

Costs of hiring and firing

Costs of hiring and firing can influence innovation in firms by affecting the risks and costs associated with investments and other business strategies that involve labour decisions. There is evidence to suggest that lower costs in hiring and firing can facilitate the creation and growth of companies, and have a lesser impact on direct productivity gains. The costs of hiring/firing differ across OECD countries, notably because of differences in employment protection legislation and regulations regarding minimum wages. The costs of hiring and firing can critically affect access to skilled labour, including from abroad. It helps shape the administrative framework for entry and growth, and can therefore impact competition. Policies can influence the costs of hiring/firing in relation to innovative businesses in several ways, such as supporting workers rather than jobs and ensuring that employment legislation is as clear and simple as possible.

What are the costs of hiring and firing?

Firms incur hiring/firing costs through:

- **administrative burdens** (keeping records, ensuring employees are legally employed)
- **compliance with related regulations**, such as anti-discrimination legislation (which affects recruitment practices) and provision for maternity leave and pensions
- **direct costs** related to minimum wages and **obligatory social charges**
- **searching for adequate personnel**, which involves substantial costs
- **difficulties in understanding complicated and changing legislation**, including difficulties in understanding the exact limits of the law and possible sanctions for breaking it
- **employment protection legislation** (EPL), which limits the employer's ability to dismiss workers individually or collectively. EPL consists of the **set of norms and procedures regulating the individual or collective dismissals of redundant workers** (Boeri and Van Ours, 2008). EPL imposes extra costs when work contracts are terminated early and generally limits the situations in which dismissals are allowed. Lay-offs are often challenged in court, which add an uncertain cost factor, especially in countries that have less efficient civil justice systems.

How does the cost of hiring and firing affect innovative businesses?

Impacts on firms' growth

Hiring and firing costs can influence innovative firms by affecting investment and expansion. For example, onerous regulations preventing the employment of foreign workers can make it difficult to recruit skilled people. As the size of a business increases, the costs of hiring and firing may inhibit the firm from expanding further. Changing, unclear and complex regulation can discourage companies from hiring new employees.

Investment and risk-taking

High costs in firing are likely to affect a company's willingness to take risks and experiment with growth opportunities. In fact, firms may be less willing to expand their workforces and to enter into new markets if they cannot shrink their workforces when their strategies prove unsuccessful. An aversion to risk taking leads to more conservative growth strategies, which reduces productivity. This can be particularly detrimental for innovative industries, which tend to be more risky and volatile. As a consequence, countries with greater worker protection and thus higher firing costs may specialize in industries that are less innovative or that rely on older technologies, since more dynamic industries have to be prepared to adjust their workforce (Samaniego, 2006). Also, innovators in countries with high firing costs may tend to specialize in "secondary innovation" that improves existing products, rather than "primary innovation" that introduces new products (Saint-Paul, 2000) and requires organizational change. Furthermore, high firing costs may create additional **sunk costs**, i.e. upfront costs incurred that cannot be recovered ex post, for emerging firms; redundancy pay, for instance, increases the risk of economic losses in the event of insolvency (Kanninen and Vesala, 2005).

Job turnover and reallocation dynamics

Stringent labour market regulations and high firing costs may prevent an efficient reallocation of human resources and reduce job turnover across firms. Therefore, strict EPL may be an obstacle to **creative destruction**, an important process through which countries create new jobs and increase their productivity (OECD, 2009; Bartelsman, Haltiwanger and Scarpetta, 2009; Bravo-Biosca, Criscuolo and Menon, 2013). Creative destruction, if it is to have a positive effect, depends on reallocating and redistributing those resources that are destroyed.

Arguments as to why hiring/firing costs are not necessarily detrimental to innovative firms

The negative link between innovation and EPL is controversial. Firms that invest significantly in training and share tacit knowledge may benefit from stringent EPL, as they can take advantage of lower rates of labour turnover and increase their return on investment (Acharya et al., 2010); similarly, stringent EPL, acting as an implicit insurance, may encourage workers to be more willing to engage in innovative and risky projects. Furthermore, efficiency wage theories suggest that workers may perceive EPL as an upgrade in the quality of their employment, which may lead them to increase their efforts and have a positive effect on innovation.

The empirical evidence on the effects of hiring and firing costs on successful innovative firms

There is a general consensus in the economic literature about the negative effects of EPL on job reallocation, with evidence available both within and across countries (Bertola, 1990; Haltiwanger et al., 2006; Gomez-Salvador et al., 2004; Kugler and Pica, 2008).

Direct effects on firms' productivity

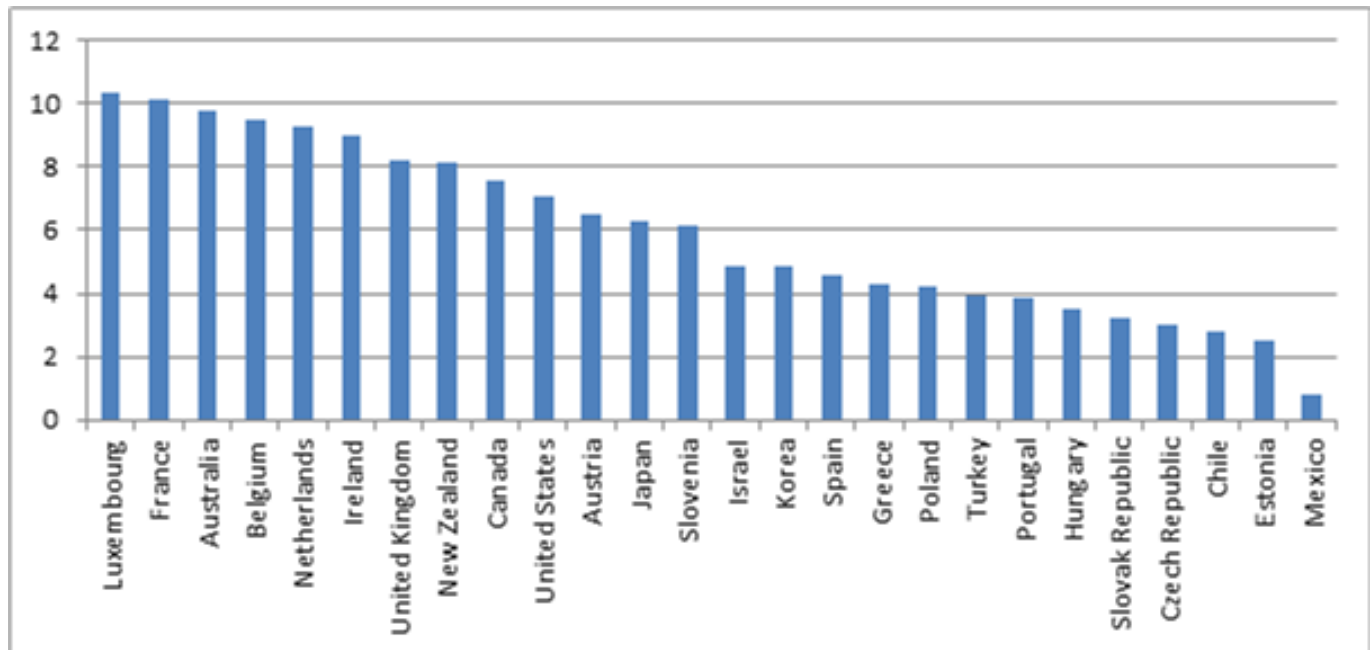
The direct effect on firms' performance is more debatable. Bassanini et al. (2009) find that mandatory dismissal regulations have a depressing impact on productivity growth in industries where layoff restrictions are more likely to be binding. However, Martin and Scarpetta (2012) extensively examine recent empirical evidence to conclude that stringent EPL has a sizeable negative effect on labour flows and, in consequence, on aggregate productivity growth.

What is the evidence on how hiring and firing costs affect innovative businesses?

Minimum wages

The OECD publishes data on minimum wages, such as annual data on real hourly minimum wages, i.e. statutory minimum wages converted into a common hourly pay period for the 26 countries for which they are available (Figure 1). Countries such as Luxembourg, France, Australia, Belgium, the Netherlands and Ireland exhibit the highest hourly minimum wages, while Slovak Republic, Czech Republic, Chile and Estonia have the lowest hourly minimum wages among OECD countries.

Figure 1. Real hourly minimum wages (in US\$ PPP), 2012



Real hourly minimum wages are statutory minimum wages converted into a common hourly pay period for the 26 countries for which they are available. The resulting estimates are deflated by national Consumer Price Indices (CPI). The data are then converted into a common currency unit using either US \$ current exchange rates or US \$ Purchasing Power Parities (PPPs) for private consumption expenditures. Real hourly minimum wages are calculated first by deflating the series using the consumer price index and taking 2011 as the base year. The series are then converted into a common currency unit (USD), using Purchasing Power Parities (PPPs) for private consumption expenditures in 2011.

Source: data extracted from OECD.Stat

Indicators to assess costs of hiring and firing

The OECD employment protection indicators cover three different aspects of employment protection:

- **Individual dismissal of workers with regular contracts.** This incorporates three aspects of dismissal protection:

- (i) procedural inconveniences that employers face when starting the dismissal process;
- (ii) notice periods and severance pay;
- (iii) difficulty of dismissal, as determined by the circumstances in which it is possible to dismiss workers, as well as the repercussions for the employer if a dismissal is found to be unfair (such as compensation and reinstatement).

- **Additional costs for collective dismissals.** Most countries impose additional delays, costs or notification procedures when an employer dismisses a large number of workers at one time.

- **Regulation of temporary contracts.** This quantifies regulation of fixed-term and temporary work agency contracts with respect to the types of work for which these contracts are allowed and their duration. This also quantifies regulation governing the establishment and operation of temporary work agencies, and requirements for agency workers to receive the same pay and/or conditions as equivalent workers in the user firm, which can increase the cost of using temporary workers relative to permanent employees.

Based on these indicators, the strictness of EPL varies widely across OECD member countries (Figure 2). The degree of variation is even larger when the different sub-components of EPL (e.g. regulation of temporary contracts or of collective dismissals) are examined individually.

The World Bank Doing Business annual reports contain a section on employing workers, which includes a number of sub-components on firing costs, along with other indicators such as indicators on difficulty of hiring, difficulty of firing. Results indicate that governments in high-income OECD economies focused on reducing redundancy costs in the past decade: 15 labour regulation reforms introduced by high-income OECD economies in the past 8 years either reduced the severance pay in cases of redundancy dismissal or shortened the required notice period for employees. In 2013, the average severance payment in high-income OECD economies is 5.83 weeks of salary (World Bank, 2013).

Figure 2. Strictness of employment protection ? individual dismissals (regular contracts)

What other topics relate to hiring and firing costs and innovative businesses?

Skilled labour. Hiring and firing costs impact how innovative firms tap into skilled labour to develop their businesses.

Migration. Foreign labour can be an alternative source of particularly skilled labour, and the associated costs of hiring and firing such labour will shape conditions for innovative businesses.

State of competition. The costs of hiring and firing can affect the start-up and/or expansion of innovative businesses and therefore impact competition.

Administrative framework for entry and growth. The costs of hiring and firing are a specific and often very important type of administrative framework, which affects the start-up and growth of innovative businesses, among other factors.

Access to labour for innovative entrepreneurship. Innovative entrepreneurs face specific challenges to access to labour which may call for targeted policy.

What policies relate to hiring and firing costs and innovative businesses?

Employment protection legislation can be directly affected by policy. It is important that labour market and social protection policies **facilitate, rather than hinder**, innovative projects.

Labour market policies targeting workers rather than jobs can be valuable. Workers should be especially sustained during unemployment spells and job-to-job transitions, and should be helped in converting their skills. The degree of uncertainty in dismissals should be minimized by reducing cases where legal action is required and by reducing delays when such action is needed.

Labour market legislation has to cover a wide range of different situations and therefore needs to be carefully framed in order to avoid becoming a disincentive. **A single organisation responsible for**

information, inspection and enforcement can be useful in that context.

Transition periods for new legislation and **readily available information about changes in legislation** can make it easier for companies to deal with regulations.

In order to avoid problems with a new employee, systems can be put in place to **subsidise the costs of initial employment** and possibly to **assist with recruitment**.

To avoid uncertainty for employers regarding possible claims for unfair dismissal, there can be **clear limits to compensation**, while the complaint process can be simplified and made less costly through **operation of an arbitration service**.

References

- Acharya, V., Baghai, R., Subramanian K. (2010), "Labor laws and innovation." NBER Working Paper 16484.
- Bravo-Biosca, A., C. Criscuolo and C. Menon (2012), "What drives the dynamics of business growth?", forthcoming STI Working Paper, OECD Publishing.
- Cingano, F., M. Leonardi, J. Messina, and G. Pica (2010), "The effects of employment protection legislation and financial market imperfections on investment: Evidence from a firm-level panel of EU countries". *Economic Policy* 25, pp. 117-163.
- Garicano, L., C. LeLarge, and J. Van Reenen (2012), "Firm size distortions and the productivity distribution: Evidence from France", Centre for Economic Performance Discussion Paper, No. 1128.
- Martin, J. P. and S. Scarpetta (2012), "Setting it right: Employment protection, labour reallocation and productivity." *De Economist*, 2012, 16 (2), 89-116
- Saint-Paul G. (2000), "Employment protection, international specialization, and innovation." *European Economic Review* 46, p. 375-395.
- Samaniego, R. M. (2006), "Employment protection and high-tech aversion." *Review of Economic Dynamics* 9(2), pp. 224-241.
- Schivardi, F. and R. Torrini (2008), "Identifying the effects of firing restrictions through size-contingent differences in regulation", *Labour Economics*, Elsevier, vol. 15(3), pages 482-511, June.
- Tito Boeri T. and J. van Ours (2008), *The Economics of Imperfect Labor Markets*. Princeton University Press.
- Venn D. (2009), "Legislation, collective bargaining and enforcement: Updating the OECD employment protection indicators", *OECD Social, Employment and Migration Working Papers*, OECD publishing, Paris.
- World Bank (2013). *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises*. Washington, DC: World Bank Group. <http://dx.doi.org/10.1596/978-0-8213-9615-5> [1]



Related Link: Skills for Innovation

Administrative framework for entry and growth

Source URL: <https://www.innovationpolicyplatform.org/content/costs-hiring-and-firing>

Links

[1] <http://dx.doi.org/10.1596/978-0-8213-9615-5>