

Policy Responses to Labour Market Duality:

— No size fits all —

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A brief historical perspective

- Due to political constraints, EPL reforms often take the form of partial reforms at the margin.
- In some countries this process created a dual labour market with separate segments for temporary and permanent jobs. The temporary contracts provide flexibility to firms, but at the cost of a large fringe of unstable jobs.
- Two-tier or dual reforms may provide an initial boost to job creation (“the honeymoon effect”), but over time they tend to create pervasive distortions.
- Labour market duality poses a serious challenge to policy makers. The improper use of atypical contracts may expand quickly and is hard to eradicate.

Atypical contracts and precarious employment

It is convenient to use a broad concept of atypical employment:

- The debates about duality often focus on the divide between temporary and permanent (*open-ended*) contracts
- However, the use of civil code contracts is on the rise in many countries.
- Furthermore, in the crisis-ridden countries there is also a rise in informal employment

Policy makers should be concerned about the *improper* use of atypical contracts. Regular open-ended contracts should be the default option.

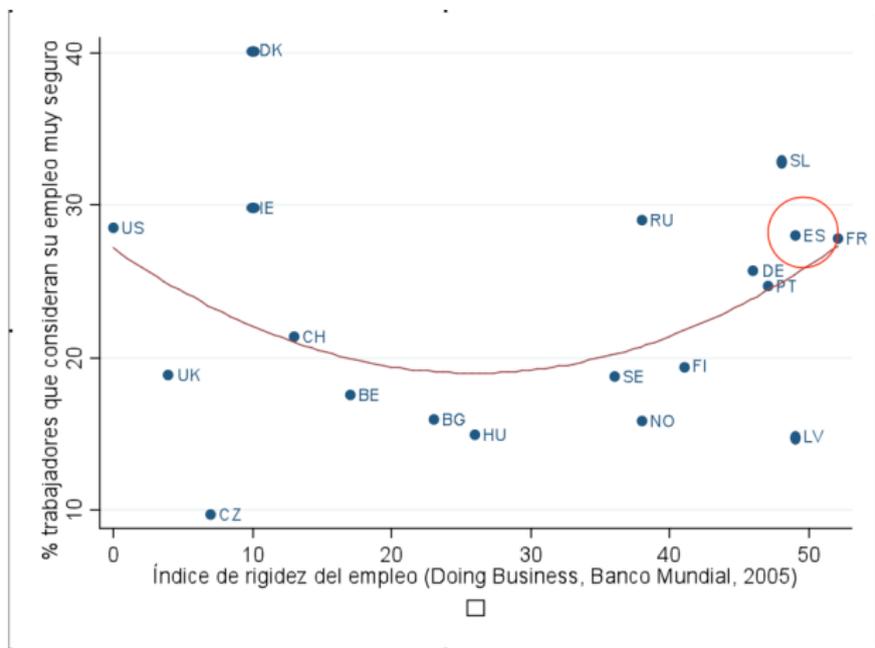
Tradeoff between stringency and coverage

It is a misconception to think that a more stringent regulation necessarily leads to a better protection of workers.

- If the regulation is *perceived* to be too stringent, firms will look for loopholes in the regulation to avoid protection.
- The first victims are typically the least productive and most vulnerable workers, including young entrants.

Attempts to improve the protection on atypical contracts are bound to produce perverse effects if they are not accompanied by measures that make regular contracts more attractive to firms.

Perceived job security



Dolado, Felgueroso and Jansen (2011)

Insider-outsider divide

The recent experience in the peripheral EU countries is a confirmation that dual labour markets are hard to reform:

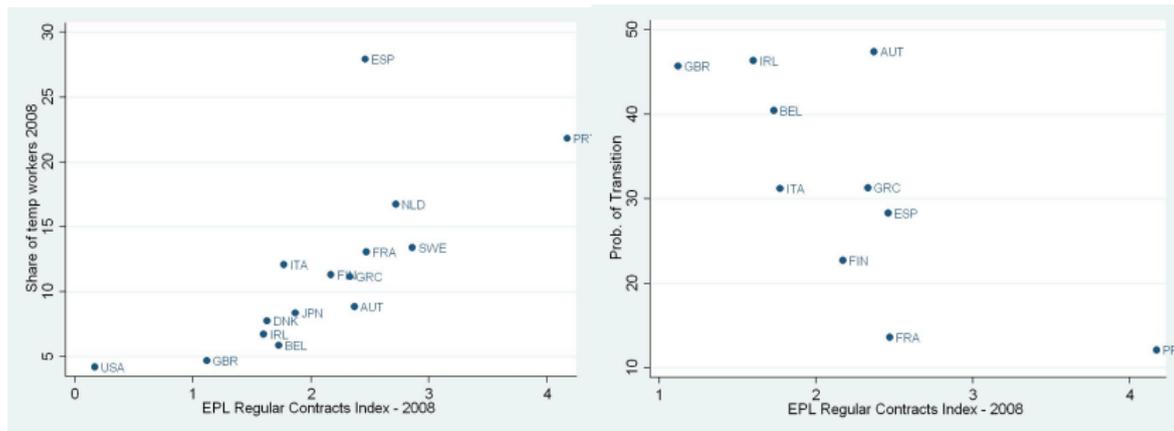
- Workers with regular contracts (“the insiders”) tend to oppose reforms and typically constitute a stable majority
- Unions tend to align with the insider interests
- Outsiders, on the contrary, are often poorly organized

Governments should try to create a level playing field by representing the interests of outsiders. But they should also strive for consensus. Insiders can be compensated if EPL reforms are part of a broad reform package.

Temporary contracts: Stepping stones or traps?

- Temporary or fixed-term contracts can play a useful role as stepping stones to regular employment.
- But in labour markets with substantial differences in EP between fixed-term and open-ended contracts they often become a trap.
- The employer prefers to recruit a replacement rather than to upgrade the incumbent worker to an open-ended contract when the mandatory limit on the duration (or renewals) of temporary contracts is reached.
- This wasteful rotation disproportionately affects youth and cohorts of disadvantaged workers
- NOTE: the problem is the gap in EPL and not the level per se.

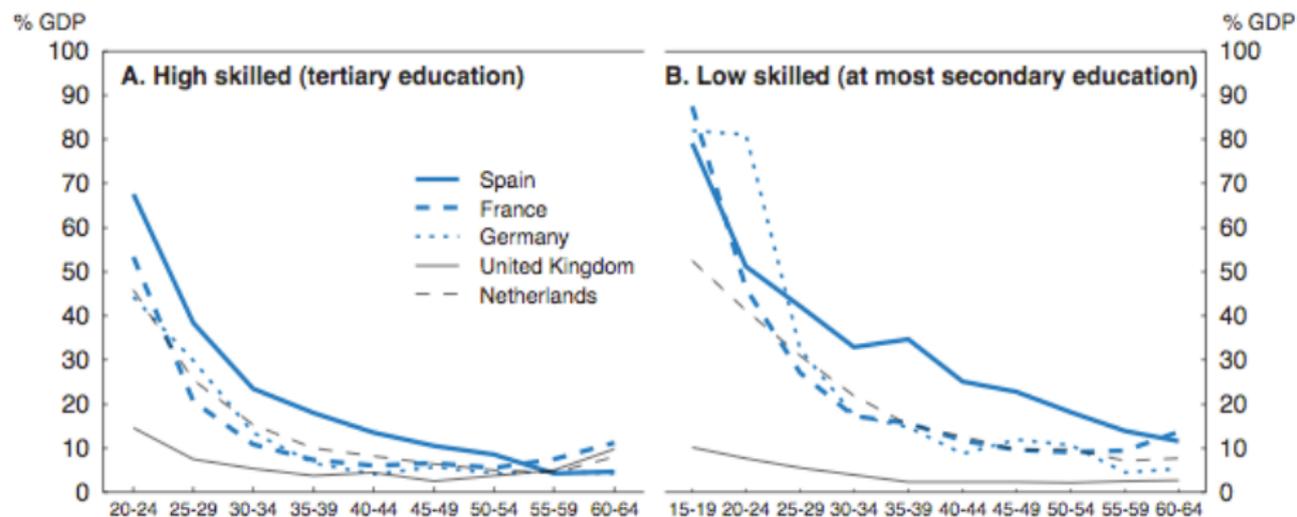
EPL and temporary Jobs



Share of temporary jobs in total (dependent) employment

Transition probability from temporary to permanent employment

Stepping stones or traps?



Source: Dolado *et al.* (2013), based on yearly subsample EU LFS (2010)

The share of fixed-term contracts by age

Table 2: Share of temporary contracts in percentage of total employees

Countries	Between 15 and 24 years		Between 25 and 49 years		Between 50 and 64 years		Between 15 and 64 years	
	2007	2009	2007	2009	2007	2009	2007	2009
Austria	34.9	35.6	4.7	4.9	2.5	3.0	8.9	9.1
Belgium	31.6	33.2	6.9	6.8	4.3	3.3	8.6	8.2
Bulgaria	10.3	9.3	4.5	3.9	5.0	5.0	5.1	4.6
Cyprus	23.3	18.4	14.0	15.0	5.2	6.1	13.3	13.5
Czech Republic	17.4	18.7	5.8	5.5	9.5	9.2	7.8	7.5
Denmark	22.2	23.6	7.0	7.2	4.1	3.2	8.6	8.9
Estonia	na	na	na	2.2	na	na	2.2	2.5
Finland	42.4	39.0	14.1	13.4	7.6	7.1	15.9	14.5
France	52.5	51.2	11.4	10.4	5.9	6.4	14.4	13.5
Germany	57.5	57.2	9.9	10.2	4.7	4.7	14.6	14.5
Greece	27.0	28.4	10.5	11.9	6.1	6.7	10.9	12.1
Hungary	19.1	21.4	6.8	8.2	4.8	5.6	7.3	8.4
Ireland	19.2	25.0	4.8	6.4	4.2	5.1	7.2	8.5
Italy	42.3	44.4	12.2	11.6	6.3	5.7	13.2	12.5
Latvia	9.3	9.3	3.5	3.8	3.2	3.7	4.2	4.4
Lithuania	9.8	5.0	2.9	2.1	2.9	na	3.5	2.3
Luxembourg	34.1	39.3	5.6	5.3	na	na	6.8	7.2
Malta	11.0	11.0	3.8	3.8	na	na	5.1	4.7
Netherlands	45.1	46.5	14.1	14.1	6.8	6.9	17.9	18.0
Poland	65.7	62.0	25.1	23.6	18.2	18.4	28.2	26.4
Portugal	52.6	53.5	21.1	21.3	10.6	10.1	22.4	22.0
Romania	4.6	3.7	1.4	0.8	0.9	0.7	1.6	1.0
Slovakia	13.7	12.5	3.9	3.5	4.0	3.6	5.0	4.3
Slovenia	68.3	66.6	14.0	12.5	6.7	6.0	18.4	16.2
Spain	62.8	55.9	31.0	25.7	15.3	12.0	31.7	25.5
Sweden	57.1	53.4	14.0	12.0	7.3	5.8	17.2	14.9
United Kingdom	13.3	11.9	4.3	4.5	4.3	4.2	5.7	5.5
EU 27	41.1	40.2	12.3	11.5	6.8	6.5	14.5	13.4

Sources: Eurostat.

Macroeconomic implications

The macroeconomic consequences of dual EPL:

- More volatile employment over the business cycle — firms use temporary contracts as a buffer stock and fail to explore other channels of adjustment
- Low productivity growth — lower training intensity, poor match quality and specialization in relatively low-productivity sectors
- Negative fiscal externalities — high incidence of unemployment produces negative externalities as firms fail to internalize the social cost of dismissals

Policy options

Broadly speaking, the policy options to overcome duality are:

- A. Fiscal incentives to stimulate the creation of permanent jobs
- B. Measures to reduce the gap in EPL on permanent and temporary contracts
 - ▶ Reducing the gap in statutory redundancy pay
 - ▶ Measures to reduce legal uncertainty in dismissal procedures
 - ▶ Stricter limits on the use of temporary contracts
- C. The introduction of a single open-ended contract for new hires

Option A. Targeted fiscal incentives

- Fiscal credits may help to improve the access to open-ended contracts for specific groups of vulnerable workers. Their use may be extended in crisis times.
- But their widespread use has important drawbacks
 - ▶ Substitution effects
 - ▶ Deadweight losses
- The empirical evidence suggest that fiscal credits have at best a modest effect on employment duration (for youth)

Option B. Measures to reduce the gap in EPL

The gap in EPL can be reduced through various channels:

- Portugal equalized redundancy payments on temporary and permanent jobs
- Spain opted for a mix of policies
 - ▶ Reduction of redundancy pay for unfair dismissals
 - ▶ Clarification of the causes for fair (economic) dismissals
 - ▶ Reintroduction of two-year limit on the use of temporary jobs

The reforms have made it substantially cheaper for firms to dismiss workers. Nonetheless, temporary jobs still make up more than 90% of new contracts.

Option C. Single Open-Ended Contract (SOC)

In recent years, economists from a number of Mediterranean countries have endorsed the introduction of a SOC:

- **France:** Blanchard and Tirole / Cahuc and Kramarz
- **Italy:** Ichino / Boeri and Garibaldi
- **Spain:** 100 academic economists (including myself)

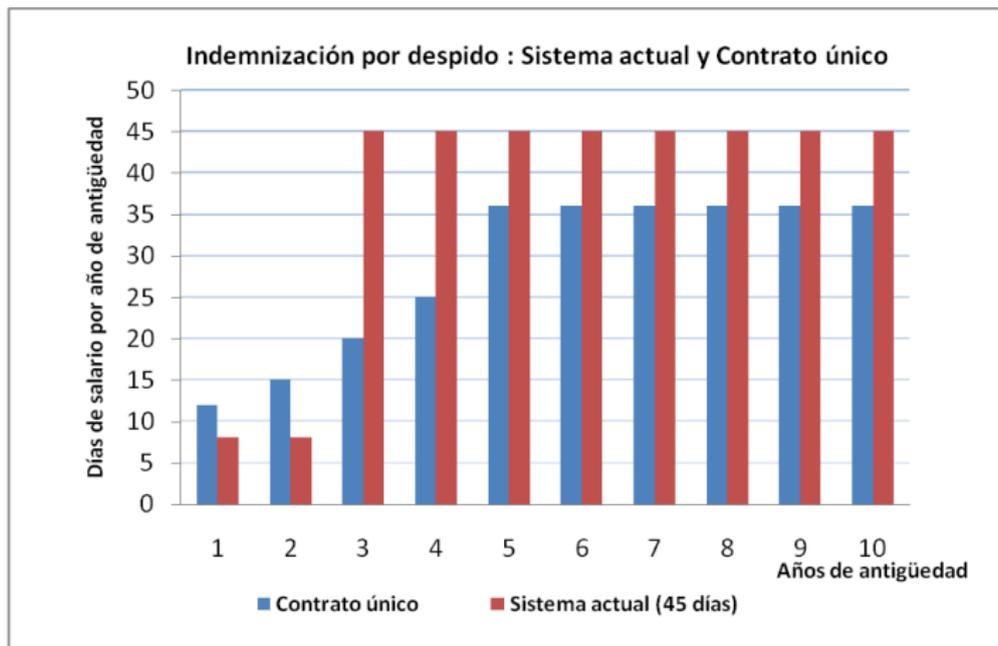
The terminology SOC is somewhat misleading. It is more appropriate to talk about a contract that offers equal opportunities.

Common features

The common elements of the existing proposals:

- The introduction of a new open-ended contract with gradually increasing employment protection.
- The SOC offers a similar degree of flexibility as temporary contracts during the initial years and similar protection as existing open-ended positions in later years
- The smooth increase in the stringency of EPL plus the absence of a mandatory termination date eliminate the incentives for wasteful rotation
- The SOC should be the default option in all **new** hires, either voluntarily (Italian proposal) or mandatory (Spanish proposal).
- The rights and entitlements of incumbent workers are respected.

The original Spanish proposal



Redundancy pay in case of fair dismissal: 20 days of salary per year with a max. of 1 yearly salary.

The Spanish example

Before the crisis, dismissal procedures were secure but extremely costly.

- Firms could circumvent legal control by paying the maximum compensation for unfair dismissals.
- No mandatory reinstatement of the worker after an unfair dismissal
- Fair dismissals for economic reasons were hardly ever granted by judges

The original SOC proposal introduced a single redundancy pay scheme for all types of economic layoffs. This effectively restricted legal control to violations of a worker's fundamental rights (ILO Convention 158).

Later versions proposed separate schemes of redundancy pay for fair and unfair dismissals. In practice both versions are isomorphic.

Menu of contracts

Given that all previous reforms failed to curb the use of fixed term contracts, the Spanish proposal opts for the suppression of almost all atypical contracts.

Three contract types would suffice (Fedea, 2013):

- A single open-ended contract
- A temporary contract for replacements
- A training contract for the insertion of youth

The SOC can be full-time or part-time and may even be discontinuous. It may be necessary to include exemptions from the rules for collective dismissals for short tenures to permit seasonal activities.

Italian proposal

BG propose *tenure track*-type contracts with two distinct phases

- **Entry phase** of up to 3 years in which workers are exclusively entitled to redundancy pay proportional to tenure
- **Stability phase** Worker is entitled to existing legal protection against unfair dismissals (including the right to reinstatement in large firms).

The proposal does not foresee limitations on the menu of contracts. The SOC is designed to be the preferential option for both employers and employees.

The change in legal protection after the first three years may still provoke considerable rotation. Especially, if workers are entitled to reinstatement after an unjust dismissal.

Tradeoffs

A new intergenerational contract

The implementation of a SOC may help to improve job stability during the early phases of an employment relationship.

But in order to avoid detrimental effects for job creation and employment

- Workers should accept (somewhat) more flexibility later in life
- Dismissal procedures should offer a high degree of legal certainty
- Internal flexibility should be a viable alternative to dismissals

In other words, more security when young in return for more flexibility when old.

Rethinking legal protection

Effective legal protection against unfair dismissals is a basic right. But policy makers have to rethink the design of EPL in order to reduce legal uncertainty and avoid excessive interventions of judges.

- Potential violations of workers' fundamental rights should be sanctioned in court
- By contrast, contingencies for fair (economic) dismissals are hard to stipulate by Law. This creates legal uncertainty
 - ▶ Implicit prerequisite of realized firm losses
 - ▶ Judges may be tempted to verify both the cause and the proposed remedy, possibly infringing the right to entrepreneurial freedom
 - ▶ Provisions for fair dismissal are usually not contingent on individual performance indicators

Alternative instruments

Economists (and some experts in labour law) recognize the role of redundancy pay as an efficient instrument against unfair dismissals.

- It acts as a filter by aligning the private and social costs of a dismissal
- The redistributive impact of redundancy pay can be undone with flexible wages
- Last but not least redundancy pay is predictable

Redundancy pay accrues to the worker. Policy makers can also discourage the creation of atypical jobs through

- Higher social security contributions on atypical contracts
- Experience-rating so that firms with higher turnover pay higher future contributions

The Austrian model: capitalized redundancy pay

- The optimal firing costs are typically non-zero because firms do not internalize the total cost of a layoff (UI benefits, firm-specific skills).
- But too high severance pay reduces the mobility of workers from low- to high-productivity sectors and jobs.
- The Austrian system of capitalized redundancy pay eliminates these disincentives to mobility because the fund is portable.
- In a mixed system the monetary part of redundancy pay could serve as insurance against income shocks. The capitalized part could finance retraining or pensions.

Summary of the pros and cons

Pros

- Open-ended contracts become the default option
- The gradual increase in EP removes incentives for wasteful rotation
- A more equal distribution of rights and opportunities
- More incentives for investments in training
- Increased stability of employment along the cycle
- No need for a retroactive reform of EPL

Cons

- Workers need to accept more flexibility later in life
- Politicians perceive SOC as a risky paradigm change

Recent experiences

The recent experiences in the Mediterranean countries illustrate the difficulties to advance in the direction of SOCs:

- **Portugal** made a step forward. It equalized redundancy pay on permanent and temporary jobs under pressure of the Troika.
- **Spain** adopted contradictory measures (reduction in redundancy pay but also the introduction of very precarious contract types)
- **Italy** seems to have moved backwards (relaxation of the use of temporary contracts)

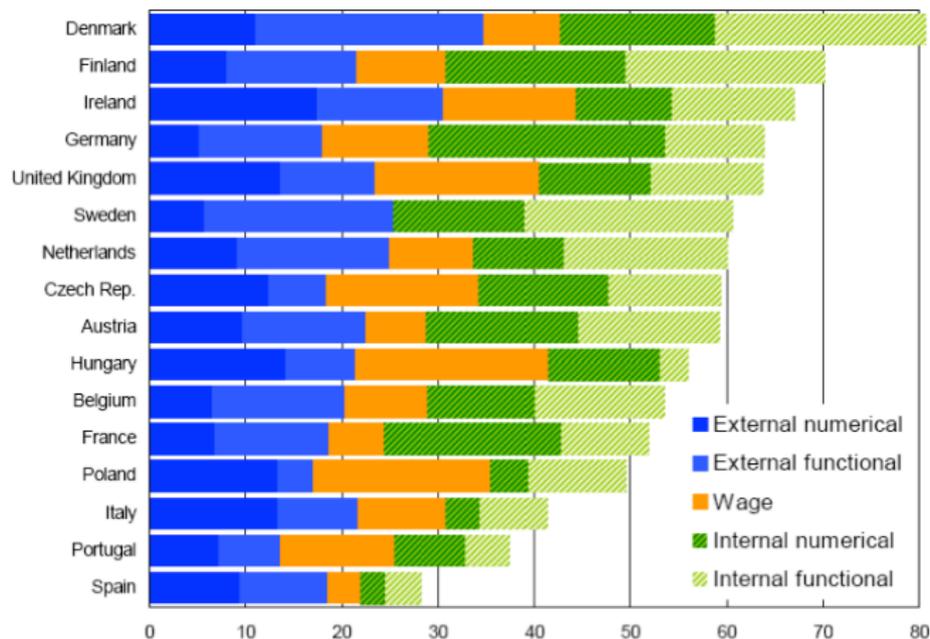
Duality in Poland

- Duality in Poland is more profound than in Spain due to the widespread use of civil law contracts
- This exposes workers to higher risks and requires strong measures.
- The rapid increase in the share of atypical contracts coincided with steep rise in the unemployment rate between 1998 and 2004
- Since then unemployment rates have returned to their previous levels, but the share of atypical contracts remained high.
- The widespread use of civil code contracts is a form of unfair competition or **race to the bottom**. As the share of these contracts grows larger, firms that offer better working conditions may be forced to follow suit or exit the market

Policy response

- Once again it is not sufficient to simply restrict or even prohibit the use of certain civil code contracts.
- The hiring under labour code contracts must also be made more attractive, notably in the case of the most vulnerable workers, to avoid a rise in informal employment.
- A first requirement is to equalize social security contributions between labour code and civil code contracts with almost exclusive dedication to one employer
- Another option is to introduce conversion clauses if a self-employment person seems to have a stable work relationship with a particular firm
- Targeted social security contributions (financed by indirect taxes) can make labour code contracts more attractive without a need to reduce salaries

Alternative sources of flexibility



Source: IZA 2009

Lessons for Poland

- The recent experience in Spain and Italy confirms the enormous difficulty to enact reforms that reduce duality.
- The governments in both countries ended up removing further obstacles to the use of precarious contracts. This is a clear mistake.
- Poland can learn from the experiences in other countries, but reforms should carefully be adapted to local circumstances and they should tackle the true root of the problem (EPL, legal uncertainty, labor costs...)

General principles

Policy makers should

- Concentrate on incentives before they impose binding restrictions on the use of certain contracts.
- Design a balanced package of reforms that avoids a rise in labor costs.
- Focus on politically viable rather than first-best solutions