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The effect of dismissal protection legislation on the stability of newly started employment relationships

In this paper we examine the effect of German dismissal protection legislation on the individual employment stability of newly started employment relationships. To identify causal effects, we exploit changes in the threshold value for the applicability of dismissal protection as a natural experiment. This allows us to identify the effect of dismissal protection on the job exit probability in companies with six to ten employees. We address two key questions. First, does the waiting period of six months before dismissal protection comes into effect increase the job exit probability as firms wish to end less productive job matches before legal employment protection applies? Second, does dismissal protection decrease the job exit probability after the waiting period?

Unlike previous studies, we use individual job stability, not firm-level mobility rates, as the outcome. This approach has several methodological advantages. First, it is possible to focus specifically on short-term spells. Due to transition periods granted to existing employment relationships, the legislative change on which the natural experiment is based affected only newly begun employment spells. Second, we are able to account for employment changes that carry firms above or below the threshold value, thus changing the application of dismissal protection. By contrast, previous studies had to classify each firm into a treatment status for the whole period of analysis. Finally, we are able to account for substitution effects whereby firms increasingly use fixed-term contracts for hiring once the law comes into effect.

Our results show that there is a positive effect of dismissal protection on the individual employment stability of newly begun jobs. The effect does not, however, apply instantly, but only unfolds after about 200 days of employment duration. Since this coincides with the length of the waiting period, we interpret this finding as support for a causal effect. By contrast, we do not observe a negative effect of dismissal protection on job stability during the waiting period. Thus, there is no evidence of increased sorting before dismissal protection applies.

We perform several robustness checks. One of them concerns the use of fixed-term contracts instead of regular employment relationships. We do not find that the results are altered substantially after excluding firms using fixed-term work. Thus, the potential bias due to the use of fixed-term contracts appears to be small. A second robustness check concerns changing the control group from firms with 11 to 14 employees to firms with one to five employees. While the estimated effect of dismissal protection is similar in magnitude, it ceases to be statistically significant. This is most likely due to a smaller number of observations, giving rise to larger standard errors.

The estimated effects apply to newly started employment relationships. As the stringency of German dismissal protection increases with employment duration, they may be interpreted as minimum effects. Previous studies have not found effects of dismissal protection on job exit rates estimated for all employees. In contrast, our finding of a significant effect even for newly started jobs suggests that the overall effects of employment protection are substantial.