

Submission

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Inquiry into unfair dismissal laws

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Submitter: Dr Paul Oslington
Senior Lecturer

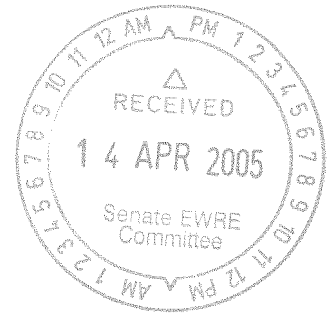
Organisation:

Address: University of New South Wales
Northcott Drive
CANBERRA ACT 2600

Phone: 02 6268 8720

Fax:

Email: p.oslington@adfa.edu.au



Unfair Dismissal Laws and Jobs – How Strong is the Link?

*Paul Oslington, School of Business, University of New South Wales / Australian Defence Force Academy. Phone 02 6268 8720 Email p.oslington@adfa.edu.au
Web http://www.unsw.adfa.edu.au/sbus/staff_cvs/about_paul_osling.html
This article draws on a large Australian Research Council funded project at University of New South Wales “The Impact of Hiring and Firing Costs on Wages and Unemployment”.*

The debate over unfair dismissal laws in Australia has featured assertions by the bucketload, some very funny numbers, and a distinct lack of hard evidence about economic impacts. The Government, for instance, has suggested that the passage of the Fair Dismissals Bill through the Senate is important to get unemployment below 5%. They have previously quoted one of the funnier numbers doing the rounds – that 50,000 jobs will be created by the reforms if one in twenty small businesses take on an additional employee. Various opinion surveys have also been quoted. Supporters of the reforms have not been alone in this – opponents of the Bill have scratched for evidence to support their claims. The basic problem is lack of modelling and data about the impact of hiring and firing costs on employment. A prominent labour economist Daniel Hammermesh has written that “the relative paucity of estimates [of hiring and firing costs] is surprising” and that “we could learn a lot if there were more surveys and cost accounting studies that measured them”. However the only survey since Walter Oi’s 1962 paper, was conducted by the Del Bocca and Rota of the London School of Economics in the mid 1990s, covering about 20 Northern Italian manufacturing firms. A couple of case studies of turnover costs for single firms have been carried out by Australian human resources academics, but these do not consider effects on employment. It is hard to think of a public policy issue of such prominence where there is so little research to go on.

How then might unfair dismissal provisions affect employment? Think about a firm that uses labour to produce output, which it sells at a price which varies over time depending on market conditions. Assume for simplicity that the wage is fixed and the firm can costlessly hire and fire workers. When economic conditions and product prices are improving the value of output produced by workers will rise and the firm will hire more workers, and fire during downturns.

If we now introduce a cost of firing, like unfair dismissal provisions, the firm will only fire if the gap between the wage and the value of the worker's output (projected into the future and future payments appropriately discounted) exceeds the firing cost. Unfair dismissal provisions will reduce firing during downturns. However they will also reduce hiring during upturns as firms foresee conditions will not always remain good and they will incur firing costs in the future. (I have been developing the argument in terms of variations over the economic cycle, but the same applies to variation in quality of workers)

Firing costs will thus smooth employment over the economic cycle, and slow down adjustment to shocks (or in terms of worker quality, fewer bad workers will be fired and fewer good workers hired). The big question is the net effect on employment of reduced hiring and firing. It will depend on a number of factors. Higher voluntary turnover (quits and retirements) will reduce the probability of the firm incurring firing costs in the future, and blunt the negative impact of firing costs on employment during upswings. Higher rates of time discount and greater uncertainty about future economic conditions will similarly reduce the impact of firing costs during upswings. The responsiveness of demand for labour to product price changes also matters, especially if it differs between upswings and downswings for some reason (for instance if firm hoard labour with specific skills in downswings).

If wages are not fixed, then the effects are more complicated. Firing costs improve the bargaining power of employees, allowing them to force up wages (or reduce effort and productivity for a given wage). This increase in labour costs will reduce employment, with the size of this impact depending on bargaining conditions and the responsiveness of labour demand to wage changes.

As well as affecting overall employment, firing costs change the pattern of employment. Instead of taking on additional permanent employees firms will use overtime, casuals, and contractors. They will also be particularly wary about taking on high risk employees, such as those with long spells of unemployment, and perhaps those from minority groups.

Unfair dismissal provisions can potentially hurt the vulnerable without jobs a great deal – it is not just the vulnerable in employment we need to think about.

So much for the mechanisms – there are many ways unfair dismissal laws can affect employment, it is not completely clear even in theory what the net impact will be. We need data to resolve the issue.

There are several approaches to measuring the impact of hiring and firing costs, including unfair dismissal provisions, on employment.

The first approach is to extract estimates of hiring and firing costs from time series data on employment (see for example Layard and Nickell). This approach has not been terribly successful because so many other things are driving employment, nor is it terribly illuminating because it yields estimates of net turnover costs rather than the components policy makers are interested in.

A second line of research (such as work by Ed Lazear at Stanford) constructs indices of the stringency of different countries firing restrictions, and sees how much of cross country variation in unemployment is explained by differences in the indices. Results vary greatly depending on how the index is constructed and the model specified.

A third approach is opinion surveys. Firms are asked whether firing costs matter to them, and whether reducing firing costs would lead them to increase hiring. The attraction of opinion surveys is that they are relatively quick and easy to conduct, but the value of the data is questionable. Economists, being the rough and tough and hard to bluff people we are, question whether firm behaviour will match their stated opinions. If firms know their answers will be used to lobby for changes in unfair dismissal provisions there is an obvious incentive to overstate the impact of firing costs on their behaviour. Data about actual costs or behaviour would be more convincing. Sometimes questions are not well specified. For instance it is not terribly surprising that firms answer that reducing firing costs will increase

their rates of hiring, but this could just be an effect on turnover. The key issue is the net effect of the costs on employment.

The limitations of these approaches have pushed researchers to detailed case studies of particular firms hiring and firing costs, and collecting survey data on costs. Some data exists, particularly for France which is the only country with any kind of official statistics on hiring and firing costs, and for Italy for which we have Del Bocca and Rota's small survey of manufacturing firms. Unfortunately the institutional arrangements are so different especially for dismissals that these studies are of limited use for Australia.

A three year project funded by the Australian Research Council is nearing completion at UNSW/ADFA in Canberra. A PhD student Benoit Freyens and I are conducting a detailed survey of hiring and firing costs (conducted with the assistance of the Australian Human Resources Institute), a larger and less detailed telephone survey of small and medium enterprises, and case studies.

Costs of hiring include:

- Advertising, interviewing and selection.
- Administrative costs associated with new workers joining the firm.
- Lost output while the new worker learns, plus other staff time and expenditure on firm specific training for the new worker.

Costs of firing include:

- Administrative costs associated with the termination of the worker's contract.
- Disruption and loss of morale for remaining workers.
- Payments on termination to the worker.
- Litigation which may arise from the termination.

Some of these costs (e.g. advertising, administrative costs) are not influenced by policy, but the largest components of the costs (training, unfair dismissal litigation costs) are closely tied to labour market policies. Our detailed survey distinguishes between costs of retrenchment, and costs of dismissal when uncontested, settled, and cases which go to court. It also considers variation in costs by industry and occupation.

We are using the survey data to calibrate a dynamic labour demand model like that sketched earlier in the article, generating estimates of the impact of various components of hiring and firing costs on employment. The project is expected to be completed in late 2005, but so far we have little evidence to supports some of the claims of large impacts of firing costs on employment. Some of these results were presented at an Economic Society of Australia Forum on the issue in November 2004.

Aside from the substantive research question of the effect of firing costs on employment, we must remember when assessing the impact of the Government's Fair Dismissals Bill that it is irrelevant to workers covered by State unfair dismissal laws, that the rights of existing employees are unaffected, that is does not apply to businesses with more than twenty employees, and that it will not eliminate all dismissal costs. It is difficult to see that the impact on employment will be anything other than minimal.

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