The unintended consequences of an Italian labour protection law

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Legislation aimed at protecting employees can damage firms' productivity, according to our research. Our study of the effects of a law in Italy that raised the cost to small businesses of dismissing staff finds that these firms increased their capital stock but that their overall productivity declined.

Employment protection legislation – the set of rules and procedures governing the firing (and hiring) of employees – is an institution designed to enhance job security, insuring workers' income against labour market fluctuations. Yet, by increasing employers' costs of adjusting the workforce in bad times, such legislation can also generate a barrier to hiring in good times. Accordingly, a large body of work has analysed the labour market consequences of changes in employment protection legislation both within and across countries.

As the authors note, however, the impact of higher dismissal costs might extend beyond the labour market affecting firms' investment decisions and ultimately their productivity. For example, by raising the relative cost of labour as a factor of production, higher dismissals costs might induce firms to substitute capital for workers. If this implies adopting a sub-optimal combination of productive factors – resource misallocation – productivity would fall.

These aspects of employment protection legislation have been neglected in the longstanding and often heated policy debate on its costs and benefits.

The study estimates the impact of dismissal costs on 'capital deepening' – the capital to labour ratio – and productivity by analysing an Italian reform that introduced unjust dismissal costs for small firms while leaving firing costs unchanged for other firms. Specifically, this law introduced severance payments of between two and a half and six months' pay for unfair dismissals in firms with fewer than 15 employees. Dismissal costs are much higher in larger firms, but they were untouched by the reform.

We show that the higher firing costs increased capital deepening and induced a decline in total factor productivity in small firms relative to larger firms. Their results indicate that firms just below the threshold of 15 employees increased their capital stock by nearly 5 per cent relative to those above the threshold because of the change in legislation – see Figure 1. Moreover, these firms saw their total factor productivity level decrease by 3 per cent relative to larger firms.

These findings are not a priori obvious because, in principle, there may be several offsetting effects. For example, higher dismissal costs may exacerbate the 'hold-up' problem typical of investment decisions (due to the fear that investment rewards may be appropriated by workers), thus lowering the stock of capital per worker. The estimates in this study indicate instead that the most likely effect is substitution of capital for labour.

The results also indicate that capital deepening is more pronounced in firms with low initial levels of capital (where the reform hit arguably harder because of the high incidence of labour costs) and among firms endowed with a larger amount of liquid resources (which could more easily finance the additional investment).

Finally, the research also finds an effect on the workforce composition, as stricter employment protection legislation raises the share of high-tenure ('senior') workers. Because workers' seniority is often interpreted as a measure of firm-specific human capital (skills and knowledge that have productive value only in that particular company), this suggests a complementarity between firm-specific and physical capital in environments of moderate employment protection legislation.

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- *The post gives the views of the author, not the position of LSE Business Review or the London School of Economics.*
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