

Reforming employment protection.

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There may be no labor market institution more controversial than employment protection regulation---the complex set of laws and procedures regulating separations between firms and workers.

Firms complain not only about the direct cost, but also about the complexity and the uncertainty introduced by such regulation. They argue that it makes it difficult for them to adjust to changes in technology and product demand, and that this in turn decreases efficiency, increases cost and, in so doing, deters job creation.

Workers, on the other hand, focus on the pain of unemployment, and argue that such pain should be taken into account by firms when they consider closing a plant, or laying off a worker.

Under pressure from firms to decrease protection, and from workers to maintain it, European governments have navigated carefully, looking for politically acceptable reforms. In most countries, these reforms have taken the form of an extension of the scope for temporary contracts. This would seem like a smart solution, both politically and economically. Politically, it maintains high protection for those workers already protected. Economically, easier recourse to temporary contracts gives firms more flexibility in adjusting to changing circumstances.

The evidence on the effects of these reforms is however quite mixed. The existence of two classes of workers, those on permanent contracts and those on temporary contracts, has led to an increasingly dual and unequal labor market. Firms are typically reluctant to keep workers at the end of their temporary contracts, as this would imply giving them high employment protection. So, new entrants to the labor market go through a long combination of many dead--end jobs and unemployment spells, before they eventually get a stable job---not the best way to start their working life. From a political point of view, the fact that the majority of workers remains highly protected, and that firms have more flexibility than before, decreases the pressure for a coherent, across--the--board reform.

Ignore political feasibility for the moment, and ask how 'good employment protection' should look like. The answer is actually simple. When deciding whether to layoff a worker, a firm should take into account the social costs of doing so. This means taking into account the unemployment benefits which the unemployment insurance fund will have to pay the laid off worker. And, at least for workers with seniority in the firm, it also means taking into account the psychological costs associated with the loss of a long held job.

How can this be done? Again, quite simply. The answer has two equally important parts. First, if it lays off a worker, a firm should pay a layoff tax equal, at least on average, to the unemployment benefits which will be paid to the laid off worker; to compensate for psychological costs, it should pay severance payments increasing in seniority. Second, if, under these conditions, a firm decides to layoff a worker, it should be free to do so. In other words, if faced with the social costs of their decision, firms still find it more profitable to close a job or a plant, then it does not make sense to keep that job or plant open.

How does this answer compare to the way employment protection is currently designed? The answer varies from country to country, but the case of France is quite representative. In France, unemployment contributions are collected through a payroll tax, not a layoff tax. This means that firms that lay off more workers do not pay more. This is wrong: Firms that lay off more workers should pay more. At the same time, the judicial process is such that judges have a substantial say in deciding whether a layoff decision is justified. This is also wrong: Not only does this lead to a long and uncertain process, but there is no reason for judges to be involved in the first place.

This tells us how employment protection reform should look like. It should involve a shift from a payroll tax to a layoff tax, and, in exchange, a reduction in the role of judges. Judges should make sure rules are followed, but, if the firm is willing to satisfy administrative requirements, pay the layoff tax and pay severance payments, they should not be able to second guess the decision of that firm.

How complicated would it be to shift from a payroll tax to a layoff tax? Ironically, the answer comes from the US where the financing of unemployment insurance is indeed done through layoff taxes. The generosity of the US system, and therefore the layoff taxes, are limited. Benefits and taxes would be higher in Europe, but the US system indicates that it can be done.

This forces us to return to the question of political feasibility. Is such a reform politically feasible? I believe so. On the one hand, higher layoff taxes, which force firms to think twice before laying off, would be welcome by workers. On the other, lighter and more predictable judicial intervention would be surely welcome by firms. The political road is narrow, but it may exist. It is worth exploring it. The economic and social rewards to such a reform would be high.

(Olivier Blanchard is the author, together with Jean Tirole, of a report to the French Conseil d'Analyse Economique aupres du Premier ministre, on the reform of employment protection (CAE, Documentation Francaise, 2003).