

THE LIKELY EMPLOYMENT IMPACT OF REMOVING UNFAIR DISMISSAL PROTECTION

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The impact of hiring and firing costs on labor markets has been intensely debated in many countries in recent years. In Australia the focus has been on the impact of unfair dismissal provisions. The government has asserted that unfair dismissal provisions stop firms taking on workers, and that the burden falls most heavily on small businesses.

Despite intense debate we know very little about dismissal costs. How large are they? What are the main components and their relative magnitudes? How do they vary across industries and occupations? Does the size of the firm matter? Finally, what impact do dismissal costs have on employment, and what is the likely impact on employment of the proposed changes to unfair dismissal laws? A previous article by Oslington (2005) discussed the current state of knowledge on these questions. This paper uses data from a large scale survey of dismissal costs in Australian small businesses to estimate the impact on employment, in conjunction with a simple neo-classical labour demand model. The impact of unfair dismissal costs on employment is found to be small, certainly much smaller than claimed by the government.

Government Claims

The Prime Minister has suggested that removing unfair dismissal protection for workers employed in small businesses is the key to

reducing unemployment below 5%. A figure of 77,000 new jobs created has been widely quoted by the government.

These assertions seem to be based on two studies. The first is the CPA (2002) Small Business Survey. This was an opinion survey in which 5% of business respondents agreed with the suggestion that unfair dismissal laws are an impediment to hiring staff. Assuming that each of these respondents would hire one extra worker if the laws were relaxed, and that the respondents are representative of the population of Australian firms, yields an estimate of 52,575 jobs created by removing unfair dismissal protection.

The 77,000 figure comes from a different study which, selectively read, provides the second basis of the Prime Minister's assertions. This study by Don Harding (2002) was commissioned by the Federal Government's Department of Employment and Workplace Relations. It involved surveying 1802 employers through the Yellow Pages Business Index. Harding discussed problems with existing opinion surveys – such as bias arising from the use of leading questions, and strategic responses from firms who have an interest in policy changes flowing from the survey. Harding adopted a different approach to previous surveys, focusing on respondents with no employees who previously had employees, and seeking employer reasons for the change. Adding up the previous employees of respondents who nominated unfair dismissal provisions as playing a major role in the change, and factoring up to the population yields an estimated employment effect of 34,812 jobs. Adding and factoring up for those who nominated unfair dismissal provisions as playing a minor or moderate role yields a total of 77,482 jobs lost. Harding's study also included a question about the impact of unfair dismissal laws on business costs, and applying a labour demand elasticity of 0.7 to the responses suggests an impact of unfair dismissal provisions on employment of 0.46 percent. If total employment is about 9 million this is about 41,400 jobs. Harding discusses some caveats to this 0.46 percent estimate, but we also consider the wording of the cost question in

the survey to be too general¹ to permit reliable inference about employment impacts.

The most valuable part of Harding's study is the discussion of the impact of unfair dismissal provisions on firms' human resources policies, and on equity. The survey was designed mainly to address these issues rather than employment impacts, which are subject to numerous caveats. Harding in fact writes that the focus on the employment impact of unfair dismissal laws is 'undesirable and potentially misleading'. None of these caveats seems have been mentioned by the government when quoting the 77,000 jobs figure.

In our view qualitative employer opinion surveys are not a suitable instrument for estimating the employment impact of dismissal costs. To date, however, almost all Australian studies (of which Harding's study is the most careful) have been of this type.

Our Study

Over the past three years the authors have been conducting a large Australian Research Council funded project on the employment impact of hiring and firing costs, at University of New South Wales at the Australian Defence Forces Academy in Canberra. To our knowledge, the study is the first in the world to use large-scale quantitative survey evidence on dismissal costs in conjunction with economic models of firm behaviour. A full description of the survey and results is Freyens and Oslington (2005).

Our survey was conducted in 2004 and covered 1800 small and medium enterprises from the Sensis® Business Index, representing a workforce of 33,356 full and part time employees. All states and most industries and occupations were included. We obtained 1438 responses, including 208 enterprises reporting redundancies in the past five years and 597 reporting fires (439 of which were not disputed, 121 of which were

1 The question did not ask specifically about costs of dismissal, but instead: 'by how much, in dollars per year, do unfair dismissal laws increase your businesses' costs?'

resolved through conciliation, and 38 of which went to arbitration or the courts). Redundancies in the survey are defined as involuntary terminations (we therefore exclude quits and retirements) coming from economic downturns, technological change, etc. – in other words for reasons not specific to the employee. Fires, or dismissals for cause, on the other hand, are involuntary terminations for reasons specific to the employee, such as poor performance, misconduct, etc. These fires may be unlawful if for reasons such as pregnancy, or they may be lawful but unfair. An employee who considers their dismissal unfair can take the matter to the Australian Industrial Relations Commission (AIRC), or a corresponding State body, which will conciliate. If this fails it may arbitrate and order reinstatement or compensation if the dismissal is judged ‘harsh, unjust or unreasonable’. It is this right to appeal against unfair dismissal through the AIRC that the Howard Government is seeking to remove for workers in businesses with less than 100 employees.

Overall, the survey data indicate that the average cost of an uncontested dismissal is \$3,044 which represents 10.3 percent of average annual wage costs. The average total cost of a contested dismissal settled through conciliation is \$12,818 or 27.7 percent of annual wage cost. For a dismissal requiring arbitration the cost averages \$14,705 or 35.7 percent of annual wage cost. Redundancies on average cost \$18,900, or 35.3 percent of annual wage cost. These redundancy costs include procedural costs and any notice or severance payments.

For all the costs there is some variation by occupation and industry, but the most interesting finding for the current debate is that there is no strong relationship between the costs and firm size. An intriguing finding that we would like to follow up in future research work is that white collar workers are less likely to lodge an unfair dismissal claim but, when they do, they are more likely to be successful and receive higher average payouts (even as a proportion of wages). The lower claim rate may be related to lower unionisation rates for white-collar workers in small businesses or to the greater ‘reputational risk’ for white collar workers lodging a claim. It is certainly also related to the salary cap imposed by Federal and State legislation on the right to lodge a claim. Their greater success rates in courts may be due to white-collar workers’

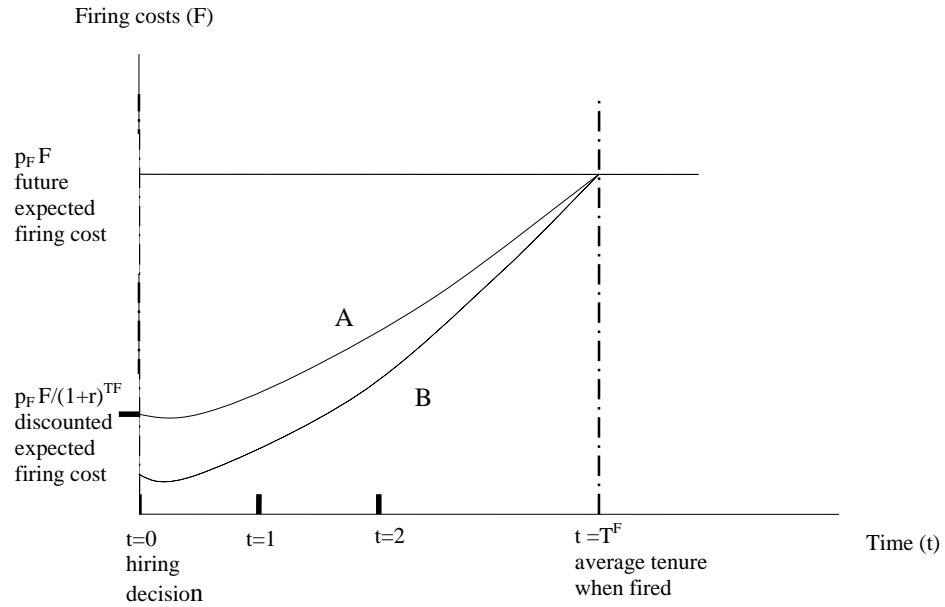
greater familiarity and confidence with claim procedures and ability to argue their case. What type of workers benefit from the unfair dismissal laws matters a great deal – we may be more concerned about the removal of protection if low paid vulnerable workers can no longer claim than if the successful claimants are highly paid professionals.

Employment Impact

The main focus of our study is the overall impact on employment. We combined the survey data on dismissal costs with a standard neo-classical model of labour demand. In the simplest model, employment is set to equate the value of the marginal product of labor with the sum of the wage and the expected present value of dismissal costs. Since dismissal costs are not incurred with certainty, we must use their expected present value. This is calculated by multiplying the future costs by the probability that the worker's employment spell will end in dismissal, to give the expected value. That future value is then discounted back to the present, using the standard present value formula with the number of years being the expected duration of employment for workers whose spell ends in dismissal, and a discount rate which approximates the firm's return on alternative investments. Figure 1 illustrates the expected present value calculation: line A shows how future expected firing costs are discounted so as to give their present value at time $t = 0$ (p_F is the probability of firing workers in the future and r is the discount rate used by firms to compute the present value of future firing costs).

Using our survey data on firing costs, a firing probability of .03 and expected duration of 3.6 years (both from ABS data, as explained in Freyens and Oslington (2005)), and a discount rate of .05, gives an expected present value of firing costs of .0048 percent of annual wage cost. The discount rate is at the lower end of plausible estimates, and using a higher figure would reduce the expected present value of firing costs (as shown by the line B in figure 1).

Figure 1 - Discounted Expected Firing Costs



This expected present value of dismissal costs can be treated like any other labour cost, and a standard labour demand elasticity argument can be applied to estimate an employment impact. We used a labour demand elasticity of 0.7, which is the centre of the range of estimates discussed by Lewis and MacDonald (2002), and the same as used by Harding (2002). This procedure yields a predicted employment impact of removing the conciliation and arbitration elements of the costs of unfair dismissal at both Federal and State level of 11,600 jobs².

2 We do not remove the time and administrative costs incurred (regardless of whether a dismissal is judged fair) because these elements are unlikely to be affected by policy. We believe it will always take some degree of management time and paper work to dismiss employees for poor performance or behaviour.

Until the draft legislation is released we do not know what proportion of Australian workers will be covered by the changes (which depends on what happens with the integration of Federal and State systems, whether the government sets the threshold at firms with 100 employees, etc.). If 50% of workers are affected then the likely employment gains from removing unfair dismissal protection will be about 6,000 jobs. This is a very small number in comparison with the government claims.

As a test of the robustness of our methods, we checked what would be the employment impact of removing mandatory severance and notice requirements for all workers affected by economic dismissals. Using our survey estimates of redundancy costs, a retrenchment probability of .14 and expected job spell of 5.8 years (again from ABS data), and the same labour demand elasticity and discount rate, yields an employment impact of about 157,000 jobs. Comparing this to our estimate 6,000 for removing unfair dismissal protection reinforces the tininess of the impact of unfair dismissal laws. On the other hand, it would not be responsible to quote this 157,000 figure as an estimate of the potential gains from changes in redundancy policy. The actual impact would be much smaller because bargained wages may rise to compensate for the removal of redundancy pay and many firms would still pay for fairness and reputation reasons (as they did before redundancy pay legislation was enacted). Our methodology ignores the business cycle, which does not matter much for unfair dismissal, but is very important for redundancy. The interaction between severance pay and bankruptcy provisions for small business would also need careful attention before any firm conclusions about impacts of retrenchment policy changes could be drawn. This is because the force of redundancy provisions is greatly reduced if the redundancies bankrupt the small business and leave employees out of pocket.

Additional Considerations

Getting back to the proposed changes to unfair dismissal provisions, although we have focused on employment impacts, other issues need to be considered when judging the changes. One such issue is productivity losses because firms carry workers who would have been fired but for

unfair dismissal protection. There is no obvious way to estimate such productivity losses, but some small business spokespersons claim that these costs of carrying unproductive workers are substantial. A related claim is that there are productivity losses from a lack of worker discipline which is alleged to be associated with unfair dismissal protection. We are unimpressed by such arguments because unfair dismissal protection, if properly designed, does not stop firms firing unproductive workers, just from treating workers in a harsh, unjust or unreasonable manner. If these arguments have any weight they are arguments for further fine-tuning the procedures rather than for removing protection.

Another issue is higher costs for employers from casualisation of their workforces to avoid unfair dismissal costs. It is difficult to quantify the extent to which this has occurred. We have some anecdotal evidence in the written comments from another survey of hiring and firing costs in large enterprises, conducted in conjunction with the Australian Human Resources Institute in 2004. There is also some anecdotal evidence of fires being renegotiated into redundancies by firms to avoid unfair dismissal cases. Redundancy payouts depend on duration of employment, and we would expect firms to have an interest in renegotiating fires for short duration workers where the reputational costs of firing are large for firms, or where firms are particularly risk averse. 'Reputational costs' will also induce workers to accept such renegotiations of fires into redundancies. The great advantage of redundancies compared to fires is that nothing is paid to third parties such as lawyers. In this sense, redundancy is more efficient for the parties. To the extent that renegotiation into redundancies hides some of the costs of firing, we would have to increase our cost estimates and their employment impact. However, it would be extremely difficult to quantify the extent of such 'hidden fires'.

Perhaps the most important additional consideration is equity. As discussed above, we have some evidence of the pattern of unfair dismissal claims by occupation, which gives us some idea of the types of workers benefiting from unfair dismissal protection, but we need to know more before drawing any conclusions about the equity implications of unfair dismissal protection. Harding (2002) argues that unfair dismissal

protection is inequitable because it benefits employed 'insiders', and reduces the job prospects of unemployed 'outsiders'. However, this argument only has weight if there are substantial employment losses, which our study suggests is not the case.

Concluding Remarks

It has been somewhat disheartening to observe the process that has led to the proposed changes to unfair dismissal policy. If, as advocated by the government, the main reason for the removal of unfair dismissal protection is to create a large number of jobs, one would normally expect the proposal to be backed by sound evidence about the negative impact of the existing provisions. This is clearly not the case.

As the debate has developed in the past few months, in the press and the Senate inquiry into the proposed changes, neither side of the debate has shown much interest in the details of the few studies of the impact of unfair dismissal procedures. It has been a battle of political spin waged on our television screens and newspapers. The study reported in this article cost a little over \$100,000 of public funds (plus salaries and overheads), and the combined costs of all the studies is dwarfed by the millions of dollars of public funds being spent by the Government on promoting the proposed changes. It is the responsibility of academics to continue to undertake and publicise the results of independent research, regardless of the state of policy debate in Australia.

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The authors acknowledge the support of an ARC Discovery Grant "The Impact of Hiring and Firing Costs on Wages and Unemployment" and a UNSW Faculty Research Grant.

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