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COMMENTARY

Why employment regulations sometimes have unintended effects on workers

By Jussi Keppo

TECH giant Yahoo announced early this month that it would be shedding 15 per cent of its workforce to cut costs. Earlier, Deutsche Bank said it would eliminate 23,000 jobs or 25 per cent of its total workforce.

With such job cuts announced almost on a weekly basis, how much do these exercises cost? How would employment protection affect the hiring, firing and relocation practices of an organisation?

Retrenchment is part of business practice in several industries, particularly for industries with uncertain demand, such as the competitive tech industry. For instance, Microsoft announced last year that it was laying off 18,000 employees, and Hewlett Packard announced it will cut 58,000 jobs.

To protect workers against unfair retrenchment, governments often pass employment regulations to ensure fair employment terms. However, such employment protection legislation may have unintended consequences.

My research at the National University of Singapore (NUS) Business School shows that because of employment protection, some companies may not be incentivised to hire new workers. Instead, they might rather relocate their operations elsewhere or just accelerate the firing process.

This is because such employment protection legislation creates labour friction. The acts of hiring and firing workers are costly and take time. There are severance and retrenchments costs when firing workers, and training costs when new workers are hired. Union contracts and regulatory constraints may also create delays when companies want to fire employees. Such labour market friction incurs costs and impair profitability, which decrease the value of employees.

The hiring and firing policy of companies, particularly those of companies facing volatile demand or uncertain employee productivity, such as those in high-tech industries, may be substantially changed due to labour market friction. High demand fluctuation, for instance, calls for such companies to adjust their labour level accordingly.

VOLATILITY, UNCERTAINTY

But if there are high costs or long delays associated with getting labour to meet such erratic demand, companies facing volatile demand or productivity uncertainty will hire less. Labour market friction reduces the value of employees, given the extra costs incurred in hiring them. Firing also becomes more difficult and expensive because of the replacement costs. Companies therefore fire fewer people.

Since the value of employees is doubtful and if a firm has to incur layoff costs for every time it fires an employee, costs run up. Instead, the firm may do better to pay such costs only once by relocating operations altogether.

Companies with the possibility of relocating are more sensitive to labour market friction than those without this option, simply because when hiring and firing costs rise, they are more attuned to waiting for the optimal time to relocate, to decrease hiring and firing substantially.

Take for example a firm in a high-tech industry. If it faces a long firing delay, high uncertainty on productivity of its employees, and a high search cost for new hires, the relocation of its operations to a country with lower labour market friction can raise the firm and its employees' value substantially.

However, as more such firms relocate, it means there will be fewer dynamic companies in the original location with high labour market friction. We are then more likely to see dynamic firms in countries with low labour market friction.

Further, while employment regulations are meant to protect employees in times of retrenchment, it may well have the unintended consequences of accelerating firing, en masse retrenchment through relocation and less optimal performance for companies in high-uncertainty industries.

The writer is associate professor of Decisions Sciences at the National University of Singapore (NUS) Business School. This research was conducted with Min Dai at NUS and Tim Maull at University of Michigan

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