

# Balancing regulations to promote jobs

From employment contracts to unemployment benefits

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# FOREWORD

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Balancing labor regulations is a crucial policy challenge for countries that want to protect their workers while promoting more, better, and inclusive jobs. These regulations help mitigate labor market imperfections, support social cohesion, and enhance economic efficiency.

Studies from both developed and developing countries show that labor market regulations can affect important economic outcomes such as productivity, labor force participation, earnings, or informal employment. The evidence points to the need to ensure that policies to promote employment opportunities also protect workers and provide incentives for work.

This report offers guidelines to design, implement, and reform labor market regulations in four areas: employment contracts, minimum wages, dismissal procedures, and income protection for the unemployed. It shows that, while there is

no 'one size fits all' blueprint for reform, there are some general principles that can help improve the design of labor laws and their implementation. The report also underscores the importance of dialogue between representatives of employers and workers as well as other major stakeholders.

Significantly, this report reflects a shared vision between the ILO and the World Bank Group to promote policies that encourage job creation and protect workers. This has been possible thanks to the commitment of both institutions to focus on the lessons derived from rigorous research and international experiences. We hope this report will inform countries' paths to achieve the Global Goal to promote inclusive economic growth, employment, and decent work for all.

Arup Banerji  
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# INTRODUCTION

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Labor regulations can correct imperfections in labor markets resulting from inadequate information, uneven bargaining power, limited ability to enforce long-term commitments, or insufficient insurance mechanisms against employment related risks.<sup>2</sup> Thus, labor regulations can, if well designed, avoid inefficient and inequitable labor market outcomes and have an important role to play in any country.

In addition, there are fundamental rights at work that should be part of any employment legislation. These include (a) the right to engage in work conditional on meeting the minimum age requirement; (b) the right to pursue a freely chosen or accepted occupation without coercion; (c) prohibition of discrimination on grounds such as race, color, sex, religion, political opinion, national extraction or social origin, that would impair equality of opportunity or treatment in employment or occupations; (d) the right to equal remuneration for both male and female workers for work of equal value; and (e) the right to establish and join workers' and/or employers' organizations and to bargain collectively.<sup>3</sup>

The challenge is to establish the right balance between workers' protection and flexibility in the management of human resources at the firm level, that is, avoiding both over- or under-regulation. Between these two extremes, there is a 'plateau' where appropriately designed regulations can alleviate (labor) market failures, offer adequate protection to workers, and contribute to shared prosperity without imposing unreasonable costs on firms.

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2. World Bank (2012).

3. The ILO Declaration on Fundamental Principles and Rights at Work and its Follow-up (1998) declares that all Members States have an obligation to respect, promote and realize the principles concerning the fundamental rights which are the subject of the core ILO Conventions, namely: (a) freedom of association and the effective recognition of the right to collective bargaining; (b) the elimination of all forms of forced or compulsory labor; (c) the effective abolition of child labor; and (d) the elimination of discrimination in respect of employment and occupation. See also the EU's Charter of Fundamental Rights proclaimed by the Nice European Council on December 7, 2000. Retrieved from: [http://www.europarl.europa.eu/charter/pdf/text\\_en.pdf](http://www.europarl.europa.eu/charter/pdf/text_en.pdf).

This report provides general principles for the design and implementation of labor regulations in four areas: (a) employment contracts, (b) minimum wages, (c) dismissal procedures, and (d) severance pay and unemployment benefits. This selection of topics resulted from internal consultations, ongoing dialogue with client countries, as well as the importance of these topics for labor markets. The report summarizes the main findings from the literature and discusses country experiences and policy implications. It targets task team leaders involved in policy dialog on labor regulations, as well as policymakers.

The report suggests that there are general principles that can guide the design of labor regulations. For instance, in terms of employment contracts, it is important to ensure convergence in the types of benefits and protections that workers receive, regardless of the length of time they spend with a given employer. For minimum wages, it is necessary to keep regulations simple and transparent, and to reduce discretion by having an independent body that periodically assesses the level of the minimum wage and its economic and social impacts. Regarding dismissal procedures, the report recommends giving flexibility to firms in the management of human resources, as long as there is appropriate advance notice, an adequate system of income protection, and efficient mechanisms to detect and sanction discrimination. Finally, for severance pay, the recommendation is to rely more on unemployment benefit systems that reduce employees' risk of not receiving payments if their employers face liquidity constraints or go out of businesses.

Beyond some of these general principles, however, there is no overall blueprint to design or adapt labor regulations. Rather, there are different reform paths that depend on country characteristics and are shaped by social, political, economic, and historical circumstances combined with different legal traditions.<sup>4</sup> A recommendation is to reform labor regulations in a

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4. See, for example, World Bank (2012).

systematic and comprehensive manner. In the past, several countries narrowly focused on selected labor regulations without considering the complexity of effects on the labor market.

A key message throughout this report is the essential role of social dialogue and tripartism in the development and implementation of labor regulations. As stated by the ILO, the main goal of social dialogue is to promote consensus building and ensure involvement of the main stakeholders in decisions and actions related to labor relations. This would improve opportunities for workers to obtain decent and productive work in conditions of freedom, equality, security, and human dignity. Social dialogue includes all types of negotiations, consultations, and exchange of information between, or among, representatives of governments, employers, and workers or between employers and workers' representatives on issues of common interest.<sup>5</sup>

It is necessary to recognize, however, that there are limits to what labor laws and policies can accomplish. In particular, labor regulations primarily benefit employees in the formal sector. According to recent estimations, over 60 percent of jobs in middle- and low-income countries are in the informal sector; these include farmers, the majority of own-account workers and informal wage employees, or close to 1.5 billion

workers.<sup>6</sup> Besides, in many countries, employment laws are often ineffective because of evasion and weak enforcement, even for workers with formal employment.

Although the focus of the report is the main labor law, it is important to note that it typically provides only for the minimum legislative requirements that employers and workers must comply with on commencing or terminating employment and during the period of employment. Minimum standards may be extended by other laws and acts, collective agreements, local (internal) regulatory acts, or individual employment contracts which define the rights and responsibilities of the parties in greater detail. These instruments, however, cannot undermine the provisions for employees established by labor law.

The report is organized into four chapters. Chapter 1 discusses essential elements of the employment contract as well as emerging forms of contractual relationships, with the focus on temporary employment and part-time employment contracts. Chapter 2 examines the establishment of the minimum wage, including setting the minimum wage, the level and differentiation of minimum wages, coverage, and adjustments in the level. Chapter 3 presents the main rules and regulations regarding the termination of employment contracts. Chapter 4 presents a discussion on the design and implementation of income protection schemes in case of unemployment, focusing on severance pay and unemployment benefit schemes.

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5. See ILO, 2013c "National Tripartite Social Dialogue: ILO Guide on Improved Governance" available at [http://www.ilo.org/wcmsp5/groups/public/@ed\\_dialogue/@dialogue/documents/publication/wcms\\_231193.pdf](http://www.ilo.org/wcmsp5/groups/public/@ed_dialogue/@dialogue/documents/publication/wcms_231193.pdf).

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6. See World Bank (2014); ILO (2015).



# 1. Employment Contracts

## 1.1. Overview

As economies and labor markets evolve, a wide variety of employment contracts have been developed. These contracts differ significantly in the degree of employment security, associated working and living conditions, and the types of benefits that must be provided to workers. Although full-time employment contracts of indefinite duration are the most common form of an employment relationship in developed countries, variations, including temporary employment (fixed-term) contracts, part-time contracts, on-call contracts, zero-hour contracts, contracts for workers hired through temporary employment agencies, or freelance contracts, have become established features of modern labor markets. Looking at developing countries, where casual work is widespread, many workers do not have written contracts at all. Moreover, many of the alternative work arrangements offer a limited set of benefits for workers, for example a lack of social insurance coverage or no protection against dismissal.

To some extent, reforms in labor legislation around the world have been associated with easing the recourse to temporary or alternative forms of employment while leaving existing provisions for regular or permanent contracts unaltered. As a result, the share of workers currently on temporary contracts is quite significant. According to data available from Organization for Economic Co-operation and Development (OECD) countries, in 2012, 11.8 percent of the workers had temporary contracts. In some countries, the ratio of workers on temporary contracts is much higher, for example, 26.9 percent in Poland, 23.6 percent in Spain, 20.7 percent in Portugal, and 13.7 percent in Japan (Annex—Chapter 1 Figure 1.1).<sup>7</sup> The share of workers on temporary contracts who claim to

have had no choice but to agree to a temporary contract varies considerably, from 25 percent in the United Kingdom to 51 percent in Poland and 65 percent in Italy.<sup>8</sup>

Fixed-term (temporary or limited duration) contracts are more common among young people, new labor market entrants, and those with the lowest education or skill levels. Women are more likely to be in temporary work than men. Among youth aged 15 to 24 years, the share in OECD countries was 24.5 percent in 2012. The highest share of young workers on temporary contracts was reported in Slovenia, 72.0 percent, followed by Spain, 62.4 percent, and Poland, 56.2 percent.

Especially for young workers, fixed-term work can provide an entry point into the workforce and an opportunity to gain experience and skills, but such contracts can also be exploited so that young people are trapped in perpetually renewed fixed-term contracts. The use of fixed-term contracts also appears to be growing in some developing countries. In this context, the policy objective is to ensure that workers have access to proper working conditions, equal pay, and access to social and fringe benefits.

In many countries of Latin America (Argentina, Uruguay, Paraguay, Peru, Bolivia, Guatemala, Honduras, and others), part-time work is widespread and particularly prevalent among women. For example, in the period 2002–2004, 43 percent of employed women worked part-time relative to 27 percent of employed men.<sup>9</sup>

Many workers are willing to take on part-time work as it enables them to combine work with family responsibilities or education. While in OECD countries a majority of part-time employees work on a voluntary basis, with few moving into full-time work and many staying in part-time jobs for long

7. OECD (2010). Labour Market Statistics: Employment by Permanency of the Job Incidence. *OECD Employment and Labour Market Statistics* (database). doi: 10.1787/data-00297-en (accessed on 26 February 2014).

8. [http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search\\_database](http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database).

9. López Bóo et al. (2009).

periods, there has been a substantial increase in involuntary part-timers in many advanced economies since the recent financial crisis.<sup>10</sup>

The key policy issue when discussing regulations regarding employment contracts is how to balance the objectives of providing sufficient flexibility to employers and workers in defining work arrangements while ensuring that workers are fully able to exercise their rights and enjoy adequate legal benefits and protections. This chapter will discuss some general principles to be considered for achieving this.

## 1.2. Objectives

The objective of an employment contract is to set up the rights and obligations of the parties to the employment relationship. An employment contract is an important indicator for the existence of an employment relationship.<sup>11</sup>

The employer is obliged to secure the employee the work agreed upon by the parties in the employment contract. The employer is required to provide the employee all the necessary means and materials for work, a safe and healthy work environment, and appropriate remuneration that may not be lower than the existing minimum wage. The employer should take the necessary measures to ensure that each employee has been given sufficient training. The worker's duty is to carry out the job that he agreed to in the employment contract, during the working hours, and at the location specified for carrying out the work. When entering into employment, the worker should have access to basic social protection arrangements that cover old age, disability, employment injury, maternity, unemployment, sickness, and medical care.

Labor law typically regulates the employment relationship, thereby setting the rights and obligations for employers and employees to comply with when commencing or terminating employment and during the period of employment. Other legislative acts, internal regulations, collective agreements, and an individual employment contract provide

supplementary guarantees to workers. These arrangements, however, may not provide conditions for the employees which would be less favorable than those established by the main labor law as well as other laws and acts.

An employment contract typically itemizes essential aspects of the employment relationship such as salary, benefits, and duration of employment if the contract is not open-ended (Box 1).

## 1.3. Labor Market and Social Impact

Labor regulations affect the nature and types of employment contracts, which in turn affect employment and salary levels, access to training, protection from dismissal, ability to exercise freedom of association, collective bargaining, and trade union rights, and social protection at work, among others.

Although international evidence is limited, some studies have found that policy reforms that facilitated the creation of fixed-term jobs in Europe in the late 1990s raised the probability, on average, that a worker would be on a fixed-term contract. However, there is no evidence that such reforms increased overall employment; instead, they appear to have encouraged substitution of temporary for permanent work.<sup>12</sup>

Several studies focus on major Spanish reforms in the early 1980s that liberalized fixed-term contracts without changing dismissal costs for regular contracts and find, in general, that this led to a large increase of fixed-term contracts and a reduction in permanent contracts.<sup>13</sup> Not surprisingly, Spain has one of the highest concentrations of workers with temporary contracts. Evidence from Spain also suggests that when the regulatory gap between permanent and temporary employment is large, transition rates across these two states are low.<sup>14</sup>

An important finding is that although temporary jobs may increase employment opportunities for some, they do not lead to net job creation and can also result in undesirable labor market outcomes.<sup>15</sup> From the workers' perspective, fixed-term jobs are less secure and pay lower than average wages. For example, in the European Union (EU), temporary workers earn on average 14 percent less than workers with open-ended contracts after controlling for a number of

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10. In OECD countries, between 2000 and 2012, the share of involuntary part-timers as a percentage of part-time employment has increased from 12.0 percent to 17.1 percent and the share of involuntary part-timers in total employment from 2.4 percent to 4.5 percent. See [http://stats.oecd.org/BrandedView.aspx?oeed\\_bv\\_id=ifs-data-en&doi=data-00299-en](http://stats.oecd.org/BrandedView.aspx?oeed_bv_id=ifs-data-en&doi=data-00299-en).

11. While the definitions of the basic terms 'employee' or 'worker', 'employer', and 'employment contract' are commonly left to national legislation, methods for determining the existence of an employment relationship are internationally recognized in the ILO Employment Relationship Recommendation, 2006 (No. 198). It is also important to make a clear distinction between employment and self-employment. See for example, the updated "Code of Practice for Determining Employment or Self-Employment Status of Individuals" prepared by the Hidden Economy Monitoring Group (<http://www.revenue.ie/en/tax/rct/determining-the-correct-employment-status-of-a-worker.html>). For more comparative examples, see also ILO (2007, 2013b).

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12. Kahn (2010).

13. See Bentolila et al. (2008); Aguirregabiria and Alonso-Borrego (2009).

14. For example, Güell and Petrongolo (2007); Garcia-Serrano and Malo (2013).

15. Kahn (2010).

## Box 1: Suggested Essential Aspects of the Contract or Employment Relationship

- (a) The identities of the parties
- (b) The place of work; where there is no fixed or main place of work, the principle that the employee is employed at various places and the registered place of business or, where appropriate, the domicile of the employer
- (c) The title, grade, nature, or category of the work for which the employee is employed or a brief specification or description of the work
- (d) The date of commencement of the contract or employment relationship
- (e) In case of a temporary contract or employment relationship, the expected duration thereof
- (f) The amount of paid leave to which the employee is entitled or, where this cannot be indicated when the information is given, the procedures for allocating and determining such leave
- (g) The length of the periods of notice to be observed by the employer and the employee should their contract or employment relationship be terminated or, where this cannot be indicated when the information is given, the method for determining such periods of notice
- (h) The initial basic amount, the other component elements, and the frequency of payment of the remuneration to which the employee is entitled
- (i) The length of the employee's normal working day or week
- (j) Where applicable, the collective agreements governing the employee's conditions of work, or in the case of collective agreements concluded outside the business by special joint bodies or institutions, the name of the competent body or joint institution within which the agreements were concluded
- (k) Probationary period, if any

personal characteristics.<sup>16</sup> Temporary contracts can enable firms to reduce labor costs, substituting lower-paid temporary labor for permanent workers. Temporary workers tend to have reduced access to training provided or subsidized by firms as the limited duration of their employment relationship discourages investment in (firm-specific) human capital. Fixed-term workers are subject to higher turnover. It also appears that the prevalence of fixed-term work is highest for those with the lowest levels of education and that it is more extensive in the primary, service and construction sectors than in manufacturing. Taken together, these outcomes can be suboptimal for the labor market and the economy as a whole if they encompass lower training, effort, productivity, and stability of household incomes.

In addition, the expansion of alternative types of employment contracts can reinforce labor market duality.<sup>17</sup> In fact, its main

effect may be to produce high turnover within these alternative types of contracts, with many workers going through several unemployment spells before obtaining a regular job.<sup>18</sup> There is a risk that part of the workforce will become trapped in a succession of short-term, low-quality jobs with inadequate social protection, leaving them in a vulnerable position. In the case of economic difficulties, temporary workers tend to be the first workers whom employers will make redundant. This effect reduces the response of wages to increases in unemployment, leading to lower permanent employment rates than otherwise.<sup>19</sup>

Part-time work can also have mixed outcomes. On the one hand, employers have more possibilities to adjust working hours to the economic cycle. They can promote higher labor force participation and more family-friendly work schedules or arrangements. On the other hand, part-time workers have lower hourly wages, on average, than full-time workers

16. EC (2010).

17. A dual labor market reflects a situation where the workforce is divided between the permanently employed and relatively well-protected "insiders" and "outsiders." Outsiders are precariously and informally employed as well as the unemployed. This group occupies a grey area where basic employment or social protection rights may be significantly

reduced or non-existent, giving rise to a situation of uncertainty about future prospects (see EC 2003).

18. Blanchard and Landier (2002); Cahuc and Postel-Vinay (2002).

19. Blanchard and Landier (2002); Bentolila and Dolado (1994).

in almost all OECD countries. Part-timers face a higher risk of poverty and are less likely to have access to unemployment benefits or reemployment assistance if they become unemployed. Part-time workers may also be excluded from coverage of social protection systems such as health care or pensions, receive fewer fringe benefits, and face more limited career possibilities than full-time jobs. Moreover, increases in the level of involuntary part-time employment often coincide with periods of economic recession since fewer standard full-time jobs are available and workers are forced to take jobs with reduced working hours as 'better-than-unemployment' alternatives.

## 1.4. Design and Implementation

This section discusses key issues in the design and implementation of employment contracts, including temporary contracts and part-time contracts, as well as important aspects of the probationary period.<sup>20</sup> The fundamental principle encompassing this approach involves ensuring adequate protection for all workers, independent of the type of employment contract.<sup>21</sup>

Due to the diversity of economic needs, employers should be able to offer different types of contracts provided that adequate protection for the workers involved can be secured. Therefore, legislation should treat workers in temporary or part-time employment to protection equivalent to that of comparable permanent full-time workers, determined in proportion to hours of work or other objective indicators.<sup>22</sup> Furthermore, employers should facilitate atypical workers' access to appropriate training opportunities to enhance their skills, career development, and occupational mobility.

Employment legislation should include measures to combat disguised employment relationships that hide their true status because these can have adverse effects on the affected workers and on tax revenue, thus externalizing the costs of the firm to others.<sup>23</sup> False or bogus self-employment, informal

work, and casual work are the relationships most commonly associated with precariousness.<sup>24</sup> In principle, employment relationships should be legitimated in a written employment contract. When this is not the case, it is particularly important to identify mechanisms to prevent abuse of employment relationships.

Temporary (fixed-term) contracts can be appropriate to allow firms to cope with unexpected fluctuations of demand; replace permanent staff on holiday, maternity leave, or sick leave; hire workers with specialized skills to carry out specific time-limited projects; or launch start-up ventures implying risky and uncertain returns. However, repeatedly renewing short-term contracts for ongoing work instead of hiring on a standard open-ended basis should be discouraged.

In an employment relationship, fixed-term workers should not be treated in a less favorable manner than comparable permanent workers. The equal treatment should apply in almost all fields: health and safety, remuneration, duration and organization of working time, paid leave and public holidays, social benefits, and information on available vacant posts and their terms (Annex—Chapter 1 Figure 1.2). Exceptions to the general principle of equal treatment are possible with respect to terms which are directly related to the limited duration of employment, for example, notice or severance pay.<sup>25</sup> National regulations, such as in Australia for casual workers, may provide that, if the equal treatment does not apply to all fields (such as paid or sick leave), workers should be compensated with a substantially higher pay. In these cases, effective monitoring or complaint mechanisms would be needed to prevent abuse.

Equalizing benefits and dismissal procedures between fixed-term and open-ended contracts might prevent misuse of successive fixed-term contracts. However, this should not lead to lower protection, as it would otherwise exacerbate the negative externalities for the labor market and the economy as a whole in terms of suboptimal investment in training, productivity, and stability of household incomes. Clearly, firms have less incentives to convert workers from temporary to permanent contracts in cases where it is easy to hire temporary workers but costly to dismiss regular ones. Addressing problems of dismissal procedures (see Chapter 3) is therefore essential to avoid temporary workers—often young, unskilled, or old workers—being forced into a constant rotation across temporary jobs. This is important since there is evidence that their low probability of being converted into a permanent job, even if they are very skilled,

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20. Other forms of atypical work are beyond the scope of this report.

21. See for example, the ILO Employment Relationship Recommendation, 2006 (No. 198).

22. ILO Recommendation No. 166 (Article 3(2)) provides examples of legal rules to prevent abusive recourse to fixed-term contracts. This may be done by (a) limiting recourse to contracts for a specified period to cases in which, owing either to the nature of the work to be effected or to the circumstances under which it is to be effected or to the interests of the worker, the employment relationship cannot be of indeterminate duration; (b) deeming contracts for a specified period, to be contracts of employment of indeterminate duration; (c) deeming contracts for a specified period of time, when renewed on one or more occasions, to be contracts of employment of indeterminate duration. The ILO Termination of Employment Recommendation, 1982 (No. 166).

23. The term 'disguised employees' refers to workers who receive payments from a client via an intermediary and whose relationship with

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their client is such that they are effectively employees of the client. They are treated as self-employed for tax evasion or other purposes.

24. McKay et al. (2012).

25. See for example, the ILO Termination of Employment Convention, 1982 (No. 158).

reduces incentives to perform well and to learn on the job, with obvious costs in productivity growth and well-being of the worker.<sup>26</sup>

In all cases, there should be provisions that define

1. objective reasons justifying the length and renewal of such contracts or relationships;
2. maximum total duration of successive fixed-term employment contracts or relationships; and
3. number of renewals of such contracts or relationships.

Employers should also inform fixed-term workers about vacancies that become available in the undertaking or the establishment to ensure that they have the same opportunity to secure permanent positions as other workers.

It is also important to ensure that part-time workers receive conditions equivalent to those of comparable full-time workers in the fields of (a) salary; (b) maternity protection; (c) termination of employment; (d) paid annual leave and paid public holidays; and (e) sick leave. Statutory social security schemes that are based on occupational activity should be adapted so that part-time workers enjoy conditions equivalent to those of comparable full-time workers or to encourage the conversion of full-time posts to part-time contracts in order to avoid providing certain benefits.<sup>27</sup> (Annex—Chapter 1 Figure 1.3). However, exceptions can be allowed to control transaction costs associated with social entitlements of certain types of part-time work. Part-time workers whose hours of work or earnings are below specified thresholds may be excluded from the scope of some measures taken in the above-mentioned fields, provided they are not excluded from employment injury benefits or maternity protection measures.<sup>28</sup> The thresholds should be sufficiently low so as not to exclude an unduly large percentage of part-time workers.<sup>29</sup>

It is important to allow the inclusion of a probationary period in the employment contract to confirm that the employee has the necessary professional and social skills for performing

the work agreed upon. During this period, labor contracts are not fully covered by employment protection provisions. If employers are not satisfied, they can terminate the employment contracts of workers under probation with more flexible conditions than for regular workers. Two main cases can be distinguished: (a) protection of unfair dismissal does not apply (though dismissals cannot be made on prohibited or discriminatory grounds); (b) normal notice period and severance pay rules do not apply.

The duration of the probationary period should be reasonable. It usually ranges between 3 and 6 months but a shorter or longer trial period may be stipulated in the collective agreement or agreed upon by the parties in individual employment contract(s) (see also Annex—Chapter 1 Table 1.1).<sup>30</sup> In some jobs, particularly high-level positions, employers need more time to determine if a worker or employee is a good match. On the other hand, for many unskilled and semiskilled occupations, it is not necessary to have a lengthy probationary period to verify the abilities of the worker. However, excessively short trial periods may not permit sufficient monitoring of workers and raise the risk of disciplinary or economic dismissals for workers' unsuitability at a later stage.

To prevent abuse of the probationary period, it might be appropriate to set a maximum number of trial workers for a single position. Especially in micro enterprises and in the service sector, this could avoid the practice of some employers misusing probationary periods by hiring the workers only on probation and replacing them at the end of the period with new employees. To mitigate the abuse of the probationary period, some countries also stipulate exemptions to specific groups. For instance, the probationary period may not be used for individuals with disabilities, pregnant women, or workers with children of up to three years of age and some other categories of employees.

## 1.5. Resources

ILO Equal Remuneration Convention, 1951 (No. 100)

ILO Discrimination (Employment and Occupation) Convention, 1958 (No. 111)

ILO Workers with Family Responsibilities Convention, 1981 (No. 156)

ILO Workers with Family Responsibilities Recommendation, 1981 (No. 165)

ILO Termination of Employment Convention, 1982 (No. 158)

ILO Termination of Employment Recommendation, 1982 (No. 166)

30. World Bank (2013).

26. Aguirregabiria and Alonso-Borrego (1999).

27. According to the ILO Part-Time Work Convention, 1994 (No. 175) and Part-Time Work Recommendation, 1994 (No. 182).

28. According to the ILO Convention 175 (Article 8), part-time workers whose hours of work or earnings are below specified thresholds may be excluded from the scope of some of the statutory social security schemes and other measures, except in regard to employment injury benefits and maternity protection measures.

29. For example, with regard to dismissal protection, in Denmark, to qualify for relevant benefits, the part-time worker must work at least 15 hours per week; in Germany, 18 hours per week; in Spain, 12 hours per week; in France and the Netherlands, there is no threshold; in Ireland, the threshold is 12 hours per week; in Austria, 12 hours per week; in Sweden, 17 hours a week; and in the United Kingdom, the threshold is earnings of at least 57 pounds per week. See [http://ec.europa.eu/employment\\_social/labour Law/docs/06\\_parttime\\_implreport\\_en.pdf](http://ec.europa.eu/employment_social/labour Law/docs/06_parttime_implreport_en.pdf).

ILO Part-Time Work Convention, 1994 (No. 175)

ILO Part-Time Work Recommendation, 1994 (No. 182)

ILO Employment Relationship Recommendation, 2006 (No. 198)

Council Directive 91/533/EEC of October 14, 1991 on an employer's obligation to inform employees of the conditions applicable to the contract or employment relationship

Council Directive 97/81/EC of December 15, 1997 concerning the Framework Agreement on part-time work concluded by UNICE, CEEP and the ETUC

WB Doing Business database on labor legislation (<http://www.doingbusiness.org/>)

ILO Working Conditions Laws Database (<http://www.ilo.org/dyn/travail/travmain.home>)

ILO Employment protection legislation database—EPLex (<http://www.ilo.org/dyn/epllex/termmain.home>)

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## Annex—Chapter 1

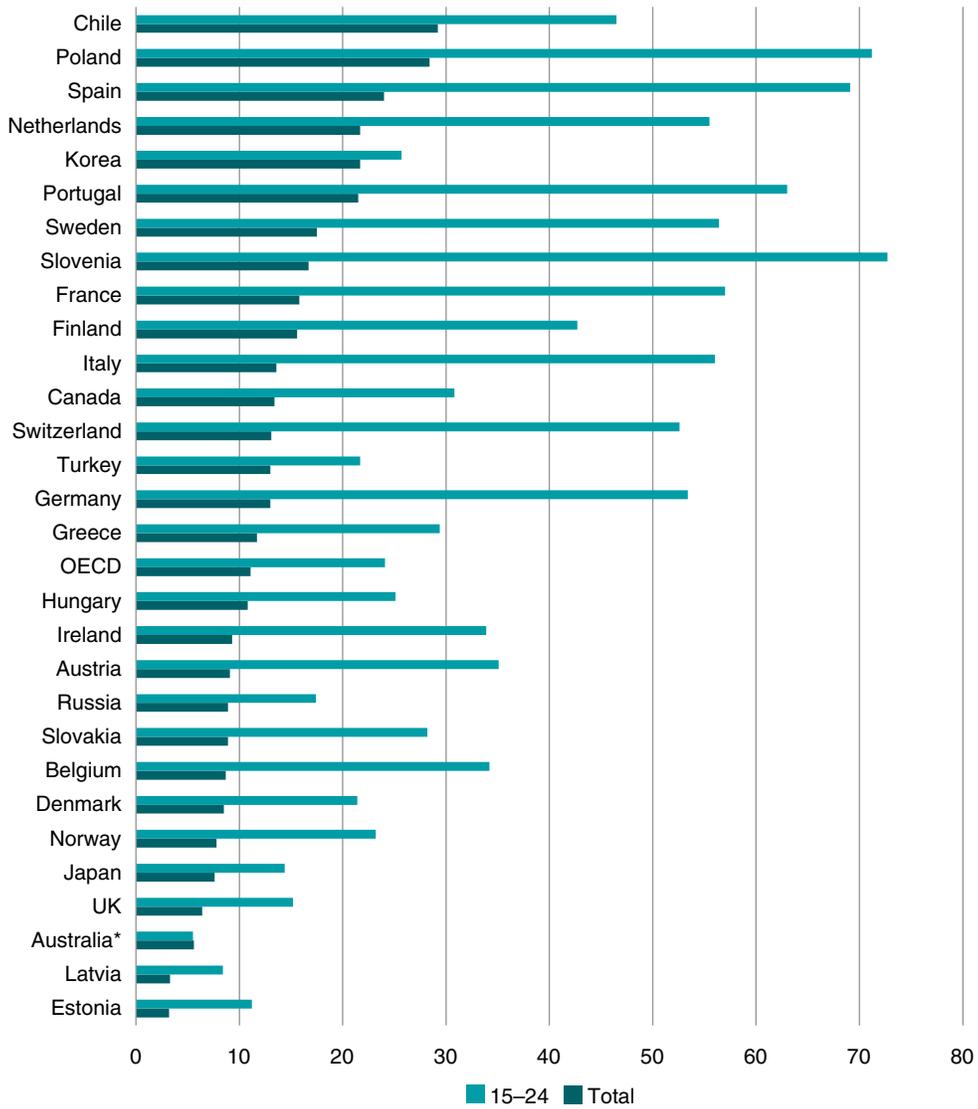
**TABLE 1.1:** Probationary Period (months) by Income Group of Countries in 2013

Income Group	Total Number of Countries*	Including:		
		2 Months and Less	3–5 Months	6 and More Months
High income	51	7	24	20
Upper middle income	49	9	25	15
Lower middle income	45	19	14	12
Low income	32	7	11	14
Total	177	42	74	61

\*Data not available for 12 countries

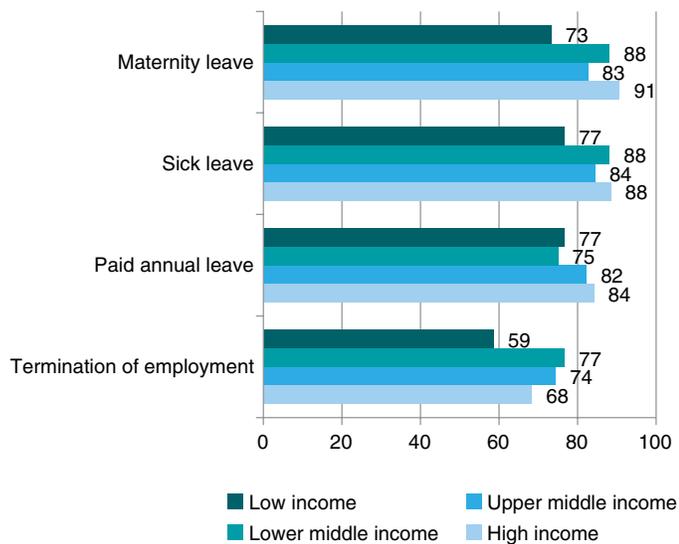
Source: World Bank 2013

**FIGURE 1.1:** Incidence of Temporary Employment in Some OECD Countries and in Russia, 2014, %



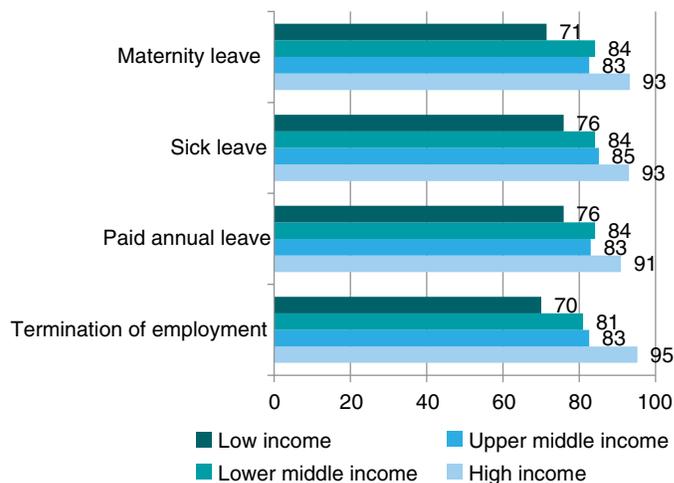
Source: [http://www.oecd-ilibrary.org/employment/data/labour-market-statistics/employment-by-permanency-of-the-job-incidence\\_data-00297-en](http://www.oecd-ilibrary.org/employment/data/labour-market-statistics/employment-by-permanency-of-the-job-incidence_data-00297-en).

**FIGURE 1.2:** Economies in Which the Law Requires That Temporary Workers Enjoy Conditions Equivalent to Those of Comparable Full-time Workers, %



Source: Kuddo and Robalino 2013

**FIGURE 1.3:** Economies in Which the Law Requires That Part-time Workers Enjoy Conditions Equivalent to Those of Comparable Full-time Workers, %



Source: Kuddo and Robalino 2013

# 2. Minimum Wages

## 2.1. Overview

Statutory minimum wage regulations were first introduced in New Zealand in 1894 and the Australian state of Victoria in 1896. Their main purpose was to protect workers who were not covered by collective agreements and who were particularly vulnerable to low pay conditions. Minimum wages exist in most of the countries in the world. By mid-2015, 160 economies out of 189 had minimum wages for a regular worker.<sup>31</sup>

Minimum wage levels vary significantly by country. According to Doing Business data, in absolute terms, in 2015 the lowest minimum wages were reported in Uganda and Burundi (US\$2 per month)<sup>32</sup> and the highest in Norway (US\$3,722 per month), Luxembourg (US\$3,062 per month), and Australia (US\$2,397 per month).<sup>33</sup>

In practice, some workers are excluded from the scope of the general minimum wage in some countries.<sup>34</sup> Minimum wage rules typically do not cover the self-employed or (unpaid) family workers. In practice, they often are not enforced in the informal economy although recent research indicates some upward impact on wages of informal workers when minimum wages are increased. Small firms are sometime excluded from coverage of laws.

31. World Bank (2015). For assumptions about the regular worker, see World Bank (2013a, b).

32. World Bank (2013a). Minimum wages in these countries have not been adjusted since 1984 and 1988, respectively.

33. Minimum wages can be set on either an hourly, daily, weekly, or monthly basis, which complicates cross-country comparisons of their levels. 'Doing Business' recalculates them on a monthly basis.

34. ILO (2014).

Important dimensions of minimum wage regulations that will be discussed in this chapter are (a) objectives and rationale; (b) labor market and social impact of minimum wages; and (c) design and implementation arrangements (setting the level, differentiation, adjusting minimum wages over time, institutional arrangements, and noncompliance and enforcement).

## 2.2. Objectives and Rationale

The primary purpose of minimum wages is to provide protection for wage earners against 'unduly low wages' (see Box 2 for wage concepts and definitions).<sup>35</sup> In this context, minimum wages can contribute to reduce wage inequality and, under certain conditions, reduce or prevent poverty.

Clearly, a minimum wage is only part of the answer to the problem of low wages. Wages may be low because labor productivity is low. This may occur as a result of low capital intensity per worker, inefficient production technologies, poor management, and/or an unskilled labor force.<sup>36</sup> Very low wages are often the result of labor market imperfections such as asymmetrical bargaining power and monopsonistic labor markets. In addition, many of the poor and low-income workers in developing countries are self-employed or subsistence farmers. Thus, minimum wages should be looked at as one instrument in a menu of policy options available to effect income distribution and poverty. In most cases several tools will be necessary for optimal effects.

35. According to ILO Convention No. 131 (1970).

36. Del Carpio et al. (2010).

## Box 2: Wage Concepts and Definitions

According to the ILO Protection of Wages Convention No. 95 (1949), the term ‘wages’ means remuneration or earnings, however designated or calculated, capable of being expressed in terms of money, and fixed by mutual agreement or by national laws or regulations, which are payable in virtue of a written or unwritten contract of employment by an employer to an employed person for work done or to be done or for services rendered or to be rendered.

The minimum wage is defined as “the minimum amount of remuneration that an employer is required to pay wage earners for the work performed during a given period, which cannot be reduced by collective agreement or an individual contract.”<sup>38</sup> Minimum wages fixed by collective agreements and made binding by public authorities are included in this definition.

The Council of Europe’s Social Charter provides for the right to ‘a fair remuneration’, referring to ‘a remuneration such as will give the workers and their families a decent standard of living’. The Social Charter defines the decency threshold as 60 percent of net national average wage (that is, after deduction of taxes and social security contributions).<sup>39</sup>

The provision of a living wage should allow the workers and their families to lead a simple but decent life considered acceptable by society, in light of its level of development, among other things, to live above the poverty line and participate in social and cultural life.<sup>40</sup>

The concept of fair wages encompasses 12 dimensions. In particular, wages must be paid regularly and in full to the workers; they must comply with the minimum wage regulations; they should not require excessive working hours; and they must lead to a balanced wage structure, free of discrimination.<sup>41</sup>

## 2.3. Labor Market and Social Impact of Minimum Wages

The labor market and social impacts of minimum wages depend particularly on the level at which the minimum wages are set, how many workers are directly affected by this measure (that is, earning at the minimum wage or slightly above), and how well they are enforced. Minimum wages that are set too high can, in principle, reduce employment levels. At the same time, minimum wages that are set too low would fail to protect workers.

**(1) Impact on employment:** Although the range of estimates from the literature varies considerably, the emerging trend is that the effects of minimum wages on employment are usually small or insignificant (and in some cases positive).<sup>41</sup> For example, based on a meta-study of 64 minimum wage studies published between 1972 and 2007 and measuring the impact of minimum wages on teenage employment in the

United States, the most precise estimates were heavily clustered at or near zero employment effects.<sup>42</sup> A meta-analysis of 16 U.K. studies found no significant adverse employment effect.<sup>43</sup> In its reexamination of the job strategy, the OECD came to a similar conclusion, basing its policy advice on the considerable number of studies that have found that the adverse impact of minimum wages on employment is modest or nonexistent.<sup>44</sup> Recent studies using natural experiments or detailed payroll data also point toward no significant effects on employment and some positive benefits such as reduced turnover and increased productivity.<sup>45</sup>

Most studies address the effects of the minimum wage in advanced economies.<sup>46</sup> Empirical evidence on developing countries and emerging market economies is more limited and the results are mixed. The effects of minimum wages on employment appear to be negative in some countries and some years and positive in others. For example, the impact

37. ILO (2014).

38. Council of Europe (2008).

39. Anker (2011); Belser and Sobek (2012).

40. Vaughan-Whitehead (2010).

41. See Betcherman (2014); Belman and Wolfson (2014).

42. Doucouliagos and Stanley (2009).

43. Leonard et al. (2013).

44. OECD (2006).

45. Card and Krueger (1995, 2000); Dube et al. (2010); Hirsch et al. (2011).

46. The most comprehensive, analytical, and unbiased assessment of the effects of minimum wage increases, based on a rigorous meta-analysis of more than 200 scholarly publications published since 1991, has been compiled by Belman and Wolfson (2014). Their findings indicate that increases in the minimum wage result in very small reductions in employment.

appeared to be negative in Colombia up until the end of the 1990s and small or negligible in Costa Rica and Mexico in the same period. In Brazil, empirical evidence shows a positive effect of an increase of the minimum wage on employment, mainly resulting from changes in the composition between hours worked and the number of jobs.<sup>47</sup>

Evidence for new EU member states suggests that adverse effects introduced by minimum wages, although present, are limited.<sup>48</sup> Similarly, empirical studies differ on the impacts of minimum wages on various groups of workers. Some studies found that in a few countries (such as Brazil, Chile, or Mexico), employment decreased for vulnerable groups such as women, youth and low-skilled.<sup>49</sup> Other studies could not validate this effect, for example, in Brazil from 1982 to 2000 or in Thailand from 2001 to 2011.<sup>50</sup>

### **(2) Impact on worker flows and informal employment:**

There is mixed evidence regarding the effects of minimum wages on worker flows and informal employment. Some studies find a negative impact of minimum wages on job retention for individuals at, or close to, the minimum wage.<sup>51</sup> However, some other studies have found no significant impact.<sup>52</sup> There are also no firm conclusions that higher minimum wages can shift employment from the formal to the informal sector. The studies that have looked at this question do not yield consistent results. Some do find a decrease in formal employment and an increase in informal employment.<sup>53</sup> No effect of minimum wages on informality was identified in Costa Rica and Brazil; a stronger negative effect of increased minimum wages on wage workers was found in the informal sector than in the formal sector.<sup>54</sup>

**(3) Impact on wage distribution:** Minimum wages also affect the wage distribution and therefore average wages, the extent of which depends on the level of the minimum wage as well as on possible spillover effects that lead to salary increases higher up the wage distribution ('ripple effect').<sup>55</sup> For example, according to evidence for Latin America, a 10 percent increase in minimum wages would entail an increase in average wages of between 1 and 6 percent.<sup>56</sup> Also almost all studies find that minimum wages do lead to a compression of the earnings distribution and reduction in earnings inequality. How much earnings dispersion is reduced

depends not only on how high the minimum wage is set relative to the rest of the distribution but also on compliance. In addition, minimum wages have tended to narrow the earnings differentials across demographic groups. For example, in Brazil, wage compression in both the public and private sectors was found to be a result of minimum wage increases.<sup>57</sup> It has been documented that wage compression in Costa Rica was due to positive wage impacts being strongest for low-wage workers.<sup>58</sup>

Despite the fact that minimum wages are often not enforced in the informal sector, it seems to influence informal sector wage distribution. From the labor supply side, the minimum wage may be a benchmark for 'fair' wages. On the demand side, employers may pay wages higher than the minimum and comparable to the formal sector market wage for a particular occupation so that their employees will not leave for a similar job in the formal sector, a kind of efficiency wage (so-called 'lighthouse effect').<sup>59</sup> Alternatively, they may not be willing to provide legislated labor benefits but instead pay the minimum wage. In some countries, increases in the minimum wage often raise, rather than depress, wages in the informal sector. This finding has been most notable in studies of Latin American countries.<sup>60</sup>

**(4) Impact on poverty:** Earlier OECD analysis found a relatively weak link between low pay and poverty in advanced economies.<sup>61</sup> This was explained by the observation that poverty is predominantly associated with nonemployment (including unemployment) rather than with low wages. Many poor households have no household member working and some minimum wage workers live in households with above-average incomes. Still, most of the additional income from minimum wages accrues to families with relatively low income, and a sizeable proportion of minimum wage earners are poor.

A review of literature in 2012 found that while most studies identified a poverty-alleviating effect of minimum wages, some studies discovered no effect.<sup>62</sup> In the United States, 20 percent of low-wage workers live in families whose income is below the poverty line and another 16 percent live in families whose income does not exceed 1.5 times the poverty line.<sup>63</sup> In European countries, household surveys show that minimum wage earners live in relatively larger households with substantially lower incomes and are much more at

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47. Bell (1997); Maloney and Mendez (2003).

48. Koettl et al. (2012).

49. Montenegro and Pages (2003).

50. Lemos (2007); DelCaprio et al. (2014).

51. Abowd et al. (2005); Portugal and Cardoso (2006); Draca et al. (2008).

52. Zavodny (2000).

53. Maloney and Mendez (2003); Jones (1997).

54. Gindling and Terrell (2007); Fajnzylber (2001).

55. Harris and Kearney (2014).

56. Cunningham (2007).

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57. Lemos (2007).

58. Gindling and Terrell (1995); Fajnzylber (2001).

59. Cunningham (2007).

60. Gindling and Terrell (2004); Lemos (2004); Fajnzylber (2001); Maloney and Mendes (2003).

61. OECD (1998).

62. Betcherman (2012).

63. CBO (2014).

risk of poverty.<sup>64</sup> In India, about 30 percent of salaried workers and 40 percent of casual wage workers earning less than state-level minimum wages live in poor households.<sup>65</sup>

Gindling noted that “whether raising minimum wages reduces poverty depends not only on whether formal sector workers lose jobs as a result but also on whether low-wage workers live in poor households, how widely minimum wages are enforced, how minimum wages affect informal workers, and whether social safety nets are in place.”<sup>66</sup> For example, a 1 percent increase in minimum wages lowered the incidence of poverty by 0.12 percentage points in Nicaragua and by 0.22 percentage points in Honduras.<sup>67</sup> Consequently, the link between minimum wages and poverty can be stronger or weaker depending on the country context.

Additional policies to mitigate poverty will typically be needed to complement minimum wages. In-work benefits, for example, might be a complementary policy tool intended to provide financial incentives for workers to take low-paid jobs by offering additional earnings, thereby reducing poverty. They may take the form of tax credits, wage-related transfers, or other lump-sum payments.<sup>68</sup> Employment guarantee schemes may also have a large and positive impact on poverty and can also influence whether statutory minimum wages reach the poorest households.

**(5) Impact on productivity:** Some studies suggest that a minimum wage and minimum wage increases could increase productivity because of higher investments in human capital. A study on productivity effects of wage costs, using cross-country aggregate data for 18 OECD member countries, estimated that a 10 percentage point increase in the minimum wage-to-median wage ratio was associated with an increase of between 1.7 to 2.0 percentage points in long-run labor productivity and multifactor productivity levels.<sup>69</sup> Recent studies using natural experiments or disaggregated data sets find a positive impact on productivity from increases in minimum wages in China, the United States and the United Kingdom.<sup>70</sup> One possible reason for this effect is the substitution of higher-skilled labor for less-skilled labor due to decreased demand for unskilled labor as minimum wages rise. To the extent that employers make this substitution, productivity levels will rise without any change in employment levels. Another possible reason is that employers could make productivity-enhancing adjustments—that is, increased investments in training or new technologies or better management techniques—

in response to the higher labor costs from minimum wage increases. An additional factor is that higher wages tend to reduce turnover among low-wage workers and thus lead to a workforce with more experience.

## 2.4. Design and Implementation of Minimum Wage Policies

### Setting the Level

In setting minimum wages, two important considerations need to be made. First, economic factors, including the requirements of economic development, levels of productivity, and the desirability of attaining and maintaining a high level of employment; and second, the needs of workers and their families, taking into account the general level of wages in the country, the cost of living, and the relative living standards of other social groups.<sup>71</sup> In practice, the level of the minimum wage depends largely on the prevailing social norms with regard to inequality and fairness, as well as on relative bargaining strengths of workers and employers.

The level of minimum wages should be carefully considered. Too low a level reduces the relevance of minimum wages and the potential for this policy tool to address inequality and the living standards of the working poor; too high a level runs the risk of firms evading minimum wage legislation. Too high a minimum wage may have an adverse impact on employment or may push vulnerable workers such as low-skilled workers, young people, and women out of employment or into informal sector jobs, although as discussed above, the limited empirical evidence available for developing countries is mixed and generally weak on this point.

There is no fixed formula to set the minimum wage level but it is important to consider its social and economic impacts. Some indicators that can be used as a reference include (a) minimum wages relative to median or average wages (see Annex—Chapter 2 Figure 2.1)<sup>72</sup> and (b) share of workers affected by minimum wages (see Annex—Chapter 2

64. Rycx and Kampelmann (2012).

65. Belser and Rani (2011).

66. Gindling (2014).

67. Alaniz et al. (2011); Gindling and Terrell (2010).

68. ILO (2010).

69. Bassanini and Venn (2007).

70. Mayneris, F., S. Poncet and T. Zhang (2014); Schmitt, J. 2013; Croucher and Rizov (2012).

71. The ILO Convention No. 131 and Recommendation No. 135 provide the principles for setting up minimum wages.

72. Median rather than mean earnings provide a better basis for international comparisons as they account for differences in earnings dispersion across countries. The median wage is the middle observation in the distribution of wages whereas the mean wage is the sum of all wages divided by the number of wage earners.

Table 2.1). These indicators should be complemented by an assessment of the needs of workers and their families, such as through the calculation of an adequate living wage.

An appropriate level of the minimum wage also depends on a host of country-specific factors, such as labor market conditions; other labor market policies; and variations in worker productivity across regions, industries, and occupations. In developed countries, minimum wages typically range from about 35 percent to 60 percent of median full-time wages, with some clustering around 45–50 percent.<sup>73</sup> In developing countries, this ratio is often higher, not least because the median worker is frequently a low-paid worker.<sup>74</sup> Given that median wages are often not readily available in developing countries, a second-best option has been to compare minimum wages with mean wages rather than median wages. Mean wages typically exceed median wages, by an extent which depends on the level of inequality in a particular country.

Based on data for 75 countries, the minimum wage level is most frequently set at around 40 percent of mean wages.<sup>75</sup> While these different ratios represent a useful reference point, it is important to disaggregate the analysis also considering the distribution of wages separately for women and men and for different industries; and to observe where a minimum wage lies in these respective distributions.<sup>76</sup> It is also useful to compare the level of the minimum wage to the wages of those workers who are legally covered, as opposed to all wage workers, which may include various groups with low wages who are not actually covered by the legislation.<sup>77</sup> For all these reasons, *ex ante* and *ex post* impact evaluations of the level set should be conducted to assess their relevance.

## Differentiation

While minimum wages differentiated by segments of a country's labor market are common, these can increase administrative complexity, create enforcement challenges, and lead to wage discrimination. Depending on the country, minimum wages are sometimes differentiated according to region, sector, age, qualifications, education, or type of job. International reviews suggest that minimum wages are generally applied uniformly at the national level (45 percent) or by sector or industry (43 percent). The minimum wages fixed for specific occupational categories or sectors may include regional variations.<sup>78</sup>

With multiple minimum wages, however, there is a risk that similar workers (for example, with the same occupation and skills levels) would be subject to varying minimum wage rates. This would affect the principle of equal treatment. Therefore, the general principle of equal remuneration for work of equal value has to be observed while fixing minimum wage levels. Furthermore, too many minimum wage levels make it difficult for workers and employers to determine which rates are applicable to them and might also affect the mobility of labor and capital.

Multiple minimum wages also add administrative complexity and are only successful if an adequately robust system of oversight accompanies them. The ILO 2014a General Survey on minimum wage systems points out that “the more complex a minimum wage system is, and the more sectoral, occupational and geographical rates it involves, the more difficult it is to monitor, particularly in countries where the labor administration services have very limited resources.”<sup>79</sup>

The general trend around the world is to reduce the number of differentiated minimum wage rates.<sup>80</sup> Nonetheless, national minimum wages are sometimes modified for first-time job seekers or for economically depressed regions with high unemployment. In countries with exceptions to the standard minimum wage to promote the employment of vulnerable workers, it is important to establish precautionary measures to avoid abuse and to ensure respect for the principle of equal remuneration for work of equal value. Substantial evidence exists that employers may use such exceptions to lower labor costs without providing any net employment creation, for example, by hiring ever younger workers to replace cohorts that age and move up the wage scale, without providing net employment creation even for the targeted group.<sup>81</sup>

According to the Doing Business 2014 database, 42 countries have youth minimum wages to encourage employers to hire this age group, given their lack of experience. A large number of countries have renounced maintaining reduced minimum wage rates for young workers, notably for reasons related to nondiscrimination.<sup>82</sup>

Instead of using age as a criterion, it might be preferable to take account of the qualifications and experience of the workers concerned.<sup>83</sup> Persons on apprenticeship or traineeship contracts should only be paid at a differentiated rate where they receive actual training during working hours at the workplace. In general, the quantity and quality of the work performed should be the decisive factors in determining the wage paid.

73. ILO (2014).

74. ILO (2013c); Rani et al. (2013).

75. Belser and Sobek (2012); ILO (2009a).

76. ILO (2014).

77. ILO (2013c).

78. ILO (2013a, 2014).

79. ILO (2014).

80. World Bank (2013b).

81. Salverda (2009); Allegretto et al. (2011); Blázquez Cuesta et al. (2011); Dickens et al. (2010).

82. ILO (2014).

83. ILO (2014).

## Adjusting Minimum Wages over Time

Minimum wage rates should be adjusted from time to time to take account of changes in the cost of living and other economic and social conditions. The main consideration should be to reduce uncertainty in frequency and levels of adjustment. The following criteria are used in different countries for the adjustment of minimum wage rates: the cost of living, which guarantees workers a certain purchasing power; consumer price index; the types of workers' needs which the minimum wage must satisfy but also those of their families; the general level of wages in the country (the mean wage); the economic situation of the country; requirements of economic development; productivity; the level of employment; economic competitiveness and the financial capacity of enterprises.<sup>84</sup> A first principle is to establish predetermined dates for minimum wage reviews and revisions, for example, once a year.<sup>85</sup> The revision does not imply that the minimum wage will be adjusted but that a possible adjustment would be studied. The results of the assessment, the decision to adjust, and the time when the new minimum wage is effective (in case of a change) should also be made public at a predetermined date. Such measures increase the predictability of the process for firms and workers.

One possible mechanism to reduce uncertainty and help set expectations regarding the level of the minimum wage is to set up a simple formula to compute a reference value. Some of the factors that could enter the formula include labor productivity, cost of living, poverty lines, and unemployment rates. The formula is not used to define what the new level of the minimum wage should be. That would depend on consultations or negotiations with the social partners and additional technical analysis. The purpose of the formula is to set an anchor to facilitate discussions among different stakeholders.

Automatic adjustments to the minimum wage could be considered, in principle, but there is a risk that the resulting level is not consistent with changing macroeconomic conditions and reduces the role of social partners in the adjustment process. In some countries, in fact, adjustment takes place following a decision by the relevant authority as minimum wages are linked to factors such as the cost of living (for example, Belgium, Haiti, Luxembourg, and Paraguay) or the mean wage (for example, Belarus, FYR Macedonia, Israel, and Montenegro).<sup>86</sup> These automatic adjustments allow safeguarding the purchasing power of minimum wages, avoid lengthy political negotiations, and reduce uncertainty among workers and employers. There should be provisions

84. See ILO (2014) for details.

85. However, ILO standards do not require the establishment of predetermined dates for reviewing minimum wages. Recommendation No. 135 provides that "Minimum wage rates should be adjusted from time to time to take account of changes in the cost of living and other economic conditions."

86. ILO (2014).

that stop such an indexation when there are concerns about economic, productivity, and employment growth.

As discussed above, an important principle would be to accompany the discussions of the adjustment of the minimum wage with ex ante and ex post assessments of the potential social and economic impacts. These assessments could be more thorough than what a simple formula can infer.

## Institutional Arrangements

Independent of the authority chosen to ultimately decide on the minimum wage, full consultations and participation of social partners need to be ensured. The process should be transparent and all social partners should be on equal footing and able to make proposals on the minimum wage.

The authority for the final decision and institutional arrangements for fixing the minimum wage can vary. The minimum wage can be set up by statute, decision of the competent authority, decision of wage boards or councils, industrial or labor courts, and tribunals.<sup>87</sup> Alternatively, minimum wages may be set by giving the force of law to provisions of collective agreements (Box 3). In case the minimum wage level is fixed by the public authority, it is essential that the decision responds to the recommendations of an independent technical assessment and consultations with social partners.

### Box 3: Minimum Wage Fixing Machinery

The minimum wage fixing machinery may take a variety of forms.

- 46 percent of countries have legislation that provides that the government agency (typically the labor ministry) sets the minimum wage after consultation with or upon recommendation of a specialized body (bipartite or tripartite) or of the social partners.
- In 10 percent of countries, the legislation permits the government alone to set the minimum wage.
- In 11 percent of countries, specialized bodies (wages boards or councils) legally determine minimum wages.
- In 9 percent of countries, minimum wages are determined through collective bargaining.

Some countries consult social partners separately or have mixed wage-fixing mechanisms.<sup>89</sup>

87. ILO Minimum Wage Fixing Recommendation, 1970 (No. 135).

88. ILO (2013b).

To this end, some countries have set up independent expert mechanisms (for example, United Kingdom and Chile) that make recommendations on the level of the minimum wage based on an analysis of economic and social impacts and consultations with social partners. Other countries (for example, Tunisia) have set up social councils with representatives from government, workers, and employers that are responsible for recommending adjustments to the minimum wages. Such councils can commission independent technical assessments.

## Noncompliance and Enforcement

Besides those workers who are not legally covered, some earn wages below the minimum because their employer fails to comply with the legislation.<sup>89</sup> This issue is particularly pronounced in countries with high informality. While necessary, enforcement itself may not be sufficient to address low compliance. Rather, a combination of measures should be taken.

First, countries should avoid overly complex minimum wage systems, be transparent, and have a broad communication regarding the minimum wage regulations and levels. Legal provisions and procedures should be simplified, thereby enabling workers to effectively claim their rights under minimum wage provisions. Likewise, arrangements need to be put in place to give publicity to minimum wage provisions in a way that raises awareness among employers and workers. Wherever it is possible and capacity is available, employers' and workers' organizations should be encouraged to protect against abuses and ensure the effective implementation of the minimum wage provisions.

Second, inspections should be carried out frequently with appropriate resources allocated to ensure that sufficient and adequately trained inspectors are employed. These inspectors should have the powers and facilities required for enforcing minimum wage provisions. In most countries, enforcement of laws on minimum wages is the responsibility of labor inspectorates or alternatively of specialized supervisory bodies of the relevant ministry, financial organs, bodies of the State Tax Inspectorate, the Procurator Office, industrial or employment tribunals, ombudsman, or labor offices. However, inspections are unlikely to be sufficient when there is a large informal sector.

Trade unions could be involved in monitoring the compliance with minimum wage legislation albeit in many developing countries, their capacity is limited. In high-income countries without a national statutory minimum wage, supervision

over collectively bargained minimum wages is often mainly delegated to trade unions or the social partners in general and industrial/labor tribunals or courts. There is also a role for NGOs in monitoring the application of regulations and helping workers understand the rights associated with a minimum wage system, for example, submitting complaints if their rights were compromised.

Third, sanctions for noncompliance with minimum wage rules have to be imposed to correct abuses and serve as a deterrent. Measures should be taken to (a) ensure that the labor legislation provides for appropriate sanctions against the infringement of minimum wages and (b) reinforce the labor inspection services or other agencies so they are able to effectively oversee compliance with the legislation. Advice, public awareness campaigns, and stimulation or motivation of employers to implement the legal requirements may sometimes be an effective approach to improve compliance.

Regardless of where the minimum wage is set, there will be firms where the average labor productivity is below the minimum cost of labor. For example, recent estimates by country authorities put these numbers at 30 percent of nonfarm activities in Morocco and 35 percent in Tunisia. It is important that countries devise explicit mechanisms to deal with this problem. One option could be to allow these firms to go out of business in the interest of discouraging low-productivity, low-efficiency firms. However, depending on the concentration of such firms, the economic and social consequences could be unacceptable. The second option could be to implicitly ignore the problem. This would reduce the credibility and effectiveness of the minimum wage policy and respect for rule of law. The third option could be to provide temporary exemptions, accompanied by measures that increase the productivity of these firms or facilitate the transition of the owner and workers to other economic activities.<sup>90</sup> Such exemptions should remain exceptional and temporary and be subject to monitoring by the authorities as well as consultations with the relevant trade unions.

## 2.5. Resources

### ILO Conventions, Recommendations and Data Sources

Minimum Wage Fixing Convention No. 131 (1970)

Minimum Wage Fixing Recommendation No. 135, 1970

Protection of Wages Convention, 1949 (No. 95)

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89. Compliance can be measured in a number of ways: first, based on the complaints made by workers in a judicial system; second, based on workplace inspection by labor inspectors; and third, by calculating the share of workers' earning less than the legal minimum wage.

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90. The ILO Committee of Experts on the Application of Conventions and Recommendations, a body of independent legal experts, has expressed its view that "allowing for deviations, however temporary, from the established minimum wage runs counter to the very concept of a minimum wage which is meant to be the minimum sum payable, guaranteed by law and not subject to abatement."

Protection of Wages Recommendation, 1949 (No. 85)

Equal Remuneration Convention No. 100, 1951

Equal Remuneration Recommendation No. 90, 1951

Discrimination (Employment and Occupation) Convention, 1958 (No. 111)

Discrimination (Employment and Occupation) Recommendation, 1958 (No. 111)

ILO minimum wage legislation database (around 150 countries); <http://www.ilo.org/dyn/travail/travmain.home>

WB Doing Business database on minimum wages (189 countries); <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB14-Full-Report.pdf>

LivingWageIndicator.org (around 100 countries).

<http://www.wageindicator.org/main/salary/living-wage/living-wage-map>

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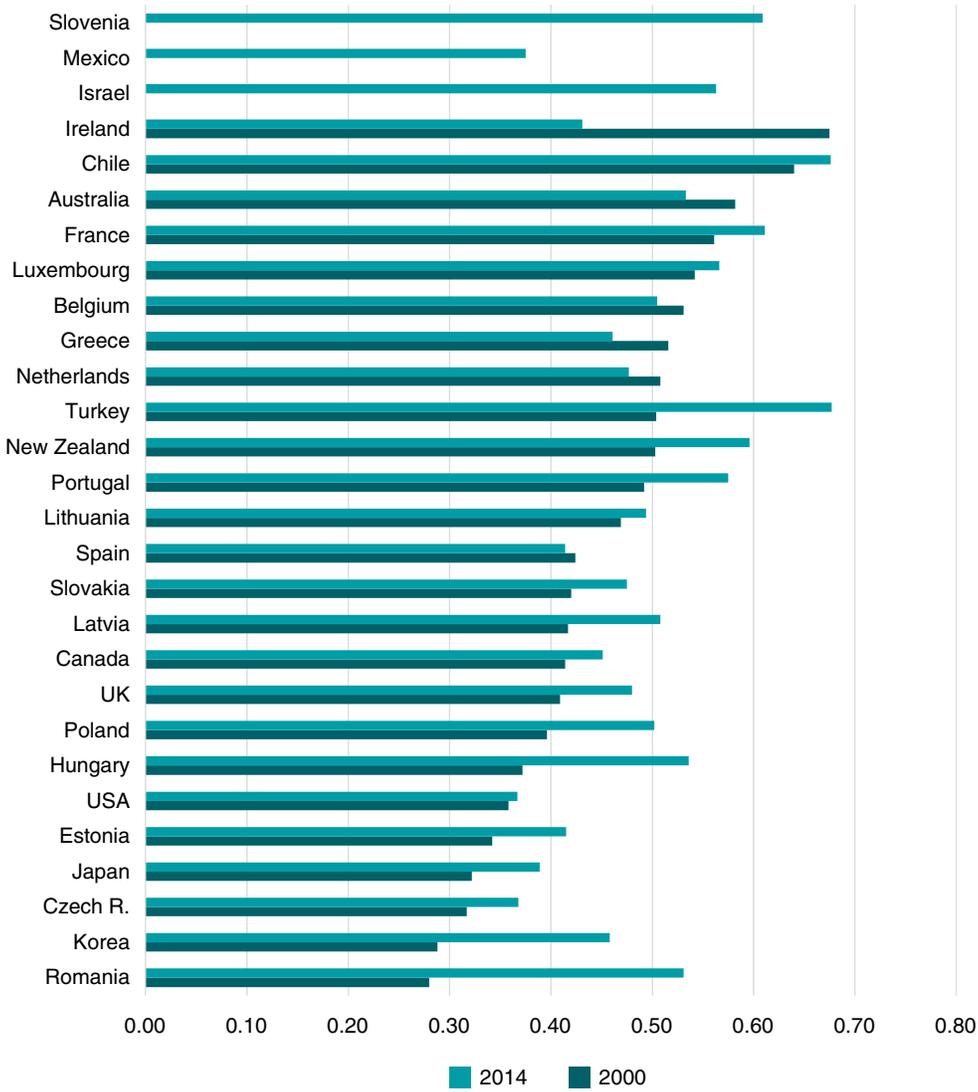
## Annex—Chapter 2

**TABLE 2.1:** Full-time Employees Earning the Minimum Wage in Some Countries, %; Latest Available Data

Belgium	3.7	Luxembourg	11.2
Czech Republic	2.5	Latvia	18.0
Estonia	4.6	Netherlands	1.6
Spain	2.6	Poland	2.0
France	10.6	Portugal	8.7
Greece	20.4	Slovenia	2.8
Hungary	2.7–2.8	U.K.	4.3
Lithuania	7.0	U.S.	4.9

Source: Marx et al. (2012).

**FIGURE 2.1:** Ratio of Minimum Wages Relative to Median Wages in OECD Countries in 2000 and 2014



Source: [http://www.oecd-ilibrary.org/employment/data/earnings/minimum-wages-relative-to-median-wages\\_data-00313-en](http://www.oecd-ilibrary.org/employment/data/earnings/minimum-wages-relative-to-median-wages_data-00313-en).

# 3. Dismissal Procedures

## 3.1. Overview

Labor markets are characterized by a continuous movement of workers between employment, unemployment, and inactivity as well as between jobs. Job displacement represents a non-negligible proportion of job flows. In countries for which data is available, between 2 and 7 percent of workers face dismissals in a typical year.<sup>91</sup> Compared with prime-age workers, older and younger workers are at greater risk of dismissal. Others at higher risk are workers in small firms and those employed on fixed-term and temporary contracts whose contracts might not be renewed.

National legislation typically establishes the scope of valid reasons for dismissals. International treaties recognize the employer's right to dismiss a worker for a valid reason and also aim to guarantee a worker's right not to be deprived of work unfairly.<sup>92</sup> Countries generally legislate some form of dismissal protection but there is a range of regulatory approaches and the right to recourse to an impartial body in case of unfair dismissal. On one end of this range stands the legal concept known as 'at-will' employment, which prevails in the United States and a few other countries. It provides that an employer is free to terminate an employee at any time, without notice and without cause, as long as it is not for an unlawful reason as specified in laws on discrimination or military service, for example. At the other end, some countries limit the valid reasons to disciplinary grounds only, as in Bolivia and Venezuela.<sup>93</sup> Apart from these examples, most

countries have legislation regulating the valid grounds for dismissals and the procedure to respect before terminating a worker's employment contract.

In case of collective dismissals for economic reasons, most governments set requirements for advance notification, negotiation, or advance approval of mass terminations. Preventive measures can avert or minimize the impact of dismissals. Examples include spreading the workforce reduction over a certain period to permit natural reduction of the workforce, internal transfers, (re)training, voluntary early retirement with appropriate income protection, restriction of overtime, reduction of normal hours of work, and work-sharing.<sup>94</sup> Both preventive measures and dismissal procedures need to balance the interests of workers and employers and should provide for a process of social dialogue to ensure that workers are being protected while firms can effectively manage their human resources.

This chapter will discuss main areas of interventions associated with dismissals for economic and other reasons of workers with regular contracts, including (a) legislative provisions setting conditions under which a dismissal is 'justified' or 'fair'; (b) procedural requirements that the employer may face when starting the dismissal process; (c) advance notice; and (d) special provisions governing collective redundancies.<sup>95</sup> While the focus of this chapter is on statutory provisions,

91. OECD (2013).

92. See the ILO Termination of Employment Convention, 1982 (No. 158), and the ILO Termination of Employment Recommendation, 1982 (No. 166). See also the Final Report of the Tripartite Meeting of Experts to Examine the Termination of Employment Convention (No. 158) and the Termination of Employment Recommendation, 1982 (No. 166), Geneva, 18–21 April 2011.

93. In Bolivia, Decreto Supremo 28699 requires the worker's consent for any contract termination without 'just grounds'. As redundancy is not

one of these just grounds, dismissal is not legally possible on the basis of redundancy. In Venezuela, under the provisions of the new Organic Labor Law (2012), work stability has been extended to protect nonexecutive employees with more than one month of service against dismissals without cause.

94. See the ILO Termination of Employment Recommendation, 1982 (No. 166). The terms 'termination of employment' and 'terminated' describe the termination of employment at the initiative of the employer.

95. Termination payments will be discussed in Chapter 4.

dismissal procedures can also be regulated through collective agreements, arbitration awards, or court decisions.<sup>96</sup>

## 3.2. Objectives and Impacts

In unregulated labor markets, employers would be able to hire and dismiss workers ‘at-will’ in the absence of any kind of dismissal protection, which can create considerable uncertainty and economic insecurity for households. Also, depending on their bargaining power, workers could be subject to abuse or discrimination. Dismissal procedures aim to (a) mitigate the adverse effects of any termination on the workers concerned and on their communities when dismissals affect large groups of workers at once and (b) protect workers from abuse and discrimination. In general, dismissal rules intend to provide protection against sudden loss of income and unfair or discriminatory practices. The fundamental principle behind their design is that the employment of a worker should not be terminated without a valid reason<sup>97</sup> and that there should be scope for redress.

The evidence of the impact of dismissal procedures on labor market outcomes is mixed. For example, employers may be reluctant to hire if constraints inhibit future dismissals for reasons related to business. As a result, dismissal procedures may lengthen job tenure and reduce turnover of those who are already employed. This may, however, have a negative effect on new employment opportunities. In particular, a study on the Italian labor market found that the increase in dismissal costs decreased accessions and separations for workers in small firms relative to large firms.<sup>98</sup> This effect is particularly strong in sectors with higher employment volatility but has a negligible impact on net employment. Another study found that stringent employment protection had a sizeable negative effect on labor market flows and, through this channel, hindered productivity growth.<sup>99</sup> At the same time, their evidence also shows that while greater labor market reallocation benefits many workers through higher real wages and better careers, some displaced workers will have longer unemployment durations or lower real wages in post-displacement jobs. The study on the impact of firing restrictions on job-flow dynamics across 14 European countries suggests that more stringent firing laws dampen the response of job destruction to the cycle.<sup>100</sup> Furthermore, stricter employment protection

legislation (EPL) reduces both the creation and destruction of jobs in declining sectors relative to expanding sectors, implying that faster growth attenuates the impact of firing costs on firms’ hiring and firing decisions. In contrast to these findings, some other studies indicate that there are no statistically significant effects of dismissal protection legislation on worker turnover.<sup>101</sup> In their study, the authors investigated the effects of variable enforcement of German dismissal protection legislation on the employment dynamics in small establishments. A recent review of the literature found that overall, “the findings on employment impacts (of EPL) are mixed, but the results can also be characterized as fragile.”<sup>102</sup>

Empirical results from OECD countries also suggest that more rigid dismissal regulations have a negative impact on productivity growth in industries where layoff restrictions are more likely to be binding.<sup>103</sup> On the other hand, countries with more protective dismissal regulations tend to have more durable or stable jobs, contributing to investments in human capital, including training.<sup>104</sup>

Overall, a meta-analysis of studies on the effects of EPL on employment finds that the impacts are relatively small and can be either positive or negative.<sup>105</sup> The *World Development Report 2013: Jobs* concludes that there is a broad ‘plateau’ covering a range of policy choices available to countries based on their preferences.

## 3.3. Design and Implementation

This section discusses key aspects of the design and implementation of dismissal procedures, including the justification of dismissals, requirements for individual and collective dismissals, and notice periods. The fundamental principle underlying the following recommendations is that employers should be allowed to manage human resources to respond to the operational and business needs of the firm but that there is a need for safeguards to ensure that (a) there is a valid reason to terminate the employment contract; (b) employers do not discriminate against workers; (c) there is advance notice; and (d) income protection and activation measures are in place. Special provisions, however, need to be considered in case of mass redundancies.

**Valid reason for dismissal.** The EPL should define ‘valid reasons,’ ‘just causes’ or ‘serious reasons’ for the termination of an employment relationship and the sanctions applicable to the

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96. See Article 1 of the ILO Termination of Employment Convention, 1982 (No. 158).

97. See Article 4 of the ILO Termination of Employment Convention, 1982 (No. 158).

98. Kugler and Pica (2008).

99. Martin and Scarpetta (2012).

100. Messina and Vallanti (2007).

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101. Bauer et al. (2007).

102. Betcherman (2012); see also Howell et al. (2007); Glyn (2003).

103. Bassanini et al. (2009).

104. Young (2003).

105. Betcherman (2012, 2014).

employer in case of neglecting this principle.<sup>106</sup> The employer may be required to substantiate the reasons justifying the dismissal. The cases for justified dismissal can be based on (a) worker-related grounds, such as worker conduct or worker capacity, but not for discriminatory reasons (for example based on age, gender, ethnicity, religion, trade union activity, or maternity and educational leave) or (b) economic or technological grounds, for example, in case demand for a given product or service plummets or a new technology that increases productivity is adopted.<sup>107</sup>

An employer should be able to terminate an employment contract for an open-ended or fixed-term contract, among others, for reasons such as (a) decline in economic activity; (b) the liquidation of the enterprise, agency, or other organization; (c) the declaration of bankruptcy of the employer; (d) unsatisfactory results of a probationary period; and (e) breach of the employee's duties.

The following, among others, should not constitute valid reasons for termination:<sup>108, 109</sup>

- (a) Union membership or participation in union activities outside working hours or, with the consent of the employer, within working hours
- (b) Seeking office as, or acting or having acted in the capacity of, a workers' representative
- (c) Filing of a complaint or the participation in proceedings against an employer involving alleged violation of laws or regulations or recourse to competent administrative authorities
- (d) Race, color, sex, marital status, family responsibilities, pregnancy, religion, political opinion, nationality, or social origin
- (e) Absence from work during maternity leave
- (f) Temporary absence from work because of illness or injury
- (g) Age, subject to national law and practice regarding retirement
- (h) Absence from work due to compulsory military service or other civic obligations, in accordance with national law and practice

National law and practice as well as collective agreements may provide further protection against dismissals. In general,

106. The principles governing dismissal procedures are laid down in the ILO Termination of Employment Convention, 1982 (No. 158) and in the ILO Termination of Employment Recommendation, 1982 (No. 166).

107. For a list of substantive dismissal requirements in 95 countries of the world see Annex—Chapter 3 Table 3.1.

108. ILO Termination of Employment Convention No. 158 (1982).

109. ILO Termination of Employment Recommendation No. 166 (1982).

just cause for termination related to conduct or performance may include reasons such as unpermitted absence from work, theft or intentional damage to property, violence, or imprisonment. A collective agreement may further limit the causes for dismissal or require a disciplinary process be exhausted before termination.<sup>110</sup> In many countries, a trade union founder or leader may not be dismissed without the prior permission of a court given the risk such a dismissal would have on the exercise of freedom of association.

Disguising the real reasons for dismissals or pushing workers into 'voluntary' separation should be prohibited and sanctioned as it occurs. For example, separations into retirement and disciplinary dismissals can be misused. Furthermore, adequate safeguards should be put in place to prevent recourse to short-term contracts of employment to circumvent the protection.

#### **Box 4: Examples of Procedural Requirements in Case of Contract Termination in Line with the Labor Law (for 187 Countries)<sup>112</sup>**

- In 93 countries, the employer is obliged to notify or consult with a third party before an employer can make a worker redundant.
- In 34 countries, the employer additionally needs the approval of a third party before an employer can make a worker redundant.
- In 115 countries, the employer has to notify or consult a third party in order to dismiss a group of 9 redundant workers.
- In 41 countries, a third party approval to dismiss a group of 9 redundant workers is required.
- In 48 countries, retraining should be provided, or there is a reassignment obligation before an employer can make a worker redundant.
- In 76 countries, there are priority rules applying to redundancies.
- In 67 countries, the labor law stipulates restrictions or obligations on rehiring.<sup>113</sup>

110. See ILO Convention No. 158 which provides, for example, that "the employment of a worker shall not be terminated for reasons related to the worker's conduct or performance before he is provided an opportunity to defend himself against the allegations made."

111. These figures only concern redundancy dismissals.

112. See Annex—Chapter 3 Figures 3.1 and 3.2.

Employers should explore options to provide retraining or reassign the worker before he or she can be made redundant. Retraining might open up new employment opportunities for the worker.

To avoid lengthy and potentially expensive administrative processes, countries may wish to provide for adequate advance notice requirements rather than obliging employers to seek third-party approval before proceeding with dismissals (see below).<sup>113</sup> However, a worker who claims that his employment has been unjustifiably terminated should be entitled to appeal against that termination to an impartial body, such as a court, labor tribunal, arbitration committee, or arbitrator. If the employment is terminated without a valid reason, the worker should have the right for adequate compensation or other appropriate reliefs, including reinstatement where appropriate. Ex post audits of dismissals could be enabled by law or collective agreement to ensure that the workers' rights have not been compromised.

**Advance notice.** All workers should be entitled to a reasonable period of advance notice before termination.<sup>114</sup> The labor law should therefore require employers to give advance notice before terminating workers, indicating the reason or reasons for termination.

Advance notice is a means to give workers ample warning of future dismissals and thus facilitate job search. It is possible, however, that notice varies with tenure and that a minimum job tenure is required to be eligible for the notice. The period of notice may be a cost factor for employers, as it could involve a period of unproductive employment.<sup>115</sup> To facilitate job search during the notice period, workers should also be entitled to a reasonable amount of time off without loss of pay, for example, through paid leave of absence. Given the impact of mass layoffs on a large number of workers and on local communities, the notice period should be extended in case of mass redundancies.

There are no general rules for the length of the advance notice period which therefore should be country specific and discussed among social partners. Out of 187 countries for which the data are available on the notice period for redundancy dismissal, 62 countries have a notice period of less than one month (of which 26 countries do not have legally mandated notice period); 66 countries have a notice period of one to two months, and 59 countries have a notice period longer than two months (see also Annex—Chapter 3, Table 3.2).<sup>116</sup>

113. Approval is, as a rule, ensured when the reasons justifying the dismissal are substantiated (for example, it is not an absolute ban).

114. ILO Convention No. 158.

115. EC (2012).

116. Notice period for workers with 10 years of tenure. In some countries, the notice period varies according to the type of dismissal (economic versus noneconomic).

Many countries distinguish notice periods according to tenure; some also have multiple advance notice periods differentiated according to professional and social criteria.<sup>117</sup>

**Collective dismissals.** In view of the economic and social implications arising from the dismissal of many employees within a short period and a specific geographical area, additional requirements are often stipulated (see Box 5 on criteria pertaining to collective redundancies). In case an employer is contemplating collective redundancies, consultations with the workers' representatives should begin in a reasonable period with focus on measures to mitigate the adverse effects of any termination on the workers concerned.<sup>118</sup> To enable workers' representatives to make constructive proposals, the employers should submit detailed information about the upcoming redundancies (Annex—Chapter 3 Tables 3.3 and 3.4).

In case of collective redundancies, employers or the government should prepare a program of measures (a social plan) aimed at mitigating the impact of mass layoffs or provide reemployment guarantees to employees made redundant because of mass layoffs. When appropriate, early retirement provisions could be considered.

In the course of the consultations with workers' representatives, the employer should be required to inform the public authority in charge of employment intermediation. This notification should contain all relevant information in connection with the planned mass redundancies and the consultations with employees' representatives. In particular, it should contain the reasons for the layoff, the number of employees being made redundant, and the period within which the layoff should occur. Governments, in turn, should consider special actions to reinstate workers, such as intermediation, job-search assistance, or training.

The law should define the criteria for collective redundancies, since these instigate special procedures (see Box 5). In about 80 percent of the 125 countries with relevant legislation, the law provides a quantitative definition of collective dismissals for economic reasons and prescribes specific procedures of consultation with workers' representatives, or notification of public authorities.<sup>119</sup>

117. For example, in the Lao People's Democratic Republic, the notice is 30 days for manual workers and 45 days for skilled workers. In Angola, the notice period is 60 days for executives and medium- to high-skilled technical workers, and 30 days for other workers. In Austria, it is a fixed term of 2 weeks for blue-collar workers but for white-collar workers, it depends on the tenure. Also, in Madagascar, the notice period depends on the length of service and professional group (it is different for laborers, skilled trades, foreman, middle managers, or senior managers).

118. See, for example, the Council Directive 98/59/EC of 20 July 1998 on the approximation of the laws of the Member States relating to collective redundancies; ILO Convention 158 and Recommendation 166.

119. Muller (2011).

## Box 5: Collective Redundancies

According to EU legislation, ‘collective redundancies’ means dismissals effected by an employer for one or more reasons not related to the individual workers concerned where, according to the choice of the member states, the number of redundancies is either, over a period of 30 days:

- at least 10 workers in establishments normally employing more than 20 and less than 100 workers;
- at least 10 percent of the number of workers in establishments normally employing at least 100 but less than 300 workers;
- at least 30 workers in establishments normally employing 300 workers or more; or
- over a period of 90 days, at least 20 workers, whatever the number of workers normally employed in the establishments in question.<sup>121</sup>

Lastly, workers undergoing dismissals, individual or collective, should have access to income protection programs for the unemployed (to be discussed in Chapter 4). It is desirable that these workers also have access to job-training and job-search assistance, or what is commonly known as active labor market programs based on activation principles.<sup>121</sup> Active labor market programs, such as training, employment services, wage subsidies, and public works can help facilitate job matching, mitigate the negative impacts of economic downturns, and fill the gap when employers or workers underinvest in training as long as they are well designed and implemented.<sup>122</sup>

## 3.4. Resources

ILO Termination of Employment Convention, 1982 (No. 158)

ILO Termination of Employment Recommendation, 1982 (No. 166)

120. The EU Council Directive 98/59/EC of July 20, 1998 on the approximation of the laws of the member states relating to collective redundancies.

121. The essence of activation is in many countries increasingly based on the principle of ‘mutual obligations’. The principle states that, in return for receiving income support (unemployment benefits and other related entitlements or social safety nets) and being offered a range of (re)employment services, individuals must commit and comply with a set of eligibility requirements (for instance, active job search behavior) and participate in training or other (re)employment programs.

122. World Bank (2012).

ILO Employment Relationship Recommendation, 2006 (No. 198)

ILO Employment protection legislation database—EPLex (<http://www.ilo.org/dyn/epl/termmain.home>).

WB Doing Business database on labor legislation (<http://www.doingbusiness.org/>).

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# Annex—Chapter 3

**TABLE 3.1:** Substantive Dismissal Requirements

	Obligation to Provide Reasons to the Employee		Valid Grounds (Justified Dismissal)			Total Countries
	No	Yes	Economic Reasons; Worker's Capacity; Worker's Conduct	Any Fair Reasons	None	
Africa	5	21	19	4	3	26
Americas	4	9	3	7	3	13
Arab States	4	1	2	1	2	5
Asia	7	10	6	6	5	17
Europe	5	29	12	16	6	34
Total	25	70	42	34	19	95

Source: ILO EPLex at <http://www.ilo.org/dyn/epllex/termmain.home>.

**TABLE 3.2:** Notice Period for Redundancy Dismissal\*

Income Group	Total Number of Countries	Less than 4.3 Weeks	4.3–8.6 Weeks	8.7 Weeks and More	Average Notice Period for Workers with 1, 5 and 10 Years of Tenure, in Weeks
High Income	56	18	23	15	5.7
Upper Middle Income	50	19	26	5	4.1
Lower Middle Income	47	11	30	6	4.8
Low Income	34	5	19	10	6.4
Total	187	53	98	36	5.2

\*Note: Average for Workers with 1, 5, and 10 Years of Tenure, in Salary Weeks.

Source: Doing Business 2014.

**TABLE 3.3:** Procedural Requirements in Case of Collective Dismissals (No. of Countries)

	Prior Consultations with Trade Unions (Workers' Representatives)		Notification to the Public Administration		Notification to Trade Union (Workers' Representatives)	
	No	Yes	No	Yes	No	Yes
Africa	4	22	5	21	1	25
Americas	8	5	4	9	7	6
Arab States	3	2	2	3	3	2
Asia	8	9	4	13	7	10
Europe	4	30	1	33	1	33
Total	27	68	16	79	19	76

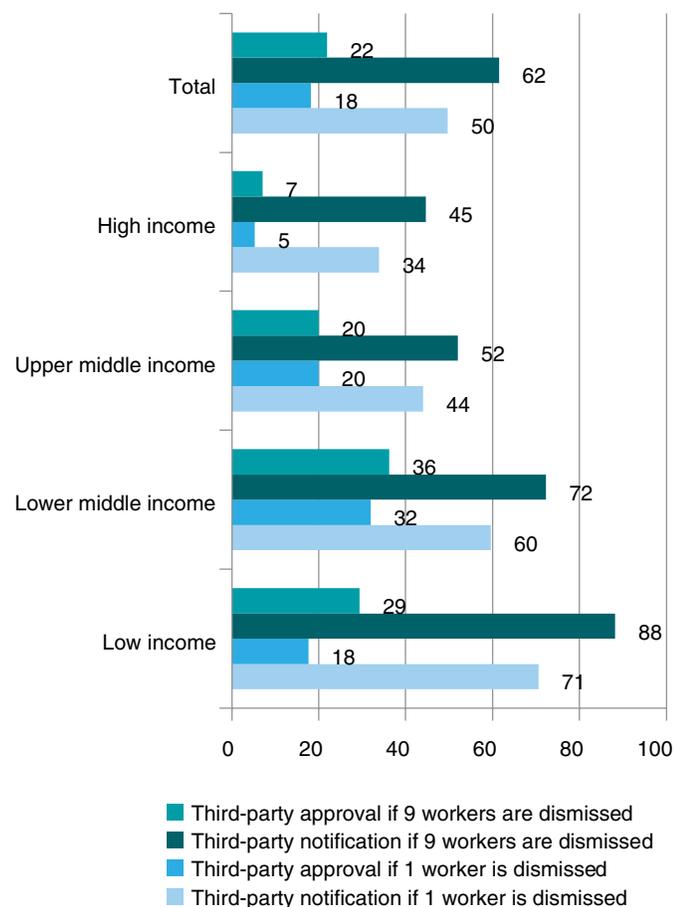
Source: ILO EPLex at: <http://www.ilo.org/dyn/eplex/termmain.home>.

**TABLE 3.4:** Procedural Requirements in Case of Collective Dismissals (No. of Countries)

	Approval by Public Administration or Judicial Bodies		Approval by Trade Union (Workers' Representatives)		Employer's Obligation to Consider Alternatives to Dismissal	
	No	Yes	No	Yes	No	Yes
Africa	21	5	26	0	11	15
Americas	10	3	13	0	10	3
Arab States	3	2	5	0	4	1
Asia	14	3	15	2	9	8
Europe	31	3	34	0	2	32
Total	79	16	93	2	36	59

Source: ILO EPLex at <http://www.ilo.org/dyn/eplex/termmain.home>.

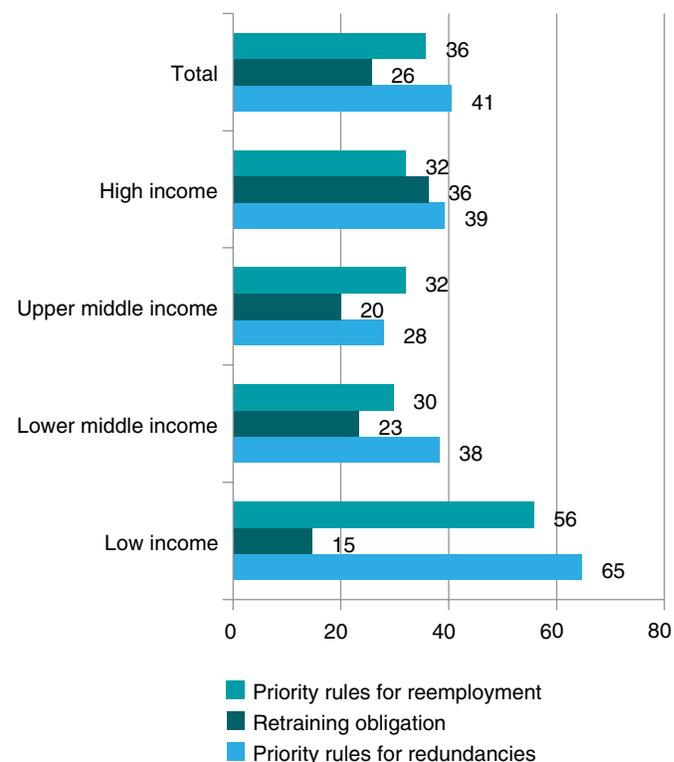
**FIGURE 3.1:** Share of Countries in Which a Third-Party Notification and Approval Is Required If One or Nine Workers Are Dismissed, 2013 (%)



Source: Doing Business 2014.

Note: Doing Business data are based on the survey of law firms and/or labor lawyers in the country and to the best of our knowledge should represent relevant provisions in labor legislation.

**FIGURE 3.2:** Share of Countries with Priority Rules for Redundancies, Retraining Obligation and Priority Rules for Reemployment in 2013 (%)



Source: Doing Business 2014.

# 4. Income Protection for the Unemployed: Severance Pay and Unemployment Benefit Schemes

## 4.1. Overview

Most countries offer some form of income protection to workers in case of dismissals or when individuals leave their jobs. These arrangements are designed to provide a certain degree of financial security to workers and their households in case of unemployment. Unemployment benefit schemes guarantee income protection to unemployed workers, usually combined with measures that support jobseekers in returning to work. Severance pay is the most prevalent form of protection in case of unemployment in most low-income economies and in middle-income economies that have not implemented unemployment benefit schemes yet.

It is important to note that severance pay and unemployment benefits are very different in their nature as discussed in more detail in the section on objectives. Severance payments typically provide lump sums to workers who involuntarily or voluntarily separate from their employers.<sup>123</sup> The lump sum is usually based on the worker's earnings and the length of service preceding the dismissal. Unemployment insurance systems also present the advantage of assisting job seekers in finding employment through the, often mandatory, condition of periodically reporting to the employment services for continuing to qualify for unemployment benefits and through facilitating the participation of unemployed workers in skills development and active labor market policy (ALMP) measures.

Country arrangements for severance pay are diverse. In 2015, the highest severance pay for redundancy dismissal (for a

worker with 10 years of tenure, in salary weeks) was in Sierra Leone, 132 weeks' salary; followed by Zimbabwe, 130; Sri Lanka, 97.5 and Indonesia, 95.3 weeks' salary.<sup>124</sup> Such a contingent liability might be especially damaging to small and medium size enterprises (SME). At the other end, 42 countries do not have a statutory severance pay. Some of these countries may still have severance pay fixed in collective agreements or in an individual employment contract.<sup>125</sup>

There is a consistent relationship between national income and mandated severance arrangements; poor countries impose firing costs 50 percent higher relative to national per capita income than rich countries.<sup>126</sup> Also, the absence of unemployment benefits in low- and middle-income countries leads to protection through mandated severance pay and dismissal rules. Globally, countries without an unemployment benefit scheme have, on average, 40 percent higher severance pay than the countries with such scheme (Annex—Chapter 4 Table 4.1).

Unemployment benefits are less common than severance pay mechanisms. Out of a total of 189 economies, only 86 have unemployment benefit schemes.<sup>127</sup> The development of government-organized protection against unemployment came after the introduction of other government-organized social protection benefits, for example, employment injury or sickness benefits in many countries. The first unemployment

123. Severance pay includes several types of termination (separation) payments whose typology depends on the reasons for dismissal and can be classified into (a) severance payments, which arise from terminating an employment relationship on worker-related grounds, such as worker conduct or capacity and (b) redundancy payments that arise when terminating an employment relationship on economic grounds. Termination payments arise mainly when separation is initiated by the employer. Some countries do not specify the difference between redundancy and severance payments and bundle them into a single severance pay provision but usually provide specific reasons for the payments, including possibly different schedules depending on the type of separation.

124. World Bank (2015).

125. This chapter will only discuss statutory severance pay schemes in case of fair economic individual dismissals. As noted by Boeri et al. (2013), "although the definition of fair economic dismissal differs quite considerably from country to country, it generally implies that some 'genuine and serious' exogenous shocks in firm's performance require 'operational changes' in the scale, and possibly, nature of the work organization, making the worker involved redundant. Often evidence of 'economic difficulties' or 'technological change' is explicitly required."

126. Holzmann et al. (2011).

127. World Bank (2013). According to the ILO World Social Protection Report 2014–15, there are 85 countries with unemployment benefit schemes providing periodic benefits and an additional 4 with lump-sum payments (UISA or provident fund; ILO 2014).

benefit schemes were adopted at the beginning of the 20th century and are now more than a century old. Nonetheless, coverage is limited: due to the structure of the labor market and the predominance of the informal economy in many countries, even where unemployment benefit schemes are in place, many of the unemployed are not eligible for unemployment benefits. This may be the case for long-term unemployed who have exhausted their entitlement or for first-time jobseekers or workers who do not have a sufficient insurance period to claim contributory benefits and yet might be eligible for noncontributory benefits. Around the world, 12 percent of the unemployed are covered by unemployment benefits. It is noteworthy that 64 percent of unemployed persons receive unemployment benefits in Western Europe compared to only one percent of the unemployed in Africa and two percent in the Arab states (Annex—Chapter 4 Table 4.2).<sup>128</sup>

Several developing countries are considering reforms to their income protection regulations in case of contract termination to balance the needs of firms and workers. One of the problems of severance pay is that, in general, it does not offer adequate protection to workers. Indeed, employers seldom make provisions for benefits and those who are facing economic difficulties and need to downsize might not be able to finance the payments. In addition, the process to effect payments can often involve courts, and the judicial process in those courts tends to be lengthy and costly. Discussions about reform options then revolve around how to improve the system and whether to introduce an unemployment benefit scheme.<sup>129</sup>

This chapter discusses the rationale for having in place severance pay and unemployment benefits, their potential impacts on labor markets and workers' protection, as well as issues related to design and implementation.

## 4.2. Objectives and Rationale

Severance pay and unemployment benefits provide some degree of income protection to workers who have lost their jobs and facilitate transitions between jobs.<sup>130</sup> There are, however, important conceptual differences between the two schemes. Severance pay is regulated by the labor law and based on the concept of employer liability whereas unemployment benefits are financed collectively and payments are secured regardless of the situation of employers.

The primary objective of severance pay is to provide income protection in case of loss of employment depending, in most cases, on job tenure. In certain cases, severance pay may be part of the compensation package upon termination of employment at retirement, which may be considered as a substitute to occupational pensions. Other objectives may include the stabilization of employment and therefore prevention of unemployment by discouraging redundancies as employers may consider it as additional cost. It can also promote longer-term relationships by making redundancies more costly and thereby retaining (valuable) workers and reducing transaction costs resulting from labor turnover. A justification to mandate payments from employers in case of dismissals is to internalize the social costs of unemployment.<sup>131</sup> In this case, however, payments do not have to be made to employees directly but could take the form of a tax for the employer that, for instance, funds collectively-managed severance payments as well as passive and active labor programs.

The primary objective of unemployment benefit schemes, as an integral part of the social protection system, is to provide adequate income protection to the unemployed while also serving employment policy goals. Such schemes aim to (a) guarantee an appropriate level of income during periods of unemployment; (b) provide better protection of workers at a relatively low cost, involving risk pooling and redistribution; and (c) integrate unemployment payments with active labor market policies that facilitate effective job search and matching, additional training, or other assistance. Beneficiaries are typically required to look actively for work and/or participate in a training program to promote their job prospects.

To better protect workers from the risk of unemployment and internalize the social costs of unemployment, countries can consider combining both unemployment benefits and severance pay. Unemployment benefits are a better structure to protect workers' income because financial risks are pooled across participants (instead of being a liability of employers). At the same time, employers could be required to pay severance or a dismissal tax that could replace severance pay, provided that adequate protection is available through an unemployment benefit scheme. The revenues from this dismissal tax could contribute to finance redistribution within the UB system.<sup>132</sup>

128. ILO (2014).

129. The ILO Convention No. 158 provides for either of these two options—severance pay or unemployment benefit scheme—or a combination thereof as a vehicle for income protection for workers whose employment has been terminated.

130. For severance payments, this is largely limited to financial support, yet there usually is a lack of access to ALMPs and public employment services.

131. Blanchard (2000).

132. For example, Baumann and Stähler (2006) note: "Financing unemployment benefits through employment taxes leads to externalities as firms that are firing workers create additional costs to the unemployment insurance that they do not have to bear. To internalize these externalities, firms can be made liable for their behavior by changing the financing system towards a scheme with dismissal taxes." See also Blanchard and Tirole (2010) and Cahuc and Zylberberg (2005). If a dismissal tax is introduced, countries may choose not to levy it in case of dismissals for economic reasons.

## 4.3. Labor Market Impacts

This section reviews the evidence of the impact of severance pay, unemployment insurance, and unemployment individual savings accounts on labor market outcomes.<sup>133</sup> Although the evidence comes from developed economies, an effort has been made to highlight the experience from developing countries.

The evidence on the impact of severance pay systems on labor market outcomes and its effectiveness as an unemployment support system are mixed. In the upper-middle to high-income countries, which usually also feature unemployment insurance schemes as part of their social protection systems, most of the studies found that the impact is seemingly insignificant. For example, a review of the empirical literature concludes that “severance pay, unaccompanied by other labor regulations, has little impact on worker separation (and accession) or average employment level.”<sup>134</sup> Differences in labor market impacts exist between severance pay due to dismissals only (also called severance insurance pay or indemnity for dismissal) and severance pay due to any separation (also called severance savings or seniority pay).<sup>135</sup> The roles of the two schemes are different, as are their effects on the labor market; for example, there is a positive effect of seniority pay on employment.<sup>136</sup> The latter in particular behaves like deferred earnings, and is often based on accumulated funds, which also alleviates some of the issues linked to nonpayment.

In contrast to these results, some researchers argue that severance pay increases firing costs and thus reduces the probability of exit from employment to unemployment, but at the same time, it imposes additional costs on employers and thus hinders job creation.<sup>137</sup> Some studies show that high firing costs slow the pace of structural change by reducing employers’ incentives to introduce new technologies.<sup>138</sup> According to some authors, these costs likely reduce productivity growth and overall economic growth. Regarding the gains, severance pay may promote longer-lasting employment relationships and thus improve employers’ incentives to provide training,

thereby increasing the productivity of workers as well as their future employability.<sup>139</sup>

As far as impacts of unemployment benefit schemes are concerned, some studies suggest that higher benefit levels and longer benefit duration tend to be associated with longer spells of unemployment and can, among other things, lead to a decline in the intensity of job searches.<sup>140</sup> On the other hand, there is also evidence that beneficiaries with longer benefit duration are able to find jobs at higher wages and longer tenure, thus allowing workers to find better-matching jobs.<sup>141</sup> A recent study of the European Commission concludes that “the generosity of income support does not prevent returns to employment” and that “benefit systems integrated with inclusive labor markets and enabling services facilitate the returns to employment.”<sup>142</sup>

Some studies reveal a welfare-increasing income effect of unemployment benefits, which is particularly important in the presence of inefficient private insurance markets and high-risk aversion. The income effect is significant for liquidity-constrained households since unemployment benefits maintain a certain level of income, which increases the opportunity for consumption while unemployed. This, in turn, reduces the need for job searches, which leads to a substitution effect. If workers are unconstrained, the income effect does not exist. The substitution effect and the income effect have contrasting welfare implications.<sup>143</sup>

The evidence for developing countries is more limited. Some early studies for Brazil showed little effect of unemployment benefits on unemployment rates. If anything, benefits increased the share of self-employment over wage employment. Cross-country studies including developing countries have found negative and not very robust effects of unemployment benefits on informality.<sup>144</sup> Some authors argue on the basis of a theoretical model calibrated to the Mexican case that well-designed unemployment benefits can increase formal employment by making it more attractive than informal work.<sup>145</sup> However, recent analysis for Mexico suggests that the main effect of unemployment insurance was to reduce the share of formal employment. In countries like Mexico, the trade-off between informal work and unemployment seems to be driven by the size of the tax wedge. The higher the tax wedge, the higher the effect on unemployment.<sup>146</sup>

133. A system of Unemployment Individual Saving Accounts (UISAs) has been proposed as an alternative to the traditional unemployment insurance system in which individuals are required to save a percentage of wages in special accounts and to draw unemployment compensation from these accounts instead of taking state unemployment insurance benefits. If the accounts are exhausted, mechanisms may be in place to provide some level of protection, for example, through a solidarity fund.

134. Parsons (2011a, b).

135. Parsons (2011a, b).

136. Heckman and Pagès (2004).

137. Blanchard (2000); Kaplan (2009).

138. Calmfors and Holmlund (2000).

139. OECD (1999).

140. EC (2006); Arias et al. (2014).

141. Caliento et al. (2013); Tatsiramos (2009).

142. EC (2013).

143. Chetty (2004, 2008); Chetty and Looney (2006).

144. Lehmann and Muravyev (2011).

145. Bosch and Esteban-Pretel (2013).

146. Ribe et al. (2012).

Moreover, in developing countries, where the informal economy still predominates, the presence of unemployment benefits prevents formal laid-off employees from growing the ranks of the informal economy in times of economic downturns.<sup>147</sup> Less is known about the effects of UISAs on labor markets. Their main perceived advantage over unemployment insurance is that workers have stronger incentives to seek and take jobs because benefits are financed out of individual savings. This seems to be the case, for instance, in Chile, which has a mixed system involving unemployment individual savings accounts as well as a solidarity fund for risk pooling.<sup>148</sup> Because balances in individual accounts can increase the value of pensions at retirement and, under some conditions, finance investments in education or home purchases, workers are less likely to exhaust their savings if there are work alternatives. However, as in the case of Chile, since these 'savings' belong to workers, it is very difficult to impose restrictive conditions on withdrawing the savings, so that in many cases the funds are used for other purposes and are not available to provide sufficient protection in case of unemployment. In those cases, individual savings accounts will not help cope with vulnerability of those losing their job. In addition, pure savings schemes usually lack mechanisms to support unemployed workers in finding a job (for example, compulsory visits to employment service centers), which may increase poverty among unemployed workers and their families. Moreover, pure unemployment individual accounts do not fulfill the condition of collective financing which is at the core of social insurance. As they often are exclusively financed by the workers and lack risk-pooling mechanisms, the contribution rate of individual savings accounts that would allow for a meaningful protection is much higher than that of unemployment insurance and the benefit level could be very low for those workers with short and interrupted careers and thus cannot play a major role of income protection for unemployed workers in many cases. Therefore, these accounts can be regressive, with risks of, for example, low-skilled workers quickly exhausting their accounts, leading to a situation where those most in need of protection are not covered.<sup>149</sup> Moreover, individual savings accounts have the potential to increase labor turnover beyond efficient levels. High mandates to save can create incentives for workers to leave their jobs to withdraw some of their savings. Below-market interest rates on savings can have the same effect, particularly when access to credit is constrained and individuals cannot 'dis-save'. For example, labor turnover seems to have increased considerably because of the system of individual savings accounts in Brazil and Chile.<sup>150</sup>

147. Peyron-Bista et al. (2014).

148. Reyes et al. (2010).

149. OECD (2010).

150. Ribe et al. (2012); Nagler (2013).

## 4.4. Design & Implementation of Income Protection for the Unemployed

Severance pay faces several challenges to provide adequate income protection to workers. There is a serious issue regarding nonpayment of severance pay by employers. Particularly in developing countries, severance pay is frequently not enforced and many workers fail to obtain benefits. Nonperformance is often due to the limited risk-pooling potential of the program, coupled with its mostly unfunded nature and the fact that the liabilities often arise when a firm is in need of restructuring but may be cash strapped and have no funds for severance payments. Many workers who were made redundant do not qualify for the severance pay since their length of service might be too short or the firms are too small and therefore not obliged to pay severance under the labor law. Furthermore, litigation costs that arise from disputes over the cause of separation might also be significant.<sup>151</sup> Therefore, from the point of view of providing income security in case of unemployment, severance pay mechanisms have obvious disadvantages compared to unemployment insurance schemes.

To provide comprehensive income protection for workers, the recommendation would be to introduce an unemployment benefit system financed by way of contributions from employers, or employers and workers, and complemented, if necessary, by public funds. If an unemployment benefit scheme is introduced, existing severance pay provisions could be reduced to their seniority-related component (as deferred compensation) while income protection for unemployment would be ensured by the unemployment benefit system.<sup>152</sup>

However, introducing a comprehensive unemployment benefit system may not be feasible in some low-income countries. For example, there could be low institutional capacity to effectively operate this type of reform. In this case, the alternative recommendation would be to improve existing severance payment provisions and make the scheme more reliable for

151. De Ferranti et al. (2000); Ahsan and Pagés (2009). Other limitations of severance pay as an income protection system are discussed in Holzmann and Vodopivec (2012)

152. ILO Social Security (Minimum Standards) Convention, 1952 (No. 102) and ILO Employment Promotion and Protection against Unemployment Convention, 1988 (No.168) as well as its attached Recommendation, 1988 (No.176) provide comprehensive and sound guidelines for the design and implementation of unemployment protection systems.

workers and, in some cases, less costly to employers, including through prefunding arrangements. This could require legislative or institutional strengthening of appeal and dispute settlements mechanisms in case of noncompliance of the severance payment provisions by employers. Existing systems do not work well in a number of countries, entailing extensive delays, lack of transparency, or other flaws.

Given the sensitivity of income-protection mechanisms, it is important to have a broad social dialogue involving all stakeholders before deciding upon changing an existing income protection scheme. Policymakers, in consultation with workers' representatives, employers, and other stakeholders, have to take into account the national circumstances when designing the unemployment benefit system.

**Designing unemployment benefit systems.** Unemployment benefit systems usually rely on risk-pooling arrangements. In these arrangements, benefit levels may be linked to workers' previous earnings or set as fixed amounts. While the financing of unemployment benefit schemes usually comes from contributions, general tax revenues can play a complementary role.

In the case of unemployment individual savings accounts, workers receive their savings, which accumulate through their own contributions and those of their employers, if required. In general, there is no guaranteed minimum replacement rate or guaranteed benefit duration, as is the case in unemployment benefit schemes and therefore are not in line with international social security standards. Policymakers, in consultation with social partners, have to make a choice between these two arrangements when designing the unemployment benefit system.<sup>153</sup> Unemployment individual savings accounts have both proponents and opponents. The main advantage over unemployment insurance, as emphasized in the literature, could be that since benefits are financed out of the individuals' savings, workers have better incentives to seek and take jobs.<sup>154</sup> The main shortcoming is that they do not provide adequate protection to workers, particularly low-skilled and low-income workers who need the protection most. These workers usually have shorter periods of contributions and more frequent periods of unemployment. The fact that benefits are often paid as a lump sum can also be problematic as there is a risk that they run out before the individual finds a job. In some countries, unemployed workers who have depleted their unemployment individual savings accounts are allowed to deplete their balance of accumulated contributions in the pension insurance,

which, however, puts at risk their income security in old age. In addition, since benefits are financed only out of savings, contribution rates are usually high. This is in contrast to the principle that contribution payments should not generate hardship. Higher contributions also reduce incentives to join the system and can increase informality while leaving more households without income protection.

There is a set of three important elements for the design of an unemployment benefit system: (a) the definition of the contingencies; (b) the features of the scheme and its parameters, such as eligibility and entitlement criteria; and (c) the institutional arrangements. The unemployment benefit system should at least incorporate the following dimensions: the protected categories of workers (coverage), the benefit level or calculation of replacement rate, the eligibility criteria, the floor or ceiling on covered earnings (if any), the duration of benefits, the minimum/maximum benefit, financing method, and the level of contributions. Furthermore, adequate institutional arrangements should be in place.<sup>155</sup> Overall, international labor standards provide guidance on setting these parameters. Choices often reflect social preferences. There are general principles one can follow to ensure that the mandate is adequate and affordable.<sup>156</sup>

**Benefits.** The contingencies of an unemployment benefit system should include suspension or loss of earnings due to the unavailability of suitable employment by a person who is capable of and available for work. Contribution rates and the levels of benefits should be fixed in a way that allows for the adequate protection of unemployed workers, including job search costs when transitioning between jobs, while ensuring the financial, economic, and social sustainability of the unemployment benefit scheme.

Systems with contributory unemployment benefits should provide a replacement rate at no less than 50 percent of previous earnings in case of full unemployment.<sup>157</sup> In case of noncontributory benefits, the amount should be fixed at not less than 50 percent of the statutory minimum wage or at a level that covers essential living expenses, whichever is higher. Countries should guarantee, as part of their national social protection floors, at least a basic level of income security that allows for life with dignity.<sup>158</sup>

153. Robalino and Weber (2013).

154. Robalino et al. (2009). Chile combines risk pooling through a solidarity fund with mandated savings in the form of UISAs so as to mitigate the moral hazard problem of traditional unemployment insurance programs (Hartley, van Ours and Vodopivec 2010). However, according to administrative data from the system, only 4.2 percent of beneficiaries benefited from the solidarity fund (Sehnbruch and Carranza 2014).

155. ILO's Social Security (Minimum Standards) Convention, 1952 (No. 102) as well as the Promotion of Employment and Protection against Unemployment Convention, 1988 (No. 168) define both covered contingencies and core parameters while leaving it to national legislation to go beyond these minimums given the national circumstances and social preferences. ILO standards also include provisions for the effective participation of representatives of the persons protected and social dialogue.

156. Robalino and Weber (2013).

157. Employment Promotion and Protection against Unemployment Convention No. 168 (1988). Convention No. 102 sets minimum standards at a slightly lower level.

158. Social Protection Floors Recommendation, 2012 (No. 202).

While there are no universal standards for the duration of benefit reception and the level of the replacement rates, the ILO suggests at least 13 weeks of benefit reception within a period of 12 months as well as replacement rates of at least 45 percent of the previous earnings of the beneficiary.<sup>159</sup>

Unemployment insurance benefits may be supplemented with an unemployment assistance scheme, which can be a flat-rate benefit or means tested. This policy could save scarce resources, which could instead be directed to employment services and ALMPs.

Maximum and minimum benefits should be established in the national legislation.<sup>160</sup> For example, the minimum unemployment benefit can be equal to the minimum wage (Brazil), between the minimum wage and the minimum living allowance (China), or a percentage of a legally defined reference salary that increases with the number of dependents and decreases after a period of time (Spain).

**Financing.** Contribution rates depend, among other factors, on the ratio of unemployed beneficiaries to contributors to the UB scheme, the replacement rate of the benefit, and the duration of the benefit. The financing of unemployment benefit system can have several options, often combining more than one: (a) contributions or other payroll tax paid by the employer; (b) contributions or tax on wages earned paid by the worker; (c) general revenues mobilized by other taxes; and (d) an implicit tax paid by those UB contributors whose unemployment risk is systematically low.

For example, in Italy and Poland, only employers contribute to the scheme, while in Hungary, only employees contribute. In some other countries, unemployment insurance contributions are shared between the employer and employee (Republic of Korea, China, Germany, Ukraine), or relevant costs are covered from the overall social (Ireland and Kazakhstan) or health insurance (Belarus) contributions. In Russia, the costs are covered by federal and local government budgets. In Australia, benefits are financed out of general taxes.

## Entitlement and Eligibility

**Qualifying conditions.** Entitlement to unemployment benefits may be subject to the completion of a reasonable qualification period, which must however not exceed the duration necessary to preclude abuse. Entitlements to unemployment benefits are generally conditional on the circumstances of

separation from the company, except in the case of partial unemployment benefits. The right to benefit may be suspended in defined circumstances,<sup>161</sup> which include voluntarily leaving employment without just cause. For example, the right to receive unemployment insurance benefits should be restricted if the person's last employment or service relationship was terminated (a) at the initiative of the employee or public servant without just cause; (b) due to a breach of duties of employment or service, loss of confidence, an indecent act, or an act of corruption; or (c) by agreement of the parties.<sup>162</sup>

To receive benefits, the applicant should meet both entitlement and eligibility conditions. 'Entitlement' conditions restrict benefits to people who, in the case of fixed-duration unemployment insurance benefits, have a sufficient record of contributions from work or an assimilated status and have been unemployed for a limited duration. Alternatively, in the case of tax-financed assistance-type unemployment benefits, the recipients should have low total income. 'Eligibility' conditions, on the other hand, should restrict unemployment benefits to people who (a) are unemployed, namely, not only out of work but also able to enter work at short notice and are undertaking active steps to find work and (b) meet administrative requirements. An example for the latter would be applying for benefits with the necessary documentation and attending interviews with an employment counselor or applying for vacancies as directed by a public employment service.<sup>163</sup>

In the event of refusal, withdrawal, suspension or reduction of the benefit, claimants should have the right to present a complaint to the body administering the benefit scheme and to appeal thereafter to an independent body.

**Institutional arrangements.** The unemployment benefit system should be administered by an institution that already efficiently handles the required business processes for a similar social insurance program. For example, these processes could be provided through the national social security administration which manages all social insurance programs. Also, public employment services can be in charge of registration of unemployment claims and payments of unemployment benefits. Some countries have found it useful to separate unemployment insurance from other social insurance payment schemes because the benefits are linked to participation in training and job-search services. There are also examples of unemployment insurance administrations run by trade unions, for instance, in Sweden. In many cases, administrative reforms will be required to enable an efficient unemployment benefit delivery system, for example, by an

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159. ILO Convention No. 102. The ILO Convention No. 168 recommends that in case of full unemployment, the initial duration of payment of the benefit may be limited to 26 weeks in each spell of unemployment or to 39 weeks over any period of 24 months.

160. ILO social security standards contain provisions with respect to the level of contribution ceilings, as well as minimum and maximum benefit levels.

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161. ILO social security conventions enumerate such circumstances.

162. See Article 20 of ILO Convention No. 168.

163. Grubb (2000).

introduction of performance incentives. Innovations in information and communication technologies can be used to improve identification, registration, eligibility checks, benefit payments, or collection of contributions.<sup>164</sup>

Unemployment benefit systems are an important component of activation policies if benefit recipients are expected to look actively for work or participate in a program to promote their job prospects. The systems should follow the principle of 'mutual obligations' meaning that, in return for receiving unemployment benefits and other related entitlements and being offered a range of reemployment services, individuals must commit and comply with a set of eligibility requirements. These requirements can for instance include active job search, participation in training, or other reemployment programs.

To receive the unemployment benefit, the job seeker should be ready to accept suitable job offers. 'Suitable work'<sup>165</sup> is described as work that registered jobseekers/unemployed cannot refuse without the suspension of unemployment benefits or their reduction. Typical reasons that may lead to sanctions for the beneficiary include the failure to report to the PES without justification; refusal to accept a suitable job offer; failure to meet the conditions of actively seeking employment and availability for work; or working informally while registered as unemployed. The reason for termination of the status of the unemployed beneficiary might also be the refusal, without good reason, to participate in active labor market programs, such as training or public works.

The two core qualifying conditions that apply to most unemployment benefit systems are (a) loss of earnings due to lack of suitable employment<sup>166</sup> and (b) to be actively searching for a job. In the case of middle- and low-income countries, enforcing either one has proven difficult. The main challenge is the high prevalence of informal employment that can render traditional enforcement mechanisms ineffective. An alternative approach would be to focus on ensuring that individuals receiving unemployment benefits—particularly through redistributive arrangements—engage in job search and activities to improve their employability.<sup>167</sup>

In some unemployment benefit systems, the unemployment benefit may be suspended for the period in which severance payments are directly received from their employer or from any other source under national laws or regulations or collective agreements.

## Reforming Severance Pay

There are three important policy choices when it comes to severance pay: (a) the level of the benefits; (b) the vesting period for eligibility; and (c) financing and provision.

**Benefits.** The simplest benefit for severance payments is a flat amount or fixed percentage of wages for all beneficiaries.<sup>168</sup> As the severance pay system evolves, a more complex severance pay formula may be required in which compensation is adjusted according to years of service or age of beneficiaries. Under such structures, older workers or those with long service records can be entitled to more generous severance pay. The severance payment may be limited by a ceiling. The generosity of severance benefits may also differ by the type of separation, including dismissal, redundancy, collective redundancy, or end of service.

**Vesting period.** It is also recommended to establish a vesting period for eligibility, thereby making the benefit payment conditional on a minimum number of months of employment. The labor legislation in several countries provides between 6 months and 3 years of job tenure with the employer before the worker is eligible for severance.<sup>169</sup> Certain types of contracts are typically excluded from severance payments (such as fixed-term contracts) and adequate safeguards should be provided against the use of such contracts with the aim of avoiding severance payments.<sup>170</sup>

**Financing and provisions.** Usually, severance pay is directly financed by employers. As employers bear the risk of contract termination, governments need to consider regulations to manage and mitigate this risk. In the case of large-scale redundancies as a result of an economic slowdown, governments may provide financial assistance. It is desirable, however, to have an explicit criteria and procedures to engage this type of financial support. Alternatives for consideration could be to mandate employers to create external reserves for payments. Another option would be to require employers to make contributions (typically quite small) into a public contingency fund which makes severance payments only in cases where the firm goes into insolvency.

**Connecting to ALMPs.** Severance pay schemes should also include provisions aimed at stimulating early registration of workers made redundant and seeking a job using employment services. In particular, the duration of severance pay can be conditional on registration with the PES, typically within 10 days after contract termination, as long as a well-functioning PES exists. Rapid registration allows the

164. Robalino and Weber (2013).

165. 'Suitable work' and criteria for the suspension of benefits are defined by ILO Convention No. 168 (Articles 20 and 21) and in ILO Recommendation No. 176 (para. 14).

166. ILO Convention No. 168. It also considers a broader range of contingencies, including partial and temporary unemployment (Art. 10).

167. Robalino and Weber (2013).

168. At least 12 countries use flat rate severance payments, mostly in the Commonwealth of Independent States (CIS), but also in Algeria, Kenya, and Mongolia.

169. World Bank (2013).

170. See ILO Convention, No. 158 (Art. 2).

jobseeker/redundant worker to be immediately offered available vacancies, provide employment services such as job counseling and job search assistance, or send him/her to participate in ALMPs, thus shortening the transition from one job to another.<sup>171</sup>

## 4.5. Resources

- ILO Social Security (Minimum Standards) Convention, 1952 (No. 102). Available at: [http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100\\_INSTRUMENT\\_ID:312247:NO](http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100_INSTRUMENT_ID:312247:NO)
- ILO Termination of Employment Convention, 1982 (No. 158). Available at: [http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100\\_INSTRUMENT\\_ID:312303:NO](http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100_INSTRUMENT_ID:312303:NO)
- ILO Termination of Employment Recommendation, 1982 (No. 166). Available at: [http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100\\_INSTRUMENT\\_ID:312504:NO](http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO:12100:P12100_INSTRUMENT_ID:312504:NO)
- ILO Employment Promotion and Protection against Unemployment Convention, 1988 (No. 168). Available at: [http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100\\_ILO\\_CODE:C168](http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C168)
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## Annex—Chapter 4

**TABLE 4.1:** Average Severance Pay in Countries with and without Income Protection Scheme for the Unemployed in 2013

Income Group	Countries with No Scheme		Countries with Scheme	
	Total Number of Countries	Average Severance Pay	Total Number of Countries	Average Severance Pay
High Income	10	10.3	46	6.7
Upper-Middle Income	26	8.2	24	13.3
Lower-Middle Income	35	17.0	12	12.5
Low Income	31	15.7	3	8.4
Total	102	13.7	85	9.7

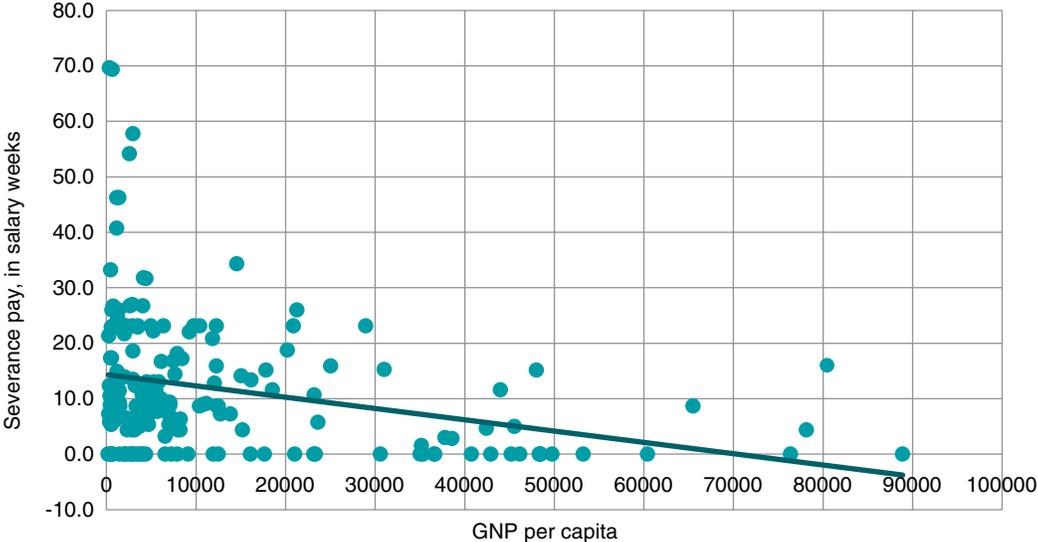
Source: Doing Business database 2014.

**TABLE 4.2:** Percentage of Unemployed Receiving or Not Receiving Unemployment Benefits

	Unemployed Receiving Unemployment Benefits (%)			Unemployed Not Receiving Unemployment Benefits (%)
	Contributory Schemes	Noncontributory Schemes	Contributory and Noncontributory Schemes	
World	10.2	1.5	11.7	88.3
Africa	0.9	0.0	1.0	99.0
Middle East	2.2	0.0	2.2	97.8
Asia and the Pacific	6.8	0.4	7.2	92.8
Central and Eastern Europe	21.1	0.5	21.6	78.4
Latin America and the Caribbean	4.6	0.0	4.6	95.4
North America	28.0	0.0	28.0	72.0
Western Europe	44.6	19.2	63.8	36.2

Source: ILO (2014). World Social Protection Report 2014/15, Geneva.

FIGURE 4.1: Severance Pay for Redundancy Dismissal



Source: Doing Business 2013.

Note: Average for workers with 1, 5 and 10 years of tenure, in salary weeks. Depending on the country level of GNI per capita (in US\$) in 2012.



This report reviews international experiences and presents options for the design of four types of labor regulations: employment contracts, minimum wages, dismissal procedures, as well as severance pay and unemployment benefits. In each case, it discusses the market failures that these regulations aim to address and suggests options to better protect workers while preserving incentives to create good jobs. The main message from the report is that labor regulations are important to protect workers from abuse and exploitation and allow them to better manage labor market risks. The report also shows that it is possible to establish a balance between workers' protection and flexibility in the management of human resources at the firm level, avoiding both over- or under-regulation. Between these two extremes, there is a 'plateau' where labor regulations can offer adequate protection to workers, and contribute to shared prosperity without imposing unreasonable costs on firms.

This report reflects a shared vision between the ILO and the World Bank on policies that traditionally have been controversial. This has been possible thanks to the commitment of both institutions to focus on the lessons derived from rigorous research and international experiences.

