

# 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.



- *This blog post is based on the authors’ paper ‘[Employment Protection Legislation, Capital Investment and Access to Credit: Evidence from Italy](#)’, in *Economic Journal*, (2016) Volume 126, Issue 595, Pages 1798-1822.*
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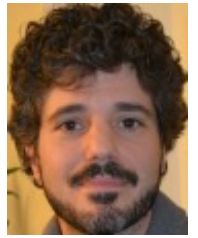
**Federico Cingano** is an Economist at of the Bank of Italy (DG Economics, Statistics and Research). He joined the Bank of Italy in 2000 becoming Senior Economist in 2006 and Head of the Industrial Organization Research Unit in 2011. Since 2016 he supervises the research at the Directorate for Structural Economic Analysis. He visited the University of Berkeley, Centre for Labor Economics (2005-06) and the OECD’s Economics Department (2011) and Directorate for Employment Labour and Social Affairs (2013-2016). His research interests are in Growth and Productivity, Labour Economics and Applied Economics. His work has been published in international and Italian refereed journals. He holds a PhD from the Universitat Pompeu Fabra (Barcelona).



**Marco Leonardi** is Associate Professor of Economics at the University of Milan since October 2010. He received his Laurea and Msc. Economics at Bocconi University in Milan. He then moved to the London School of Economics where he took his Master in Econometrics and his Ph.D. in Economics. In 2002 he won the young economist prize of the European Economic Association. He has spent visiting periods at the MIT Department of Economics, UC Berkeley and Georgetown University. He is fellow of IZA and sits on the board of AIEL (Association of Italian Labor Economists). His research interests are in labor economics with particular reference to wage inequality, wage polarization and earnings mobility. He published recently on the *American Economic Journal: applied economics*, on the *Economic Journal* and on the *Scandinavian Journal of Economics*. He is currently a consultant for the Italian Prime Minister on labor market reforms.



**Julián Messina** is lead research economist at the research department of the Inter-American Development Bank (IDB). Prior to joining the IDB, he worked at the World Bank and the European Central Bank, and he taught at the Universities of Barcelona GSE, Georgetown, Girona, Frankfurt and Mainz. He has co-authored the World Bank Latin American Flagship Reports “Economic Mobility and the Rise of the Latin American Middle Class” and “Latin American Entrepreneurs: Many Firms but Little Innovation”. His research focuses on the labor markets adjustments with a focus on wage determination. His work has been published in leading academic journals including the American Economic Journal: Macroeconomics, Journal of Economic Perspectives, the Economic Journal, Journal of the European Economic Association, and Labour Economics, and is often featured in popular blogs and media outlets including the Economist. He has extensive experience advising governments in Latin America, Europe and Asia. Julian obtained his PhD. in economics at the European University Institute in 2002.



**Giovanni Pica** is associate professor of economics at the [Department of Economics, Management and Quantitative Methods](#) of the University of Milan. I am also affiliated with [Centro Studi Luca D’Agliano](#), [CSEF](#), [Centro Baffi](#) and [fRDB](#). My research concentrates on the labour market effects of financial market imperfections, globalization and labour market institutions. I am currently working on the role of internal capital and labour markets within organizations, on the labour market impact of the financial crisis, on the link between social mobility and macroeconomic outcomes, and on occupational licensing.



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