three years.[19] In 1999 this practice was abolished and only professional lawyers could become labor judges. Also, judges were given lifelong tenure, which reduced their susceptibility to political pressure. By 2001, the time needed to resolve disputes was halved.

Large Divergences in Practice

Employment regulation is an area of great divergence among developed countries. A comparison of New Zealand and Portugal, two OECD members with similar income per capita, illustrates the differences in regulatory scope.

- Fixed-term contracts may be entered into in New Zealand for any reason, and no maximum duration is prescribed by law. In Portugal, such contracts are allowed only for specific tasks, such as substitution for another worker or seasonal activity, and are temporary.
- Working times and leave times in New Zealand are regulated by collective bargaining and individual employment contracts. In Portugal, the constitution regulates work and leave times, remuneration, and working conditions.
- New Zealand mandates no premium for overtime work. There are no restrictions on night work, and paid annual leave is 15 days. In Portugal, the

premium for overtime work ranges from 50 percent to 75 percent. There are restrictions on night work, and paid annual leave is 24 days.

- New Zealand allows "contracts at will," which can be terminated with notice by either party. Portugal has a public policy list of fair grounds for dismissal, mandatory early notice, and priority rules for re-employment of redundant workers.
- In New Zealand "reasonable notice," usually one week, is required to dismiss a worker, and there is no regulation on the amount of severance pay. In Portugal, the standard dismissal notice is 60 days, and the severance pay for workers with 20 years of tenure is mandated by the law to be 20 months of wages.

The transplantation of employment laws during colonial days created stark differences between developing countries as well.

- In Ghana, a common-law jurisdiction, fixed-term contracts are allowed for any reason, and there is no maximum duration. In Mozambique, a former Portuguese colony with a similar income per capita, fixed-term contracts are allowed only for seasonal activities.
- In Ghana, leave and remuneration are negotiated in individual employment contracts. In Mozambique, the constitution regulates them, with minimum annual leave of 22 days.
- Ghana allows contracts at will. Mozambique's labor code lists fair grounds for dismissal and imposes stringent procedural limitations, such as mandatory notification of the government and priority rules for re-employment of redundant workers.
- Labor regulation in Ghana imposes no severance payment for dismissal. In Mozambique, the length of notice is regulated at 12 weeks, and the severance payment for a worker with 20 years of experience is 30 months of wages.

To document the systematic differences in employment regulation across countries, three indices were constructed by studying the letter of the law and conducting surveys of labor lawyers in each country (table 3.1). The methodology is simple: if the regulation restricts the ability of managers and workers to negotiate the employment contract, a value of 100 is entered, zero otherwise. For example, fixed-term contracts are allowed in Venezuela only for temporary tasks, while in Vietnam they are allowed for any task. On this component of the hiring index, Venezuela gets a 100, Vietnam a 0. Similarly, managers have to give fair cause for dismissal in Cameroon, but not in Jamaica. On this component of the flexibility-of-firing index, Cameroon gets a 100, Jamaica a 0. The scores are averaged across the components of each index to get the value of the index itself.[20] Table 3.1 details the components of each index (flexibility of hiring, conditions of employment, and flexibility of firing). Averaging across these three indices yields the index of employment regulation, where higher values represent more rigidity in employment regulation.

Employment regulation is more flexible in developed countries. Austria, Denmark, Hong Kong (China), New Zealand, Singapore, the United Kingdom, the United States, and New Zealand are among the 10 countries with the most flexible employment protection (table 3.2). Malaysia, Papua New Guinea, and Zimbabwe are also in this group. The countries with the most rigid employment regulation include six Latin American countries (Brazil, Mexico, Panama, Paraguay, Peru, and Venezuela), and Angola, Belarus, Mozambique, and Portugal.

Some countries have very strong protection in one of the indices but not in others. Greece, Taiwan (China), and Tunisia restrict the use of fixed-term contracts. Hungary and Poland are among the countries with the most regulation on conditions of employment. Belarus, Mexico, and Peru have strict regulations on firing. In general, however, the indicators of labor regulation tend to move together: restrictions on hiring go with restrictions on firing (figure 3.5), as well as with more rigid conditions of employment.

Which groups of countries have the most flexible regulation? Rich countries have the lowest average scores on all indices (figure 3.5). Nordic-origin countries regulate employment relations the least in conditions of employment but less so in dismissals, in which

Table 3.1
Rigidities in Employment Regulation

Hiring	Part-time contracts	Is part-time employment prohibited? Are part-time workers exempt from mandatory benefits of full-time workers? Is it easier or less costly to terminate part-time workers than full-time workers?
	Fixed-term contracts	Are fixed-term contracts allowed only for fixed-term tasks? What is the maximum duration of fixed-term contracts (in months)?
Conditions of employment	Hours of work	What is the mandatory minimum daily rest? What is the maximum number of hours in a workweek? What is the premium for overtime work? Are there restrictions on night work? Are there restrictions on weekly holiday work?
	Leaves	What is the number of legally mandated days of annual leave with pay in manufacturing? Is paid time off for holidays mandatory?
	Minimum wage	Is there a mandatory minimum wage? Are conditions of employment specified in the constitution?
Firing	Grounds for firing	Is it unfair to terminate the employment contract without cause? Does the law establish a public policy list of "fair" grounds for dismissal? Is redundancy considered a fair ground for dismissal?
	Firing procedures	Must the employer notify a third party before dismissing one redundant employee? Does the employer need the approval of a third party to dismiss one redundant worker? Must the employer notify a third party before a collective dismissal? Does the employer need the approval of a third party before a collective dismissal? Does the law mandate retraining or replacement prior to dismissal? Are there priority rules applying to dismissal or layoffs? Are there priority rules applying to re-employment?
	Notice and severance payment	What is the legally mandated notice period (in weeks) after 20 years? What is the severance pay as a number of months for which full wages are payable after covered employment of 20 years?
	Job security	Is the right to job security specified in the constitution?

Source: Doing Business database.

English-origin countries have the lightest regulation. Across regions, East Asian economies regulate the least and Latin American countries the most, even after the significant labor reforms in the 1990s. This result is consistent with previous studies. For example, in 1999 the cost of firing a full-time worker was equivalent to 93 days of wages in Latin America, twice the 45 days in the OECD.[21] Countries in the socialist legal tradition have the second-strictest labor regulation.

What Are the Effects of Employment Regulation?

The fact that employment regulation arose in response to market failures does not mean that today's regulations are optimal. Their design may have been poor to begin with. And what was appropriate in, say, 1933, when Portugal adopted its constitutional protections of workers, may not be appropriate today, because circumstances, technology, and business organization have changed.

Indeed, although employment regulation generally increases the tenure and wages of incumbent workers, strict regulatory intervention has many undesirable side effects. The first is to limit job creation. Quarterly job creation in Portugal, the most heavily regulated labor market in the sample, is 59 percent of that in the United States, one of the ten least regulated labor markets. With fewer new jobs available, Portuguese workers stay in jobs they do not like.[22] Conversely, the relaxation of labor regulation in the United States

Table 3.2
Indexes on Employment Regulation

Flexibility of hiring		Conditions of employment		Flexibility of firing		Employment laws	
Most-flexible regulation							
China	17	Hong Kong (China)	22	Hong Kong (China)	1	Singapore	20
Czech Republic	17	Zimbabwe	22	Singapore	1	United States	22
Namibia	17	Denmark	25	Uruguay	3	Malaysia	25
Nigeria	17	Malaysia	26	Papua New Guinea	4	Denmark	25
Papua New Guinea	17	Singapore	26	United States	5	Papua New Guinea	26
Australia	33	United States	29	Japan	9	Hong Kong (China)	27
Canada	33	South Africa	36	United Kingdom	9	Zimbabwe	27
Denmark	33	Sweden	39	Australia	13	United Kingdom	28
Poland	33	Norway	39	Austria	14	Austria	30
Uganda	33	Kuwait	40	Malaysia	15	New Zealand	32
Least-flexible regulation							
Brazil	78	Nicaragua	90	Brazil	68	Paraguay	73
Chad	78	Mongolia	90	Panama	68	Peru	73
Greece	78	Paraguay	90	Peru	69	Mozambique	74
Guinea	78	Turkey	91	Ukraine	69	Venezuela, RB	75
Thailand	78	Poland	92	Mexico	70	Belarus	77
Venezuela, RB	78	Hungary	92	Belarus	71	Mexico	77
El Salvador	81	Ukraine	93	Russian Federation	71	Angola	78
Mexico	81	Chad	93	Paraguay	71	Brazil	78
Panama	81	Rwanda	94	Portugal	73	Portugal	79
Taiwan (China)	81	Bolivia	95	Angola	74	Panama	79

Note: Indexes range from 0 to 100, with higher values indicating more-rigid regulation. The employment-laws index is the average of the flexibility-of-hiring, conditions-of-employment, and flexibility-of-firing indexes.

Source: Doing Business database.

since the 1950s has helped increase new employment opportunities by as much as 150 percent.[23] When a Portuguese business decreases employment, it is 40 percent less likely to increase it when the economy picks up than a U.S. company is. This result is corroborated by other studies that show jobless recoveries in economies with heavily regulated labor markets.[24] It means that some workers remain in perennial unemployment.

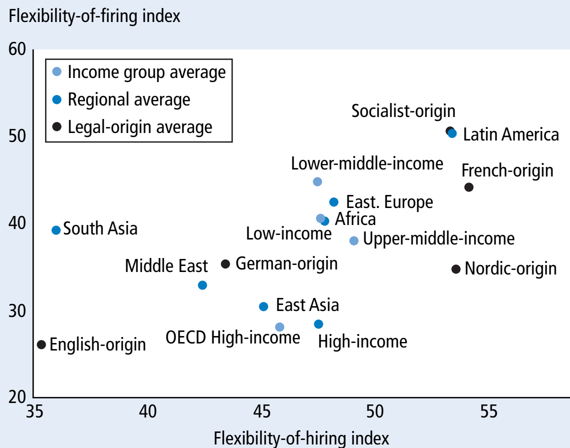
A second effect is to reduce the flexibility of the workforce: workers who have endured long unemployment spells tend to have obsolete skills. Unemployment duration is three times higher in Portugal than it is in the United States, and more than twice as high in Brazil and Spain, two other heavily regulated markets.

Third, flexible labor regulation is associated with higher R&D investment in technologies. In particular, businesses in low-employment-protection countries in the OECD have almost 30 percent higher investment in R&D than businesses in OECD economies with rigid employment laws.[25] Why? Because organized labor frequently resists attempts to acquire new technology, particularly if it is perceived to displace workers. In addition, stringent regulations on firing may push managers into reorganizing the production process in ways that provide employment for displaced workers, which in turn reduces incentives to buy the latest technology.

Fourth, restrictions on hiring and firing have been shown to result in smaller firm size, and to leave economies of scale unexploited in manufacturing and some services (the evidence is primarily from OECD economies).[26]

All of these effects—less job creation, longer unemployment spells and the related skill obsolescence of

Figure 3.5
Who Regulates the Employment Relation?



Source: Doing Business database.

workers, less R&D investment, and smaller company size—may serve to reduce productivity growth.[27]

Surveys of managers also show that employment regulation is a burden on businesses in many developing countries. One survey asks managers to rank eight areas with regard to the burdens regulations impose on the operation and growth of their businesses: business licensing, customs and foreign trade restrictions, foreign currency and exchange regulations, employment regulations, environmental regulations, fire and safety regulations, tax regulations and their administration, and high effective tax rates.[28] Employment regulations were seen to be the major obstacle to improving productivity in Bangladesh, Brazil, Chile, Colombia, India, Panama, Portugal, Thailand, Tunisia, and Venezuela. And they were rated the second-most-important obstacle to productivity growth in Argentina, Bolivia, Ecuador, Mexico, and Uruguay.[29]

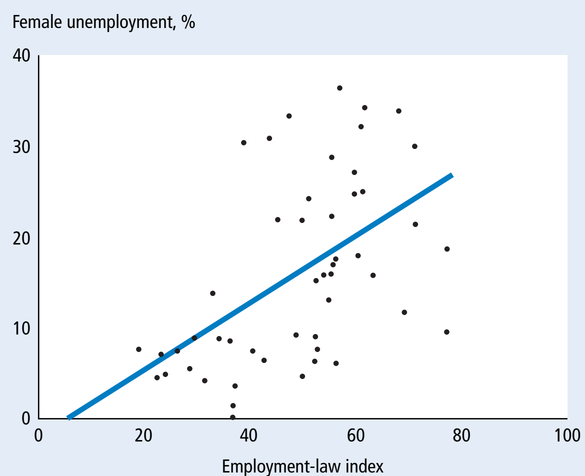
More worrying, employment regulation limits the opportunities of disadvantaged groups to come out of poverty. Excessive regulation is associated with higher unemployment,[30] especially for youths and women (figure 3.6). Cross-country analyses suggest that if France were to make its labor regulations as flexible as those in the United States, the employment rate might increase by up to 1.6 percentage points. The effect is even larger for Spain, at 2.3 percentage points. Women would benefit the most, with more than 70 percent of the new jobs. Using the employment regulation index in this chapter, a reduction in the value by a third would be associated with a 10-percentage-point fall in the unemployment rate of young women.

Without job opportunities in the formal economy, many people join the unofficial sector (figure 3.7). There, workers have no social protection whatsoever. Cross-country studies show that a reduction of the employment regulation index by a third is associated with a 14-percentage-point decline in informal employment and a 6.7-percentage-point fall in output produced in the informal economy.

What to Reform?

Reform is taking place, but it is often hotly contested by labor unions and frequently falls short or is reversed.[31] In the early 1980s, Spain introduced more-flexible legislation on fixed-term contracts, only to roll it back in the latter part of the decade. In 1996, the Peruvian government tried to reduce severance payments by 50 percent. The ensuring

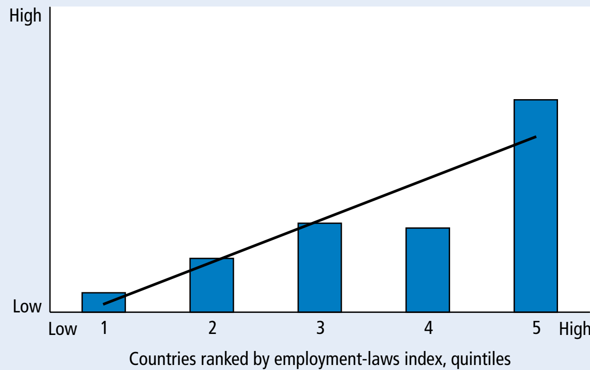
Figure 3.6
Rigid Employment Regulation Is Associated with Higher Female Unemployment



Note: The correlation shown in this figure remains statistically significant when controlling for income.

Sources: Doing Business database; World Bank 2003.

Figure 3.7
Labor Regulation and Informality



Note: The correlation shown in this figure is controlled for income per capita. The relationship is statistically significant at the 1 percent level.

Sources: Doing Business database; Schneider 2002.

uproar caused the government to instead increase severance payments. In 1998 Argentina revoked temporary employment contracts—which had been introduced in 1995 as the main component of the labor reform.

A general reform oriented toward less regulation of labor markets has yielded positive results in Latin America and in some transition economies. Six Latin American countries have reformed their employment legislation in the last decade: Argentina, Brazil, Colombia, Guatemala, Panama, and Peru. With the exception of Panama, all of those countries introduced temporary contracts. The contracts have lower dismissal costs, and employers usually pay lower payroll taxes. Among transition economies, the Czech Republic, Estonia, Hungary, Poland, the Russian Federation, and the Slovak Republic made the hiring of workers more flexible and reduced regulation on conditions of employment. Estonia's reform is the most far-reaching: it reduced regulation on both the hiring and the firing of workers. There has been little reform of employment regulation in Africa and South Asia.

Several other types of reforms of employment regulation have eased the burden on businesses and provided better job opportunities for poor people:

- Many OECD countries have introduced flexible part-time and fixed-term contracts. These contracts bring groups less likely to find jobs, such as women and youths, into the labor market. Germany increased the duration of fixed-term contracts to eight years, whereas Poland has eliminated the time limit.
- Several countries have either introduced apprentice wages (Colombia) or lowered the minimum wage for new entrants (Chile).
- Some countries (Hungary, Poland) have made it possible for employers to shift work time between periods of slow demand and peak periods without the need for overtime payment.
- Other countries have eased regulations on firing. Serbia and Montenegro reduced the severance payment for a worker with 20 years of tenure from 36 months to 4.

As countries adopt better technology for monitoring the labor market and build up their administrative capacity, they will be able to undertake more-sophisticated reforms. Several OECD countries have implemented legislation on short-term compensation, which provides employees with job security at times of low demand. If an employer cannot gainfully occupy a worker during slack times, a government fund covers the payment for such periods. Belgium, Italy, and Sweden have good experience managing such funds.[32] This innovation reduces employee turnover and shifts the burden away from the business. Further reform may include a negative income tax in place of a mandatory minimum wage. Such a tax would give people an incentive to join the workforce in entry-level jobs while alleviating the burden on unemployment insurance.[33]

Notes

1. Valenze 1985, p. 36.
2. Turin 1934, p. 34.
3. Fallon and Lucas 1991.
4. ILO 1998, 2000, 2001, 2002, 2003.
5. Becker 1971. Economic studies show that the presence of such fundamental rights improves productivity.
6. Heckman and Pages 2000.
7. Saavedra and Torero 2000.

8. Fallon and Lucas 1991. The negative effects of rigid labor regulations are not limited to developing countries. The introduction of high severance payments in France after World War II is estimated to have increased long-term unemployment by 4.4 percentage points (Lazear 1990).
9. Hopenhayn 2001 for Argentina; Montenegro and Pages 2003 for Chile; Kugler 2000 for Colombia; Dolado and others 1997 for Spain; World Bank 2002a for the Russian Federation; Abowd and others 1999 for France.
10. Betcherman 2002.
11. Botero and others 2003.
12. Besley and Burgess 2003.
13. Mulligan and Sala-i-Martin 2000; Botero and others 2003.
14. Fishback 1998.
15. OECD 1999. All figures are for 1999.
16. Blanchard and Landier 2000.
17. World Bank 2003.
18. Gill, Montenegro, and Domeland 2002.
19. World Bank 2002b.
20. The rankings generated by this index are consistent with the rankings on regulation on dismissals in Latin American countries (Heckman and Pages 2000) and the rankings on employment protection in the OECD (OECD 1999). The correlations are highly significant, at 0.63 and 0.73, respectively. These provide support for the robustness of the methodology.
21. Heckman and Pages 2000.
22. Blanchard and Portugal 2001.
23. Holmes 1998.
24. Betcherman and others 2001.
25. Nicoletti and others 2001.
26. Nicoletti and Scarpetta 2003.
27. Scarpetta and Verdier 2002; Montenegro and Pages 2003.
28. Batra and others 2003.
29. World Bank 2003. Two other surveys, by the chamber of commerce in 2000 and 2001, also show that 52 percent of managers of private manufacturing enterprises perceived labor regulations to be excessive, especially in the textiles, chemicals, and construction industries.
30. Scarpetta 1996 for the OECD; Fields and Wan 1989 for South Asia; Aidt and Tzannatos 2003 for a recent survey of country studies.
31. Gill, Montenegro, and Domeland 2002.
32. Van Audenrode 1994.
33. Blanchard 2002.