

CHAPTER 4

Employing workers

- ◆ Nearly 40% of low- and lower-middle-income economies prohibit the use of fixed-term contracts for permanent tasks. In many of those economies, such legislation is obsolete.
- ◆ Six economies revised legal restrictions on nonstandard working hours in 2018/19.
- ◆ In economies with flexible employment regulation, more young women join the labor force.

Employment laws—introduced in response to market failures including worker exploitation, discrimination in hiring and working policies, and unfair dismissal practices—are vital to worker well-being. At the same time, firms should also be free to conduct their business in the most efficient way possible. When labor regulation is too cumbersome for the private sector, economies experience higher unemployment—most pronounced among youth and female workers.¹ With fewer formal job opportunities, workers turn to the informal sector.² Flexible labor regulation provides workers with the opportunity to choose their jobs and working hours more freely, which in turn increases labor force participation.³

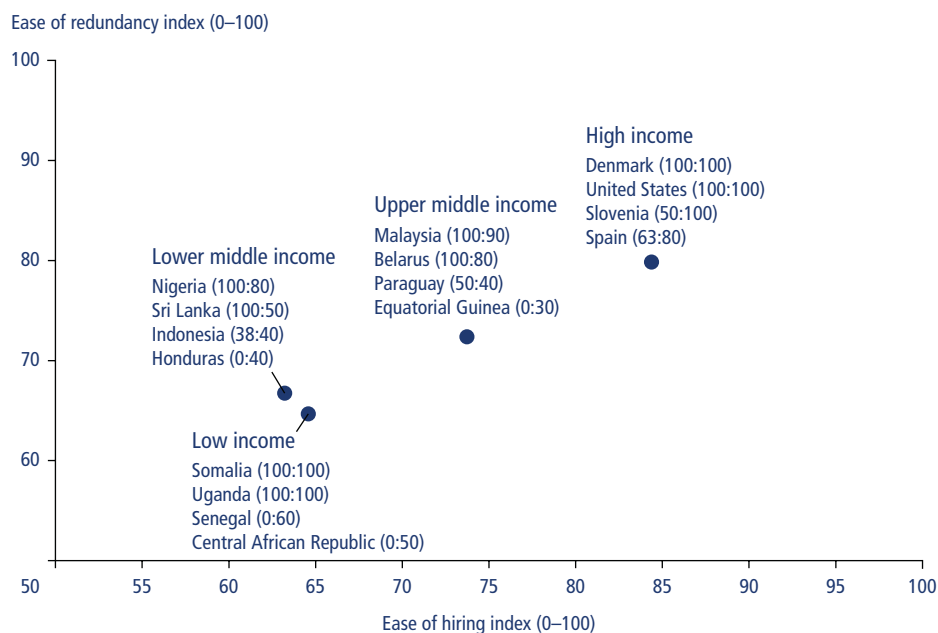
For example, if France were to attain the same degree of labor market flexibility as the United States, its employment rate would rise by 1.6 percentage points, or 14% of the employment gap between the two countries.⁴ When Sweden increased labor market flexibility, by giving firms with fewer than 11 employees the freedom to exempt two workers from their priority list, labor productivity in small firms increased 2–3% more than it did at larger firms.⁵

Governments face the challenge of striking a balance between worker protection and labor market flexibility. As argued in the World Bank’s *World Development Report 2019: The Changing Nature of Work*, extending protection is the task of the government, not the firm.⁶ The employing workers indicator set measures the flexibility of employment regulation. The indicators follow the life span of a typical employment relationship—from hiring to work scheduling and eventually to redundancy in a manner consistent with international conventions.⁷

Who regulates employment the most?

Low- and lower-middle-income economies tend to regulate employment more than do high- and upper-middle-income economies (figure 4.1). For example, regulation in the Central African Republic, Madagascar, and Senegal presents significant obstacles for employers hiring new workers or dismissing redundant ones. Among lower-middle-income economies in East Asia and the Pacific, Indonesia is one of the economies with the most rigid employment regulation, particularly on hiring. In the same region and income group, Mongolia allows the use of fixed-term contracts for permanent tasks with no limit on their renewal. In the Europe and Central Asia region, regulation on hiring in Serbia is relatively rigid, and authorities could benefit from the experience of Hungary where employers have the freedom to use fixed-term contracts of up to five years for tasks of a permanent nature.

Many high- and upper-middle-income economies, including Denmark, Namibia, and the United States, have flexible labor regulation. In other advanced economies, including Luxembourg, Slovenia, and Spain, strict labor rules make the process of hiring employees arduous. Research shows

FIGURE 4.1 Low- and lower-middle-income economies regulate employment the most

Source: *Doing Business* database.

Note: A higher index score indicates more flexible regulation, with 100 being the highest possible score. The dots indicate the income group average score. The numbers indicate the economy's score on the employing workers ease of hiring index (left number) and the ease of redundancy (right number). Computation of the indexes is primarily based on the *Doing Business* 2013 data notes.

that strict employment protection legislation shapes firms' incentives to enter and exit the economy, which in turn has implications for job creation and economic growth.⁸ When designing labor laws—specifically those that regulate hiring, work scheduling, and redundancy—authorities must assess the impact on firms.

Ease of hiring

Businesses need flexibility in hiring. *Doing Business* uses the ease of hiring index to measure the availability and maximum length of a fixed-term contract for a task related to the permanent activities of a firm, the probationary period, and the ratio of the minimum wage to value added per worker. Using a fixed-term contract, an employer can hire a worker for a specific period of time. These contracts afford employers the flexibility to respond quickly to changes during the course of their operations, temporarily substitute workers on leave, and reduce the risk of new business ventures. Fixed-term contracts can be critical to boosting youth employment by acting as a channel for youth to gain work experience.⁹ *Doing Business* data

show that 124 economies allow fixed-term contracts for permanent tasks. Those that do not are primarily low- and lower-middle-income economies where legislation is obsolete in this area. Honduras, for example, prohibits the use of fixed-term contracts for permanent tasks according to legislation from 1959. Pakistan limits employer flexibility in this area with legislation dating to the 1960s.

Some economies have reformed their laws governing the use of fixed-term contracts. In 2017, as part of a revision of its Labor Code, Nepal introduced fixed-term contracts for permanent tasks, and Benin made fixed-term contract renewal unlimited. Although studies suggest that potential risks could be associated with an overreliance on fixed-term contracts, the availability of fixed-term contracts should be considered in economies that have large youth populations but outdated legislation.¹⁰

The probationary period is used to evaluate a potential full-time employee's suitability for a job, including that person's skills, expertise, and productivity. It is a low-risk mechanism for employers, on the one hand, because it gives them the freedom to terminate employment contracts at a low cost if a worker turns out to be a poor match for the job.¹¹ Employees, on the other hand, use the probationary period as a means to secure a permanent job. Often the duration varies between different groups of workers, with longer average probationary periods allowed for high-skilled workers. Moldova's labor code, for example, establishes a six-month probationary period for employees in a managerial role and a one-month probationary period for low-skilled employees. The duration of a probationary period also depends on firm size. In Australia, firms with 15 employees or more are allowed to offer a maximum of 6 months of trial period, whereas firms with 14 or fewer employees can employ workers on a probationary basis for the first 12 months of their employment.

A mandatory minimum wage is designed to ensure that all workers receive fair compensation. Research shows that firms in developing economies struggle to pay minimum wages to their workers because the ratio of minimum wages to median earnings is too high relative to the ratio in high-income economies.¹² For example, a 10-percentage-point increase in the minimum wage in Indonesia was associated with a 0.8-percentage-point decrease in employment on average in a given province.¹³ Turkey's subsidy for low-income workers failed to boost either employment or economic activity and negatively affected the fiscal accounts.¹⁴ The relationship between minimum wage and employment is sometimes positive, however. A 2018 study on Mauritius—where the minimum wage is set by sector—found that a 10% increase in the minimum wage has a slightly positive effect on employment in the covered sector.¹⁵

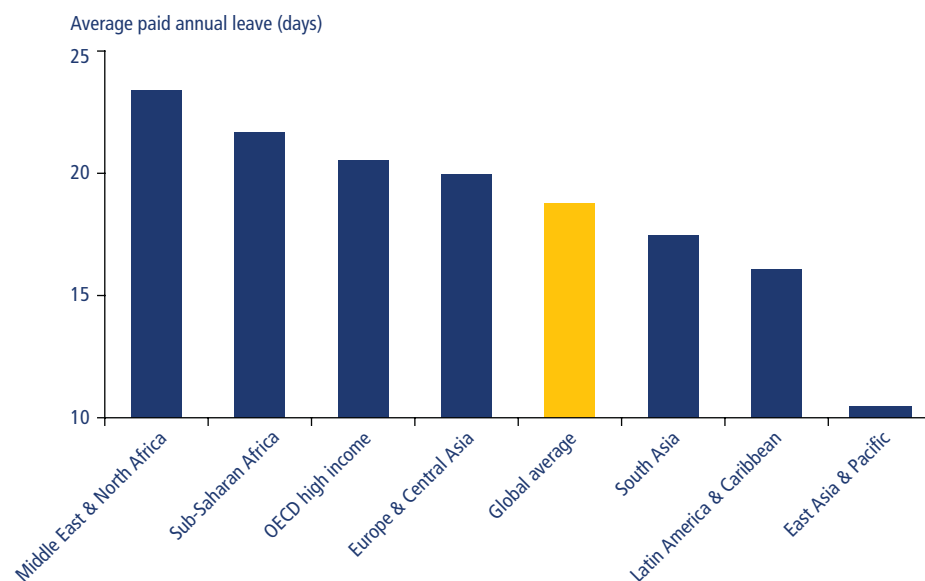
Flexibility of hours

To capture the flexibility in legislation governing working hours, the employing workers indicator set measures the length of the workweek, restrictions

and premiums on nonregular working hours (such as night work, weekly holiday work, and overtime work), and the length of paid annual leave. Research shows that greater employee freedom in choosing working hours leads to higher productivity.¹⁶ Nevertheless, daily hours must not be set so high that workers become susceptible to fatigue and reduced productivity.¹⁷ Ninety percent of economies have a workweek that is between five and a half and six days. In 2018/19 Austria and Hungary reformed in the area of working hours. Austria increased overtime to 12 hours per day and 60 hours per week.¹⁸ Hungary raised its overtime allowance to a maximum of 400 hours per calendar year. In 2016, Hungary also removed restrictions on working hours for retail stores, allowing them to open on Sundays.

Paid leave is the period during which workers take time away from their job while continuing to receive an income and social protections.¹⁹ *Doing Business* measures annual leave days for workers with 1, 5, and 10 years of tenure. With 23.4 working days on average, the Middle East and North Africa is the region with the most paid annual leave, followed by Sub-Saharan Africa with 21.7 days. Workers in Guinea, Libya, and Togo, for example, are entitled to annual leave of 30 working days on average, one and a half times the global average of 18.8 days (figure 4.2). However, 9 out of every 10 employees in Sub-Saharan Africa operate in the informal sector;²⁰ therefore, the intended social protection provided by paid leave reaches only a select few.

FIGURE 4.2 Economies in the Middle East and North Africa and Sub-Saharan Africa have the longest paid annual leave



Source: *Doing Business* database.

Note: Paid annual leave is measured in working days.

Ease of redundancy

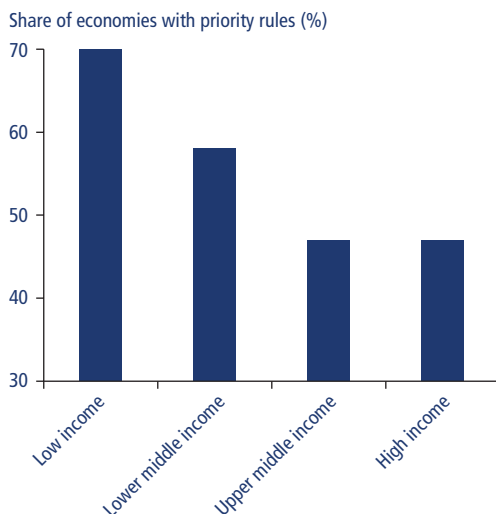
Cumbersome redundancy procedures pose challenges to firms. The employing workers indicator set measures aspects of regulation governing notification and approval requirements, retraining obligations, and priority rules for dismissal and reemployment. Rigid regulation can lead to a misallocation of company resources, providing older workers with job stability while leaving younger, less experienced workers vulnerable.²¹

Redundancy is permitted as grounds for dismissal in all economies except Bolivia, Oman, Tonga, and República Bolivariana de Venezuela. Half of economies globally require that a third party, such as a government agency, be notified of redundancy dismissals of a single employee or group of employees. Although approval obligations are mandatory in just 16% of economies, they complicate the process. In Ghana, for example, an employer must notify the Chief Labor Officer and the trade union of the dismissal of any employee at least three months before termination—such a rule significantly reduces the freedom of employers to adjust to shocks when they arise.²²

Priority rules for dismissal stipulate that certain workers must be laid off first on the basis of attributes such as seniority, marital status, or number of dependents. Similarly, priority rules for reemployment require that a firm first offer any position that becomes available to workers previously dismissed for redundancy before opening recruitment to a wider pool of

applicants. *Doing Business* data show that priority rules are most widespread in low-income economies (70%), where young and part-time workers remain highly vulnerable in case of redundancy termination (figure 4.3). In Cameroon, an employer must establish the order of redundancy dismissals on the basis of professional aptitude, seniority, and the expenses of a worker's family. Although priority rules aim to protect workers from unfair dismissals, they make it more difficult for those workers perceived as higher-risk—including young, female, immigrant, or disabled workers—to find employment.²³ Economies including the Kyrgyz Republic and Slovenia have eliminated priority rules for reemployment and redundancies.

FIGURE 4.3 Priority rules are most prevalent in low-income economies



Source: *Doing Business* database.

Note: Data include priority rules for redundancies and reemployment.

Redundancy cost

Severance payments for redundancy dismissals aim to protect the income of redundant workers. Although the size of severance payments varies across the 79% of *Doing Business* economies that require them, they can be difficult or impossible for small firms to disburse. South Asia and Sub-Saharan Africa are the regions with the highest redundancy cost. Redundancy costs on average in South-Asia amount to more than twice the weeks of salary paid to redundant workers in the OECD high-income group. In Zambia, severance payments amount to 20 months of salary for workers with 10 years of tenure. Alternative unemployment protection systems, including unemployment benefits, can be more effective at mitigating the effects of an unanticipated worker dismissal. Whereas severance payments do not consider the worker's financial situation, unemployment insurance collects funds to provide support to workers who require support. Moreover, large severance payments rarely reach more vulnerable groups of workers. Unemployment benefit programs have been proven more effective at reaching these groups.²⁴

Why flexible employment regulation matters

When faced with rigid employment protection laws, firms lose the freedom to conduct business efficiently. They find alternative ways to meet their business needs, often hiring workers informally (figure 4.4). A large informal

FIGURE 4.4 Economies with flexible employment regulation tend to have a smaller informal sector



Sources: *Doing Business* database; World Development Indicators database (<http://data.worldbank.org/data-catalog/world-development-indicators>), World Bank.

Note: The figure shows the employing workers indicator set score and informal employment rate (2003–18 average). The sample comprises 68 economies. The relationship is significant at the 1% level after controlling for income per capita.

sector, particularly in developing economies, undermines productivity and economic development which, in turn, leads to increased unemployment, especially among disadvantaged groups.²⁵ Unemployed workers, or those with jobs in the informal sector offering no health or social protection benefits, are less likely to come out of poverty.

Restrictive labor regulation also restrains the freedom of employees to choose their employment and working hours, which negatively affects productivity. A firm's ability to adjust to shocks is adversely affected by rigid labor regulation.²⁶ Moreover, firms invest less in new product creation in such an environment.²⁷ Restrictive steps for dismissing workers cause managers to divert their attention from performing more productive tasks and investing time in innovation as well as research and development.²⁸ They also result in smaller firm size and the relocation of firms to economies with flexible regulation, which in turn reduces the benefits of trade liberalization.²⁹

Summary

Although labor laws provide essential protections to workers, firms should not have to confront overly burdensome regulation. By changing restrictive labor regulation, economies could better adjust to fast-changing market conditions and dynamic work environments, generating positive outcomes that include smaller informal sectors, increased employment, and higher growth. Reinstating the option of fixed-term contracts would boost youth employment. Similarly, miscalculated changes to the minimum wage could lead to a decline in employment. Easing redundancy procedures facilitates businesses in allocating resources more efficiently, while revising legal restrictions on nonstandard working hours allows both employers and employees to maintain competitiveness.

Notes

1. Djankov and Ramalho 2009.
2. Djankov and Ramalho 2009.
3. Cournède, Denk, and Garda 2016.
4. Di Tella and MacCulloch 2005.
5. Bjuggren 2018.
6. World Bank 2018.
7. Five of the 189 International Labour Organization conventions cover areas measured by *Doing Business*: hours of work, weekend work, holidays with pay, night work, and employee termination.
8. Bottasso, Conti, and Sulis 2016; Fernández and Tamayo 2017.
9. Cockx and Picchio 2012.
10. Duality of labor markets can have a number of negative outcomes. For a discussion, see *Doing Business 2017*.
11. Marinescu 2009.

12. Ahn and others 2019.
13. Ahn and others 2019.
14. Betcherman, Daysal, and Pagés 2010.
15. Asmal and others 2018.
16. Collewet and Sauerman 2017.
17. Pencavel 2014.
18. As stipulated in Austria's Working Time and Rest Periods Act.
19. According to International Labour Organization Convention 132 on holidays with pay, employees have the right to take up to three weeks of paid annual leave each year.
20. Choi, Dutz, and Usman 2019.
21. Francis and others 2018.
22. As stipulated in section 65 of Ghana's Labour Act of 2003 (Act 651).
23. Kugler and Saint-Paul 2004.
24. World Bank 2018.
25. Botero and others 2004; Djankov and Ramalho 2009; La Porta and Shleifer 2014.
26. Almeida and Carneiro 2009.
27. Kleinknecht, van Schaik, and Zhou 2014.
28. Lisi and Malo 2017.
29. Almeida and Carneiro 2009.

