EMPLOYMENT PROTECTION LEGISLATION AND THE GROWTH OF THE SERVICE SECTOR IN THE EUROPEAN UNION

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In modern developed economies it is the service sector that generates jobs. In Anglo-Saxon economies, where employment protection legislation is low and unions comparatively weak, services account for three-quarters of income and four-fifths of jobs. Yet in France, Germany and Italy, where the reverse is true, the service sector accounts for much less of the economy in terms of income and jobs. This article shows that employment protection legislation – defended by trade unions still dominating manufacturing in continental Europe – results in higher unemployment rates and also negatively affects the growth of services.

> 'Modern economies need to constantly reallocate resources including labour from old to new products, from bad to good firms.'
>
> (Olivier Blanchard, quoted by *Economist*, 2006b, p. 32)

Introduction

In modern developed economies the service sector, which encompasses a wide array of activities from low-tech plumbing to website design, generates new jobs. Seven out of ten posts in rich countries are created in services. In Anglo-Saxon economies services account for three-quarters of income and four-fifths of jobs. Yet in France, Germany and Italy the service sector accounts for six to ten percentage points fewer in terms of income and jobs. Symptomatically, in continental Europe a relatively large proportion of the workforce is still employed in union-dominated manufacturing.

In contrast to Britain, French and German unions remain – despite falling membership numbers – a force to be reckoned with. In principle, the power of the trade union movement stems from the legislation protecting its activism, most notably, the right to strike or the requirement for workers councils. And high on its agenda is job security, guaranteed by high employment protection legislation, which was introduced during the manufacturing-driven post-war boom. Hence continental unions are determined both to thwart efforts to ease strict employment protection legislation and to pressurise governments into protecting their posts through subsidies and other interventionist measures.

Yet employment protection legislation, whilst possibly fulfilling its stated purpose of protecting existing jobs, discourages new job creation. And this, coupled with the anti-reformist activism of trade unions, lends credence to the hypothesis that employment protection legislation has lain behind an insider–outsider labour market, which discriminates against job-seekers and those on temporary contracts. Unionists – as classic insiders in well-protected jobs – block attempts to reduce labour market rigidities that, applying across-the-board, impede job creation in services.

This article argues, therefore, that strict employment protection legislation in continental Europe not only leads to higher unemployment rates and labour market dualism, but also negatively affects the growth of services. In other words, stringent firing and hiring procedures can be understood as constituting an obstacle that prevents

labour flowing from declining to promising industries, thereby slowing down the shift to a more advanced stage of socio-economic development. The next section focuses on statistical correlations between employment protection legislation and union protection and unemployment. We then examine a link between the former two variables and employment in services. Then, bearing in mind that simple correlation is not tantamount to statistical causality, we will attempt to explain why there might be a causal link between these seemingly separate phenomena.

Statistical links between employment protection legislation, unionisation, unemployment and services

Employment protection legislation is one of the most important areas of labour market regulation. It can be defined as a set of rules governing the hiring and firing process that can arise through both labour legislation and collective bargaining agreements (OECD, 2004, p. 64). Siebert (2005) notes that, 'a supportive legal environment for collective bargaining reinforces strict laws on employment protection' (p. 4). Employment protection legislation is supposed to provide employees with a sense of job security and hence is thought of as improving their welfare.

Our summary measure of employment protection legislation strictness is based on three components: (1) protection of regular workers against dismissal; (2) specific requirements for collective dismissals; (3) regulation of temporary forms of employment. These all vary sharply from country to country. Thus at one extreme are Anglo-Saxon economies with very low employment protection – the USA's overall index stands at 0.7 and Britain's at 1.1. At the other extreme are continental states whose indices reach much higher values: 2.5 for Germany and 2.9 for France (OECD, 2004, p. 117). The root cause of the disparities is seen in different economic models and legal systems (Botero *et al*., 2004, p. 1340). Continental Europe, influenced by French dirigisme and its 'civil code', has stricter employment protection legislation, whereas Anglo-Saxon countries, founded on the English common law and economic liberalism, are characterised by low protection.

It is also necessary to take into consideration laws protecting unions and reinforcing their influence. Indeed, the two types of regulation – the strictness of employment protection legislation and the degree of union protection – tend to go together (Siebert, 2005, p. 3), at the same time, reflecting the aforesaid distinction (see also Table 1).

Most of the literature on employment protection legislation emphasises the parallel between employment protection legislation and an employer-borne tax (on employment adjustment) to reflect the cost implications of various regulatory provisions for employers. The stricter is employment protection legislation, the more costly it is for the employer to fire. So it is often argued that strict employment protection legislation damages labour market performance (see, for

Table 1: Correlations between employment protection legislation and union protection and unemployment

	Unemployment rate (%)	EPL (0–6)	Union protection index (0–1)
Australia	5.5	1.5	0.37
Austria	5.2	2.2	0.36
Belgium	13.2	2.5	0.42
Canada	7.2	1.1	0.20
Denmark	4.8	1.8	0.42
Finland	8.4	2.1	0.32
France	9.8	2.9	0.67
Germany	11.6	2.5	0.61
Greece	9.8	2.9	0.49
Ireland	4.2	1.3	0.46
Italy	7.7	2.4	0.63
Japan	4.4	1.8	0.63
Netherlands	4.7	2.3	0.46
New Zealand	3.9	1.3	0.25
Norway	4.6	2.6	0.65
Portugal	7.6	3.5	0.65
Spain	9.2	3.1	0.59
Sweden	6.3	2.6	0.54
UK	4.7	1.1	0.19
USA	5.1	0.7	0.26
Regression on unemployment rate	Correlation index	0.56	0.78
	Slope	1.98	5.40

Source: Unemployment rate, OECD (online), Paris (accessed 12 July 2006). Available at: www.oecd.org; EPL, OECD (2004); union protection index, Botero *et al.* (2004) (website dataset). (The data within Tables 1 to 3 do not cover exactly the same period for all variables, as is indicated in the original sources.)

Table 2: Correlations between employment protection legislation and union protection and employment in services

	Employment in services (% of total employment)	EPL (0–6)	Union protection index (0–1)
Australia	74.9	1.5	0.37
Austria	67.2	2.2	0.36
Belgium	73.1	2.5	0.42
Canada	75.0	1.1	0.20
Denmark	73.1	1.8	0.42
Finland	69.3	2.1	0.32
France	72.6	2.9	0.67
Germany	66.6	2.5	0.61
Greece	64.9	2.9	0.49
Ireland	65.9	1.3	0.46
Italy	64.5	2.4	0.63
Japan	67.1	1.8	0.63
Netherlands	76.6	2.3	0.46
New Zealand	69.8	1.3	0.25
Norway	75.6	2.6	0.65
Portugal	56.5	3.5	0.65
Spain	64.0	3.1	0.59
Sweden	75.2	2.6	0.54
UK	76.4	1.1	0.19
USA	78.4	0.7	0.26
Regression on employment in services	Correlation index	–0.6	–0.50
	Slope	–4.1	–17.50

Source: Employment in services, OECD (online), Paris (accessed 12 July 2006). Available at: www.oecd.org; EPL, OECD (2004); union protection index, Botero *et al.* (2004) (website dataset).

instance, Heckman and Pagès, 2000) and, along with substantial union protection, lies behind much higher unemployment rates in Europe. As emerges from Table 1, there is indeed a statistically significant, positive correlation between these variables. Economies with stricter employment and higher union protection have higher unemployment rates.

Some studies, however, accentuate positive aspects of employment protection legislation and present economic justification for its existence. Above all, it is suggested that employment protection legislation can be, as mentioned above, welfare-improving by safeguarding workers' income against labour market uncertainty. This takes as its premise that workers are risk-averse and have no possibility of insuring themselves privately against insecurity. Given this, it could be in the interest of both the employer and the employee to include in the employment contract provisions that protect workers against the loss of income in the event of dismissal (Pissarides, 2001).

That argument is often pushed further. It is argued that, considering that the government finances unemployment benefits and other public goods from payroll and income taxes, the social value of a job may well be higher than its private value. A post might well be unproductive and hence cost-incurring for the employer, but still offer some benefits to society because keeping the job avoids the payment of unemployment benefit. Thus, the argument goes, without government intervention there would be too many lay-offs relative to what is socially desirable. (For a discussion of positive employment protection legislation effects on staff commitment, see Belot *et al.*, 2002.)

As OECD (2004) admits, the implications of employment protection are controversial, both in theory and in applied research (p. 62). Nevertheless, it is instructive to look at another relationship that shows the link between employment protection legislation, union protection and employment in services (see Table 2). In line with what has been argued in the introduction, the service sector, being the main provider of jobs, is the backbone of modern economic systems. It has to be remembered that services should not only be associated with low-skilled jobs in hotels and restaurants, but also with high-skilled occupations. Big retailers are now the world's most high-tech-intensive companies. In this sense, considering the stress laid on the necessity to develop a knowledge-based economy (European Commission, 2000), the size of the service sector might be regarded as an emblem of modernity.

As can be seen from Table 2, there is a statistically significant, negative correlation between employment protection legislation and union protection and employment in services. So countries with stricter employment protection legislation and higher union protection have lower rates of employment in the service sector. It follows that labour market rigidities may not only lie behind higher joblessness levels, but also affect negatively the growth of services. Hence it seems pertinent – accepting that, of course, correlation does not prove causation – to ask why employment protection legislation and unionisation might constitute an obstacle to development of the service sector. Thus the next section provides a theoretical explanation of why there may be a causal connection between the phenomena in question.

Economic mechanisms lying behind a causal connection

The question of why employment protection legislation, along with unionisation, might affect service-sector growth is a complex one. Yet it is possible to highlight a number of economic mechanisms that could lie behind that link. These are:

- the pace of technological progress and its impact on the socio-economic paradigm;
- the power of insiders (trade unionists in manufacturing and the public sector) and the incidence of labour market duality;
- the prevalence of union-dominated collective bargaining and union-inspired protectionism.

Employment protection legislation may well fulfil its stated purpose of protecting existing jobs. However, this comes at a cost as employment protection discourages new job creation. In recent years, due to globalisation-driven trade and the rapid pace of technological progress, the process of job churning has intensified. This means that businesses are set up and wound up on a larger scale than in the recent past.

The acceleration of job churning is spurred by innovation. As new products – often intangible products – are devised, service-sector firms are established to bring them to the market. Furthermore, an increasing number of tangible goods are endowed with a 'knowledge input' in the form of design, technology or customer service (Woodall, 2000, p. 29). For example, the latest models of cars are so technologically advanced that it is impossible for an amateur mechanic to repair the simplest defect without recourse to a service station.

In this sense, as new jobs are predominantly generated in the service sector, stringent employment protection legislation, by imposing additional costs and constraints on existing and *potential* employers, acts as an impediment to the growth of the service sector in continental Europe. In the same vein, excessive red tape, which complicates and lengthens the process of starting up businesses, stifles entrepreneurship and is not conducive to generating new employment.

Accordingly, de-industrialisation, or the disappearance of industrial jobs, is regarded as a sign of economic decline when in a de-regulated economy it could be a sign of renewal. In fact, de-industrialisation is a natural phase of socio-economic development. As a country becomes richer, a lower percentage of workers is needed in manufacturing as consumer demands change and productivity increases in the manufacturing sector. But, as workers move from manufacturing into more valuable areas of economic activity overall economic welfare increases.

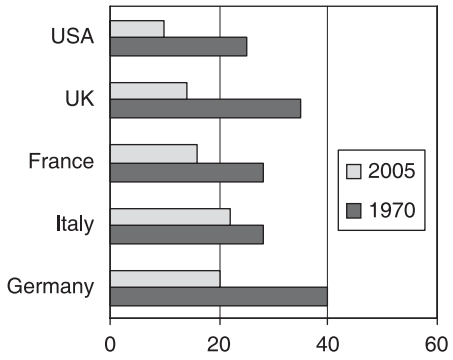

Figure 1: Jobs in manufacturing (% of total employment)
Source: OECD (online), *OECD in Figures – 2005 edition*, Paris (accessed 5 March 2006). Available at: www.oecd.org; Eurostat (online), *Employment in Manufacturing 2003*, Brussels (accessed 24 March 2006). Available at: http://epp.eurostat.cec.eu.int/.

In continental Europe, these changes are not occurring to as great a degree. A considerable proportion of the workforce still holds posts in the manufacturing sector (see Figure 1). Whereas in Anglo-Saxon economies services account for three-quarters of income and four-fifths of jobs, in France, Germany and Italy the service sector accounts for six to ten percentage points fewer in terms of income and jobs. In other words, the flow of jobs and capital from declining to expanding industries in Germany, France and Italy has not been as high as in Britain or the USA. Crucially, however, not only does manufacturing play a non-negligible part in continental economies, but it is also dominated by trade unions.

Unions in the manufacturing sector consequently thwart efforts to ease employment protection legislation (Gelauff and Pomp, 2000) to protect their own job. This is fraught with implications as employment protection legislation *de facto* leads to two opposite effects on labour market dynamics. It reduces inflows into unemployment from existing employees and renders it more difficult for job-seekers to enter employment, thereby lowering outflows from unemployment. This, coupled with the anti-reformist activism of unions, lends credence to the hypothesis that employment protection legislation has lain behind the emergence of an insider–outsider labour market.

Insiders – people within a system (those on permanent contracts in well-protected employment) – see free-market reform as bringing about the end of their privileged status as protected insiders. To them, the possible gains from change are worth less than the risk of losing what they have already, as insiders in the labour market.[1] As a result of the success of insiders in protecting their own status, outsiders, i.e. job-seekers and those on temporary contracts, do not benefit from employment security and stand less chance of entering the inner circle. In this way, a two-tier (dual) system emerges. The campaigns of trade unionists are entirely rational from a self-interested, welfare-maximising point of view according to this analysis.

Table 3: Relationship between employment protection legislation and female unemployment

	Female unemployment rate (% of female labour force)	EPL (0–6)
Australia	5.5	1.5
Austria	5.5	2.2
Belgium	14.6	2.5
Canada	6.8	1.1
Denmark	6.2	1.8
Finland	8.9	2.1
France	11.0	2.9
Germany	9.3	2.5
Greece	15.9	2.9
Ireland	3.7	1.3
Italy	10.6	2.4
Japan	4.4	1.8
Netherlands	5.2	2.3
New Zealand	4.4	1.3
Norway	4.0	2.6
Portugal	7.6	3.5
Spain	15.0	3.1
Sweden	6.2	2.6
UK	4.2	1.1
USA	5.4	0.7
Regression on female unemployment	Correlation index	0.6
	Slope	3.05

Source: Female unemployment rate, OECD Ò(online), Paris (accessed 12 July 2006). Available at: www.oecd.org; EPL, OECD (2004).

This, therefore, could provide a causal explanation of the statistical correlation between employment protection legislation, unionisation and slow growth in services: high protection of unionised jobs that are predominant in manufacturing reinforces unions' power as insiders; unions use their clout to preserve labour market rigidities which, as shown above, affect negatively the expansion of job-providing services; those outside employment lose as new service industries do not expand; those inside the labour market gain from increased job security, at least in the short term.

The situation is further aggravated by union-dominated collective bargaining. In Germany, for example, in sectors employing skilled labour, powerful trade unions systematically obtain pay rises. Then these wage increases are transferred to other industries, including those employing unskilled workers, thus translating into 'unjustifiably' high wage levels (not justified by higher productivity), which is likely to discourage lower-end job creation. Bentolila and Dolado (1994) also suggest that the larger the incidence of temporary forms of employment, the bigger the bargaining power of insiders. Likewise, as Pelkmans and Casey (2004) note, trade unions, insisting on solidarity and equality, ignore the fact that collective bargaining does not allow for regional disparities in costs and productivity, which reinforces disincentives to employment generation in less developed regions – again creating outsider groups.

This, as already noted, hits especially hard at the low-wage end of the service sector. In services where no special skills are required more jobs might potentially be created if the effects of the power of insiders were minimised. Insufficient job creation in services has a particularly negative effect on the employment prospects of certain social categories. As emerges from Table 3, there is a statistically significant, positive correlation between employment protection legislation and female unemployment. So in continental economies, marked by stricter employment protection, more women stay out of work. This is because services are the main provider of jobs for women,[2] young school leavers and the elderly. Indeed, countries with the highest share of services also have the highest labour-participation rates for women as well as people aged below 24 and over 55.

Likewise, by opposing EU-wide liberalisation of the service sector, as exemplified by union-led protests against the introduction of the so-called Bolkestein directive, labour organisations deprive all citizens of cheaper but good-quality services (Polish plumbers, for example), thereby impeding economic growth. As a consequence, national labour markets together with welfare systems bear all the characteristics of 'a fortress' (Veil *et al*., 1997), which is itself a hindrance to economic activity.

Alternative hypotheses

That the growth of the service sector is slower in continental Europe than in Anglo-Saxon countries can be put down to other factors. This section therefore aims to explore those alternative mechanisms. Trade unions, whose power is not only buttressed by favourable legislation, but also by widespread public sympathy, pressurise decision-makers into protecting their jobs via interventionist measures in the form of state subsidies or trade barriers (quotas and customs duties imposed on Asian goods). In line with public choice theory (see, for instance, Saint-Paul, 1996), trade unionists – unlike the unemployed (who are numerous and heterogeneous) – are homogeneous and well-organised, which effectively helps them further their ends.

As, under union pressure, priority is given to current consumption – be it public aid to declining industries or generous welfare provisions – rather than to investment, the gap in overall research and development spending and education investment between the USA and the EU is widening (2.8% of GDP in the USA against 2.0% in the EU in 2003). In the same year, France and Germany spent 1.0% of GDP on their universities, whereas the USA spent 2.7%. There are also weak links between academia, business and government in Europe. It is no coincidence that the EU produces only one-quarter of the number of patents per million

people as are produced in the USA. All this has serious ramifications.

It is now commonly recognised that knowledge and technological progress are the important determinants of growth (Porter, 1990; Barro and Sala-i-Martin, 1995). It transpires that the pace of technological change – and, consequently, economic growth – hinge, to a large extent, on governments and firms. It is both politicians and managers that decide how much to spend on research and development and the upgrading of human capital. As economies are increasingly based on knowledge, they obviously necessitate well-educated, highly-skilled labour. There is evidence that countries investing in human capital and education grow faster than those spending less (Barro and Sala-i-Martin, 1995).

That skills and education are of such value is conditioned by the very process of innovation and the nature of creativity, defined as 'the ability to combine existing information in new ways, producing [new] knowledge' (Jensen-Butler, 1996, p. 252). Yet, as Elam (1993) points out, there are two basic prerequisites of successful innovation: information and the capacity to process and interpret it (p. 63). That is why information has no meaning until it is complemented by personal knowledge and experience and interpreted by a skilled person (Te Velde, 1999).

As mentioned above, given that innovation and service industry growth go together, less money spent on education and research and development might affect the capacity to innovate and thus slow down growth of the service sector. In this sense, the fact that in continental economies considerable financial resources are devoted both to protecting jobs in manufacturing and to short-term consumption (with resulting lower investment in education and research) is a portent of trouble and a symptom of economic weakness.

Spending on innovation activity and new technologies enhances productivity. Indeed, higher rates of investment in ICT in America and Britain has laid behind faster productivity growth in services there. Since 1995, productivity growth in the service sector has been less than 0.5% a year in the eurozone, 3% in the USA and 2% in Britain (*Economist*, 2006a, p. 28). This not only boosts service industries, but also translates into higher living standards.

Also, it is manufacturing industries, rather than services, that are currently far more vulnerable to the vicissitudes of globalisation. That is why countries such as Italy and Germany with 20–25% of jobs in manufacturing are likely to be challenged by mounting competition from Eastern Europe and Asia. People working in restaurants or hotels simply have to be physically present to provide their services. Of course, it is true that ICT might equally threaten service jobs in rich countries, but empirical evidence does not bear this out. Relocation of services is a limited phenomenon and concerns mainly routine activities (European Commission, 2005, p. 96). Amiti and Wei (2005) conclude that there is no evidence of net service jobs exports from the USA to developing countries. The UK and the USA are *de facto* net exporters of business services (European Commission, 2005, p. 173).

It should also be considered that when some functions are moved offshore or production shifted to low-cost countries (which is opposed by unions in France and Germany), the purchasing power of local employees increases. Higher disposable incomes in poorer countries mean that their emerging middle classes can increasingly afford service imports from developed countries (including investment in higher education).

Thus there might be other factors lying behind a statistical correlation between employment protection legislation and unionisation and growth of the service sector. Indeed, it could be argued that the ability to generate innovation is assuming a strategic importance and is increasingly seen as the key to preserving a competitive advantage. There is a growing risk that the entire EU – and continental economies in particular – will systematically lose its competitiveness.

Yet, apart from spending on education and research and development, there is another dimension to competitiveness: flexibility. Flexibility is undermined by, amongst other things, the strictness of employment protection legislation. This, in turn, brings us back to the crux of the present article. Less dynamic growth of services in continental economies could be attributed both to higher employment protection legislation and union protection, on the one hand, and to inadequate expenditure on research and development and education, on the other. Likewise, both are likely to lead to a fall in competitiveness (being, in fact, the two sides of the same coin; see also Young, 2003).

It seems, however, that it is employment protection legislation and unionisation that should be understood as being the root cause of slower growth of the service sector. Excessive employment protection constitutes a far bigger obstacle to its development because, due to its structural character, it effectively hinders the re-allocation of resources. The key to socio-economic advancement requires the removal of the barriers that prevent labour (and capital) flowing from declining to prospective industries. As the Industrial Revolution gathered strength 200 years ago, labour was massively shifted from agriculture and low-scale production to manufacturing. In the nineteenth century, employment protection legislation and union protection was very low or non-existent. Today, with the IT revolution accelerating and a knowledge-based economy becoming a reality, resources have to be transferred

from (declining) manufacturing to expanding services. Yet for this to happen, flexibility – hence lower employment protection legislation – is called for.

Indeed, the research and development investment argument could be turned the other way round. Private investment in research and development and education could be hindered by the low prospective returns arising from the reduced opportunities to exploit the gains from investment because of the inflexibility of EU economies. Low investment may be an entirely rational response to a lack of flexibility.

Conclusions

It transpires that there is a conflict between a particular group of employees, who value job and income security, and the economy as a whole, which needs flexibility to develop and grow. Low employment protection legislation – at least in the eyes of many Europeans accustomed to job security and welfare – is a US-inspired threat to their well-being. In the words of Hofheinz, 'Europeans do not really take services seriously. We tend to think of the economy as manufacturing, and of jobs in terms of industrial jobs, with a big salary, lots of benefits and security' (quoted by *Economist*, 2006a, p. 28).

Nonetheless, in the age of knowledge and services, employment security might be perceived differently. Rather than seen as job and income stability – guaranteed by employment protection legislation and, in part, generous unemployment benefits – employment security could be identified with employability, i.e. the possibility of finding a job rapidly in the event of being fired. This can be facilitated by active labour market policies designed to accelerate transition from unemployment to employment via job-search assistance, vocational training or re-qualification schemes, etc.

To put it differently, nowadays the employee's recognition that the 'human capital' he or she 'embodies' is in demand in the jobs market or that in case of dismissal he or she will be helped to acquire such capital should equally be seen as a source of security (of course, low unemployment reinforces it, too). In this sense, the Danish model of flexicurity (OECD, 2004, p. 97) comes to mind. In Denmark, not least thanks to union co-operation, employment protection legislation is not strict. This provides flexibility for the employer. However, active labour market policies are well-targeted, and this offers a sense of security for the employee.

That is why a failure to ease employment protection legislation and reduce the power of insiders is not only likely to reinforce labour market dualism, discriminating against unemployed outsiders, but is also likely to slow down the shift to a more advanced stage of development.

1. See the discussion in *Economist* (2006b, p. 32).
2. There could be many reasons why women gravitate towards services. However, it should be clear that they are 'outsiders' during the time they have children unless they choose to return to work immediately. Their position as outsiders leads them to lose out from the lack of job creation that takes place in economies where 'insider' (often male-dominated) jobs are protected.

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