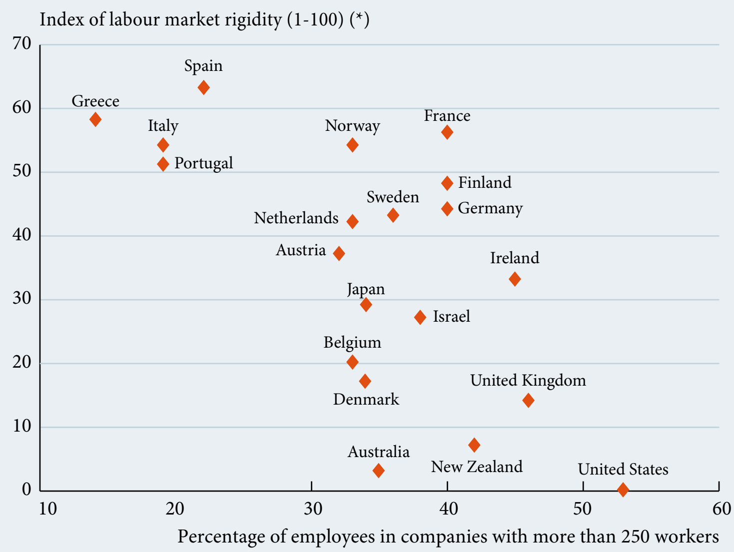
Does labour regulation allow company growth?

Labour market regulation is in the firing line. Most European countries have changed or are about to change some key aspects of their legislation. The fear of an economic standstill has placed issues firmly on the table that had, until very recently, been taboo, such as dismissal costs and collective bargaining. The reforms being discussed appear to be broad and far-reaching. However, almost nothing has been said about the different labour legislation conditions for companies depending on their size. According to several studies, this aspect could be vastly limiting the growth of the production fabric of the main countries in Europe.

As has been mentioned in the box «Companies and productivity: a matter of size» generally speaking company size is crucial in being able to improve productivity and gain export share. Labour market regulation is also related to all this. There is a clear correlation between the degree of flexibility of the labour market and company size. As can be seen in the graph below, those countries with a more flexible labour market have a higher percentage of people employed in large firms.

THE MORE FLEXIBLE THE LABOUR MARKET, THE LARGER THE COMPANIES



NOTE: (*) Higher index numbers are associated with greater rigidity in the labour market.
SOURCES: OECD, World Bank and own calculations.

This relationship, however, cannot be interpreted causally. It might be the case, for example, that countries with a more rigid labour market specialize in industries where the optimum company size is smaller. A study published by the Organization for Economic Cooperation and Development (OECD) uses more sophisticated statistical techniques that precisely take this kind of consideration into account.[1] Its conclusion is categorical: excessively restrictive labour market legislation makes it difficult for many companies to grow. This means that companies

(1) See «Product and labour markets interactions in OECD countries» (2001). G. Nicoletti, A. Bassanini, E. Ernst, S. Jean, P. Santiago and P. Swaim. WP 312.

that are very productive and that can potentially employ a large number of people limit their size; and vice versa, firms that should disappear or be very small take advantage of this and, although they are not very productive, are considerably large.

This connection could be particularly worrying in Spain. As can be seen in the graph above, Spain appears as one of the countries with the most rigid labour market regulations and, at the same time, is one of the countries with the smallest share of large firms. The aforementioned study tells us little about which aspects of labour legislation might be key. However, analyses have been carried out of specific cases and these can provide us with clues as to the potentially decisive aspects.

In France, for example, the percentage of large firms is significantly smaller than in the United States or the United Kingdom. Some studies have related this to labour costs being significantly higher for firms with more than fifty workers. These firms, for example, if they want to dismiss 10 or more workers, have to offer them a social plan that must be approved by the Ministry of Labour; or they must set up a health and safety committee of their workers, whose members must be appropriately trained by the company. A study by L. Garicano et al. concludes that a large number of companies decide to remain just below the threshold of 50 workers in order to avoid this regulation and this therefore has huge consequences for the growth capacity of France's productive fabric.[2] In fact, they estimate that the cost generated by this legislation is equivalent to a wage rise of between 5% and 10%.

The proportion of small firms in Italy is also very large and, in part, this is also due to discriminatory treatment in labour regulation depending on company size. For example, in a dismissal declared wrongful by a court, companies with more than 15 workers must readmit the worker or pay compensation equivalent to 15 months' salary. Firms with fewer than 15 workers do not have to readmit the worker and the compensation that must be paid ranges from 2.5 to 6 months' salary. Redundancy costs also increase considerably as from 15 employees. These are just two examples of the higher labour costs for Italian firms with more than 15 workers. According to a study by Borgarello et al., the impact on the distribution of company size is significant.[3]

Portugal is another country where labour market regulation varies considerably depending on the size of the company. In fact, some studies state that this aspect is one of the key factors underlying the country's low productivity in the last decade.[4] Among the different distortions, of note are, on the one hand, the subsidies offered to firms with fewer than 50 workers for hiring young people and for investment and, on the other, the reduced red tape for companies with fewer than 20 workers in dismissals on objective grounds.

In Spain, the relationship between company size and labour market regulation has yet to be studied in depth but the aforementioned examples for France, Italy and Portugal are quite similar to Spanish legislation. For example, dismissal costs are not the same for all firms. For those with fewer than 25 workers, and in the case of objective dismissal, out of the compensation package of 20 days' pay per year worked, 8 are provided by the Wage Guarantee Fund. The entrepreneur support contract offers significant fiscal benefits to companies with fewer than 50 workers and union representation costs increase as a firm gets larger.

(2) See «Firm Size Distortions and the Productivity Distribution: Evidence from France» (2012). L. Garicano, C. Lelarge and J. V. Reenen.
(3) See «Identifying the effects of firing restrictions through size-contingent differences in regulation», F. Schivardi and R. Torrini, Labour Economics, 2008. Also «Employment Protection Legislation and the Size of Firms», A. Borgarello, P. Garibaldi and L. Pacelli, IZA Discussion Papers, 2003.
(4) See «The incredible shrinking Portuguese firm», S. Braguinsky, L. G. Branstetter and A. Regateiro, NBER WP 17265, 2011.

The growth prospects of the Spanish economy are not at all encouraging. In 2012, activity is more than likely to fall sharply again and, in the medium term, any recovery will be hindered by a domestic demand that is still completing its deleveraging process. The great challenge facing the Spanish economy is therefore to improve its productivity and set its sights on export markets. Many firms are already doing this and are world leaders in their sector. The obstacles for those companies that can and want to follow this path must be minimal. Spain must be sure that labour market regulation does not penalize them but actually supports them.

This box was prepared by Oriol Aspachs Bracons
European Unit, Research Department, "la Caixa"