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Relationship between Employment Regulation and Labour Market Flexibility

1 Introduction

The following paper considers the potential impact regulation has on employment levels and labour market flexibility.

Regulation within the labour market is directly related to labour market flexibility and impacts upon employers and employees. This paper will briefly discuss labour market flexibility in the UK and will subsequently consider research which has highlighted the impact of regulation on employment.

It should be noted that a recent question was asked in the House of Commons (June 2012) regarding the correlation between employment regulation and employment figures. The response from the Minister of Business, Information and Skills stated that:¹

¹ House Of Commons: Parliamentary Question: HC 98926, Questions from Chris Ruane MP (Vale of Clwyd)

- the immediate effect of employment regulation is likely to be on the amount of legal employment opportunities that are available and it is not always clear how these translate into economic growth; and
- Secondly, the employment regulation system in any country is just one part of the overall social protection system. For example, social protection in the UK tends to be delivered through the tax and benefit system rather than through employment regulation. It is, therefore, difficult to isolate the effect of employment regulation from some other parts of the overall system or to distinguish separate from joint effects.

As such it is important at this stage of the paper to highlight the inherent difficulties there are in establishing links between labour market regulation and the level of employment.

The Department for Employment and Learning is currently undertaking research into this area which should provide a more detailed response than that provided in this paper (as a result of the Department having a greater resource level than that available to RaISe).

This paper will therefore attempt to provide Members with a basic understanding of the main issues surrounding Labour Market Regulation including a discussion of Labour Market Flexibility, Employment Protection Legislation and the implications on business of regulations such as the Minimum Wage.

2 Key Points

- Labour market flexibility (LMF) describes how a labour market functions – the more flexible a labour market, generally the higher employment is;
- However, a more regulated labour market, whilst less flexible, provides additional benefits to workers such as job security, social protections and equitable wage distribution;
- LMF is determined by three main factors – supply side factors, labour costs and functional flexibility;
- Recent research has found that the relationship between LMF and employment may not be as clear as previously thought, with increased levels of employment protection legislation potentially resulting in lower levels of joblessness and labour market inactivity;
- Labour Market Regulation (LMR) in the UK focuses on employment rights such as the National Minimum Wage (NMW), working time and employment agency standards;
- The NMW was introduced in 1999 and was designed to alleviate issues regarding low pay across the UK;
- The NMW was criticised at the time for the additional costs it was forcing on employers and that it would result in a growth in unemployment – however, there is little evidence that the NMW had a negative effect on employment;

- Employment Protection Legislation (EPL) concerns the rules governing the hiring and firing of workers;
- EPL has an impact on both employers and employees. For example, strict EPL can encourage firms to have longer working relationships with employees, resulting in improved human capital development;
- However, restricting staff turnover can limit a firm's ability to react to changes in their operating environment such as changes to consumer demand or technology;
- It should be noted that the UK has one of the lowest levels of EPL in the OECD, with only the USA and Canada having lower levels;
- It should be noted that the effectiveness and impact of EPL is greatly influenced by the historical structure of the legal system, the economic structure and labour market of the relevant nature – as such what works in one nation may not be effective in another; and
- The scope of the EPL can also have a significant impact. For example, EPL designed to take into consideration the resources and skills in large companies may have a negative impact in regions which have mainly small to medium enterprises (SMEs) such as Northern Ireland. As such changes to EPL on a national level may impact differently on a regional basis.

3 Labour Market Flexibility

Labour market flexibility (LMF) describes how a labour market functions. The more flexible a labour market (i.e. a labour market with a limited amount of regulation) generally the higher employment is. It may also be more efficient, competitive and productive. As can be expected it is an indicator of the overall performance of a nation's economy.²

On the flip side of this, a more regulated labour market, whilst being less flexible, has more benefit to workers, such as increased social protections (such as welfare benefits), more job security (i.e. it is more difficult for employers to lay off staff) and equitable distribution of wages.

The figure below details the various factors that influence Labour Market Flexibility and highlights the difficulties in developing policy on it.³

² Sloman, J, 2000, Economics

³ BIS, 2006, Labour Market Flexibility and Foreign Direct Investment <http://www.bis.gov.uk/files/file33254.pdf>

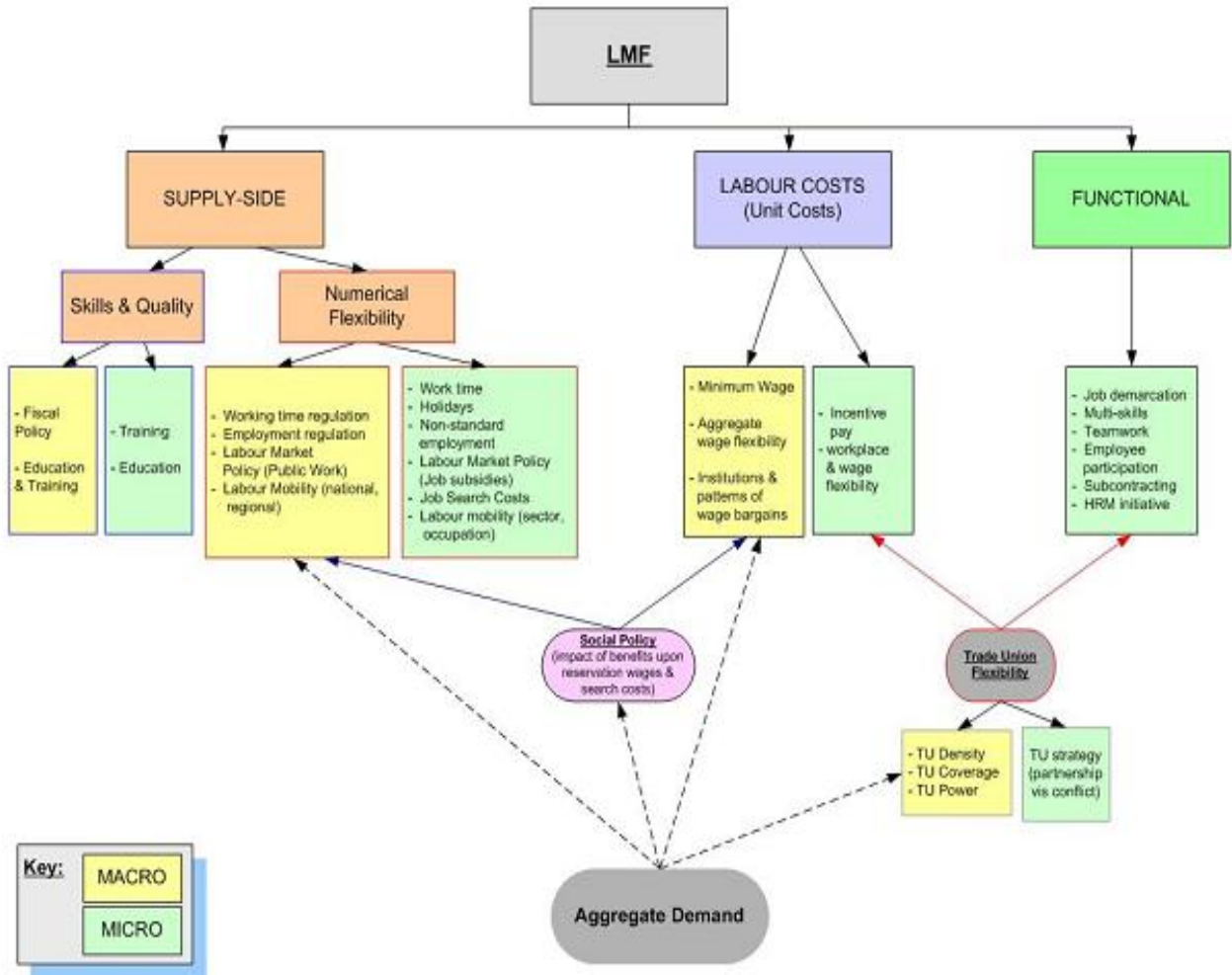


Figure 1: Labour Market Flexibility

Please note, Macro refers to Macroeconomic factors such as government intervention and Micro refers to Microeconomic factors, such as individual company policy.

As can be seen above, LMF is determined by three main factors (which consist of multiple variables) – Supply Side factors, Labour Costs and Functional flexibility.⁴

- **Functional flexibility:** this refers to the flexibility available to an employer. It includes elements such as where an employer is able to transfer labour between different tasks within a production task.⁵ A functional workforce tends to be multi-skilled and relatively highly skilled, unlike a traditional workforce which will have limited flexibility to take on new tasks and will tend to stick to a specific job;
- **Supply Side:** This has two main factors, numerical flexibility and skills and quality, both of which have microeconomic and macroeconomic variables.

⁴Sloman, J, 2000, Economics and BIS, 2006, Labour Market Flexibility and Foreign Direct Investment <http://www.bis.gov.uk/files/file33254.pdf>

⁵ Sloman, J 2000, Economics

- Numerical flexibility refers to where a firm is able to adjust the size and composition of its workforce according to market conditions, adjust working time (an important factor at both micro and macro level and subject to EU Regulation). On a macro level this can include labour market mobility (again an issue which is regularly considered by the EU) and national wide labour market policies.
- Skills and Quality: This covers issues such as training and education available to the general population and to employees. Fiscal policy also plays a role.
- **Labour costs, or financial flexibility**⁶: At a micro level this includes a company's control over its wage costs and incentive pay (i.e. bonuses). At a macro level this can include whether or not there is a minimum wage in place, the level of said wage (such as the ongoing debate regarding a 'working wage') and collective wage bargaining between government and trade unions.

It should be noted that within the table a number of other factors are listed, including Trade Union flexibility, social policy and as a major macroeconomic factor, Aggregate Demand.

The main arguments surrounding labour market flexibility focus on the impact of regulation. As stated by the HM Treasury:⁷

An appropriate degree of regulation can correct market failures and increase fairness and safety in the workplace...however, if regulation is set ineffectively then it can constrain the choices of employers and employees, i.e. reduce labour market flexibility.

Sloman (2000) found that as a result of world recessions and rapid changes in technology, firms wanted increased flexibility in the labour market.⁸

There are a number of policies which can impact on labour market flexibility, including:⁹

- Regulations on working hours;
- Regulations on part time contracts;
- Policies on wage setting (such as Minimum Wage legislation); and
- Policies on 'safety nets' (such as unemployment benefits or incapacity benefit¹⁰).

It is generally assumed that a 'rigid' labour market, such as those with high levels of regulation, restrictive wage bargains or 'excessive' safety nets result in lower levels of employment.

⁶ Sloman, J, 2000 Economics

⁷ HM Treasury, 2003, EMU and labour market flexibility

⁸ Sloman, J, 2000 Economics

⁹ OECD, Venn, D, 2009, Legislation, collective bargaining and enforcement

¹⁰ OECD, Van der Noord et al, 2006, Social safety nets and structural adjustment <http://www.oecd-ilibrary.org/docserver/download/519j0m8g4x7j.pdf?expires=1355226588&id=id&accname=guest&checksum=19AF21102D4279B7C154F4C4D73C9599>

This is a result of a number of potential factors, including increased costs to employers in terms of administrative costs or the impact of regulations such as working time resulting in the need to hire additional staff.

However, it should be noted that a study carried out on behalf of the Trade Union Congress (TUC) highlighted that:¹¹

- Research has found that contrary to established arguments, that increased levels of employment protection legislation results in lower levels of joblessness and labour market inactivity;
- Research has found positive links between labour market regulation (particularly employment protection) and productivity growth (the more LMR leads to greater productivity);
- Counter to this it was found that high levels of employment protection and generous unemployment benefit systems are positively correlated with unemployment, although the effects were relatively small; and
- Countries with co-ordinated wage bargaining systems have lower unemployment controlling for other factors;

Overall the paper concluded (following a review of existing research) that evidence for the orthodox view of labour market regulation (i.e. that it negatively impacts on economic performance and employment) was mixed, at best.

Based upon the arguments above, it is important when considering labour market regulation to note that:

The idea that employment regulation is always and everywhere 'bad' – and deregulation therefore correspondingly 'good' – is as simplistic as the opposite idea that regulation is always the best way to promote job-creation or boost workplace productivity.¹²

4 Labour Market Regulation in the UK

As stated in a BIS report:¹³

The UK has a hybrid system for enforcing employment rights, based on an accessible system of employment tribunals for the majority of rights alongside government enforcement for some rights.

In addition, the UK Government enforces a number of employment rights including:

- The National Minimum Wage and the Agricultural Minimum Wage;

¹¹ Trade Union Congress, 2011, <https://www.tuc.org.uk/extras/Flexiblewiththetruth.pdf>

¹² CIPD, May 2011, The Economic rights and wrongs of employment regulation
www.cipd.co.uk/binaries/5547_Work_Horizons.pdf

¹³ BIS, October 2011, Flexible, effective and fair: promoting economic growth through a strong and efficient labour market
<http://www.bis.gov.uk/assets/biscore/employment-matters/docs/F/11-1308-flexible-effective-fair-labour-market>

- Employment agency and employment business standards,
- Gangmaster licensing; and
- The 48-hour working week (otherwise known as Working Time).

The following section will discuss, briefly, some of the main labour market regulations in operation in the UK and any related research which indicates its impact on employment levels. Please note, it is not possible to cover all the areas which may impact on the correlation between LMR and employment due to the large number of potential variables.

4.1 The Minimum Wage

The intention behind a government set minimum wage is to relieve poverty. The UK has a history of having minimum wage regulations, with the first established in 1909 with the creation of Wage Councils. These were abolished in 1993 by the Conservative government.

In 1999, the Labour government reversed this decision with the introduction of a national minimum wage (NMW) designed to alleviate issues that had arisen with the growth in low pay jobs across the UK.

As can be expected, the main argument around the introduction of a minimum wage is the impact on employment. It is argued by critics that a minimum wage creates opportunity cost problems, with the 'higher' wage created by the NMW forcing employers to spend money on salaries that could be better spent on additional employment or capacity building.

In the initial years of its introduction, the NMW:¹⁴

operated in the context of a buoyant labour market when real wages were rising, employment rates were high and unemployment rates were low.

A number of studies were carried out during this period and found that there was little evidence that the introduction of the NMW had a negative effect on employment.

Of course, it should be noted that these studies took place during a period of economic growth, giving rise to the possibility that the NMW could impact upon a firm's ability to react to the financial crisis and the subsequent recession.

A study published in February 2012 by the Low Pay Commission¹⁵ examined this and found that the NMW had no overall impact on employment or on hours worked. It did, however, recommend that further research needed to be conducted on the full effect of NMW on hours worked.

¹⁴ The Low Pay Commission, February 2012, Bryan et al, The impact of the national minimum wage on earnings, employment and hours through the recession, http://www.lowpay.gov.uk/lowpay/research/pdf/ISER_NMW_Report_Final.pdf

¹⁵ Ibid

4.2 Employment Protection Legislation

Employment protection legislation (EPL) concerns the rules governing the firing of workers, the use of temporary contracts, working time and working patterns.¹⁶

The OECD states that:

*Employment protection...is justified by the need to protect workers from arbitrary actions and have firms internalise at least some of the social costs of labour turnover.*¹⁷

Like other forms of labour market regulation, EPL has an impact on both employers and employees, influencing job creation and destruction¹⁸. For example, strict EPL can encourage firms to have longer working relationships with employees resulting in improved human capital development and industrial stability (as a result of the lower turnover of labour).

On the flip side of this, restricting labour turnover can limit a firm's ability to react to changes in their operating environment such as changes in consumer demand or technology. A report by the HM Treasury found that too strict EPL can reduce job flows, negatively impact on youth employment and hinder economic growth.¹⁹

Low levels of EPL can have positive implications - for example, Denmark has a limited level of EPL, which allowed its firms to react swiftly to the financial crisis by adjusting their employee levels quickly (i.e. they were able to quickly lay off staff to react to the need for a lower level of production). As a result, unemployment increased significantly in Denmark. However, Denmark's labour market recovered quickly and by 2008, its unemployment rate was 3.3% in comparison to an average of 7.1% in the European OECD countries. It should be noted, however, that this result was made possible in part by the 'flexicurity' labour market model used in Denmark, which sees two additional strands to the LM including extensive social safety nets and labour activation policies.²⁰

One complaint regularly heard in the UK is that EPL is too restrictive in the UK. The OECD has carried out research on the level of EPL in Member States. The figure below summarises its findings.²¹

¹⁶ OECD paper and HM Treasury, 2003, EMU and labour market flexibility

¹⁷ Ibid

¹⁸ HM Treasury, 2003, EMU and labour market flexibility

¹⁹ Ibid

²⁰ VOX, Andersen et al, April 2011, The Danish flexicurity model in the Great Recession <http://www.voxeu.org/article/flexicurity-danish-labour-market-model-great-recession>

²¹ OECD, 2009, Venn, D, Legislation, collective bargaining and enforcement: Updating the OECD employment protection indicators

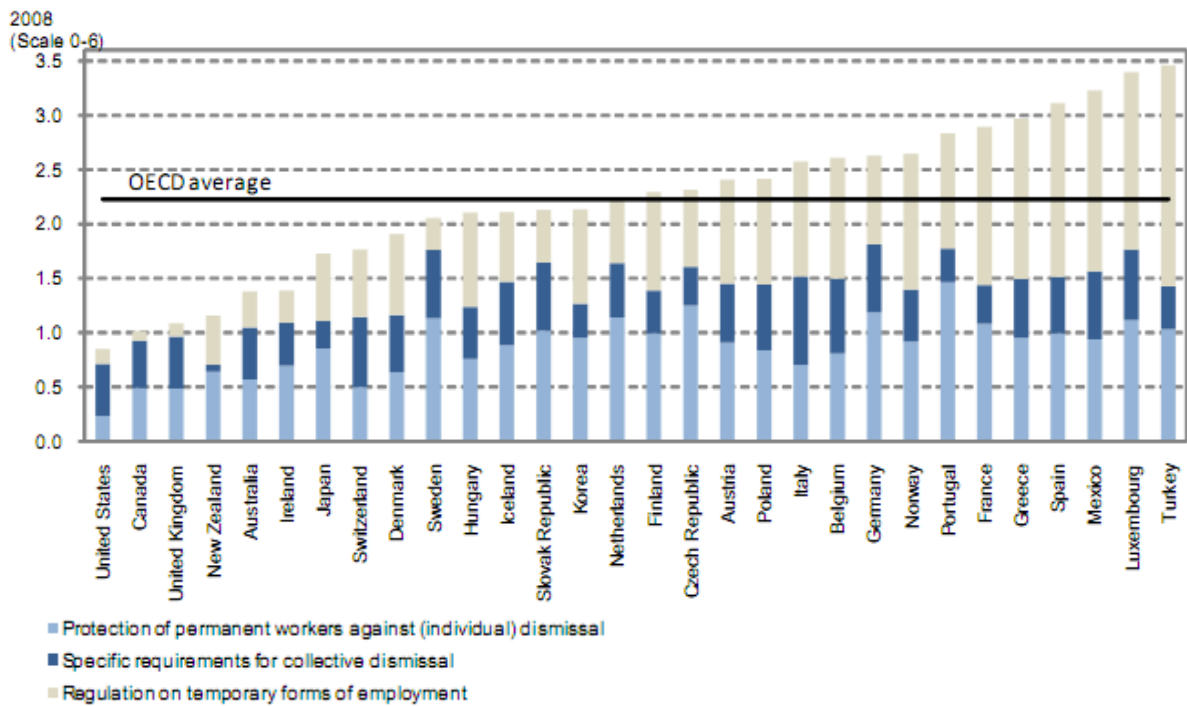


Figure 2: Level of EPL in OECD Member States (2008)

As can be seen above, the UK has one of the lowest levels of EPL in the OECD, with only Canada and the United States having more flexible labour markets. Of the three types of regulation shown, regulation of temporary forms of employment was the smallest type in the UK.

Protection of permanent workers and requirements for collective dismissal are both significantly larger than the EPL provision for temporary workers. This lower level of EPL for temporary workers creates an additional level of flexibility in the UK labour market, allowing firms to employ temporary workers as needed and dismissing them once this need has been met. It should be noted, however, that this report was compiled prior to the introduction of the Agency Workers Directive which came into operation in 2011.

In a BIS response to a parliamentary question it is argued that the wide difference between the UK's and other EU countries level of EPL is a result of historical differences. It states that:²²

Employment regulation has never been a major feature of the UK's social protection system. The tax and benefit system has always been much more important.

It also states that the variation is a feature of the different social protection systems in place in each nation and differences in the legal systems.

²² BIS, September 2012, Employment Regulation, Employment and Growth: Consideration of International Evidence <http://www.bis.gov.uk/assets/biscore/employment-matters/docs/e/12-1147-employment-regulation-and-growth-international-evidence>

In terms of the effect of EPL in the UK, Marinescu (2009) carried out research on the impact of the EPL adopted by the UK in 1998 following the Labour government signed up to the European Social Charter.²³

Part of the charter increased protection from unfair dismissal for workers between one and two years in post. Marinescu found that there was a sharp reduction in the layoff rate of staff with one or two year's tenure.²⁴ She also found that those with less than one year's job tenure were also less frequently dismissed. Marinescu suggested that this was the result of firms taking more care with the recruitment process, rather than take on the added costs now associated with dismissing someone who was not suitable for the post.

Marinescu also found that:²⁵

Unemployment duration decreased after the policy change, training increased, and wages were unaffected.

It should be noted, however, that in 2003 the HM Treasury found that:²⁶

The impact of EPL on labour market turnover is unambiguously negative.

It found that EPL can have a number of negative effects, including:

- Increase the duration of unemployment;
- Reduce the efficiency of job matching; and
- Increase employee bargaining power.

EPL is similar to other forms of LMR in that a delicate balancing act is needed of the legislation in order to ensure that economic growth is not stifled through overenthusiastic legislation nor that workers' rights are too limited, again as this may, ultimately, impact on growth (such as through too high a level of labour market turnover resulting in a lack of human capacity being built up).

An important consideration of this is the need to ensure that EPL is appropriate to the structure of the economy. For example, legislation that results in increased employee protections may include additional costs being accrued by employers. Whilst large employers are able to absorb these costs (potential through having dedicated Human Resources teams) small businesses, especially micro businesses, may not have the capacity (including in terms of skills, available employees or financial resources) to take on this additional work.

Northern Ireland has, as is well documented, a small private sector which is mostly made up of Small to Medium Businesses (SMEs). As such, regulations which are

²³ Gregg, P and Wadsworth, J 2011, The Labour Market in Winter

²⁴ Harris School Working Paper, Marinescu, I (2009), Job security legislation and job duration: evidence from the UK <http://www.marinescu.eu/Marinescu2008b.pdf>

²⁵ Ibid

²⁶ HM Treasury, 2003, EMU and labour market flexibility

developed in a **one size fits all** approach may not necessarily be appropriate for small businesses which may have no more than ten employees.

The Committee may wish to note that the Department for Employment and Learning is undertaking research into the impact of changes to regulation may have on NI's SME sector.

5 Conclusion

As discussed above, labour market regulation and employment are closely related, with the 'orthodox' argument that increased regulation results in lower levels of employment.

However, recent studies have found that this may not necessarily be the case. In addition, regulation can bring along other benefits such as job security which can improve human capital development with long term benefits to the economy.

The impact of LMR can also vary depending on the region it is introduced, with the structure of the local economy shaping its effect. This is important for a region such as Northern Ireland which has a large SME sector which may find it more difficult to absorb additional regulation than regions which host large companies (such as the South East of England). The Department for Employment and Learning is currently undertaking research into the impact of regulation on NI's SME sector which may be of note to the Committee for Employment and Learning in its consideration of the forthcoming Employment Legislation.

Further information on LMR is also available via a recent paper by the Department for Business, Innovation and Skills: <http://www.bis.gov.uk/assets/biscore/employment-matters/docs/e/12-1147-employment-regulation-and-growth-international-evidence>.