Forthcoming, *De Economist*

Redesigning the Employment Protection System*

Olivier Blanchard[†] and Jean Tirole [‡]

December 10, 2003

Introduction

Following repeated attempts to reform Dutch dismissals law in the past, Professor Rood was asked in 1999 to form a committee to study possible reforms of the dismissals process. The committee's report, published in November 2000, called for the abolition of the preventive check on dismissals by the Center

* Paper prepared for the second author's Tinbergen lecture (October 24, 2003), who thanks the Royal Netherlands Economic Association and the Dutch Central Bank for their warm hospitality. The paper builds on a report by the two authors on the reform of employment protection in France (2003a). The authors are grateful to Frank den Butter, Jan van Ours, and an editor for helpful comments, and especially to Michèle Belot for both very detailed information on the Dutch labor market and institutions and useful reactions to previous drafts.
[†] MIT and NBER.
[‡] IDEI and GREMAQ (UMR 5604 CNRS), Toulouse, CERAS (URA 2036 CNRS), Paris, and MIT.

for Work and Income and argued in favor of an ex post procedure to resolve disputes. The Committee's proposals were, at the request of the government, examined by the bipartite Labor Foundation (Stichting van de Arbeid, STAR.) The Foundation, while recognizing weaknesses in the current system, sharply criticized the proposal, thereby stalling further reform. Strikingly, it took more than two years and a half for the trade unions' and employers' organization to come up with a stance on the report.[1]

It would be presumptuous for us to assess which side was right — at best, the arguments developed in this lecture will shed some light on the relevant trade-offs. Rather, we see this episode as epitomizing the fact that there may be no labor market institution more controversial than employment protection regulation—the set of laws and procedures regulating separations between firms and workers. Even in a country such as the Netherlands, known for the quality of its social dialog,[2] and in a state of low unemployment, where one would believe the topic could be approached dispassionately, social partners had a hard time reaching a conclusion.

More generally, wherever the issue of employment protection is

1. The proposition to abolish the administrative procedure received strong support from the largest employers' association. Trade unions were reluctant, and employers in the small and medium-size business sectors were keen to keep the existing and relatively cheap procedure.
2. This social dialogue in turn has been facilitated by close networking between unions, employers' organizations, the government, and other third parties (advisory bodies, central bank), as argued in Den Butter and Mosch 2003.

raised:

- Workers 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. That workers protected by employment protection would favor it is no great surprise. But evidence from surveys shows that support for employment protection is more general, more broad based.
- Firms, on the other hand, complain not only about the direct cost, but also about the complexity and the uncertainty introduced by employment protection 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 labor cost and, in so doing, deters job creation.
- Most economists and international economic organizations, from the OECD to the IMF, tend to side with firms. There is, they argue, a trade-off between insurance and efficiency. The current systems impede reallocation, and, by implication, reduce efficiency. They lead to higher costs, and thus lower employment. At a minimum, they could and should be made more efficient. More likely, overall employment protection should be reduced.

Faced with such conflicting demands and advice, the governments of Western Europe have been timid. They have learned, often the hard way, that workers covered by employment protection are not eager to see it reduced, and that these workers

represent the majority of the labor force, and a large part of the electorate. So, most recent employment protection reforms have worked at the margin, through the introduction and extension of the scope for fixed duration contracts—contracts subject to more limited employment protection and simpler administrative rules. For the most part, employment protection for regular contracts has remained unchanged. The evidence so far is that this dual system has led to an increasingly dual labor market, with mixed efficiency and negative distributional effects.

We believe that what has been missing most in these discussions and in these reforms is a clear idea of what "good employment protection regulation" should look like. Starting from the status quo, firms and international organizations have argued for less protection. Workers and unions have fought to keep the protection they had. Governments have looked for politically feasible incremental reforms. But the ultimate goal, the shape of optimal employment protection, has been left undefined.

Our goal in this lecture is to explore this question. The lecture has three parts. We begin by using economic reasoning to draw the contours of a good employment protection system. We then describe employment protection systems in France and in the Netherlands. Having done so, we indicate directions for reform.

1 Economic analysis: letting firms internalize the social cost of their layoffs

1.1 Broad principle

Let us begin with a broad principle: Economic agents can be given discretion provided that they bear the cost that their decisions impose on other agents. This "internalization of externalities" ensures that the decision-maker in question reflects others' preferences and is therefore accountable. For example, it is widely accepted that polluters ought to pay for the social cost of their pollution.

The translation of this broad principle in the matter of employment is that firms ought to pay for the cost they impose on society when they lay workers off. This cost includes the financial cost born by the unemployment insurance (UI) fund and the psychological and other costs born by the dismissed worker.[3] The former can be addressed through a layoff tax, and the latter, as it now is, through severance pay. In particular, a full internalization of the impact of a layoff on the UI fund calls for a layoff tax equal to subsequent unemployment benefits, or, in other words, for a contribution rate— defined as the ratio of the layoff tax to unemployment benefits— equal to 1.

The layoff tax could be computed in two ways. It could be a fixed amount, possibly indexed on various observables such as age, or location. Alternatively, and following the US experience rating system put in place in the 1930s, the tax could be levied

3. Collective layoffs may further impose substantial costs on local communities in a depressed area.

"ex post" on the basis of the actual length of unemployment of the dismissed worker. The latter approach offers two benefits besides simplicity. First, it better reflects the actual cost of the layoff for the fund; firms' layoff decisions therefore react more finely to the actual re-employability of the worker. Second, ex post tax assessments incentivize firms to provide better training to their employees so that they can find a job more quickly after a layoff.

It may actually be worth describing the "experience rated" systems of unemployment contributions used in the United States in more detail.[4] The systems vary across states, but all base the payments of firms on their past behavior (as in a bonus-malus system). The most commonly used system is called the "reserve ratio" system of unemployment contributions. Leaving aside the many complicated details, its principle is simple: Each firm has a running balance with the state unemployment agency, with contributions by the firm to the fund on one side, and benefits paid by the agency to the workers laid off by the firm on the other. Once a year, the state computes the net outstanding balance, and requires the firm to pay some proportion of this outstanding balance over the following year. The factor of proportionality depends both on the net balance of the firm, and the net balance of the state fund as a whole. This system has two implications:

- Ignoring discounting, and assuming that firms do not go

4. A useful description of the US experience is given in Fougère and Margolis (2000).

bankrupt and do not hit the various ceilings that limit contributions (all considerations being relevant in practice), firms eventually pay the full cost of unemployment benefits for the workers they lay off—the contribution rate is equal to one.

- The factor of proportionality determines how the timing of payments depends on current and past layoffs. If the factor of proportionality is equal to one, so firms are asked to return to zero balance each year, then payments are closely related to current (or more precisely last year's) layoffs. The lower the factor of proportionality, the more contributions depend on past layoffs in the more distant past.

  How should one then think about the choice of the factor of proportionality? If firms are operating in a stable, ergodic, environment, going sometimes through good times, sometimes through bad times, then letting the factor of proportionality be small will make the firm's contributions depend on its mean observed layoff rate in the past, which is also equal to the probability of a layoff in the future. If, however, as is more likely, the underlying probability changes over time, then a higher factor of proportionality, giving more weight to recent layoffs, will be closer to the underlying current probability. But it will impose higher liquidity costs on firms.

Note (and we shall come back to this in more detail) that the principle of internalization is at odds with the systems of em-

ployment protection prevailing in France and the Netherlands in at least three related dimensions. First, in these systems, contributions by firms to the unemployment insurance fund take the form of payroll taxes: A firm with a higher layoff rate does not pay higher contributions to the unemployment insurance fund. In other words, the contribution rate is zero. Second, in the absence of layoff taxes, unemployment benefits must be financed through the payroll tax, providing an added incentive for firms to lay workers off. Third (and relatedly!), the layoff process is subject to administrative and judicial control. Firms have to prove either fault by the worker in the case of an individual layoff, or economic need in the case of collective layoffs. By contrast, under the economic approach, employment protection stems from the deterrence effect of a layoff tax rather than from an administered process.

1.2 Complications

This benchmark of a unit contribution rate defines a useful and simple guiding principle: a firm should pay to the insurance fund the full amount of unemployment benefits received by the dismissed worker. In practice, the principle has to be refined. We now study (separately) four major complications: limited unemployment insurance, firms' financial fragility, ex post wage bargaining, and firm and worker heterogeneity, and discuss, in each case, how they modify our conclusions.[5]

a) *Limited unemployment insurance*

5. See Blanchard-Tirole (2003b) for a formal treatment of these ideas.

Workers should not be, and in practice are not, fully insured against the unemployment risk: to the extent that the agency cannot fully monitor the search behavior of the unemployed, offering anything close to full insurance would lead the unemployed to stop searching and remain unemployed.[6]

A number of recent reforms of the unemployment system in Europe, such as the PARE in France, have aimed at combining more generous and longer lasting unemployment benefits with stronger incentives for the unemployed to accept jobs if offered by the unemployment agency. These reforms clearly go in the right direction. They potentially offer better tailored insurance: If truly no jobs are available, then the unemployed continue to receive unemployment benefits. And they remove, at least in principle, some of the problems associated with the open ended unemployment benefits of the past. But realistically, even the best designed systems cannot fully eliminate monitoring problems, and so, less than full insurance is optimal.

Under incomplete insurance, the firm exerts two externalities when laying a worker off: one on the unemployment insurance fund, and the other on the worker. Because the worker cannot, for incentive reasons, be fully compensated by the fund, the firm ought to take the net cost to the worker into account. To lead

---

6. As with any insurance scheme and as shown theoretically by Pauly (1974), such incomplete insurance may require prohibiting supplementary arrangements, as secondary insurers and insurees have incentives to strike supplementary insurance deals at the detriment of the primary insurer (as was observed for example in the Netherlands for disability schemes).
For a recent survey of the literature on unemployment insurance, see for example Frederiksson and Holmlund (2003).

firms to take these costs into account, unemployment contributions by firms to the agency must now exceed the unemployment benefits paid by the agency to workers: *The optimal contribution rate is now greater than one.* The lower the feasible level of insurance, the higher the utility costs that layoffs impose on laid-off workers and the higher the contribution rate.

Under this deviation from the benchmark, unemployment insurance and employment protection are (imperfect) substitutes. The poorer the insurance, the higher the optimal degree of employment protection. While the result is normative, this negative relation appears to be present in the data across Continental European countries.[7] The countries with the highest degree of employment protection (using the OECD index) are also the countries where unemployment insurance coverage is relatively limited.

b) *Firms' financial fragility*

Introducing financial fragility considerations raises two distinct issues: the possibility that a layofff tax may encourage rather than discourage dismissals and the concern that the tax may be evaded.

Let us start with the former. In the case of small and medium enterprises, or else, large undiversified firms, layoffs often occur when the firm encounters hardship. For such firms, a layoff tax may compound the difficulties and potentially trigger further layoffs. Should the contribution rate therefore be brought down

7. See for example Boeri (2002).

and be less than unitary in order to limit the scope for such "snowball effects"?

One can entertain one of two opposite views in this respect. The first is that one should not take the firms' financial structures as given. A wide array of arrangements across sectors and companies are observed, that show that financial arrangements adjust to accommodate the specificities of the companies' environments. One may therefore expect that firms would in the long term adjust their financing to reflect the existence of a layoff tax. They will want to insulate spillovers of an adverse evolution in their activity A on their otherwise healthy activity B. One may hope that, in response to an increase in layoff taxes, financial markets will at least partly adjust to alleviate the problem, providing more funds to the firms in bad times in order to allow them to pay the now higher layoff tax. Concretely, firms may take on more long-term debt and issue more equity, obtain larger credit lines from banks, and more generally alter their risk management. This line of thought presumes that financial markets will in the long term fully adjust to the new regulatory environment, and implies that the principle of full internalization continues to apply.

Alternatively, one can take a less optimistic view of the ability of firms to adjust their financial structure; furthermore one must surely do so at the time of the introduction of the layoff tax as financial structures of existing firms are still run by legacy arrangements. Under that view, in order to avoid snowball effects, the layoff tax should then be lower than unitary.

To sum up, the firms' financial fragility implies that the layoff tax should grow after its initial introduction to reach a level that is smaller than or equal to the cost of unemployment. How close the contribution rate should be to one depends on one's optimism as to the possibility of adjustment of financial structures.

Let us now come to the second issue, the possibility that the layoff tax be evaded. An analogy with environmental matters is useful here. There is much evidence that activities that are environmentally hazardous and therefore subject to contingent environmental penalties tend to be operated by separate, poorly capitalized, collateral-free companies. The strategy is one of tax evasion and consists in leaving the state with a judgment proof entity in case of pollution or disaster. Although less extreme, layoff taxes may generate qualitatively similar behaviors. Activities with high layoff risks might be spun off into separate entities; or firms that encounter hardship may reduce their capitalization or delocalize their new activities abroad in order to evade future layoff taxes. There is no simple solution to this problem. Fundamentally, the UI fund cannot monitor the solvency of each and every undertaking in the country. But (imperfect) solutions exist: the posting of collateral (with the equivalent of "margin calls" by the UI fund, as the firm's debit increases); the requirement of a bank guarantee; liability tracing, that is making "Potentially Responsible Parties" liable as is done in the US since 1980 in environmental matters through the Comprehensive

Environmental Response, Compensation and Liability Act.

c) *Ex post wage bargaining*

Other things equal, a transfer of the financing of unemployment benefits from the payroll tax to a layoff tax increases efficiency and therefore encourages job creation. This reasoning, though, presumes wage moderation or, in the parlance of economics, wage bonding. By contrast, under wage renegotiations,[8] the introduction of a layoff tax may raise the cost of labor and discourage job creation. The reason is that the layoff tax and the cut in the payroll tax both make the firm more accountable for its layoffs and thus weaken its bargaining position vis-à-vis workers.

What should the state then do? It now clearly faces a trade-off: Making firms pay for the full cost of an additional layoff will lead firms to take the right decision at the destruction margin: But this high contribution rate will also increase the bargaining power of workers, and thus increase the wage. This will increase the overall cost of labor and will adversely affect job creation. By how much will depend on the amount of effective bonding. Conversely, choosing a contribution rate less than one will lead firms to destroy too many jobs, and lead to too many layoffs. It will however lead to a smaller increase in the overall cost of labor and thus have a smaller adverse effect on employment creation. In short, the more firms are made to pay for the expected cost of unemployment benefits, the smaller the distortion will be at

8. In particular if they occur at the firm's or worker's level.

the destruction margin, but the larger the distortion will be at the creation margin.

Thus, to the extent that effective bonding is limited, the contribution rate must now be less than one. It will be closer to one, the higher the workers' commitment to wage moderation, or, in the absence of commitment, the lower their bargaining power.

d) *Heterogeneity of firms and workers*

Not all firms and all workers are alike. What does a positive contribution rate imply for their respective fortunes?

Let us first handle firms' heterogeneity by dividing them into "weak" and "strong" firms. Firms may be weak for one of several reasons: they may have lower average productivity; or they may face more volatile demand; or they may have shallow pockets and therefore little liquidity to meet adverse shocks. Either way, such firms will have more layoffs on average and thus will to pay higher layoff taxes.[9] They will therefore have higher labor costs.

This is to some extent as should be, given that they impose larger social costs. Things are a bit more complex, though, and, in fact, firm heterogeneity calls for a reduced contribution rate. Intuitively, if weak firms have an incentive to create jobs, so do *a fortiori* strong firms. So addressing the creation margin requires making it attractive for weak firms to create jobs. By contrast, at the destruction margin, weak and strong firms face a similar problem: ex-post, whether to keep the worker given the

9. They will not be able to pass those costs on to workers through lower wages.

realization of productivity. Put differently, a change in the layoff tax affects the destruction margin of both weak and strong firms, but affects the creation margin only for weak firms. A small reduction in the layoff tax compensated by an increase in the payroll tax cross-subsidizes weak firms and thereby encourages job creation. To sum up, firm heterogeneity is a further argument in favor of a contribution rate below one.[10]

So is worker heterogeneity, for pretty much the same reason. "Weaker workers", those with a lower expected productivity and a higher layoff probability, or with worse labor market prospects when unemployed—say because they live in a depressed region—will need to accept lower wages or else run the risk of remaining unemployed when the layoff tax is raised. A small reduction in the layoff tax compensated by an increase in the payroll tax cross-subsidizes weak workers and therefore raises their employability.

Does worker heterogeneity therefore call for a reduction in the contribution rate? The answer depends on whether the fragility of certain categories of workers is observable by the state. Sup-

10. Interestingly, the Dutch Reduced Pay Fund, which pays for short-term (less than 33 weeks) benefits to the unemployed, is a sector-level fund (the General Unemployment Fund, which pays the remaining benefits by contrast is a national fund). Premia are differentiated across sectors (for example, the sector of temporary work agencies had the highest payroll tax rate: 9.20%). This differentiation is probably good from the point of view of encouraging job creation in sectors with low layoff rates. On the other hand, because the fund is financed through a payroll tax rather than a layoff tax, this differentiation does not help with the destruction margin. In particular, high payroll tax rates in risky sectors raise the firms' incentive to lay workers off.

pose first that it is. The "weaker worker" may live in an isolated labor market or depressed region, be senior, or else registered on a disability list. In this case, the way to enhance the worker's employability is not to reduce the layoff tax (after all, layoffs of such workers are undesirable), but rather to subsidize the employer. This subsidy can take the form of a targeted cut in the payroll tax, as is done for example in the Netherlands for workers with registered disability. Alternatively, one could design targeted job creation subsidies, although the latter, being lump sum, are more likely to be abused than payroll tax reductions.

Some other forms of worker fragility cannot however be verified by the state, at least not easily. In that case, facilitating the worker's employability then requires a reduction in the layoff tax, combined perhaps with the introduction of an unemployment-length-insensitive component in the structure of the layoff tax, so as not to penalize too much workers who are likely to stay unemployed for a long time.

1.3 Other considerations

Two further remarks to close the theoretical analysis:

First, we have focused on layoffs. Separations also occur as workers quit either to another job or into unemployment. In the absence of a layoff tax, the employer and employee have an incentive to reclassify a quit into unemployment as a layoff if, as is the case in France and the Netherlands, workers who quit do not receive unemployment benefits. The introduction of a layoff tax

reduces the incentives for such gaming of the insurance system. In passing, a similar form of gaming used to occur in the Netherlands with respect to entry into disability status (as discussed in van der Ploeg 2003). Until the reform of 1998, employers and employees had a common interest in disguising a layoff as a disability. As there was no premium differentiation between employers, the latter thereby did not have to incur the cost and bother associated with dismissals, and workers' access to the allowance thereby became open-ended. Reforms since 1998 have reduced the gains from reclassification. Firms have to pay for part of their former employees' disability benefits. Furthermore, there have been reforms and there are further plans to bring disabled workers back to work, for example by cutting benefits and by strengthening medical requirements.[11]

Second, and as we know for example from Belot-van Ours (2002) and as we have already discussed with the issue of wage moderation, the effect of an institutional reform depends on other institutional features. Another case in point is the governance of the unemployment agency. To the extent that the layoff tax is assessed ex post on the actual benefits paid to the dismissed workers, employers will have an increased demand for overseeing the agency. This raises the issue of who should have control rights over the agency. An agency run by employers might hassle the unemployed into accepting inappropriate jobs. Conversely,

11. The law allows employers to fire disable workers if they have been on a disability scheme for two years or longer. In some cases, disabled workers can be fired earlier if, for example, they did not try hard enough to reintegrate the labor market (this being determined by the UWV, the office in charge of unemployment benefits).

an agency controlled by the workers or the government (as we see in France) may exhibit the opposite bias. Independent agencies or else a social-partners cooperative undertaking are the two most appealing governance structures, but giving them a clear mission certainly is no easy task.

2 The employment protection system in France and the Netherlands

Having sketched the contours of an optimal system of employment protection, the next question is how it relates to actual employment protection systems in Europe. In this section, we shall look at employment protection in France and the Netherlands. Our purpose is not to give an exhaustive presentation of the two systems, but rather to present them in such a way as to facilitate the comparison with the conclusions of the previous section.[12] Our tentative conclusions are that, relative to the optimal system, (a) the French system is deeply inefficient and (b) the Dutch approach exhibits some of the same structural flaws, but their negative impact has been much alleviated by certain specificities and pragmatic adjustments, which *de facto* have made the Dutch labor market more flexible than the French.[13]

12. Three useful sources on French institutions are Pélissier et al. (2002)(which presents the legal structure), CFDT (2003) (which gives a user guide for workers) and JurisClasseur Groupe Lexis-Nexis (2002), which gives the text and interpretation of the 2002 law, called "Loi de Modernisation Sociale".

13. On paper, the Netherlands are not that much more flexible than France, except for the regulation of temporary employment. While em-

2.1 The need for motive

France: The general principle today is the need for motive: The firm must have and must show "real and serious cause". Only if such a cause exists can the firm lay a worker off.

The law distinguishes between two types of layoffs:

- "Personal" (that is, related to the behavior of the employee.) The firm must show that the layoff is the result of a "serious misdemeanor" ("faute sérieuse".) What "serious" means is not clearly defined (One definition, found in the reference labor law text (Pélissier et al. 2002), is: "Serious: sufficient to justify the layoff"...). It does not require malicious intent, but it must be more than a "light misdemeanor" ("faute légère") which does not justify a layoff.
- "Economic" (that is, related to the situation of the firm).

---

ployment protection legislation indices must be taken with caution, the following table indicates the analogies in legislation concerning regular employment in the two countries:

Labour Market Statistics – strictness of employment protection legislation (EPL)

	late 80s		late 90s	
	FRA	**NLD**	**FRA**	**NLD**
Overall EPL Version 1	2,7	2,7	3	2,1
Regular employment	2,3	3,1	2,3	3,1
Temporary employment	3,1	2,4	3,6	1,2
Overall EPL Version 2			2,8	2,2
Collective dismissals			2,1	2,8

Source: OECD Employment Outlook, 1999

The firm must show that the layoff (or layoffs) are the result of a "real transformation or elimination of job(s)". What this exactly means is even more unclear. The ambiguity, and why this is an issue, is best shown in the recent case of layoffs at Michelin–Wolber. In July 1999, Michelin decided to lay 451 workers off at its Wolber plant, at the same time as it was announcing large benefits for the group as a whole. In February 2002, the labor tribunal concluded that the layoffs were not justified, and asked Michelin to pay a total of 10 million Euros to the 162 laid off employees who had contested the decision, or about 60,000 euros per employee. The tribunal argued that "layoffs for economic reasons cannot be justified on the basis of improving the competitiveness or the profits of the firm, but only on the basis of maintaining its competitiveness. In the case of Michelin, the purpose was to improve competitiveness, and thus the layoffs were not justified". (The First Court of Appeals confirmed the decision in october 2003).[14] Lest one think that this is an isolated case, very much the same thinking was embodied in the December 2001 law, which stated that, only when other avenues had been exhausted, were layoffs justified. The legislation provided for only three possible grounds for economic layoffs: major economic difficulties where

14. A charitable interpretation of the court's opinion is that the firm should exercise more restraint with regards to layoffs when it is not liquidity constrained (such a conditioning would make economic sense). We doubt, though, that the courts have the ability and the information to make such business judgments.

> all possible solutions have been exhausted, technological changes endangering the very survival of the company, reorganization required to ensure the survival of the company. Two of the provisions of the law were subsequently (January 2002) thrown out by the French Supreme Court (the Conseil Constitutionel) on the grounds that the law had moved from the principle that layoffs were justified if they were required to maintain competitiveness to the principle that layoffs were justified if they were required to ensure the survival of the firm—a much more stringent criterion.

In short, the principles that the courts must use in assessing whether layoffs are justified are extremely unclear; and certainly the fact that the firm decided that such layoffs were necessary is clearly not by itself sufficient proof for the courts.

Netherlands: At a formal level, the Dutch situation does not appear all that different. The burden of proof in principle also rests on the employer, who must bring hard evidence that the employment relationship ought to be terminated. Courts require a dossier before they are willing to treat cases. For a personal layoff, the employer must show malfunctioning, disability[15] or serious misbehavior. Economic layoffs are deemed to be justified if "adverse circumstances" call for a reorganization or a bankruptcy. As in France, the absence of objective criteria confers substantial discretion upon administrative bodies and

15. See section 1.3 for a description of the process for laying off sick or disabled workers.

judges.

2.2 Limited direct financial costs

Payroll and layoff taxes

In both countries, payments by firms to cover unemployment benefits are collected through payroll taxes. In France, the payments come for half from the workers, for half from the firms. In the Netherlands, there are two funds: One, the "Reduced Pay Fund", for short-term unemployed (less than 33 weeks) and the other, the "General Unemployment Fund", distributing the remaining payments. The average payroll tax rates are quite different for those two funds: the employee plus employer contribution rate is 7.35% for the latter and 1.30% for the former. Unsurprisingly, in the current, low unemployment, context, the General Unemployment Fund is running large surpluses. The Reduced Pay Fund is running a deficit. In both countries, the rate is independent of the history of layoffs by the firm—in our terminology, the contribution rate (recall: defined as the ratio of the layoff tax to unemployment benefits) is zero.

One exception in both countries, relates to the layoffs of older workers. In France, the "contribution Delalande", introduced in 1987, mandates additional payments to the unemployment agency in case of layoffs of older workers. For large firms (50 employees or more), the contribution is equal to two months for a 50 year old, increasing to 12 months for a 56 year old, and decreasing back to 6 months for a 59 year old or older (the number

of months being halved for firms with less than 50 employees). In the Netherlands, workers over 57,5 years are protected directly by a higher severance pay, an exception to the otherwise prevailing last in–first out rule for selecting laid-off workers, and protected indirectly by the requirement that the firm pay part of the unemployment benefit. The share of the unemployment cost born by the firm remains small, though (from 10% for firms with less than 6 workers to 30% for firms with over 50 workers). Such measures go in the direction of discouraging layoffs that are on average socially costly, but they also give rise to "threshold effects' as they encourage firms to discharge workers before they reach the age requirement.

Another exception to the absence of internalization is supplied by the Dutch sickness and disability system, in which experience rating was progressively introduced starting in the early 1990s, following an obvious abuse of the system by employers and employees. Dutch employers now have to pay sick workers full pay for a year (as opposed to 12 weeks in France). Experience rating in disability insurance was introduced in 1998. Today, employers have incentives not to have their employees disabled: They have to pay a substantial part of the disability costs for 5 years. In order to reduce the employers' concomitant incentive to screen out employees with high sickness or disability risk, employers are exonerated from this penalty if they hire a person with a registered work handicap, and they receive reductions in their sickness and disability insurance premia when keeping or hiring

employees with work handicaps.[16]

Severance payments

Severance payments mandated by French law are relatively low, and grow more than proportionally with seniority: 2/10 months per year of seniority, plus, for workers with more than 10 years, 2/15 months per year above 10 years. This gives 2 months for a worker with 10 years seniority, 8.3 months for a worker with 30 years seniority.

"Quasi-legal" levels of severance pay (meaning: according to the formula agreed upon by sub-district courts. In 1997, 75% of the sub-district judges reported to have used this formula) are more generous in the Netherlands. The number of months received depends on the number of years in service and the age of the worker. For example, a 50-year old with 10 years of service receives 15 months of severance payments. A correction factor can also be applied (for example a layoff motivated by poor employee behavior cuts the severance pay by anything from 0 to 100%. Conversely, the correction factor may exceed 1 in case the employer is to blame).[17] Administrative bodies do not determine

16. For more on incentives in this system, see van der Ploeg (2003).
17. The courts' formula goes as follows: The level of severance payment is given by the product $A \times B \times C$ where

- A is a weighted average of number of years of service. Years of service receive weight 1 before age 40, 1.5 between age 40 and age 50, and 2 after age 50;
- B is the last earned monthly wage of the employee;
- C is the correction factor.

severance payments, but they define a "noticing period", over which the worker still receives pay.

2.3 Procedure

France: Firms that decide to lay workers off for personal or economic reasons must follow an often long series of administrative steps. These steps have two separate purposes. The first is to give time to the workers to prepare themselves for the layoff and to facilitate their reemployment. Depending on seniority, workers get an advance notice of up to three months. Workers in large firms (1000 employees or more) are entitled to a retraining period ("congé reclassement") of 4 to 9 months. For the part of the period that coincides with the advance notice period, workers get 100% of their salary; for the rest of the period, they get 65% of their salary, paid by the firm. Under the new unemployment insurance system, workers in smaller firms are eligible for training and help in finding jobs from the start of their advance notice (the "PARE anticipé"), not the moment they become unemployed. The other purpose is, officially, to make sure that alternatives to the layoffs have been fully explored.

The steps (which must take place before workers are notified of the layoff) grow more numerous with the size of the firm, and the size of the layoffs. For layoffs for personal reasons, the steps are typically minimal—an interview and the sending of an official letter. For layoffs for economic reasons, and for firms with more than 100 workers, the process can take up to half a year. The steps involve a number of meetings with the representatives of

the workers, the presentation by the firm of a detailed "plan to save jobs" ("Plan de sauvegarde de l'emploi"), the approval of the labor inspection office; they may also involve the nomination of an auditor if requested by worker representatives, and the recourse to an arbitrator if the workers' representatives disagree with the firm's plan.

At the end of this process, the firm can start the advance notice period, and then proceed with the layoffs. But the workers, if they disagree, can go to court. Different courts have different jurisdictions. In case of collective layoffs, workers or firms go to regular tribunals ("Tribunaux d'instance" or "Tribunaux de grande instance".) For individual layoffs, as for most labor contract disputes, the standard court is the a labor tribunal known as the "Prud'hommes", an institution created in 1806. Each such tribunal has two elected union representatives and two elected representatives from employers' organizations. In case of a tie, the decisive vote is cast by a professional judge. When a case is taken to the Prud'hommes, the first step is an attempt at arbitration ("audience de conciliation"). The second is a judgment ("audience de jugement"), which can decide that layoffs were not justified, and impose fines and payments to the firm. (98% of the cases are brought by workers, only 2% by firms; 80% of the cases are decided in favor of workers). The judgment can then be appealed, going first to the appeals court ("Cour d'appel"), then possibly to the highest court ("Cour de cassation"); 50% of the cases are appealed, 70% are decided in favor of workers. The number of cases taken by the Prud'hommes has increased

rapidly in the recent past, reaching close to 200,000 new cases (half of those related to layoffs) per year at the end of the 1990s.

Both at regular tribunals, and at the Prud'hommes, the delays in reaching a decision can be substantial (the mean time to the first judgment at Prud'hommes is now around 10 months). If layoffs are found not to be justified, the firm has to pay additional severance payments. These payments can be substantial. If for example the firm has more than 11 employees, and the worker has more than two years seniority, severance payments must be at least equal to six months.

Netherlands: The Dutch process is quite similar in spirit, with a prior-check institution in place for nearly 60 years, but it is much more expedient.[18] Dutch firms are offered a menu of options:

The first option is the administrative process. After an advance notice period (which in the case of individual layoffs increases with the worker's seniority and goes from 1 to 4 months), the firm can attempt to obtain authorization from a public administrative body, currently the Center for Work and Income (CWI). The procedure is rather lengthy, but cheap.

Alternatively the firm can make its case to the sub-district court (without advance notice period). The procedure is then more expensive, but involves smaller delays. In principle, the procedure is completed within a month. The costs of the administrative and court procedures are estimated at about 5,000 and 27,225 euros,

---

18. In 1975, France introduced the need for prior administrative authorization. This requirement was eliminated in 1986.

respectively (van Zevenbergen-Oelen 2000). Despite the cost, the swift procedure appeals to many firms, especially large ones. For the first time, in 1998, the number of requests for dissolution filed at sub-district courts exceeded the number of requests filed with the administrative bodies. In either case decisions are seldom in favor of workers. For example, for individual dismissals and the administrative procedure, only 6% of the firms' requests are rejected (CPB1997). According to van Zevenbergen-Oelen (2000), the courts and administrative bodies allowed the layoffs in 96.5% of cases. Of course, such statistics must be taken with caution; after all 20% of the layoff demands are withdrawn and employers do not seem to be willing to engage in a procedure unless they have a particularly strong case.

2.4 Instruments of flexibility: fixed duration contracts and outsourcing

a) *Fixed-duration contracts*

France: Since the late 1970s, successive governments have introduced fixed–term contracts, called "contrats à durée determinée", or CDDs. These contracts still require a severance payment, but eliminate the recourse to courts when termination takes place at the end of the contract.[19]

A brief history of CDDs goes as follows: CDDs were introduced in 1979. With the election of a socialist government in 1981 and the passage of another law in 1982, their scope was reduced: A list of 12 conditions was drawn, and only under those conditions

---

19. Poulain (1994) gives a detailed description of the rules governing CDDs.

could firms use fixed-term contracts. In 1986, the 12 conditions were replaced by a general rule: CDDs should not be used to fill a permanent position in the firm. The current architecture dates for the most part to an agreement signed in March 1990. Under this agreement, CDDs can be offered by firms for only one of four reasons: (1) The replacement of an employee on leave (2) Temporary increases in activity (3) Seasonal activities (4) Special contracts, aimed at facilitating employment for targeted groups, from the young to the long term unemployed. The list of special contracts has grown in the 1990s, as each government has tried to improve labor market outcomes for one group or another; some of these contracts require the firm to provide training, and many come with subsidies to firms.

Fixed duration contracts are subject to a very short trial period, typically one month. Their duration goes from 6 to 18 months, depending on the specific contract type. Mean duration is roughly one year. They typically cannot be renewed, and, in any case, cannot be renewed beyond 24 months. If the worker is kept, he or she must then be hired on a regular open-ended contract, called a Contrat à durée indéterminée (CDI). If the worker is not kept, he or she receives a severance payment equal to 10% of the total salary received during the life of the contract.[20] Note that this is a much higher percentage of salary than is the case for severance on regular contracts. But, as emphasized earlier, workers on CDDs cannot go to the Prud'hommes to contest the end of employment on the CDD.

20. As of January 2003. A collective agreement can bring this "prime de précarité" down to 6% in exchange for additional training.

Fixed duration contracts have been very popular with firms, and represent now 70% of the flow of hires, and a bit above 10% of total employment.

Netherlands: By contrast, Dutch workers on fixed duration contracts receive no severance pay. However, the divide between fixed duration and open-ended contracts does not seem as sharp as in France. Two recent reforms, the Flexibility and Security Act (that originated in a 1996 Labour Foundation agreement between the social partners and came into force on January 1, 1999), and a new law in 2001, grant new rights to fixed-duration contracts: transformation, under certain conditions, of consecutive temporary employment contracts into a permanent one, requirement for firms to offer vacancies for open-ended contracts to employees on fixed-duration contracts, treatment of contracts with temporary employment agencies as permanent contracts. As Table 2 on new work relationships demonstrates, the share of temporary workers in the flow of new hires is much smaller than in France (while the 2000 percentage of workers on a temporary contract, 12%, is comparable with the French level):

Terms of employment	1994		1995		1997		1998		1999		2000	
	Number	%	Number	%	Number	%	Number	%	Number	%	Number	%
Stable	313	50%	375	50%	570	56%	661	58%	733	62%	723	65%
Temporary work	76	12%	105	14%	139	14%	154	14%	125	11%	99	9%
Remaining temporary	177	28%	199	27%	193	19%	226	20%	245	21%	200	18%
Freelance	40	6%	46	6%	58	6%	64	6%	42	4%	39	4%
Remaining	26	4%	20	3%	58	6%	25	2%	32	3%	38	3%
Total	632		745		1.018		1.130		1.177		1.108	

Source: Research voor Beleid/Arbeidsvoorziening (HZW2000)

Table 2

The Dutch unions' willingness to improve the rights of temporary workers in exchange of a relaxation of statutory dismissal protection is as remarkable as their actions in favor of part-time work and integration of women in the work force. By contrast, French unions traditionally focus (except rhetorically) on the interests of workers with open-ended contracts.

b) *Outsourcing*

In the Netherlands, the Flexibility and Security Act made it more attractive for traditional employers to outsource, as they can call the same workers as many times as they want (there is no limitation to the number of contracts an employer can sign with an employee of a temporary work agency-TWA). The employee has a regular contract with the temporary work agency. The new regulation improved the rights of the employees of TWAs but do not require more from employers employing workers through

these TWA. In that sense, it provides flexibility to traditional employers and reduces their labor costs (for example, they do not have to pay firing costs; they can simply not re-employ the worker at the end of the temporary contract).

3 Contours of employment protection reform in France and in the Netherlands

In our report on employment protection reform in France, we concluded that there was a strong case for reform along three major dimensions: An increase in the marginal financial cost of layoffs for firms, a decrease in the role of courts, and a reduction of the sharp contrast between permanent and temporary contracts. It would be presomptuous for us to make specific recommendations for the Netherlands. But our assessment is that the first dimension is equally important for the Netherlands, while the other two are probably less important: In those two dimensions, Netherlands has largely avoided some of the problems France is now facing.

Let us review the three dimensions in turn:

1: *An increase in the marginal financial cost of layoffs for firms.*

We saw that the contribution rate of firms should be positive, although probably less than one.

Starting either from the French or the Dutch current legislation, this implies a reduction in the payroll tax, and the introduction

of unemployment contributions by firms related to their layoff behavior. While shifting to a positive contribution rate will induce firms to reduce layoffs, this increase in employment protection (with payments from firms to the unemployment insurance agency, rather than directly to workers) will be less visible to workers than some of the other forms of employment protection. But it is nevertheless an increase in employment protection: It leads firms to take into account the social costs of unemployment, and decrease their layoff rate.

If and when such a payroll tax is introduced, is there a role left for severance payments, direct payments to workers? We think so, but their role should be only to offset the costs of job loss (as separate from unemployment). This should be their only and limited purpose; unemployment insurance is better provided through unemployment benefits. Given that the costs of job loss appear to be increasing and convex in seniority, this suggests the use of a schedule which is increasing and convex in seniority, with low payments until high seniority is achieved.

Here, there may be a relevant difference between France and the Netherlands. Legally mandated severance payments in France are, as we saw, relatively low. Quasi-legal severance payments in the Netherlands are significantly higher. Adding a layoff tax to these severance payments may lead to excessive payments by firms in case of layoff. In this case, it may make sense to decrease severance payments paid by firms as the layoff tax is introduced. This however will have distributional implications: If unemployment insurance payments are not increased, workers

will receive smaller overall payments in case of unemployment (smaller severance payments, same unemployment benefits).

In any case, if severance payments are convex in seniority, there are constraints, as we saw in our discussion of the Delalande contribution in France, on how steep the schedule can be at high seniority. If it is too steep, it runs the risk of generating discrimination against middle–age workers.

In case of bankruptcy, firms should be liable for layoff taxes and severance payments, and the state should be a senior creditor. As we know however from recent cases, firms have an incentive to escape those liabilities by designing complex structures of ownership so as to benefit from limited liability. The problem will only grow more serious, if, as we argue should happen, contribution rates are increased.

2: *A decrease in the role of courts in case of layoffs, leading to a less costly and less uncertain process for firms.*

In light of our discussion, the heavy hand of the judicial process, as it now exists in France, seems largely unjustified. We do not see why the Prud'hommes or tribunals should be asked to second guess the decision of the firm, if the firm goes through the proper administrative steps and is willing to pay both contributions to the UI fund and severance payments to its workers.

The role of the tribunals in France should therefore be much more limited than it is today. Courts should, if requested by the dismissed workers or the fund, check that proper administrative steps have been taken, and that contributions and severance are

being paid, and, in the case of an individual layoff, that the firm did not discriminate (e.g., against a union representative or a pregnant woman) and did not harass the worker to masquarade a layoff as a quit.

In this respect, the Netherlands appears in much better shape than France. In practice, courts are much more expeditious. While one might worry that the need for administrative authorization led to a heavy burden on firms (this was the case in France when such an authorization was in place), this does not appear to be the case. Thus, it does not appear essential to modify that aspect of the employment protection system in the Netherlands.

3: *The sharp contrast between fixed-duration and open-ended contracts should be eliminated.*

The elimination of the two-contract regime in place in France should reduce the dual nature of the labor market, which we see as a major and perverse effect of recent reforms. The increase in the financial marginal cost of laying off a worker, compensated by a decrease in the complexity and the uncertainty of the layoff process, might well be more attractive both to firms and to workers. The appeal for French firms of fixed-duration contracts, which combine a higher severance pay than open-ended contracts, with a much simpler process of termination, suggests that firms would be eager to accept such a trade off. But we believe that this need not come with a decrease in the welfare of workers, both those on fixed-duration contracts, and those on open-ended contracts. Given its goals, the current system is

inefficient. Efficiency gains can make both sides better off.

Here, again, the Netherlands appears to have less of a problem, and indeed, may offer some directions of reform for France. Even if political considerations make it difficult for France to shift from a two-contract regime to a common regime, the purpose should be to reduce the differences between the two regimes over time, so as to avoid the sharp threshold effects that characterize the current system.

References

[1] Belot, M., and J. van Ours (2001) "Unemployment and Labor Market Institutions: An Empirical Analysis," *Journal of the Japanese and International Economics* ," 15: 403–418.

[2] Blanchard, O., and J. Tirole (2003a) "Protection de l'Emploi et Procedures de Licenciement", Conseil d'Analyse Economique, Documentation Francaise, numero 44. (English version: "Contours of Employment Protection Reform", MIT working Paper, November 2003)

[3] Blanchard, O., and J. Tirole (2003b) "The Design of Optimal Labor Market Institutions", mimeo.

[4] Boeri, T.(2002) "Making Social Europe Compete," mimeo, Universita Bocconi.

[5] CFDT (2003) *Salariés: Guide de vos droits 2003*. La Découverte; Guides.

[6] CPB Netherlands Bureau of Economic Policy Analysis (1997) *Challenging Neighbours: Rethinking German and Dutch Economic Institutions*. Berlin and New York: Springer.

[7] den Butter, F.A.G., and R. Mosch (2003) "The Dutch Miracle: Institutions, Networks, and Trust", *Journal of Institutional and Theoretical Economics*, 159, 362–391.

[8] Fougère, D., and D. Margolis (2000), "Moduler les cotisations employeurs à l'assurance chômage : les expériences de bonus-malus aux Etats-Unis," *Revue Française d'Economie*, 2: 3–76.

[9] Frederiksson, P., and B. Holmlund (2003) "Improving Incentives in Unemployment Insurance: A Review of Recent Research," CES IFO Working Paper 922.

[10] JurisClasseur Groupe Lexis-Nexis (2002) *Le licenciement pour motif économique après la loi de modernisation sociale*, sous la direction de Christophe Willmann et Jean-Yves Kerbough.

[11] Pélissier,J., Supiot, A., and A. Jeammaud (2002) *Droit du Travail*. Dalloz, Paris.

[12] Poulain, G. (1994) *Les contrats de travail à durée déterminée*. Litec, Paris, France.

[13] van der Ploeg, R. (2003) "Role of Employers in Transforming Disability into Ability: Learning from Dutch Mistakes," mimeo.