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Labour Market Flexibility and Decent Work

Gerry Rodgers

Abstract

This paper reviews evidence from both industrialized and developing countries on the relationship between labour market flexibility and employment. It is argued that the notion of flexibility and its impact is often oversimplified. The evidence, such as it is, does not provide much support for the view that greater flexibility results in higher employment. There is more evidence for an impact on the distribution of employment among different groups of the population, but also effects which vary widely between countries. Flexibility needs to be considered within a wider framework of policies and institutions to promote decent work.

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Gerry Rodgers is Director of the ILO's International Institute for Labour Studies. An economist, he has worked on labour market institutions, poverty and employment, social exclusion and decent work, mainly in Asia and Latin America. E-mail: rodders@ilo.org.

Comments should be addressed by email to the author.

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Editor:

Typesetter: *Valerian Monteiro*

United Nations
Department of Economic and Social Affairs
2 United Nations Plaza, Room DC2-1428
New York, N.Y. 10017, USA
Tel: (1-212) 963-4761 • Fax: (1-212) 963-4444
e-mail: esa@un.org
<http://www.un.org/esa/desa/papers>

Labour Market Flexibility and Decent Work

Gerry Rodgers¹

Debates on labour market flexibility are not new, although the term itself only became popular in the 1980s. Historically, the evolution of labour markets has been marked by periods when market forces dominated thinking and policy, alternating with periods when there was a spread of institutions to provide representation or regulate outcomes. Polanyi's analysis of the development of the capitalist system in the latter part of the 19th century and the early part of the 20th century drew particular attention to the tensions which arise when economic relationships are separated from their social context, and it is certainly true that much labour market regulation reflects efforts by governments and other actors to address the consequent need for coherence between economic and social goals and relationships.

Flexibility tends to become a metaphor for unfettered markets. Yet, there is no such thing, for markets, whether for labour or for anything else, function effectively only because they are surrounded by a set of institutions which generate common rules, reflect the interests of participants and guide behaviour. This is all the more so in the market for labour, which is in reality a social institution, not only supporting work and production, but also impacting on representation, social integration and the personal goals of its participants. So, one must start by being wary of simplified arguments about the role of labour market institutions.

In industrialized countries, labour market flexibility was part of the strategy proposed by the OECD in its *1994 Jobs Study*—which regarded higher job creation in the US compared with Europe as due to greater flexibility in the former—and both the World Bank and the IMF have often taken a similar view. The *2005 World Development Report*, for instance, argued that labour market deregulation would improve the investment climate, while the IMF has taken the position, in discussions on policy coherence among international organizations, that labour market flexibility is key to employment creation. However, other views can also be found in World Bank publications, while the OECD's views have evolved, and its *2004 Employment Outlook* calls for a more pragmatic approach to labour market reform.

At the risk of oversimplifying the discussion, changing views of labour market flexibility can be interpreted as reflecting changes in the model of growth and development. In a Keynesian world, where technical change and aggregate demand drive growth, labour market institutions and regulation reflect a social compromise among social actors, which stabilizes economic relationships. This was the dominant pattern in industrialized countries in the period after the Second World War up to the early 1970s. When this model broke down, macro-economic policy shifted towards a more restrictive monetarist stance, emphasizing control of inflation and supply side incentives. In such a world, micro-flexibility is essential to generate economic adjustments.

The constituents of the ILO—workers, employers, governments—have quite different views of this issue. Not surprisingly, employers favour flexibility more than workers. World Bank surveys in a fairly large number of countries found 34 to 38 per cent of firms reporting that employment protection legislation is a moderate or major obstacle for them. Equally unsurprising, workers tend to be sceptical of the benefits of flexibility. And the positions of governments vary widely. So there is no agreed ILO position on this issue, despite its obvious importance for the ILO's decent work agenda.

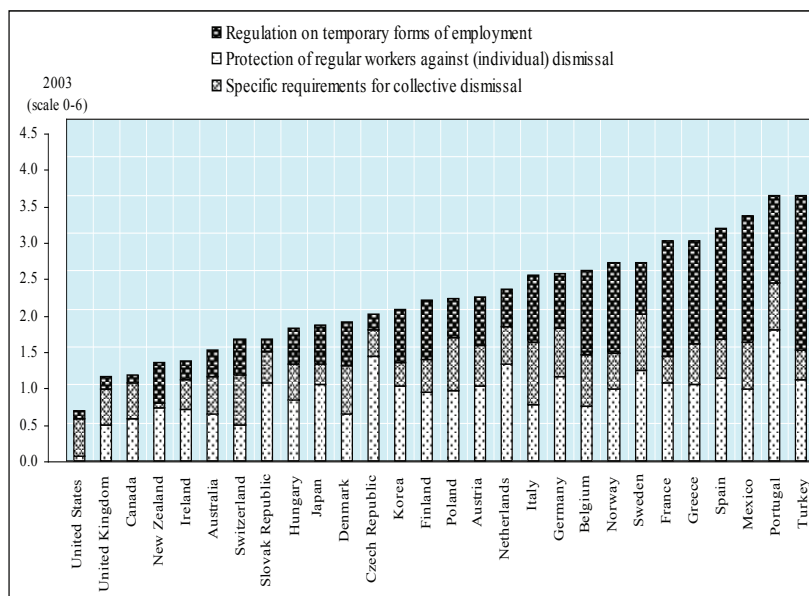
1 The views expressed here are personal and do not commit the ILS or the ILO. Thanks are due to Peter Auer for helpful comments.

The forms of flexibility

The flexibility of a labour market might be defined as its ability to adapt and respond to change (Rubery and Grimshaw, 2003). Several different dimensions of flexibility are identified in the literature:

- *Employment protection.* Employer freedom to hire and fire is at the heart of debates on flexibility. Employment protection measures, of course, have a double effect, reducing both inflows to and outflows from employment, so the net impact on employment and unemployment is ambiguous *a priori*. However, reducing these flows overall is likely to limit firms' ability to adjust to changing circumstances. Levels of protection vary widely across OECD countries (Figure 1). In most countries alongside the protection of regular, standard jobs a variety of temporary or otherwise less protected employment statuses are also a widely used means of flexibility.
- *Wage flexibility.* A variety of institutions and regulations may limit wage variation, including minimum wage regulation, trade union activity and the extent to which there is coordinated wage bargaining.
- *Internal or functional flexibility.* This largely concerns the ability of firms to organize and reorganize internal processes of production and labour use in the interests of productive/dynamic efficiency, e.g. through the flexibility of working time, job content, skill needs or technical change.
- *Supply side flexibility:* While attention tends to focus on flexibility in labour demand, there are important issues on the supply side too. Workers may demand flexibility in working time to meet work and family needs, or the portability of rights and entitlements which would permit mobility between jobs.

Figure 1.
Strictness of employment protection legislation



Source: OECD (2004).

A central element of the debate on flexibility concerns the relative importance of adaptability and security. Both firms and workers need both. Insofar as labour market flexibility implies a lessening of control of workers over their employment, it may affect both perceived and real security. However, attitudes to flexibility and security to a significant degree reflect social preferences. Some societies give a greater value to mobility and others to stability. Even at this simple level, there is no universal formula. A more sophisticated understanding of the importance of flexibility and stability for enterprises, and the different forms of security demanded by workers, is called for.

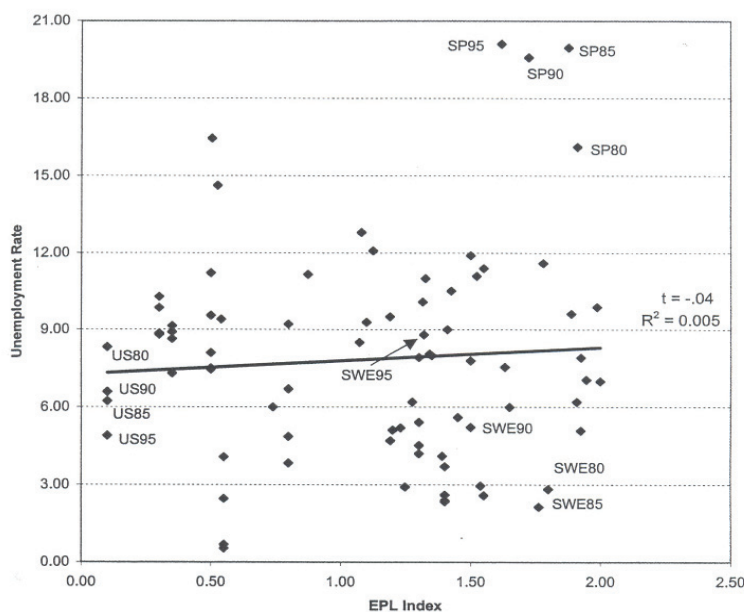
The effects of flexibility and inflexibility

There is a widespread argument today that can be paraphrased as follows: The slow and inadequate growth of employment around the world reflects labour market institutions which provide a disincentive to job creation. Highly regulated labour markets were easier to maintain in relatively closed economies, where competitive pressures were less. But globalization has sharply increased the range and intensity of competition, and more adaptable production systems and labour markets are essential if firms are to survive in the new global economy. Conventional economic models support this argument. In such models, where wages and conditions of work adjust more rapidly to market forces, full employment is much more easily attained.

So essentially, the argument is that in a globalized economy, flexibility is a precondition for employment creation. How far is this position supported by the evidence? It is an issue on which a great deal of work has been undertaken in OECD countries in particular. The results are surprisingly muddy.

First, the relationship between employment protection and aggregate employment or unemployment is weak. Different studies show varying different results. Baker and others (2005) show that the direct relationship between employment protection and unemployment is insignificant (Figure 2), and this is confirmed by more sophisticated multivariate analyses. Baccaro and Rei (2005) find the same result in virtually all of a wide range of specifications, including corrections for a variety of possible econometric and substantive biases. Other authors report varying results depending on the specification of their models. The OECD *Employment Outlook 2004* concludes, on the basis of extensive empirical work, that employment protection does not clearly lead to higher unemployment, although it was found to be associated with lower employment rates. But Baccaro and Rei's work does not support the latter conclusion either.

Figure 2.
Labour market institutions and unemployment: Employment protection



Source: Baker and others (2005).

On the other hand, the OECD finds that employment protection legislation may change the distribution of employment. While prime age males benefit, younger people and women seem to be disadvantaged. This is plausible, in so far as employment protection reduces inflows to employment of labour market entrants, though other research, e.g. by Schmitt and Wadsworth (2002), finds little evidence that the more flexible US and UK labour markets performed better for marginal groups. There is also some evidence to support the proposition that stricter protection of regular jobs is associated with higher levels of temporary and other non-standard contracts.

Such non-standard employment relationships have been growing, on the whole, over the last twenty years, and a considerable literature has emerged on labour market segmentation and ‘insider-outsider’ tradeoffs, with varying interpretations of the causal relationships.

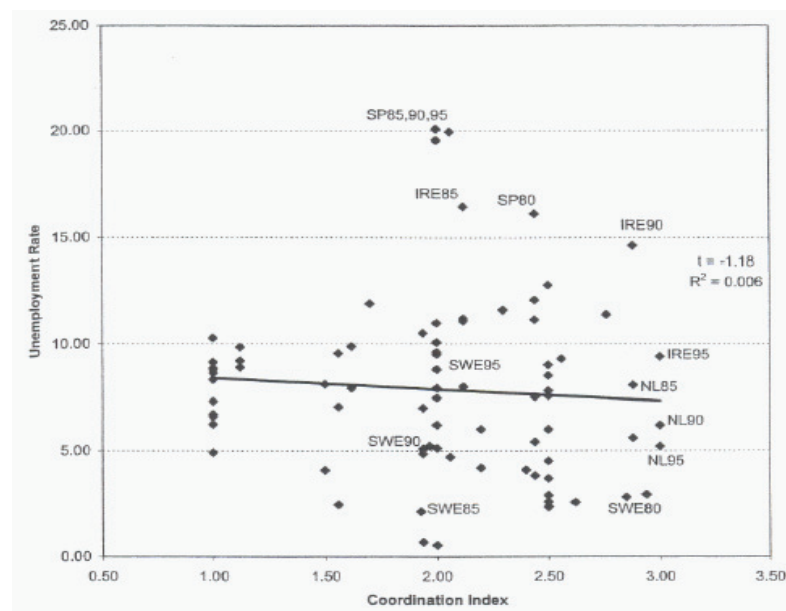
On wage flexibility, the evidence for an adverse effect on employment of minimum wages is also weak in OECD countries. There must be some level of minimum wages that would have such an effect, but within the observed range the effect seems to be modest. Another rather consistent finding of research in OECD countries is that coordinated wage bargaining does not have an adverse effect on unemployment (Figure 3). In fact, multivariate analysis suggests that the relationship with employment is positive. Since decentralized wage bargaining is sometimes seen as an important aspect of labour market flexibility, this is an interesting result. It reflects the importance of social dialogue in the debate on flexibility, a point to which I will return. On the other hand, Baccaro and Rei (2005) find union density to have a positive impact on unemployment, in the absence of bargaining coordination, and argue that this may come from the impact on wage levels.

Functional and organizational flexibility within firms may well be more important than labour market flexibility as such, but situations are diverse and evidence correspondingly anecdotal. National models for the organization of production vary widely, and local and specific factors are usually involved. The growth of global production systems is probably the most significant factor here, introducing flexibility and adaptation through new sourcing arrangements which by-pass national policies.

An important issue concerns the relationship between employment stability, skill development and productivity. Auer, Berg and Coulibaly (2004) show that employment tenure has a positive effect on productivity at the firm level, at least up to a certain length of tenure. There is a great deal of case study material which shows that job stability is important for training—obviously longer tenure increases the returns to investment in job specific training. Other research suggests that longer job tenure is associated with greater

Figure 3.

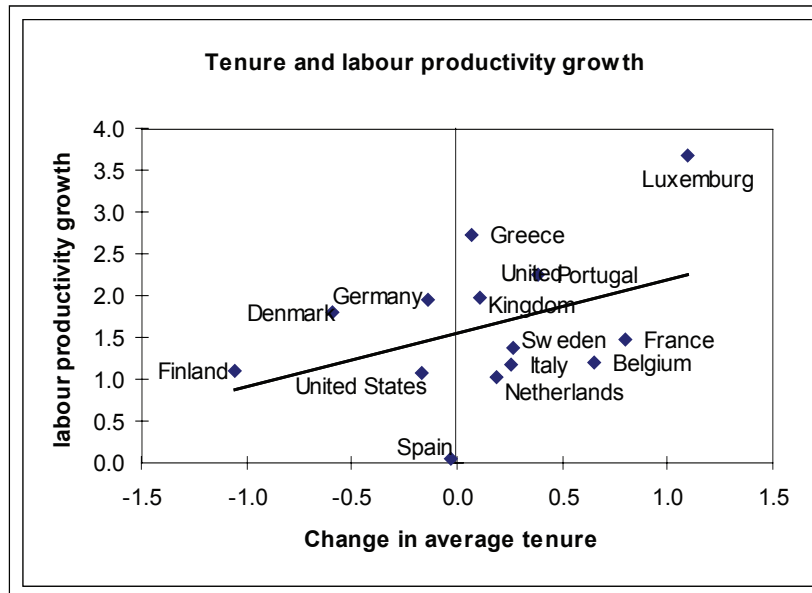
Labour market institutions and unemployment: Bargaining coordination



Source: Baker and others (2005).

innovation, where this is knowledge intensive, presumably because of the importance of on the job learning. More innovative firms tend to offer somewhat longer tenure to their workers than less innovative firms. Figure 4 also shows that changes in tenure across industrialized countries are positively associated with labour productivity growth. But there are considerable variations in job tenure between countries, suggesting there are many possible institutional frameworks. And Auer, Berg and Coulibaly (2004) find tenure is negatively correlated with employment rates, hinting at a productivity-employment trade-off. All of this illustrates the complexity of the analysis of labour market

Figure 4.
Change in job tenure and labour productivity growth, 1992-2002



Source: Auer, Berg and Coulibaly (2004).

with low and flexible working hours, which contribute to goals of gender equality and permit varying strategies through the life cycle.

On the whole, it would be risky to draw strong policy conclusions about the impact on employment of labour market flexibility on the basis of this literature. There is much that remains unclear, or dependent on local factors, in this complex relationship between labour market institutions and employment performance.

And although there is no consensus in the literature, the case can readily be made that aggregate demand conditions are more powerful predictors of employment outcomes than labour market regulation. After all, even in less flexible economies job creation and destruction is fairly large (20 per cent of jobs per year in France) so large adjustments do occur all the time. Schmitt and Wadsworth (2002), for instance, argue that in both the US and the UK, employment growth can be largely traced to macro-economic policy, and that labour market flexibility has mainly helped to increase inequality. Baker and others (2005) reach similar conclusions.

The evidence cited thus far comes mainly from the industrialized world. What can be said about developing countries?

The first and most obvious point is that most developing country labour markets are in reality highly flexible because of the presence of a large informal economy. Production systems very frequently straddle the formal and the informal, there are informal workers in formal enterprises and informal enterprises delivering goods and services to formal markets. This does not mean that the informal economy is unregulated—even when laws are not fully enforced, they have an indirect effect, and there is a great deal of informal social regulation.

flexibility, since institutions and their roles differ from country to country, making the cross-country analyses discussed above particularly unreliable.

On the supply side, there is wide variation across countries in the degree to which workers can move flexibly between enterprises, maintaining pension and other rights, adapt working time to family needs, and so on. Not much research addresses the implications for growth and employment, but the experience of Scandinavian countries, where such policies are most advanced, suggests that the synergies can be positive. These countries have, on the whole, high employment rates

But it does mean that the discussion of labour market flexibility in low income countries cannot reasonably be separated from discussion of informality. It is true that there is a widespread assumption, much as in industrialized countries, that part of the employment problem lies in overregulated formal sectors which promote dualism and reduce employment levels. As noted above, the World Bank's *World Development Report 2005* takes the line that developing country labour markets are widely overregulated, and that this has an adverse effect on investment and growth. They argue that this is true of minimum wages, working time and employment protection, among others.

But the data base for such conclusions is much weaker than in industrialized countries, and hard evidence on the real impact of regulation on employment growth is scarce. It is true that if the minimum wage is set far too high, either it will be ignored or it will constrain employment creation. But in fact the evidence, such as it is, does not point to minimum wages as a major constraint on employment growth. On the contrary, in many countries it plays an important stabilizing role. The 1996-1997 *World Employment Report* argued that observed minimum wages in most developing countries were unlikely to have a serious adverse effect on employment, while real wages tended to move in line with productivity, and to be rather flexible. More recent ILO work has reached similar conclusions. A recent literature review (Devereux, 2005) concluded that carefully designed minimum wage policies do help to reduce poverty. Much depends on the interpretation and application of such policies, making it difficult to compare country experiences.

The recent experience of Argentina and Chile is consistent with the view that labour market flexibility was not the main factor driving employment growth. In Argentina, for instance, the flexibility policies put in place in the 1990s appeared to lower employment elasticities rather than raising them (Marshall, 2004), so that rapid GDP growth was accompanied by rising or stagnant unemployment. In Chile in the 1990s, on the other hand, the gradual re-regulation of the labour market was consistent with continued employment growth up to the Asian Financial Crisis (ILO, 1998). Recent work by the Asian Development Bank also argues that while some labour reforms are needed, labour policies are not the main cause of increasing unemployment and persistent underemployment in Asia (ADB 2006).

In Latin America, more systematic work by Marquez and Pages (1998) is interesting in that it mirrors to some extent the findings in industrialized countries—employment protection legislation does reduce job turnover, and is associated with greater self-employment (which can be interpreted as an indicator of dualism), and perhaps less wage employment, for younger and older workers at least, but not necessarily with lower employment overall. In other words, the distributional implications may be more important than the aggregate impact. On the whole, while employment protection is strong in Latin America, job turnover is high and tenure low, an inconsistency which is hard to explain unless it simply reflects poor implementation of the legislation.

In those situations, the real issue is the construction of universal policies and institutions. We should note that the influence of formal regulation reaches deep into the informal economy—minimum wage legislation for instance, clearly affects informal wages even when it is not fully enforced. We should also note that there is little evidence that reducing the levels of protection of the formal economy is likely to help to reduce informality. But there may be institutional strategies in which a more flexible approach to the formal economy is part of a universal strategy in which there are also more serious efforts to construct viable frameworks of regulation which embrace the informal. In that context, the work of Galli and Kucera (2003) shows that countries with stronger civic rights (basically freedom of association) have a higher share of formal employment. So such rights may well play an important part in constructing a coherent policy response.

Labour institutions and social models

We have seen that the empirical evidence is mixed. But this should not really be a surprise. Labour market flexibility or rigidity is in general only one aspect of a broader social model. In reality, labour market institutions are or can be ways of accommodating different interests and achieving sustainable results. Different combinations of policies and institutions may achieve similar goals. In Europe, the debate on the future of the social model has made it clear that there are a number of quite different routes being taken in different countries. Table 1, taken from work by Peter Auer, suggests one typology, in which high employment protection and expenditures on labour market policy complement or substitute for each other in different countries. Recently the ‘Danish model’ of flexicurity, in which low employment protection is combined with effective income protection and labour market policy to provide occupational or career security, has received particular attention. But there are different ways of combining flexibility and security, and the Swedish and Finnish approaches provide another, different example, embracing high public expenditure on social services, flexibility for enterprises, labour market security for workers, and an egalitarian framework of values in which all actors have both rights and responsibilities (Lefebvre and Méda, 2006).

Table 1.
Employment security or labour market security?

	<i>High labour market policy spending</i>	<i>Low labour market policy spending</i>
High Employment Protection	France, Germany	Japan, Portugal, Greece, Italy, Spain
Low Employment Protection	Denmark, Belgium, (Netherlands), Finland, (Ireland)	United States, United Kingdom

Source: Auer (2006).

The basic issue is to find a balance between employment protection provided at the level of the firm (or the public sector), and social protection and income security provided at the societal level. When a firm is embedded in broader institutions of social protection, it is much easier to achieve a negotiated flexibility at the enterprise level, than where the worker is exclusively dependent on the firm—unless, as was the case in Japan, the firm itself plays this broader role (Dore, 1986). Workers likewise need flexibility in order to take advantage of new labour market opportunities, and that too has implications for the design of institutions for protection—for it may be that the best way to increase security will be to increase the portability of rights between jobs, in a framework of ‘protected mobility’.

The goal of decent work: Flexibility, security and dialogue

How do these issues relate to the ILO goal of decent work? In reality, the decent work agenda constitutes a framework for social policy which integrates many of these elements. Each country has its own social goals and institutions, but there are broad goals which are widely shared: the importance of access to productive employment for all; security of work and income, and in the workplace; respect for core rights at work, including freedom from coercion and discrimination, and freedom of association; and a democratic process of negotiation and social dialogue by which these goals are set and achieved. This concerns the dignity of work and gender equality in work, and the role of work in social integration and personal development. These are all elements of a decent work agenda.

Achieving decent work calls for a coherent set of policies for employment promotion and protection, for security and income support, for the promotion of equality in opportunity and access, for rights at

work—but also for competitive and effective production systems, in which adaptability and innovation are key. It involves not only public action, but also representative institutions through which social actors can express their views and participate in decisions. It is precisely this combination of institutions and policies which constitutes a social model. And because work is in many ways the point of articulation between economic and social goals, it makes sense to build coherence in economic and social policy on this foundation.

Within that framework, the issue of flexibility can be adequately addressed only by considering its multiple effects and the packages of measures of which it might be part. If there are tradeoffs, e.g. between security and employment, it is necessary to find institutional and policy frameworks which can address both. For instance, if employment protection legislation is an important source of security, and has little overall effect on employment, but has an impact on labour market segmentation or exclusion, a coherent approach will require complementary active measures aimed at promoting employment for excluded groups. Weakening employment protection overall may undermine other goals without necessarily improving labour market opportunities.

While a wide variety of approaches may work in different situations, one important lesson from successful experiences in both Europe and elsewhere is the essential nature of broad participation and social dialogue in the process. Institutions which involve tradeoffs among objectives and the different interests of different groups cannot be easily imposed from above. They need to be constructed by the actors concerned, if they are to achieve legitimacy and stability. Representative organizations of workers and employers have played a vital role in many countries in achieving solutions in the common interest.

In the end, labour market regulation is about what society you want to create—economic success is only part of the picture. Within efforts to achieve decent work, the flexibility of employment relationships is part of a much wider balance. The real issue lies in constructing the institutions that can achieve that balance.

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