Extreme disparity in European labour markets: an Employment Flexibility Index

Lithuanian Free Market Institute[1]

The recent Employment Flexibility Index uses data provided by the World Bank's Doing Business Labour Market Regulation Questionnaire to compare labour market regulations.

The data covers a set of labour regulation indicators from 2018 on hiring, working hours as well as redundancy rules and costs to rank OECD and EU countries.

Labour market regulation tends to vary greatly between countries due to social, cultural and political differences. Rigidity is often associated with negative economic outcomes, including lower labour market participation and higher unemployment, a two-tier labour market, lower productivity as well as reduced job creation and labour mobility.

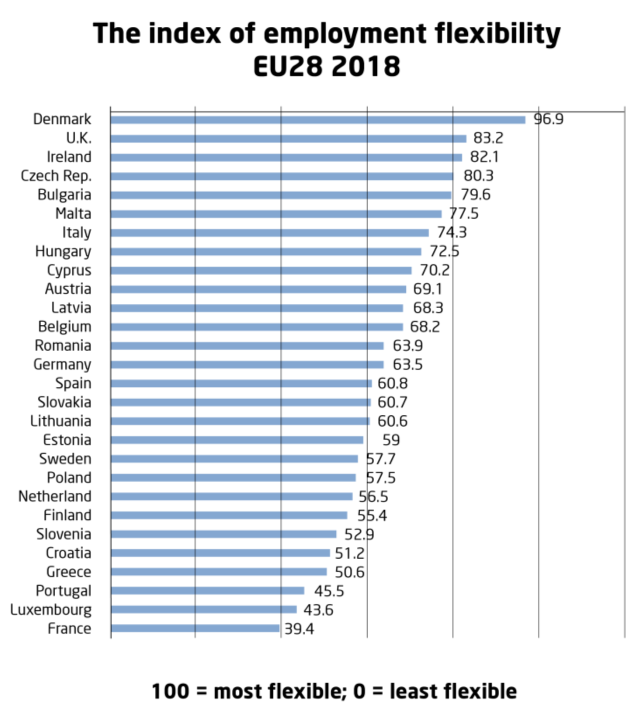
Despite this, all countries tend to follow the general principles of flexibility in hiring, employment contracts, minimum wages, working hours and dismissal procedures.

Components of labour rigidity

Excessive labour regulation will raise hiring and firing costs thus leading to a labour market duality. Such duality describes a situation where the 'primary' sector is composed of 'insiders' who benefit from upward mobility, job security and stable incomes, whilst the 'secondary' market is composed of 'outsiders' who typically receive low incomes and little job security. Labour market duality discourages human capital accumulation and mainly affects the young, since newcomers to the labour market are generally disadvantaged. On the other hand, higher flexibility will allow economies to adjust to economic shocks and changes in the business cycle. Allowing for more flexible employment legislation is important for business creation, which in turn is the source of job creation.

Debates around minimum wage policies are a salient political issue, with politicians typically proposing increases as a way to alleviate poverty and keep up with the cost of living. But minimum wages tend to exclude low-skilled workers from the labour market. They also reduce the number of jobs available, encourage part-time hiring and often unwittingly promote the growth of the informal economy.

Redundancy rules include the obligation to reassign and retrain redundant workers, notice periods and severance payments. They show how difficult it can be for employers to terminate employees for business reasons. Empirical studies suggest rigid regulations have negative impacts on productivity growth and create obstacles to the reallocation of surplus labour (Martin and Scarpetta: 2012). Higher redundancy costs, in the form of long notice periods and high severance pay for workers, may provide protection for some, yet they impose additional costs on employers, in turn harming those workers who cannot secure employment opportunities. Additionally, severance pay typically increases with workers' years of tenure, which contributes to the creation of a market duality where junior workers will tend to be targeted by redundancy decisions.



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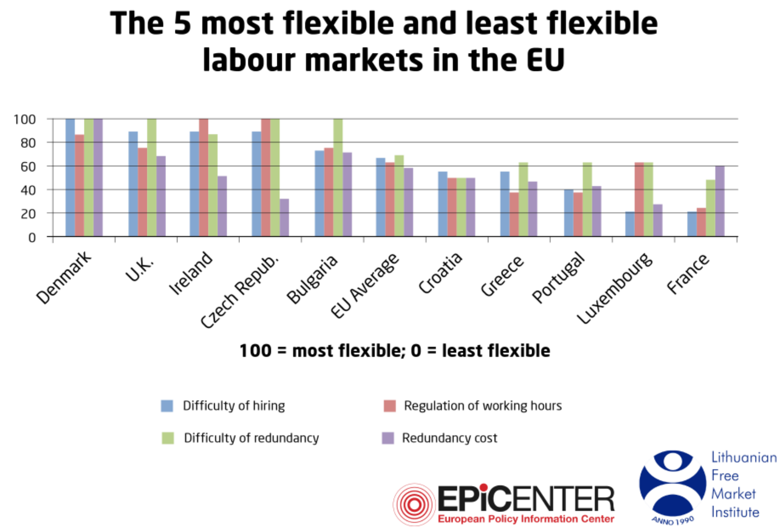
Index rankings

The index ranks countries using an aggregated score of 4 sub-indexes (difficulty of hiring; regulation of working hours; difficulty of redundancy; redundancy cost) where the more flexible labour markets are given higher scores (0-100). We briefly describe the two examples by looking at the most flexible (Denmark) and least flexible labour market (France) that illustrate the huge disparity in labour market regulations across the Union.



Denmark ranks first in both the EU and the OECD as the most flexible labour market (Fig. 1). No restrictions are applied on hiring and there is no mandatory minimum wage, although the country's system allows for wage floors to be set in both individual and collective agreements. There is no restriction and no premiums applied on night-time work, weekly holiday or overtime work. Denmark also has the highest score for both the difficulty and cost of redundancy, as there are no restrictions on redundancy rules as well as no statutory notice period or statutory severance pay required from an employer before an employee is made redundant.

At the other end of the spectrum is France, whose score is less than half those of Denmark, the U.K. and Ireland. The most rigid labour market in both the OECD and the EU limits fixed-term contracts to 18 months. A specific mandatory minimum wage is applied to full-time workers. The French system restricts night-work, weekly holiday and overtime work and requires 30.3 working days of paid annual leave. Redundancies are also difficult and costly, with employers having to notify or consult a third party and having to retrain or reassign an employee before making them redundant. Additionally, employers must provide 7.2 weeks of salary notice period. The average severance pay, calculated by aggregating the severance pay for redundancy dismissal for a worker with respectively 1, 5 and 10 years of tenure, is of 4.6 salary weeks.

Macroeconomic consequences

We relate in the table below macroeconomic data with the index scores. We look at the average scores of the 5 most flexible (Denmark, U.K., Ireland, Czech Republic, Bulgaria) and most rigid (Croatia, Greece, Portugal, Luxembourg, France) in comparison to their average real GDP growth, unemployment, labour productivity levels (nominal and real) as well as GDP per capita (PPP).

The macroeconomic data corroborate the case for labour market flexibility. Real GDP growth in the most flexible labour markets averaged 3.08% in comparison to 1.76% in the least flexible. Nominal productivity levels are relatively close, mainly due to the high productivity of Luxembourg. The notable difference is in real labour productivity growth, which reached 1.54% in the top 5 compared to 0.48% in the lower 5 (Eurostat 2016).

As predicted by the theory, unemployment levels are strikingly lower in the more flexible labour markets. They are nearing full employment levels with an average of 4.92% in October 2017. This is well below the EU average of 7.4%. The average rate of joblessness in the least flexible member states is 10.94%, with Luxembourg again an exception to the rule (5.7%) (Eurostat 2017).

Macroeconomic indicators in the top and bottom 5 countries of the employment flexibility index

Eurostat	Top 5	Bottom 5
Real GDP growth (2016)	2.82	1.94
Unemployment (October 2017)	4.92	10.94
Labour Productivity (Nominal - EU=100)	106.12	101.4
Labour Productivity (Real - change in %)	1.54	0.48
GDP per capita (2016)	109	115
GDP per capita (excluding Bulgaria and Luxembourg)	124.5	77
Debt to GDP (2016)	52.92	102.22
Debt to GDP (excluding Greece) (2016)	NA	82.575

Conclusion

The Employment Flexibility Index is a tool for comparison of labour markets in the EU and the OECD. The macroeconomic data for European economies goes to show that countries with more flexible labour markets generally perform better than economies with rigid labour markets. Policy-makers should be aware of the evidence when implementing labour regulation.

Biography

Eurostat - 2016 Real GDP growth
Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00115&plugin=1

Eurostat - October 2017 Unemployment Statistics
Available at: http://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment_statistics

Eurostat - 2016 GDP per capita in PPS
Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00114&plugin=1

Eurostat - 2016 Real Productivity person employed
Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tipsna70&plugin=1

Eurostat - 2016 General government gross debt
Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=teina225&plugin=1

Eurostat - 2016 Labour productivity and unit labour cost
Available at: http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=fr&pcode=tesem160&plugin=1

Lithuanian Free Market Institute – Employment Flexibility Index
Available at: http://www.epicenternetwork.eu/publications/employment-flexibility-index-2018/

Martin, J. and Scarpetta, S. (2012) "Setting it right: employment protection, labour reallocation and productivity." OECD.
Available at: www.cpb.nl/sites/default/files/paper-flex-martin-2_0.pdf