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## Moving towards a single contract? Pros, cons and mixed feelings<sup>[1]</sup>

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*\* Les auteurs adhèrent à la charte de déontologie du LIEPP, disponible en ligne, et n'ont déclaré aucun conflit d'intérêt potentiel.*

### RÉSUMÉ

Bien que peu prisé des syndicats de salariés et des représentants patronaux, le contrat unique reste paradoxalement au cœur du débat public. Si le contrat unique semble à première vue être une réponse séduisante pour réduire le dualisme, il ne règle pas pour autant les problèmes liés à la précarité et à l'impact de la protection de l'emploi ; ceux-ci peuvent être traités par des politiques alternatives ciblées plus efficaces. De plus, bien que réels, les coûts du dualisme sont moins évidents et moins bien démontrés que ceux engendrés par la protection de l'emploi elle-même. Enfin, la suppression des CDD entrainerait, à protection inchangée, une perte d'emploi importante car tous ces emplois ne seraient pas remplacés par des CDI compte tenu de la prudence à l'embauche des entreprises. Un assouplissement fort de la protection de l'emploi du nouveau contrat unique serait alors nécessaire. Mais celui-ci peut intervenir dans le cadre existant et n'a pas de raison d'être lié à un nouveau contrat : d'autres contreparties en termes d'assurance-chômage ou de formation professionnelle sont possibles.

### EXECUTIVE SUMMARY

Although the single employment contract is not popular among both representatives of workers and company leaders, the proposal for a single labor contract, created with the goal of reducing dualism, has paradoxically remained at the forefront of debates on the need for reform of the labor market. At first glance, the single employment contract seems to be an attractive response to the issue of dualism. However, upon looking more closely, it appears that a single contract would not resolve problems linked to precariousness and the consequences of employment protection. Most of the time, alternative policies could be more efficient. Moreover, while there are costs to dualism, these are not as obvious and well established as the ones triggered by employment protection itself. Finally, suppressing temporary contracts would lead, at a constant level of employment protection, to important employment losses, given that not all temporary jobs would become permanent jobs. A drastic reform of employment protection would be needed. Such a reform does not need to be linked to the creation of a new employment contract: counterparts in terms of unemployment insurance or firm-sponsored training are possible.

### 1/ An overview of the actual situation in Europe

[1] This brief is a summary of an extended analysis: "Moving towards a single contract? Pros, cons and mixed feelings," *OECD Economics Department Working Paper* 1026, Feb. 2013, by the three authors. We thank Florian Zito for valuable research assistance.

In Europe, dualism is pervasive: it mainly affects young people under temporary contracts and has led governments to initiate several labor market reforms. Some countries such as France, Germany and Spain focused their efforts on limiting the use of fixed-term contracts whereas countries such as the United Kingdom, Italy, Denmark and Finland have moved towards flexible employment protection regulations. Are these regulations really efficient in increasing the share of permanent contracts? Statistics suggest otherwise. Between 1985 and 2008, European countries (excepted Denmark) experienced an increase

in the share of temporary contracts (12% on average in OECD countries). It is particularly high in Spain (24.9% in 2010, Eurostat) and in the Netherlands (18.5% in 2010, Eurostat), both countries where employment protection for regular contracts is high.

In order to reduce the negative consequences of dualism, exacerbated by a context of economic crisis and high unemployment, several policy experiments have been conducted with mixed results.

- In August 2005, the French government created the “Contrat Nouvelle Embauché” (CNE) for companies of less than 20 workers, a contract with a 2-year probation period. The French government tried to extend this contract to all companies for workers below the age of 26 (CPE). However, both reforms were overturned: the CNE for legal reasons (it was deemed contrary to International Termination of Employment Convention n°158) and the CPE after protests by employees’ unions in March 2006.

- In February 2012, the Italian government launched a comprehensive reform to simplify its labor code: first, the forty different types of employment contracts were brought down to eight. A new contract with a probationary period of three years replaced the permanent one. Following these three years, employers were required to hire workers permanently. However, a large part of these modifications were abandoned during the ratification of the bill in July of 2012.

- In Spain, in March 2012, the government also proposed a drastic reform of its labor market, which mostly consisted in the introduction of a new open-ended contract for small companies (less than 50 workers) with a probationary period of one year. This reform gave tax breaks to employers who used this contract to hire workers below the age of 30 or that had faced a long-term unemployment period. It also clarified the notion of “termination for economic reasons” and limited the duration of temporary contracts to 24 months.

Among the proposals to increase flexibility and reduce dualism which arose through public debate, the single labor contract is one of the most popular. However, there are different ways to move towards such a contract. One, supported by some French unions, would be to remove all forms of temporary contracts. This solution would result in the loss of a margin of adjustment for firms. A second possibility would involve replacing all existing contracts by a unique single contract that would be somewhere in between the traditional permanent contract and the fixed term contract. This contract, more flexible than the current permanent one, could

have an extended trial period or be subject to less dismissal requirements. Cahuc and Kramarz (2004) have notably proposed to remove all the collective regulations on layoffs and replace them with a termination tax. Generally speaking there are two forms of single employment contracts: contracts with Progressive Seniority Rights or contracts with Long Probationary Periods, and any combination of these two logics is possible. Changing the labor market in order to implement this type of single employment contracts requires a lot of work. The question we raise is whether it is really worth the trouble.

## 2/ Would the single contract reduce inequalities between workers?

The single employment contract is presented as a tool to reduce inequalities between workers caused by dualism in contracts. It also gives employers (but also landlords and banks) means to legally discriminate between different groups of workers based on demographics or skills. In particular, whereas workers under permanent contracts are highly protected in case of dismissals and therefore, can develop stable working habits, temporary workers face job insecurity.

### 2.1 Temporary workers face greater difficulties in their access to credit and training, but this may not change for workers under a probationary period in the single contract

Cahuc and Kramarz (2004) argue that permanent workers are much more likely to be home owners because they benefit from an easier access to credit. Banks are less willing to grant loans to temporary workers, viewed as economically unstable. This makes it more difficult for them to purchase a house. More specifically they show that workers above the age of 30 in a permanent contract are 10 to 15 percentage points more likely to become home owners than workers in a temporary contract. However, in this context, introducing a single contract with a long probationary period is likely to be inefficient: workers in the probationary period would still be discriminated against by banks and the gap between workers would remain. Moreover, alternative reforms such as a partial deregulation of the housing market may be more effective.

Another consequence of the gap between temporary and permanent workers is the inequality in the access to training. Firms invest in training if it provides workers with skills that are profitable to them: hence, permanent workers are more likely to receive training than others. Yet again, a single contract with a long probationary period is unlikely to improve the current situation. The effects of a single contract with less dismissal

requirements might be positive but have yet to be proven. However, more efficient solutions do exist. For instance, Lemoine and Wasmer (2010)<sup>[2]</sup>, proposed to introduce specific Pigouvian incentives for French firms by reducing their taxes or layoff costs depending on whether they train more or fewer workers, with more general training to internalize the externality created by general training, following upon the logic of Blanchard and Tirole of an experience rating system<sup>[3]</sup>.

## 2.2 The screening of workers in a single employment contract would require either excessive probation periods or layoffs for no-cause which leads to stigma effects

Due to the difficulty for employers to dismiss their workers under a regular contract, they use temporary contracts as a screening device. However, temporary workers whose contracts have not been renewed are not necessarily presumed to be less motivated or less skillful since a bad economic situation could have made companies fearful of offering regular contracts. Instead, the termination of a worker under a Contract with Progressive Seniority Rights or with Long Probationary Periods, would serve as a much better signal on the worker: the termination of such a contract would necessarily be due to the workers' lack of skill or motivation, not to the firms' characteristics or to the formal impossibility to renew the contract. Furthermore, there is a risk that a single contract with a long probationary period could reinforce abuse: probationary periods, which are less regulated than the current temporary contracts, could be used in the same way while reducing the workers' protection to workers, since terminating a temporary contract is prohibitive in most countries.

## 3/ The coexistence of permanent and temporary contracts and the efficiency of the labor market

### 3.1 A single contract as a means to reduce employment volatility?

The cost difference in terms of employment adjustment costs between temporary and permanent contracts leads firms to use temporary contracts as a cheaper adjustment variable to the economic conjuncture: in periods of economic booms, the high costs linked to permanent contracts lead firms to use temporary contracts

[2] Mathilde Lemoine et Etienne Wasmer, Rapport n°90 du Conseil d'analyse économique avec Mathilde Lemoine, *Les mobilités des salariés*. 233 pages, Conseil d'analyse économique et la Documentation française, May 2010.

[3] Olivier Blanchard et Jean Tirole, *Protection de l'emploi et procédures de licenciement*, Conseil d'analyse économique et la Documentation française, October 2003.

(subject to weak regulations) to hire new employees. In periods of crisis, the existing regulations force firms to respond to economic fluctuations through labor turnover instead of using alternative methods such as changing the workplace organization. This results in an excessive turnover in the labor market (more hires in temporary contracts but also more contract terminations).

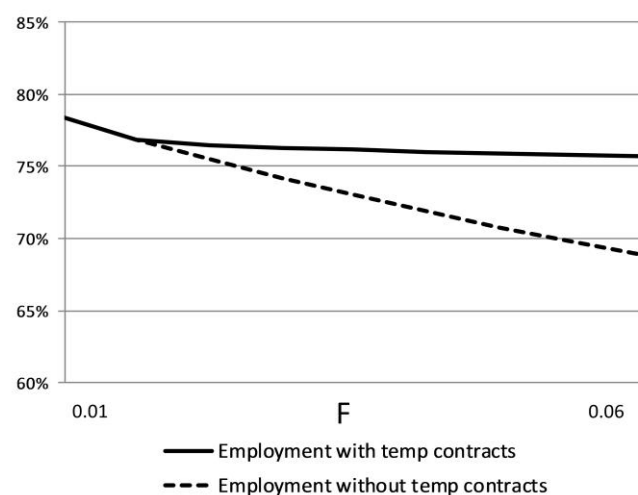
The model we built and quantified confirms what analyze Bentolila et alii. (2010). They find that the larger gap between the dismissal costs of workers with permanent and temporary contracts in Spain as compared to France is responsible for the much higher unemployment rate in Spain, as more temporary contracts to expire.

### 3.2 Without a drastic reform of employment protection, suppressing temporary contracts reduces employment

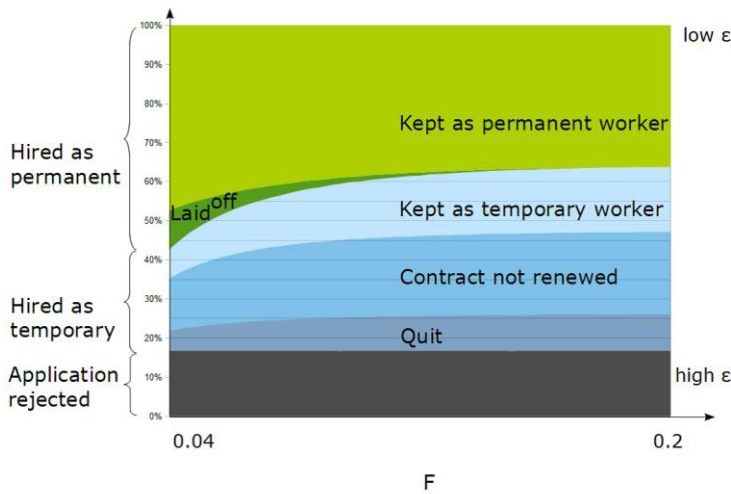
There is considerable heterogeneity in the labor market turnover rate even with a single labor contract. Removing temporary contracts would simply discourage firms to take risks by hiring new workers. Figure 1 represents the employment effect of varying layoff costs of regular contracts denoted by  $F$ . The solid line is equal to total employment under dualism (both permanent and temporary employment). The dashed line gives the level of employment in a world without temporary workers. Starting (from the right) from a large level of employment protection (say,  $F=0.06$ ), the employment rate (averaging up the first and second employment period, which is interpreting the model as reflecting an overlapping generation of two-period firms) is approximately 76%.

Figure 2 (next page) further illustrate how changes in firing costs affects hiring decisions and termination of contracts. The green region is made of two areas: the light green region represents the number of workers initially hired as permanent

Figure 1 : Impact of layoff costs for regular contracts







workers and retained by the firm; while the dark green region represents workers initially hired as permanent workers but laid-off due to low productivity. The blue striped region represents workers hired under temporary contracts that will eventually arrive to an expiration date without incurring firing costs for the firm.

The model gives the following conclusions:

1. In this specific example, removing temporary contracts leads to a 7 percentage point drop in employment at a constant level of employment protection for regular contracts.
2. Reducing employment protection raises employment in both worlds; it is faster in the absence of temporary contracts.
3. Without temporary contracts, one can restore the same level of employment as in the case of coexistence of permanent and temporary contract if layoffs costs in permanent contracts  $F$  are drastically reduced, namely a third of their initial value.

### 3.2 The need for a larger reform of the labor market

The essence of our argument is to focus more on the costs of employment protection than on the need to reduce dualism. In many countries, the prerequisites of “economic layoffs” are not well defined in the law and are thus a source of uncertainty: in France, 70% of litigation cases concern individual layoffs when in reality they are the result of a bad economic situation. These litigations often last more than one year. Employment protection is paradoxical: countries

with the strongest employment protection are also those where employees perceive their job to be the less secure. Likewise, they are also those where stress is the highest among workers: for permanent workers, the risk of layoff is lower but can be associated with adverse social consequences. Costly economic layoffs lead firms to put more pressure on their workers to increase productivity or to obtain dismissals at lower costs. Employment protection has in addition an ambiguous effect on the allocation of productive units: on the one hand, it can favor less productive structures and slows the allocation process of workers on the most productive activities. A vast literature has shown that this results in distortive effects on capital accumulation and in misallocation of productive units leading to a lower productivity, even if the overall marginal effect of employment protection may sometimes be positive in low protection countries such as in the United States.

## 4/ Conclusion

A large part of the debate on how to favor employment and reduce dualism focuses on the idea of implementing a single labor contract. Advertising for labor market reforms through the single labor contract label is a way to argue for the convergence of different types of labor contracts and the removal of temporary contracts which appears as the least costly solution. But this focus undermines alternative reforms which could be more efficient in limiting the negative effects caused by dualism. Moreover, advocates of this proposal have conflicting views on the characteristics of such a contract. The 'single labor contract' is meant to be a *quid pro quo* (meaning an exchange of something against something else, understood by all parties). By single labor contract, proponents of this measure probably mean ambitious reforms of permanent contracts with less protection. This part may however be a *quiproquo* (a misunderstanding due to voluntary ambiguity on the concepts) if this amounts to the disappearance of temporary contracts in exchange for an extended probationary period. It is hard to believe that unions would favor this solution since fixed duration contracts are fairly well protected and would be replaced by contracts with long probationary periods, or an increase of individual layoffs even within permanent contracts. ■