Replacing Dual Employment Protection by a Single Labour Contract[*]

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Abstract

The dual labour markets of Southern Europe and France create a "revolving door" through which many workers – especially youths – rotate between dead-end jobs and unemployment. The problem lies in the difference between the costs of firing workers on permanent versus temporary contracts. This column proposes a framework for evaluating what the optimal single contract should look like taking account of transitional issues and political economy constraints.

One of the main rationales for having Employment Protection Legislation (EPL) is that, through fostering job stability, it can insure workers against job losses in the absence of perfect capital markets. In addition, EPL reduces moral hazard by employers who fail to internalize the cost of unemployment imposed on taxpayers.

Both issues are particularly relevant in the dual labour markets of Southern Europe and France. It is well known that the dysfunctional performance of these labour markets has not been due to the coexistence of permanent (PC) and temporary contracts (TC). After all, the use of TC to accommodate for the fixed-term nature of many seasonal activities is widespread in most countries. What really matters is the so-called EPL gap: the difference between the stringent EPL (defined as days of wages per year of service: d.w.y.s. hereafter) applied to longer-tenured workers and the very low compensation (if any) that other workers receive at the end of their short-term contracts.[1]

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[1]See, *inter alia*, Cahuc and Postel-Vinay (2002), Dolado, García-Serrano and Jimeno (2002), Bentolila et al. (2012) and García Pérez and Osuna (2014).

As noted by Blanchard and Landier (2002), though flexible TC increase job creation and job destruction, a sizeable EPL gap reduces the conversion of TC into PC. This happens when wages are not flexible enough to offset the transfer from employers to employees implied by severance pay *per se*, and when uncertainty regarding litigation is large. As a result, dual EPL creates a "revolving door" through which workers rotate between dead-end jobs and unemployment. Plenty of evidence documents that this gap has negative consequences on unemployment, wage pressure, human capital accumulation and innovation.[2]

Regrettably, the financial and sovereign debt crises have confirmed all of these predictions in the olive-belt countries, with Spain having become the epitome of a dysfunctional dualism. Indeed, despite of suffering a similar cumulated fall in GDP as in other large EU economies during the Great Recession, the Spanish unemployment rate has rocketed to above 20%, as it also happened in the early nineties when the European Monetary System collapsed.

This poor performance, also shared by other GIIPS (Greece, Italy, Ireland, Portugal, Spain) and France, has triggered a policy debate on how to redesign EPL in those countries. Several proposals have been made advocating the replacement of dual EPL by a *single/unified open-ended contract* (SOEC hereafter) applied for new hires or even retroactively.[3]

The key feature of SOEC is that it has no ex ante time limit (unlike TC) and that mandatory severance pay increases *smoothly* with seniority, rather than *abruptly*. In this fashion, a SOEC would avoid the damages inflicted by dual EPL by providing a sufficiently long entry phase to discern the quality of job matches and a rather smooth rise in protection as job tenure increases. A gradually raising redundancy pay-tenure profile would be justified by the larger losses of specific human capital and the difficulties of finding new jobs that dismissed older workers face, as well as to enhance employer-sponsored training.

However, despite being high in the European political agenda, so far most proposals on SOEC have been rather vague on their specific recommendations regarding design and implementation.

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To help filling this gap, in a recent CEPR discussion paper (Dolado, Lalé and Siassi, 2015) we propose a methodology to evaluate the following pending issues:

1. a precise definition of the tenure profile that a SOEC should have depending on several relevant labour-market characteristics;

2. an assessment of the allocation and welfare gains that would result from a reform replacing dual EPL by a SOEC;

3. an evaluation of the political support to such a policy change;

[2]See Dolado (2016) for a review of this evidence.

[3]See Bentolila, Boeri and Cahuc (2012), Cahuc (2012), OECD (2014) for overviews and discussion of these proposals.

4. an analysis of how the transition towards the new steady state would limit losses and enhance gains.

For tractability, we develop a search and matching model for a labour market where there is only one type of contract which is characterized by a large EPL gap after a few (two) years of job tenure. In this fashion, the first stage of this contract mimics TC, except that there is no pre-specified termination date. Likewise, the later periods become akin to PC. This simplifying assumption allows us to focus on the role of EPL gap as the main culprit of dysfunctional dual labour markets.

A distinctive feature of our model is that workers are risk averse (while firms are risk neutral) and therefore demand insurance to smooth out consumption.[4] This enables us to compute the optimal tenure profile of severance pay according to some pre-specified welfare criterion (see below). Other relevant features in our setup are that unemployment benefits (the other source of insurance) are financed by a payroll tax and that redundancy costs may have in part a layoff tax nature due the existence of red-tape cost associated to litigation procedures. In this fashion, our analysis is related to Blanchard and Tirole (2008)'s discussion on the relationship between layoff taxes and unemployment benefits to minimize the moral hazard problem affecting redundancies.

More specifically, our model has a life-cycle structure where young and older workers differ in the way they use severance pay and in their search intensity for jobs. On the one hand, while younger workers are hand-to-mouth because they are subject to binding credit constraints, older workers can use severance pay to buy actuarially fair annuities which help them smooth out consumption after becoming unemployed . On the other hand, whereas laid-off young workers search actively for jobs, unemployed older workers stop searching to capture the difficulties that these workers often face in re-entering the labour market. In this fashion, job security is allowed to play a key role in bridging the gap in consumption, and for this reason forward-looking young workers are very keen on accumulating job tenure to gain access to annuity markets. Yet, wage-setting systems prevent them to fully achieve this goal, leading to the detrimental revolving-door effect.

For illustrative purposes the model is calibrated to Spain just before the Great Recession, at a time when its unemployment rate was close to the EU average rate, namely 8.5%. Once the calibrated parameters reproduce a set of targets prior to the crisis and under the EPL gap prevailing at that time, we compute the optimal tenure profile of redundancy pay. In this computation, optimality refers to maximization of the steady-state lifetime utility of new labour-market entrants. We can then analyse how the new EPL scheme affects welfare across the *current* population at the time of the SOEC reform. In particular, during the transition phase from dual EPL to SOEC we consider two alternative scenarios for workers under existing matches: (Reform 1) where they retain their accrued-to date EPL rights until the date of the reform and subsequently become subject to new SOEC regulations, and (Reform 2) where they also keep previous EPL rules after the reform.

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[4]See Lalé (2015) for a forerunner of this model.

Using conventional values for the coefficient of risk aversion, unemployment insurance replacement rates, quit rates (not entitled to EPL) and share of red-tape costs, our main findings can be summarized as follows:

- Optimal SOEC has an initial "entry" phase of one year (involving no redundancy costs) and a slope of 14 d.w.y.s. Figure 1 displays the tenure profile of SOEC and of the actual EPL scheme before the recession for unfair dismissals (8 d.w.y.s. for the first two years and 45 d.w.y.s. later on, with a cap of 42 months), both in cumulated terms as a multiple to annual wages.[5]

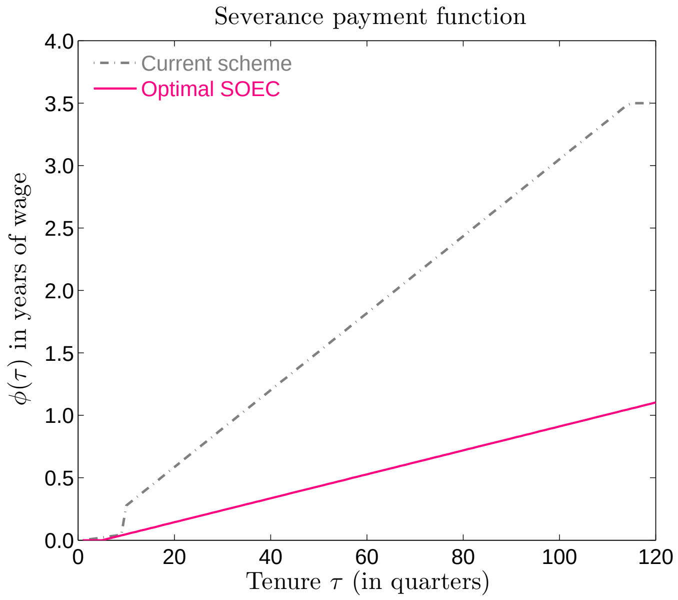

Figure 1. Current scheme (dashed line) vs. optimal SOEC (solid line)
Severance payments are plotted as a function of tenure (in quarters) on the horizontal axis; Severance payments are expressed as a multiple of the average annual wage on the vertical axis.

- By removing the revolving door, the optimal SOEC raises welfare by 1.7% relative to the status quo. Job destruction of short-tenure jobs decreases, overall job creation increases and the payroll tax goes down.[6] In addition, there is a rise of young workers' wages since they are no longer threatened by the EPL gap. Due to the flatter slope of SOEC, employers find it less costly to dismiss older workers when hit by negative productivity shocks. Meanwhile, the reduction in reservation wages of these workers make them accept wage cuts more often (than with dual EPL) to save their jobs. The net effect of lower dismissal costs and higher wage flexibility is that job losses among older workers become fairly small. Since this is accompanied by job gains for young workers, unemployment goes down substantially (Figure 2).

- Reform 1 brings in positive effects much earlier than Reform 2. Foremost, 87% of workers support it (almost 100% of young/prime age workers and 27% of older workers).

[5] For example, the solid line in Figure 1 indicates that a worker suffering an unfair dismissal after 10 years (40 quarters) of job tenure in a firm, would get a severance package of 1.23 annual wages ($= 45 \times 10/365$). By contrast, using five contracts of two years each in sequence implies a severance pay of 0.22 annual wages ($= 16 \times 5/365$).

[6] The proposed SOEC is fairly robust to changes in the key parameters of the model.

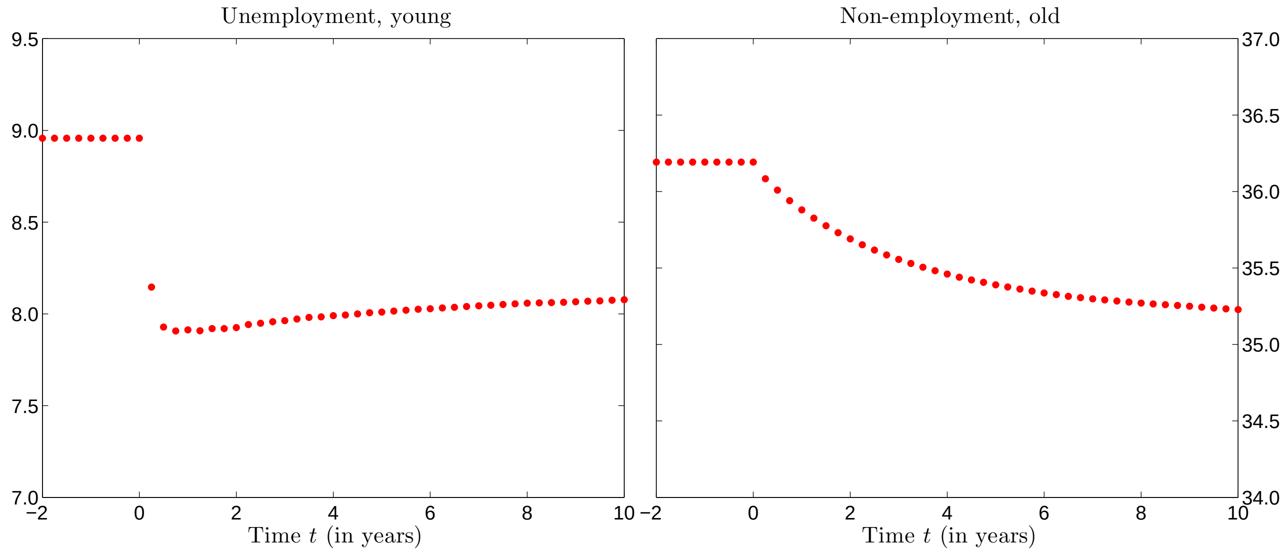

Figure 2. Transition dynamics towards the optimal SOEC
The unemployment rates of young workers (left) and nonemployment rates of older workers (right) are in percent. Time is in years relative to the introduction of the SOEC, which occurs in period 0.

- When comparing the effects of the SOEC to the EPL reform implemented by the Spanish conservative government in 2012 (where the EPL gap went down from 37 d.w.y.s (= 45 – 8) to 25 d.w.y.s. (= 33 – 12)), welfare gains are twice as large under the former (1.7% vs. 0.86%).

- To limit the uncertainty stemming from PC worker's appeal to labour courts (something that TC workers are not entitled to), we argue that, as in the recent Italian Jobs Act, combining SOEC compensations exempted from income taxation together with higher but taxed severance pay for unfair dismissals could be a fruitful EPL design to eliminate the scourge of dual labour markets with high EPL gaps.

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