



**Università Commerciale
Luigi Bocconi**

Department of Legal Studies – Bocconi University
Via Roentgen 1 - 20136 Milan Italy
Tel. +39.02.5836.5209/5221
Fax +39.02.5836.5202

Bocconi University
Department of legal Studies "Angelo Sraffa"
Legal Studies Research Paper Series

Evaluate Labor Law: Dismissal Rules¹

Stefano Liebman

Research Paper No. 43

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¹ This paper has been presented by the author as an introduction to an atelier on “Dismissal Rules” held within the framework of an International Conference organized in Venice, on September 26-27, 2008, by the International Labor Organisation (ILO) and the University of Venice.

Stefano Liebman
Professor of Labor Law - Department of Legal Studies
Bocconi University, Milan.

Since the early '90s of the last century, there has been a growing tendency, in discussions over economic policy, to quantify employment protection systems (EPS).

The translation of institutional data into numerical indicators fulfils, as it were, two scopes: the first is to resolve through field studies those shop-worn controversies over the impact of EPS on the performance of an economic system; the second is to render numerical indexes instrumental to policy-making by enabling international comparisons and allowing identification of institutions that supposedly cause a rigidity of a specific labor market, with a view to changing them.

It is worth noting that, precluding the doubtful theoretical foundation of the approach, reform of the labor market – aimed at eradicating sources of rigidity in some countries – appears to be one of the areas of intervention where consensus runs highest.

In 1999, the OECD elaborated an index of employment protection systems that proved a significant step forward compared with the previous standards, as the next paragraph makes clear. Unquestionably, the OECD index has been the most widely used since its first release.

In November 2003, a small group of lawyers and economists of the Bocconi University, including the author of these notes, wrote a paper aiming to analyze the method used to build the index and underscore some of the issues it raises, specifically in Italy, but we think more broadly speaking (Del Conte M., Devillanova C., Liebman S., Morelli S., 2004).

The analysis high lightened the extreme variability of the index, inasmuch as its standards are subject to decisions at times arbitrary and to interpretations at times questionable. We also expressed some reservations as to the opportunity of merging partial indexes to generate a single index of global rigidity.

As mentioned, the OECD index (1999) is the latest stage in a long series of efforts (Emerson 1988, Bertola 1990, Grubb and Wells 1994 and, more recently, the famous paper on regulation of labor by Botero J., Djankov S., La Porta R, Lopez-De-Silanes F. and Shleifer A., 2004) to measure employment protection systems and the rigidity of the labor market legislation that regulate them.

Such an index introduces two major innovations. First, the number of indicators is extended to include, in addition to legislation on no-term contracts and fix-term contracts, legislation on collective dismissals. Second, the new index is based on cardinal digits and attributes to each country a *rigidity index* graded from zero to 6, moving upwards to higher EPS rigidity.

This latter innovation is extremely attractive inasmuch as it enables the monitoring of an EPS over time to study its impact on the economic system. In fact, all the indexes before 1999 were based on ordinal digits and provided a standing of the countries on the basis of the relative rigidity of the labor market.

This type of information could be of use to make comparisons between nations but was wholly inadequate for dynamic analysis. Indeed, any reform that does not modify the position of the respective countries in the classification falls, by definition, outside the reach of an index based on ordinal numbers and does not permit assessment of the impact of the reform.

The OECD index, instead, monitors variations in EPS over time and enables dynamic analysis on time series and panel-data. It also permits classification of countries according to relative labor market rigidity and the relative position of the respective countries. Italy, for instance, with a rigidity index of 3.5 ranks among countries with low-flexibility labor markets alongside Greece, Portugal and Turkey. The United States and Great Britain, instead, rank at the other end with an index below 1.

Thanks to these advantages, the OECD index has been, by far, the most widely used for field studies and policy discussions. Cazes and Nesporova (2003) have applied the same method to five countries in transition (Bulgaria, Estonia, Poland, Russian Federation and the Czech Republic).

Moreover, even those authors who concede that a rigidity/flexibility index falls short of explaining things and suggest other broader standards to assess the role of other labor market

policies and institutions (Boeri T, Garibaldi P., Macis M., Maggioni M., 2002), agree on the OECD index to measure EPS.

The very fact the index is so widely used largely prompted our research.

The notion of labor market rigidity/flexibility itself is subject to controversy and may be viewed from an array of angles.

The OECD itself (1999) provided a broad definition of EPS: “*employment protection refers both to regulations concerning hiring (e.g. rules favoring the disadvantaged groups, conditions for using temporary or fix-term contracts, training requirements) and firing (e.g. redundancy procedures, mandatory pre-notification periods and severance payments, special requirements for collective dismissals and short-time work scheme*”.

In fact, the index was based on 22 specific indicators that are successively aggregated. The first step consisted in attributing values to the indicators specific to labor legislation. With respect to no-term contracts, for instance, the OECD factors in twelve specific indicators. Similarly, the six successive indicators measure other forms of contracts (the first three for fix-term contracts and the remaining three for temporary contracts). Finally, the last four report information on collective dismissal regulations.

The attribution of value is immediate where magnitude is measurable – such as the amount of severance entitlement, the maximum duration of a contract, etc. – yet, even in such cases the complexity of legislation requires a compromise between a variety of institutions.

Where magnitude is not measurable, instead, legislation data are translated into numbers according to some specific criterion. For instance, the definition of dismissal without cause is rated - **0** where the professional performance of the worker or redundancy fall into the definition of dismissal with cause;

- **1** where the choice of the workers to be dismissed is subject to social considerations such as age or workplace seniority;

- **2** where dismissal must be preceded by alternative posting and/or training for outplacement;

- **3** where insufficient performance of the worker does not qualify for dismissal with cause.

Once a value is attributed, each variable is adjusted to a scale from zero to 6, moving to higher rigidity. The next step is to aggregate the specific indicators and this was done by weighting the self-same indicators.

Before expressing reservations on the concrete elaboration of the index, we wanted to stress the dangers inherent to the aggregating process, and then we examined the attribution of numeral values to the partial indexes operated by the OECD, in particular in the case of Italy.

Leaving to the reading of the original paper in order to analyze the technical criticism we raised to the OECD index (Del Conte M., Devillanova C., Liebman S., Morelli S., 2004), I shall summarize here a set of issues which, in our opinion, are preliminary to any dialogue between legal scholars and economists on the topic of the different models to regulate flexibility in the employment of labor force.

Legal scholars have always underlined the theoretical core underpinning legal systems to comparative studies. Arguably, comparing a rule from one legal system with the correspondent rule of another and verifying empirically their concordance or discordance is as old a practice as the awareness of the legal fact proper.

But comparative study as a social science raises a substantial epistemological problem with regards to its scope. The current theoretical debate takes its cue from the absolute independence of comparative study from any specific utilitarian scope. As a social *science*, comparative study does not harbor objectives of social prevention. It does not aim to improve mutual understanding between peoples or perfect the edifice of international public law, nor does it aim to approximate and harmonize legislation, or better national law (Kahn-Freund O., 1966 and 1974).

As has been magisterially stated, what is expected of comparison nowadays is to “deflate bogus instruments of knowledge: substitute hard data for them and thereby acquire valid knowledge. Indeed, comparison challenges and debunks hasty generalizations; it dissolves issues rooted in nominalism; it moves beyond underlining correspondences and divergences to discern their causes. Comparison seeks *law in action* and not *law in the books*: the former reflects applied law, reality, substantial resolution, while the latter reflects apparent law, superstructure, and not law. Comparison is history and such history, as pulverizes false notions, is conducive to knowledge” (Gorla G. 1954).

These synthetic but final words amply justify the caution, not to say downright skepticism, which has characterized the attitude of legal scholars towards cross-country econometrics studies of institutional data.

As regards the OECD index on labor market rigidity proper, labor law scholars are at pains to grasp the sense of an analysis and juxtaposition of legal texts picked from different national

legal systems with the avowed aim of attributing to each a numerical value enabling comparative assessment.

Laws in *the books* may be pretty similar in different countries and yet may prove quite divergent when set against laws *in action*. If, in case of unfair dismissal, the law provides for damages commensurate to unpaid salary between the time of dismissal and the time of reinstatement of the worker, it is quite clear that the computing of the damages is contingent on a time frame that is not determined at law, but that depends on court practice.

Moreover, said practice not only varies from country to country, but, even inside the respective legal systems, from jurisdiction to jurisdiction. Yet again, practice varies inside jurisdictions according to the avenue of remedy selected by the claimant (ordinary procedure, urgent procedure) and, hence, also depends on the availability of the single judges confronted with a massive influx of petitions for urgency proceedings. Not to mention the disparity of productivity between judges, due to the actual absence, in many systems, of provisions setting down express time limitations to proceedings, inclusive of release of judgment.

Even assuming that all such variables (and many others which can not be adduced here for obvious limits of space) were factored into the making of numerical indexes (and be it said here that such operation is not even remotely considered), before embarking on an attempt to make comparable the data measured in a single country it would be necessary to tackle those issues raised by comparison which have been briefly described above. In other words, it would be necessary to explain how such data fit in with the variety of historical, social, cultural, structural and superstructural configurations of the different legal systems (Ichino A., Polo M., Rettore E., 2003).

In reality – and this is what puzzles most legal scholars – it seems that the, doubtless sophisticated, quantitative measurement of institutional factors proceeds from an inverted sequence: comparison is subsequent to the generating of numbers, because numbers are the starting points for comparison.

We believe the reason for such inversion in the method lies in the immanent and intrinsic nature of the development of numerical indicators itself, that is, in the production of practical tools instrumental to comparative study.

Hence the first question the legal scholar puts to the economist: is it admissible for a scientific approach to renounce measuring values whenever considerations of an exquisitely

cultural tenor warn against dubious quantitative measurements? Or is there an overriding exigency, instrumental to the objectives of econometrics research, to produce comparable values regardless?

Another issue raised by the translation of institutional data into numbers regards language. The issue has generated a vast and impassioned debate among comparative law scholars, which can not, even briefly, be outlined here. However, some aspects of the issue need be mentioned here.

To the legal scholar, the language of law is a formal instrument highly distinctive from the specific language that expresses it. Not only: inside the language of law proper there exists identical wordings with changing meanings, either caused by the evolution of the law, or by different contextual determinations.

As regards the interpretation of the language of law, the problem is compounded by the necessity to compare it with other languages of law couched in different national languages. Needless to say, heuristic problems increase alarmingly at that stage.

Thus, if it is true to say that two pieces of legislation in a single body of rules may vary the meanings of words, it is also true to say that two provisions in different countries may use homonymous words with different meanings.

It appears that pretty much the opposite phenomenon is taking place in the field of economic studies. There, a single language (English) is crowding out the diversity of national languages and occupies such a dominant position as to incorporate and, thus, shape every aspect of reality, both in the economic and legal spheres, blissfully unconcerned by national variables.

The problem, indeed, has become a pressing issue. It is a fact that within the European Union the problem was faced and resolved by recognizing as official languages the languages spoken in the respective member States.

The use, in the in the construction of the OECD index, of *severance pay* as an all-embracing notion is emblematic of the distortion caused by hasty incorporation into English language of divers realities expressed in their respective languages. Whereas *severance pay* which, strictly speaking, refers to the money paid to an employee upon termination of his employment, it has been used in that occasion to cover equally schemes which, in their respective countries, may either amount to additional costs to the company in case of dismissal

or, else, to savings for said company through the deferred payment, in any cases of employment termination, of portion of salary due the worker.

At this juncture, a second question needs be answered with regards to any attempt at harmonizing institutional data: in the process of comparing institutions, has due allowance been made to the fact that lexically homonymous expressions used in a diversity of countries may have different meanings at law? And, therefore – yet again – is it admissible for such an approach to renounce quantitative assessment whenever linguistic and judicial examination of homonymous institutional edicts uncover substantial differences in meaning?

The observations here briefly outlined –inspired by the teachings of comparative law – only aim to caution researchers using cross-country analysis and evaluation of legal systems comparable on paper against such hasty generalizations as are only too prone to emerge from the crunching of numbers.

To avoid such pitfall, it is necessary to adopt a comparative model which does not only record formal similarities and dissimilarities, but which also tracks down their causes. In addition, such model should unreservedly embrace the possibility that it might not have any practical purpose, in the light of the fact that not always are legal systems amenable to quantitative models.

The OECD index was calculated for the late 80s, the late 90s and for 2003. The index for the 90s had Italy appear as a country with a high level of employment protection and, to that extent, comparable to other Mediterranean countries. In the 1999 index its position was affected by the fact that – in addition to other anomalies – the so called “Employment Termination Indemnity” was placed inside dismissal costs, not considering that, according to the Italian law, such an amount of money is only a deferred payment of a portion of salary due to the employee. The OECD has since admitted the error in its 2004 issue of the *Employment Outlook*.

The index of employment protection established by the OECD for 2004, instead, takes into account the modifications introduced in Italy by labor market reform in the previous years. Thus, it changes position (from 3.1 to 2.4): the overall index for Italy now compares favorably with the 2.6 of Norway and Sweden (Nordic countries), the 2.9 of France and the 2.5 of Germany (continental countries).

Italy still comes across as “more rigid” than the United Kingdom with its 1.1 index.

The difference between the overall employment protection indexes in Italy and in the United Kingdom, 2.4 and 1.1 respectively, is caused by the significant difference between the indexes attributed to temporary contracts (2.1 and 0.4) and to those attributed to mass redundancy (4.9 and 2.9), compounded by the disparity between the indexes attributed to permanent contracts (1.8 and 1.1, respectively).

Inside the class of permanent contracts (who weighs for 5/12 on the composite index, though such contracts account for 90% of all payroll workers) a line is drawn between *unfair dismissal compensation at 20 years of tenure* (compensated by 15 monthly wages in Italy and 8 in the UK) and the *possibility of reinstatement after 20 years (whether the employee has the option of reinstatement into his/her previous job, even if this is against the wishes of the employer)*.

On that score, in reality, the assessment of the OECD is somewhat crude and essentially misleading. Indeed, in the Italian case the OECD puts together companies subject to reinstatement provisions (i.e., “absolute” protection by way of mandatory *reinstatement*) and which, under the terms of law, applies only to companies with more than 15 workers (5% of the companies active on the Italian labor market), and those subject to weaker employment protection (i.e., *reemployment* or compensation, at the discretion of the employer) (Schivardi F., Torrini R., 2003).

In addition, the rigidity attached to reinstatement and to the fifteen monthly wages in compensation in case the worker refuses reinstatement and asks for compensation is erroneously compounded by an improper multiplication of dismissal costs since reinstatement and 15-month wages compensation are mutually exclusive.

Lastly, duration of legal proceedings and court practice are not factored in as variables, though they play a critical role in such matters.

It appears quite clearly at this stage that the determination of indexes of rigidity is based on errors that hamper proper assessment.

The OECD also attributes different levels of rigidity to the two countries with respect to redundancies. The impact of this third component is, however, limited, owing to the already mentioned reduced weight attributed to it in the construction of the composite index.

Yet, the level of rigidity attributed by the OECD to mass redundancy provisions in Italy is based on a substantial confusion between different schemes, namely *redundancy benefits* and

integrative benefits for idled workers, as well as on an estimation of the legal requisites to redundancies – i.e., corporate reorganization – as “restrictive of freedom of enterprise”, though in practice the entrepreneur retains the discretion to proceed as he chooses without further ado.

Assuming as known the mentioned limits of the OECD methodological approach in the construction of the indexes for employment protection systems, here is sufficient to reiterate the opinion that the endeavors to quantify and synthesize complex systems for the scope of comparison rest on shaky foundations.

In many respects, particularly where these analyses are used to inspire economic policy, the suspicion arises that the indexes are built in such manner as to justify the orientations or biases of the people who first build these indexes to then utilize them.

More to the point, the fundamentally ideological assumption that fully liberalized labor markets would trigger a rise in employment levels and would favor “fair income distribution” seems to preside over the construction of these indexes. Such assumption, blithely setting aside all the problems regarding disparities in information and differences in bargaining powers between parties, quite naturally comes to the conclusion that any restriction to the free play of market forces generates inefficiency (Freeman 2005). I do believe, instead, that history amply proves how employment protection schemes, regardless of the positive or negative courses they took over time, were adopted specifically to remedy market dysfunctions which had little to do with abstract conceptualizing.

On the economic level, the OECD itself appears very cautious in assessing the impact of employment protection systems on employment levels.

The *Employment Outlook* 2004, p. 80, reads: "*Overall theoretical analysis does not provide clear-cut answers as to the effect of employment protection on overall employment and unemployment. It is not surprising that economists have turned increasingly to empirical analysis to try to resolve the question. At first glance, simple cross-country correlations are still partly inconclusive... Naturally it is not possible to draw policy conclusions on the basis of such bivariate associations and several studies have been carried out in search for clearer conclusions from multivariate analysis. There too, however, researchers are not unanimous*".

The study mentioned earlier that criticized the method of construction of the rigidity indexes adopted by the OECD has inspired new forays by scholars of institutional data who have seized on this opportunity to point out the necessity to clarify the theoretical issues attached to

comparative study of distinct legal systems. In particular, it has been said that the main scope of such comparative study is to demythologize instruments of knowledge of dubious validity and to replace them by historical data in order to attain valid knowledge (Artoni R., D'Antoni M., Del Conte M., Liebman S. 2006).

As mentioned above, comparison disputes and lays bare hasty generalizations, dissolves questions mired in nominalism: its scope is not merely to gather differences and similarities, but to fathom the reasons of such differences and similarities. The analysis of social protection systems must start from the general and specific reasons that presided over their formation to, then, move on to the analysis of the processes whereby legal provisions influence or bind the options of the players and to conclude with an assessment of the effects generated by either the loosening or strengthening of these provisions in a given historical and institutional context.

An approach along those lines by Blanchard (2005), who himself had made ample use of the OECD indicators in the past, has been illustrated in a paper where he writes “*in the process of looking at the effects of institutions, I have become less convinced that existing measures fully capture what is going on*”. After re-examining the developments of the last years he concludes “*the decrease in employment protection has come in the form of introduction of two types of labor contracts, traditional and highly protected permanent contracts, and new, less protected, temporary contracts. Whether such a reform actually decrease unemployment is ambiguous; what is certain is that it has created a dual labor market, with protected and marginal workers*”.

As mentioned earlier, these observations should be properly integrated to informed surveys on employment and distributive situations in other countries and should proceed with the identification of the sets of provisions that have led to or permitted the persistence of misinterpretations. In any event, and notwithstanding the impact of provisions on the prosecution of a proper distributive system, our findings take us far from both the OECD indicators and from substantially arbitrary measurements. The neglect of such structural data renders the terms of comparison irredeemably flawed and produces abstract and nominalist operations, instrumental – in the best of hypotheses – in *justifying*, on supposedly scientific grounds, conclusions that rather belong to common wisdom.

All the observations developed thus far impel to opt for a methodology that envisages analysis within a broader hermeneutical frame of reference, where economic analysis and legal scholarship interpenetrate in a process of confirmation and refutation.

In conclusion, I think that any realistic analysis of employment protection systems in a diversity of countries must proceed by examining institutional provisions according to the principles of methodology of comparative law. But this implies, among other things, that comparison of legislative systems may and must be conducted outside any concern for their possible measurement by index. Indeed, quantitative measurement – howsoever arrived at – of formal elements extrapolated from legislative provisions not only is technically fallacious, but is also uncharacteristically constraining, it being very much a self-fulfilling prophecy inspired by ulterior motives (Artoni R., D’Antoni M., Del Conte M., Liebman S. 2006).

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