

A analyses Économiques

vol. II-06 (Oct. 2003)

The Newsletter of the French Council of Economic Analysis

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EDITORIAL

The Institutional Design of Employment Protection

Report by Olivier Blanchard and Jean Tirole

This report makes recommendations aimed at promoting greater accountability among companies in the area of human resources management policy.

The key theme is clear: businesses that lay off workers should pay a tax to an unemployment insurance fund.

This system is partly drawn from a method applied in the United States. The Delalande contribution provides a specific illustration of this in the context of the French economy.

The report shows why the redundancy tax rate must be positive but less than one unit. In other words, unemployment insurance must be partly mutualised. Specifically, this tax would target redundancy plans.

This particular tax would have many implications: links with adult education policy, a potential but not essential effect on job creation subsidies. The role of the courts would also have to be reviewed.

The report concludes that this tax could lead to 'more efficient employment protection, lower costs for businesses and a reduction in unemployment'. The debate has been launched.

Christian de Boissieu
Executive Chairman of the CAE

Olivier Blanchard and Jean Tirole examine the links between unemployment and employee protection in the face of redundancy. The overall effect of high protection on the unemployment rate is unproven. In countries where workers are highly protected, the labour market is less fluid and the average redundancy period is longer. The authors suggest making businesses more accountable by requiring them to contribute to the financing of unemployment insurance in a more direct manner (according to the jobs that they cut). Incentives to do this could be based on the system used in some American states. The role of the courts in the redundancy process would be reduced. At an equal cost, the incentives thus introduced would increase the efficiency of employment protection, to which workers are so attached.

This report, coordinated by Jean-Christophe Bureau, a permanent member of the CAE team, was discussed at plenary sessions of the Council on March 27, 2003 and May 5, 2003, attended by the Prime Minister.

Tense negotiating climate, marginal reform

It is difficult to have constructive dialogue on employment protection, i.e. the duties of companies and workers when a contract is terminated. Businesses complain of the direct cost of redundancies and the complexity and uncertainty of the relevant legislation. They consider that current legislation prevents them from adjusting to the technological advances and rapid changes in demand that characterise

modern economies. To them, this loss of efficiency and the extra costs involved discourage job creation. Workers cite the personal and social cost of unemployment and insist that businesses should bear the cost when laying off staff. While recognising the high cost of unemployment, a number of economists believe that current social security systems are inefficient. At the very least, legislation needs to be improved and simplified, and the level of protection probably needs to be reduced.

Governments in continental Europe have learned, often at their expense, that workers are very fond of labour laws. Not only do those protected by these rules have considerable electoral weight, but support for policies protecting workers goes beyond the circle of those who benefit directly. Reform in this area has for the most part been 'marginal'. For example, in France there was the introduction of fixed-term contracts (CDD: *contrats à durée déterminée*). Protection for permanent employment contracts (CDI: *contrats à durée indéterminée*) has changed little. These reforms have created a two-tier labour market with significant inequalities between workers and dubious effects on the overall efficiency of the system.

More generally, with businesses calling for a reduction in protection, workers and unions sticking to their guns and governments pushing through the reforms that appear the least politically damaging, the consistency of reforms is limited and the objective badly defined.

The role of the state in employment protection and the cost of redundancy

If we compare the reality in France with other experiences, the following questions come to mind:

- Why do labour agreements fail to provide sufficient protection for workers against unfair dismissal or at least a partial guarantee against a fall in income in the event of unemployment, using voluntary contributions to an unemployment insurance fund? What is the justification for public intervention on the labour market?
- If the labour market has failed in this respect and the state is therefore required to regulate protection and unemployment benefits, how should it approach this task? Should the internalisation of the cost of unemployment involve mandatory payments by businesses in the event of redundancies or does it require additional government and legal control?
- Should unemployment benefits be financed by contributions (employer or employee) deducted from earnings, as currently happens, or do we need to move to a more incentive-based system?
- Should the payments made by businesses making redundancies go to the workers losing their jobs (in the form of a pay-off), as is the case in France, or to the unemployment insurance fund?
- Should these payments cover part, all, or more than all of the unemployment benefits and other costs incurred by UNEDIC and attributable to the relevant redundancy?
- Should these payments be immediate or deferred, as applies to the no-claims bonus system (for example, the experience rating system in the United States described in the box below)? Should these require guarantees or a search for the responsible party, or should the government assume the risk that the payments may never be made?

These issues are discussed in the report, which suggests ways in which unemployment protection can be reformed in France.

The link between job protection and unemployment

Most labour market theories hold that employment protection, i.e. administrative and legal constraints and the benefits and payments made to laid-off workers, increases the length of unemployment and makes the labour market less reactive and more 'stagnant'. The net effect on the unemployment rate is less easy to discern as, on average, periods of unemployment appear to be longer, but redundancies are discouraged.

Empirical comparisons on an international scale generally support these theoretical forecasts. We can see a close negative correlation between employment protection and the length of unemployment. There is also a negative correlation between employment protection and flows between employment and unemployment and vice versa. Empirically speaking, however, there is no conclusive correlation between employment protection and the unemployment rate, due to two conflicting forces (employment protection reduces flows to unemployment but extends the duration of the latter). For example, the unemployment rate is fairly similar between two countries where the level of protection is high in one case (Portugal) and low in the other (United States). But behind the figures, there are effects other than those mentioned above: in Portugal, the average length of time spent out of work is three times greater than in the United States, and flows into the labour market are three times lower.

At a microeconomic level, in-depth statistical studies are highly fragmented, but recent works suggest that employment protection discourages businesses from hiring workers who they think will be temporary, but fails to prevent them from reducing the headcount if staff changes appear permanent. If these conclusions are borne out, employment protection would not be a major obstacle to adjustments to technological advances and growth.

The ambiguous effects of fixed-term contracts

Empirical works on the impact of corporate reform in European countries show that the increasing use of CDDs (70% of new hires in France and 46% of all jobs for 20-24 year olds) has had a lasting effect on the nature of the labour market. The impact of these temporary contracts on unemployment is inconclusive: companies often prefer to recruit a new worker on a CDD than award a CDI (permanent employment contract) to a worker already on a CDD and higher staff turnover prevents an appreciation of the employee's human capital (little investment in training). To date, the main effect of CDDs in France seems to be the emergence of an increasingly two-tier, unequal labour market.

Tax redundancies?

Economic theory clearly shows the need for businesses to assume greater responsibility for the social cost of redundancies. In particular, the current system in which the company pays nothing to the unemployment insurance fund in the event of a redundancy implies a dual incentive to make redundancies:

directly, as the company bears little of the cost incurred by the unemployment benefit fund; and indirectly, as this fund must be financed by means other than payments by businesses when making redundancies, in this instance through employer and employee social security contributions, which increases wages costs.

Whereas the principle of internalisation suggests a unit rate of contribution (the rate of contribution is defined as a business's payment to the unemployment insurance fund divided by the unemployment benefits paid by this fund to its ex-employees), several factors need to be considered when attempting to define the optimal level of this contribution rate.

Pooling the cost of unemployment

One argument for businesses to make higher contributions is that a redundancy affects not only the unemployment insurance fund but also the individual involved. This implies redefining the denominator of the rate of contribution to include not only the cost to the fund but also the financial cost to the employee (the psychological cost to the employee when laid off gives rise to redundancy payment). This correction should, however, be minor in the French system, in which unemployment benefits are generous.

Other factors argue in favour of a lesser degree of internalisation, pooling the cost of unemployment so that businesses do not bear the entire burden. First of all, there is a risk that employment protection will increase rather than decrease the wage cost for businesses: payments made by businesses when laying off staff increase the bargaining position of employees and therefore wages. This has a dissuasive impact on job creation. A reduction in companies' rate of contribution against the backdrop of a strong union negotiating position would limit the impact of the above.

A moderate rate of contribution may have an impact on the 'creation margin' in one way or another. Businesses in financial difficulty have trouble investing and creating jobs. But it is precisely these businesses that lack the cash and are therefore more inclined to make redundancies in the future and worst hit by internalisation. A reduction in the rate of contribution gives a boost to these businesses to create jobs (it involves cross-subsidisation from businesses with more robust finances). A low rate of contribution reduces the incentive for businesses to only offer jobs to candidates whom they think they are unlikely to want to make redundant. On the other hand, too much responsibility may lead to excessive screening before recruitment and during trial periods.

1. La réduction du temps de travail
Reduction in Working Time
2. Partage de la valeur ajoutée
The Sharing of Value-Added
3. Service public/Secteur public
Public Service and Public Sector
4. Croissance et chômage
Growth and Unemployment
5. Coordination européenne des politiques économiques
Coordination of Economic Policies in Europe
6. Pauvreté et exclusion
Poverty and Social Exclusion
7. Retraites et épargne
Pensions and Savings
8. Fiscalité de l'environnement
Environmental Taxation
9. Les cotisations sociales à la charge des employeurs
Social Security Contributions Paid by Employers
10. Innovation et croissance
Innovation and Growth
11. Fiscalité et redistribution
Taxation and Redistribution
12. Emplois de proximité
Local Employment Initiatives
13. Régulation du système de santé
Regulation of the Health-Care System
14. Instabilité du système financier international
Instability of the International Financial System
15. Égalité entre femmes et hommes
Equality between Women and Men
16. Agriculture et négociations commerciales
Agriculture and Trade Negotiations
17. L'architecture des prélèvements en France
Architecture of Levies in France
18. Architecture financière internationale
Architecture of the International Financial System
19. Le temps partiel en France
Part-Time Work in France
20. Le cycle du millénaire
The Millennium Round
21. Retraites choisies et progressives
A Voluntary Gradual Retirement Scheme
22. Formation tout au long de la vie
Life-Long Training
23. Réduction du chômage
National Achievements in Overcoming Unemployment
24. État et gestion publique
State and Public Sector Management
25. Développement
Development
26. Politiques industrielles pour l'Europe
Industrial Policy
27. Questions européennes
European Issues
28. Nouvelle économie
Economics of the New Economy
29. Régulation des relations entre fournisseurs et distributeurs
Which Regulation for Trade?
30. Pleinemploi
Full Employment
31. Aménagement du territoire
Regional and Urban Planning
32. Prix du pétrole
The Oil Price
33. Inégalités économiques
Economic Inequalities
34. Enchères et gestion publique
Auctions and Public Affairs Management
35. Démographie et économie
Demography and Economy
36. Enjeux économiques de l'UMTS
Economic Analysis of the UMTS Project
37. Gouvernance mondiale
Global Governance
38. La Banque centrale européenne
The European Central Bank
39. Kyoto et l'économie de l'effet de serre
Kyoto and the Economics of Global Warming
40. Compétitivité
Competitiveness
41. Propriété intellectuelle
Intellectual Property
42. Les normes comptables et le monde post-Enron
Accounting Standards and the Regulation of the Financial Information Industry
43. Crises de la dette : prévention et résolution
Sovereign Debt Crises: Working In and Working Out
44. Protection de l'emploi et procédures de licenciement
The Institutional Design of Employment Protection

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www.ladocumentationfrancaise.fr

Overall, a rate of contribution that is positive but below 1 (and therefore requiring pooling of costs) seems justified. The contribution from the business to the unemployment insurance fund in the event of redundancy should bear a closer relationship to unemployment benefits paid to ex-employees. Such an internalisation of the costs that redundancies impose on the government is based on the same logic as the principle that the polluter pays. Although it is difficult to apply the figures to the situation in France, making Canadian and US businesses responsible for the impact of their decisions on the finances of the unemployment insurance fund does not seem to have had any effect on the number of bankruptcies. The responsibility invoked by the experience rating system (see inset) suggests one possible method of financing.

The role of legal authorities

An increase the responsibility of businesses must go hand in hand with a decrease in the role of the legal authorities in the redundancy process. The legal system must nevertheless maintain its right to determine the nature of departures. To avoid making redundancy payments and contributions to the unemployment insurance fund, the business may want to declare that the redundancy is due to misconduct by the employee, or try to harass the employee into accepting 'voluntary' redundancy. At the request of the employee, the role of the judge is then to check that a redundancy has not been turned into a dismissal for misconduct or a resignation. Equally, it is important to check that the redundancy has not been motivated by racial or sexual discrimination or on the basis of union membership, and that notice periods have been applied, etc. Conversely, an employee wishing to leave a company without losing entitlement to redundancy payments (and potential unemployment benefits if the departure is not simply a switch to another job) may try to sabotage the job in order to be made 'redundant' by the company. The role of the judge is then, at the company's request, to check whether the redundancy is really a dismissal for misconduct.

However, judges must not act as a substitute for the judgement of the company's management as, generally speaking, they do not have the necessary skills or information, not to mention the precise criteria to guide their judgement. It seems appropriate that if the business recognises the act of redundancy and is ready to bear the costs, the role of the judge should be confined to checking that the correct procedures have been carried out.

Increasing the responsibility of businesses, as with any reform that affects incentives, will

change their behaviour. In particular, businesses may unite in an attempt to avoid the penalties with which they will be faced in the event of redundancy. The nature of these evasive techniques will depend on the exact method of collecting penalties, going from the company relocating after redundancies to the creation of undercapitalised subcontractor companies. Experience in other areas, such as the environment, will be vital to preclude this kind of behaviour.

Lastly, these reforms should, for the most part, replace previous reforms. The introduction of CDD alongside CDI as well as other specific measures (such as those relating to the 'Delalande' contributions paid when laying off older workers) have been unsuccessful and even counterproductive in some circumstances. The same objectives can be reached more efficiently using a single employment protection scheme, making businesses responsible with regard to the UNEDIC and the redundancy payments to be made to employees.

The experience rating system (loaded premium) in the United States

Unlike French businesses, Canadian and US businesses are responsible for the impact of their decisions on the finances of the unemployment insurance fund. In the United States, the current system in place, created in 1935, varies between states. The most common formula, called the reserves ratio and adopted by 33 states, establishes fictitious accounts for companies. Contributions are credits and unemployment benefits paid to ex-employees are debits. For example, an employer for whom the unemployment benefits paid to employees laid off in the past exceed the contributions paid in (i.e. a company that has made a lot a redundancies) has a negative balance. Each year, a scale is used to determine the proportion of this balance that the business will have to pay over the year. If this proportionality factor is equal to 1, for example, the business will have to pay its debts every year and contributions will largely depend on redundancies made the previous year. The proportionality factor is generally less than 1 and so businesses pay their debt over a longer period of time than in the example given above.

In practice, it is important to spread the cost of redundancy, largely due to the existence of contribution ceilings, which mean that businesses making a lot of redundancies do not pay all of the costs incurred. On average, 40% of the cost of unemployment benefits was shared between 1988 and 1996, although this percentage was much lower in some states (New York in particular). The fact remains, however, that the system makes businesses directly responsible for redundancies, unlike the system in other countries where the costs are supported by the state.