2 European Union Dual Labour Markets: Consequences and Potential Reforms

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Abstract

This chapter provides an overview of a growing literature on the emergence of dual labour markets and their persistence in some EU countries, as well as the impact that dualism has on a large range of labour market dimensions including, among others, job and worker flows, (overall and youth) unemployment, wage setting, training, labour mobility, household formation, and technology adoption. A distinctive feature of the chapter is that it places the accumulated evidence on these issues in a general equilibrium framework, which helps understand why dual labour markets have performed so poorly since 2008, and also to identify promising avenues of research for the near future. The chapter also evaluates recent reforms and reform proposals (single and unified labour contracts) to eliminate the undesirable consequences of excessive dualism in the labour market.

2.1 Introduction

This COEURE Survey deals with the consequences of dual labour markets, namely labour markets where workers are entitled to different employment protection depending on the contract they hold, and where these differences are large. The effect of dualism on several labour-market dimensions has been widely analysed in the literature but many of these issues have strongly re-emerged during the recent crisis due to the poor performance of countries subject to strong dualism. In this survey we review the main lessons drawn from past experience with these labour market regimes, where they originate from, why they are so difficult to change, why they have failed during the Great Recession and the subsequent sovereign crisis, what reform proposals have been posed and which ones are more likely to work. In addition to reviewing the accumulated stock of knowledge on these issues, we place them in a general equilibrium framework to understand which ones constitute the most promising avenues of research for the near future. The rest of the survey is organized as follows. Section 2.2 deals with the historical origins of dual labour

markets. Section 2.3 considers conditions under which labour contracts become too different, leading to optimal versus nonoptimal arrangements of stability and flexibility in the labour market. Section 2.4 looks at the performance of dual labour markets since the onset of the Great Recession. Section 2.5 documents the case of Spain, as an epitome of a dual labour market. Section 2.6 discusses the effects of dualism on youth labour market outcomes. Section 2.7 critically evaluates different proposals to abolish inefficient dualism. Finally, Section 2.8 provides some concluding remarks. An Appendix summarizes the main features of different proposals for the introduction of Single/ Unified labour contracts.

2.2 The Emergence of Dual Labour Markets in Europe

Since the oil crisis in the 1970s, the fight against unemployment in Europe has centred on allowing more flexibility in the labour market. In line with this goal, employment protection legislation (EPL) has been subject to frequent policy changes in many EU countries.[1] Although in several instances EPL reforms have taken place across the board, this has not always been the case. A well-known example is provided by labour market reforms in the Southern Mediterranean countries of the Euro Zone (EZ) where, until recently, rules for regular open-ended contracts have hardly been modified. Instead, changes in EPL regulations have mostly affected new hires, either through the introduction of a large spectrum of flexible fixed-term contracts or by expanding the opportunities to use existing temporary contracts (probation, replacement, training, internships, etc.) for regular economic activities. As a result, strong differences in the degree of employment protection between workers hired on permanent/open-ended (PC) and temporary/fixed-term (TC) contracts have emerged as the most salient feature of the so-called *dual* labour markets (see Booth et al., 2002a).

Not surprisingly, segmented labour markets have been hotly debated in academic circles and the policy arena over the last few years. After all, they have been largely responsible for the disappointing performance of employment and unemployment in Europe since the onset of the Great Recession (GR), as reflected by the large differences in labour market outcomes between the North/Centre and the South/Periphery during the crisis.

Following seminal work by Saint-Paul (1996, 2000), the political economy of these two-tier reforms has received a lot of attention over the past couple of decades. In particular, this literature has shed light on the determinants and timing of different types of EPL reforms. Among the relevant issues analysed from this viewpoint, the following stand out:

1. identifying the median voters in union elections (typically middle-aged middle-skilled workers with PC) as a key element in the development of insider-outsider models,

2. characterizing the cyclical properties of EPL reforms where rules pertaining to PC have been liberalized (these reforms are typically approved in recessions rather than in expansions because protected workers face higher exposure to job losses in the former business cycle phase),
3. analysing the dynamics of insiders and outsiders (driven by the pressure placed on union decisions by a growing share of unemployed or workers under nonregular contracts), etc. (cf. Boeri, 2010 and Bentolila et al., 2012a).

Following these two-tier reforms, the use of temporary workers has increased in total dependent employment, especially in those countries where EPL for permanent workers was higher to start with. For instance, this was the case of the olive-belt countries (Greece, Italy, Portugal and Spain) as well as in France. The reason why labour law was stricter in the first set of countries has to do with the fact that, in different periods of the twentieth century, they experienced transitions from authoritarian dictatorships to democratic regimes. In effect, though EPL regulations were mostly approved in the aftermath of World War I (see Table 2.1 for a chronology of these rules; Aleksynska and Schmidt, 2014), social pressure in military regimes with low productivity and wages (typical of autarkies) was kept under control by means of very stringent rules regarding worker dismissals, in conjunction with the ban of most trade unions. When democracy was restored and unions became legalized, upward wage pressure in collective bargaining took place but the prevailing rigid employment protection was kept fairly unaltered in order to get the support of unions.

As regards France, the origin of the implementation of stringent EPL can be traced back to the 1960s, when large migration inflows, especially from the Maghreb, led to downward pressure on wages (see Comte, 2015). As is well known, stagnating wages and deteriorating working conditions resulted in French wage earners' revolt in May 1968. The crisis was solved through a sharp increase in the minimum wage and its reassessment mechanisms (with the creation of SMIC in the 1970), which, from 1968 to 1982, almost tripled in real terms. The role of such an aggressive policy was to establish a barrier to downward wage pressure driven by increasing competition from migrant workers. The high minimum wage initially caused the ousting of less skilled migrant workers and a slight increase in the share of native's wages. However, after a while, the continuous rise in labour costs led to a surge of unemployment, especially among the youth. As a result, French unions successfully pushed for stricter conditions for dismissals and higher protection of the regular employment contract.

Yet, regardless of differences in the historical origins of EPL in the Southern Mediterranean area, the loss of competitiveness associated with upward pressure on wages in the context of the large adverse supply shocks of the 1970s and the increasing global trade competition in the 1980s called for drastic reforms

Table 2.1 *Chronology of EPL reforms in EU countries (Aleksynska and Schmidt, 2014)*

Area of regulation/country	FRA	GBR	ITA	ESP	GRC	PRT
Employment protection legislation						
Maximum trial period	–	–	1919	1976	1920	1969
Regulation of fixed-term contracts	1890[a]	1963	1919[b]	1926	1920[a]	1969
Obligation to provide reasons to the employee	1973	1975	1966	1956	–	–
Valid grounds (justified dismissal)	1973	≈ 1963[c]	1966	1926	–	–
Prohibited grounds (unfair dismissal)	1910	1971	1966	1931	1920	1933
Workers enjoying special protection	1910	–	1919	1931	1928	1933
Notification requirements	1958	–	–	1956	1930	1969
Notice period	1928	1963	1919	1931	1920	1969
Severance/redundancy pay	1967	1965	1919	1972	1930	1969
Compensation for unfair dismissal	1890	1975	1950	1926	–	1969
Procedure of reinstatement	1973	1975	1950	1931	–	–
Court procedure (preliminary mandatory conciliation, competent court(s), existing arbitration, time limits)	1941	1918	1919	1926	1920	1933
Regulation of collective dismissals	1975	–	–	1972	1934[d]	1974
Unemployment insurance	1905[e]	1911	1919[f]	1919	1945	1979

[a] Recognition of the use of temporary contracts as the laws on contracts of employment are only applicable to indefinite contracts.

[b] The law acknowledges the existence of such contracts and provides an attempt to regulate them.

[c] Case law.

[d] Only applicable to public utility undertakings with more than 50 employees.

[e] This very first unemployment insurance system was founded by Decree of September 9, 1905 and consisted of state support to provincial syndicates that established sectorial unemployment benefits schemes for their members.

[f] The Legislative Decree as of 1919 contains information on the Decree No. 670 as of April 29, 1917 introducing a general compulsory unemployment insurance.

of the existing EPL schemes in all these countries. With labour relations still dominated by highly protected workers affiliated to unions (the median voter in union elections) and by firms pushing for a quick implementation of cost-saving policies, the only politically feasible way of allowing for internal and external flexibility in firms' adjustment to demand/supply shocks was through reforms at the margin, that is, only applicable for newcomers. The typical reform made it easier for firms to use fixed-term contracts or TC with low firing costs, without significantly changing the protection of open-ended or PC (see Figure 2.1 where time patterns of OECD indices of EPL strictness are displayed). This resulted in a rapid increase of the share of fixed-term contracts, to the point of eventually representing virtually all hires. Furthermore, subsequent reforms have also

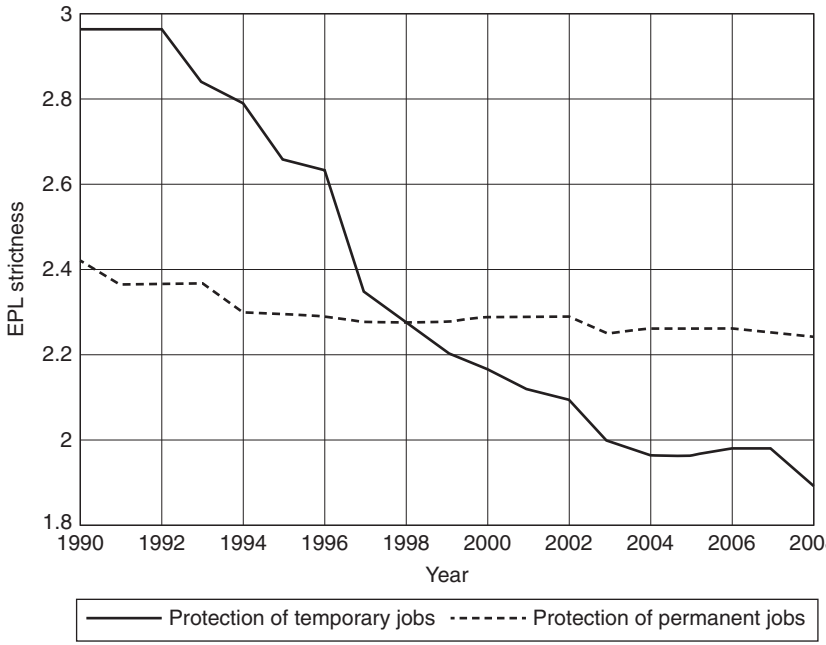


Figure 2.1 Time trends in EPL for permanent and temporary jobs, 1990–2008 (OECD, 2008).

blurred the boundary between dependent employment and self-employment, as illustrated by the growing use of nonregular forms of employment regulated by commercial laws, like freelance work contracts in Italy or contracts for services in Poland (see Bertola et al., 2000, OECD, 2014).

2.3 Temporary Contracts: Stepping Stones or Dead Ends?

It should be evident that temporary work is a key element in the good functioning of any labour market because it is tailor-made to cope with seasonal changes in demand or other activities of a fixed-term nature (e.g., project-related, replacement and substitution contracts). On top of that, TC can provide a useful device for employers in screening the quality of job matches, especially with young inexperienced workers, as well as ease the transition of entrants towards better stable employment. Indeed, whereas in some countries (Austria, Denmark, Sweden, UK and US), these jobs become '*stepping stones*' (see Holmlund and Storrie, 2002, Booth et al., 2002b, Heinrich et al., 2005)[2] to more stable jobs, the key issue is why they have become '*dead-end*' jobs and a source of excessive labour market volatility in others (see Boeri and Garibaldi,

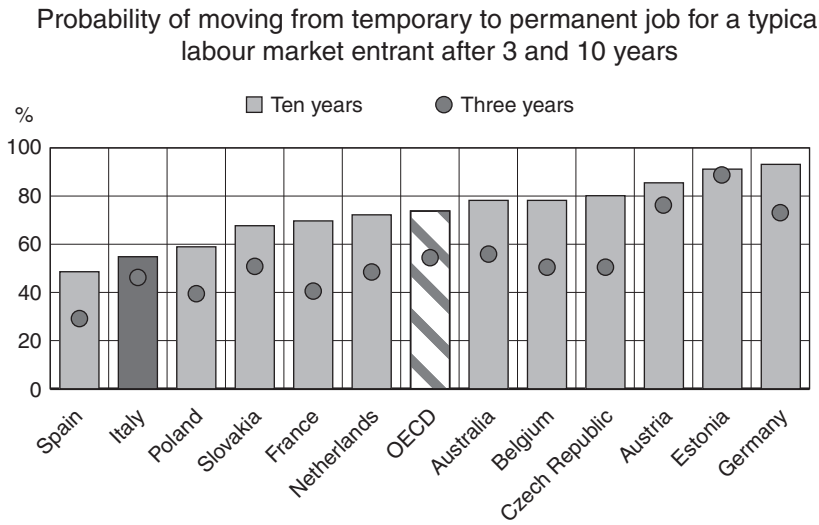


Figure 2.2 Probability of upgrading a TC to a PC (OECD, 2014).

2007). As Figure 2.2 shows, the probability of reaching a PC ten years after entering the labour market with a TC is lower than 60 per cent in countries like Italy or Spain, whereas is close to 100 per cent in Germany. After all, the conventional justification of all these nonregular contracts is to improve the labour market outcomes of disadvantaged workers in countries where employment protection is stringent.

But are temporary contracts really so helpful? In theory, by decreasing firing costs, they can help some workers to accumulate human capital and/or job experience. Yet, in parallel, there is the danger that they may end up moving from one fixed-term contract to another, leading to lower employment stability and no transition towards better jobs (see Blanchard and Landier, 2002, and Cahuc and Postel-Vinay, 2002). Indeed, it has been argued that the large discontinuity created by two-tier EPL schemes (i.e., the so-called EPL gap) in dual labour markets has negative consequences on unemployment, human capital accumulation and innovation. This is so because a large gap in redundancy pay leads to excessive worker turnover. In effect, given this discontinuity in EPL and the lack of wage flexibility, firms prefer to use TC in sequence rather than converting them into PC. The reason is that in case of dismissal, the latter become much more expensive, and wage rigidity prevents offsetting transfers from workers to firms in exchange for being insured against job losses (see Lazear, 1990). As a result, as the expected duration of temporary jobs gets

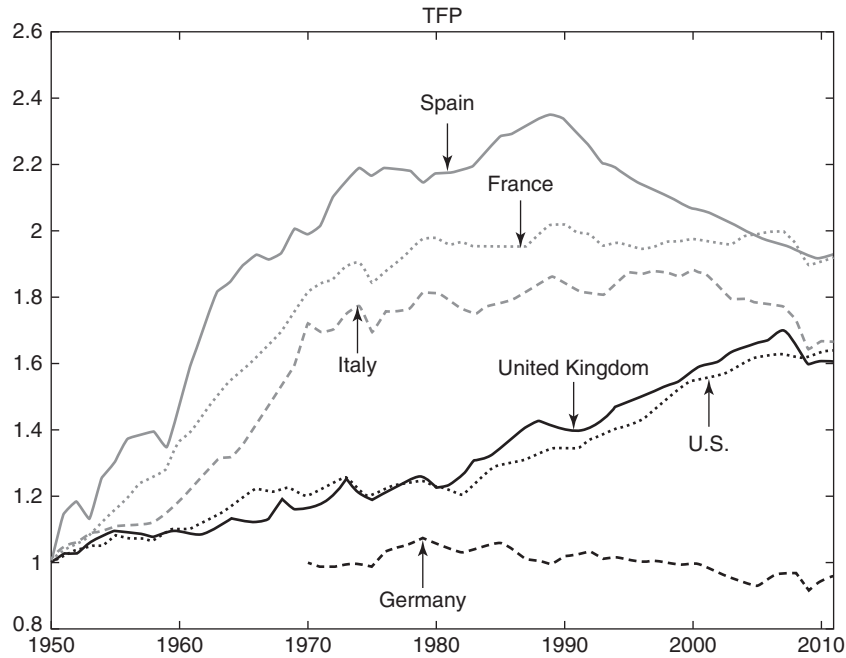


Figure 2.3 TFP in some OECD countries (Index 1950 = 1, Fernández-Villaverde and Ohanian, 2015).

shorter, firms become more reluctant to invest in workers' training because they can benefit less from this investment in human capital.

By the same token, temporary workers may lack the right incentives to improve on their job performance through exerting more effort and accumulating better productive capabilities. Further, given that these skills are important determinant of multifactor productivity, this mechanism may have played a relevant role in explaining the unsatisfactory development of TFP growth in EU countries with segmented labour markets, as depicted in Figure 2.3.

The empirical evidence about the impact of temporary work on labour market outcomes shows that, in general, it could be beneficial in unified labour markets (*stepping stones*) while it is unambiguously detrimental in dual labour markets (*dead ends*). As mentioned above, this is especially the case when wage bargaining is ruled by an insider-outsider model which prevents wages to offset labour turnover costs. For example, Zijl et al. (2004) and Dolado et al. (2015a) find that TC do not improve access to PC. Furthermore, they create excessive wage pressure (see Bentolila and Dolado, 1994), lead to low firms' training investments on workers (see Cabrales et al., 2014, OECD) and incentivize

the adoption of mature rather than innovative technologies (see Saint-Paul, 2000, Bassanini et al., 2009, Garcia-Santana et al., 2015). Thus, it is quite well established that the coexistence of workers with quite different seniority rights could have important undesirable consequences for wage setting, human capital accumulation and even for the political economy of labour market reforms (see Saint-Paul, 1996). For example, given than the median voter in union elections is often a worker with a PC, reforms entailing cuts in EPL will take place in recessions, when this type of workers feel the risk of losing their jobs, instead of in expansions, when the benefits of higher contractual flexibility would translate into higher job creation rather than job destruction (Wasmer, 1999).

2.4 Dual Labour Markets Before and After the Great Recession

Overall, the Great Moderation and GR periods have shown that economies with higher segmentation in the labour market exhibited most of the following salient features:

1. A growing specialization in low value-added sectors (such as construction, tourism or personal services) as the engine of rapid output and employment growth during expansions, followed by very dramatic negative adjustments during recessions,
2. A significant productivity (TFP) slowdown,
3. A high dropout rate both in secondary and tertiary education, together with an increasing degree of over-education among college graduates,
4. Large immigration inflows,
5. A very large cyclical volatility in the labour market.

There is an extensive literature analysing the developments of these economies from the early 1990s to the mid-2000s, before the onset of the GR (Dolado et al., 2002, OECD, 2004, and Boeri, 2010). However, a common feature of these studies is that they address the above-mentioned salient features separately or, at best, they treat them from a partial equilibrium viewpoint. For example, there are studies dealing with the rise of the construction sector and its complementarities with the immigration (see Gonzalez and Ortega, 2011), as well as with innovation deficit and specialization in low-value added sectors (see Cingano et al., 2010). Given this background, it would be advisable for future research to unify all these themes under the umbrella of a single (general equilibrium) framework. This could be useful to understand the course of events, which has led to the current recession, as well as to draw policy lessons for subsequent recovery. The basic roadmap guiding this unifying approach could be as follows:

1. Following large cuts in real interest rates, as a result of the Great Moderation period in general and of accession to the EZ in particular, future profitability of mid- and long-run investment projects experienced a large boost in

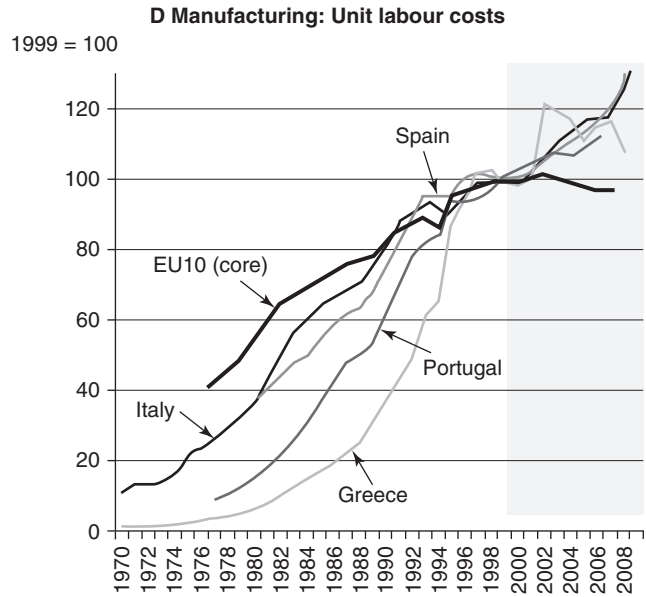


Figure 2.4 Unit labour costs in some EU countries, 1970–2008 (Eurostat).

several EU countries, especially in those with high inflation whose nominal interest rates became assimilated to the German ones. In countries with dual EPL, for reasons spelled out in the next paragraph, cheap credit fuelled job creation through flexible TC in less skilled labour-intensive sectors. These were fixed-duration jobs which are much cheaper to open and destroy than permanent jobs (leading to the so-called '*honeymoon effect*'; cf. Boeri and Garibaldi, 2007). The fact that the latter were subject to high statutory and red-tape dismissal costs inhibited job creation either through PC or conversion of TC into PC. That initial surge in job creation led to a rise in school drop-out rates and to lower on-the-job training. As regards the first phenomenon, high wages paid in the growing industries meant larger opportunity costs for youth staying in school. With regard to the second feature, it was due to the fact that in most of these countries neither temporary workers nor firms creating these jobs had incentives to accumulate and provide much human capital, as reflected by the low rate of conversions from temporary to permanent jobs (see Dolado et al., 2015a, and Cabrales et al., 2014). This hampered TFP growth and increased unit labour costs (as a result of the high demand for real estate), reinforcing the choice of retarded technologies (see Figure 2.4). For example, employment in the construction sector reached levels close to 15 per cent of overall employment. Furthermore, the

widespread use of temporary contracts led to a huge workers' turnover rate, which increased labour market risk impinging negatively on labour mobility, household formation decisions and fertility (see Ahn and Mira, 2001, and Becker et al., 2010). Not surprisingly, this '*job-bust, baby-bust*' phenomenon, with negative consequences for the sustainability of pay-as-you-go pension systems, has been further aggravated during the GR (see Figure 2.5).

2. As mentioned earlier, these mechanisms implied a relative abundance of less-skilled labour which favoured large investments in nontradable industries like construction and some service sectors (tourism, hotel and catering etc.), as well as in the public sector (Greece and Portugal). Notice that this did not happen in other countries with more unified labour markets (and better education systems) which experienced similar cuts in real interest rates. A well-known example is Finland, which in the aftermath of the collapse of its main trade partner, the USSR, invested in IT rather than in '*bricks and mortars*'. On top of this, the dual nature of contracts in the labour market induced a rigid wage-setting system (Bentolila and Dolado, 1994) making it inadequate to specialize in more innovative sectors: more flexibility would have been required to accommodate the higher degree of uncertainty associated with producing riskier higher value-added goods (see Saint-Paul, 1997 and Beaudry et al., 2010). In parallel, the size of the cohorts entering the labour market (e.g., someone born in 1980 and entering the labour market in 1996 after completing or dropping out of compulsory lower-secondary education), proved to be too small for the needs of the highly labour-intensive sectors where entrepreneurs had targeted their investment. As a result, large inflows of less-skilled immigrants were attracted, as in Italy or Spain (see Figure 2.6). The rapid increase in the population of these countries meant an additional increase in the demand for residential housing, which was further reinforced by the higher demand of youth workers, stemming from an increasing home-leaving rate resulting from the high employment growth process fuelled by the booming sectors. Thus, '*Say's law*' got resurrected in labour markets subject to strong search frictions: supply created its own demand and mortgage loans soared.
3. Since the industrial structure chosen in some of the Southern-European countries had favoured the expansion of small- and medium-sized firms, which heavily relied on cheap credit, the financial crisis hit these companies hard, leading to bank failures and the burst of housing bubbles (see Bentolila et al., 2014). The large gap between the firing costs of permanent and temporary workers and the lack of response of insider-dominated bargained wages led to a free fall of employment where flexible TC bore most of the burden and the unemployment rate surged. Moreover, the uncertainty surrounding TC as *stepping stones* to indefinite contracts gave rise to

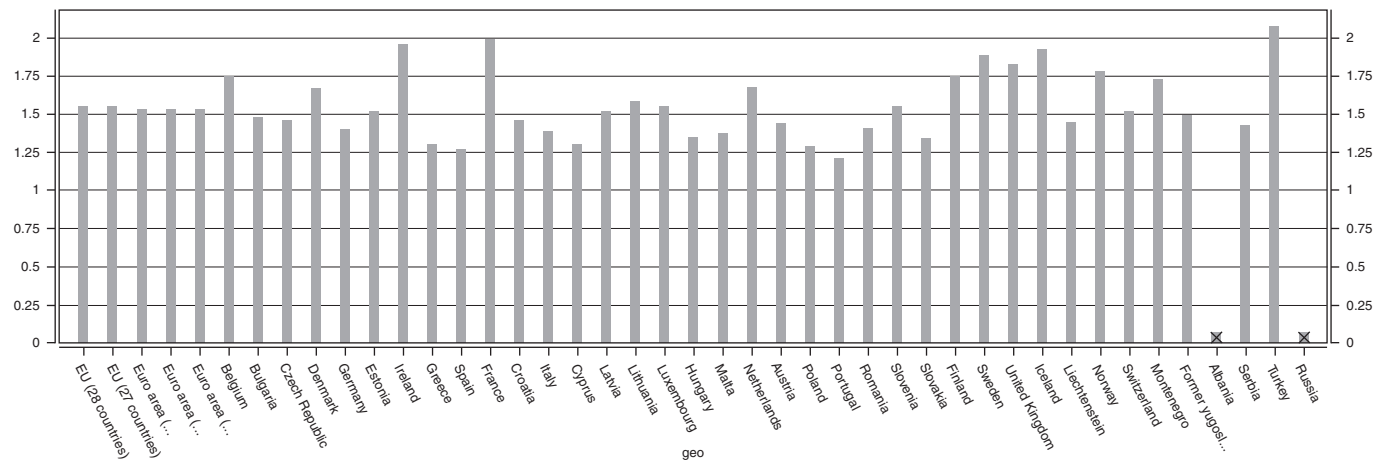


Figure 2.5 Fertility rates in OECD countries (OECD, 2012)

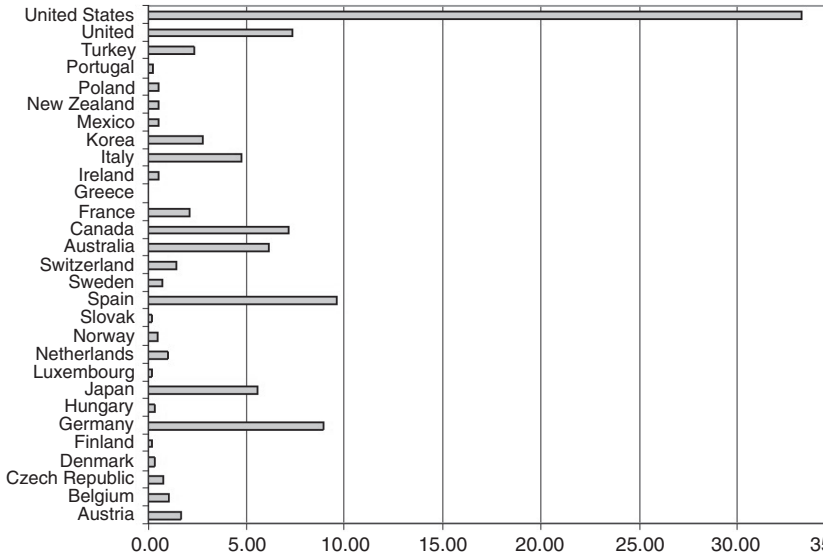
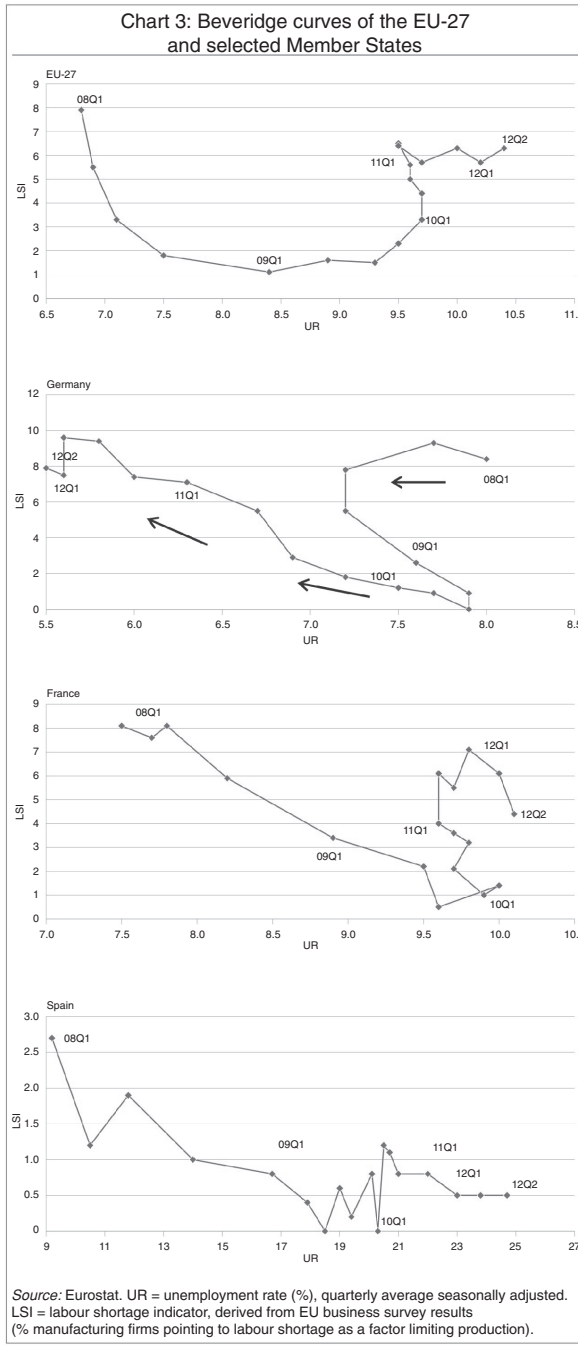


Figure 2.6 Immigration inflows in some OECD countries (2000–2007).

very low geographical mobility and therefore a higher mismatch (the Beveridge curve shifts outwards in countries like France and Spain, whereas it shifts inwards in countries like Germany; see Figure 2.7). Higher mismatch reinforces higher equilibrium unemployment via a reallocation shock compounded with the initial aggregate financial shock (see Carrillo-Tudela and Visschers, 2014).

2.5 Lessons from Spain

Having become the epitome of a dual labour market, Spain provides the best illustration of the pervasive effects that temporary contracts may have in the long run. For almost three decades (see Figure 2.8), about one-third of employees worked on this type of contracts, although currently the rate of temporariness has gone down to about 25 per cent since temporary workers have suffered massive layoffs during the GR and the subsequent sovereign debt crisis. Thus, without any substantial changes, it seems that TC will remain the predominant entry route to employment as the Spanish economy starts recovering (see Caggese and Cunat, 2010). This seems to be the case in 2014 and 2015 when temporary employment is shooting up again and conversion rates remain low.[3] In a recent paper using Spanish social security data, García-Pérez et al. (2014) find that cohorts of native male high-school dropouts who entered the labour



Source: Eurostat. UR = unemployment rate (%), quarterly average seasonally adjusted.
LSI = labour shortage indicator, derived from EU business survey results
(% manufacturing firms pointing to labour shortage as a factor limiting production).

Figure 2.7 Shifts in Beveridge curves in some EU countries (Eurostat).

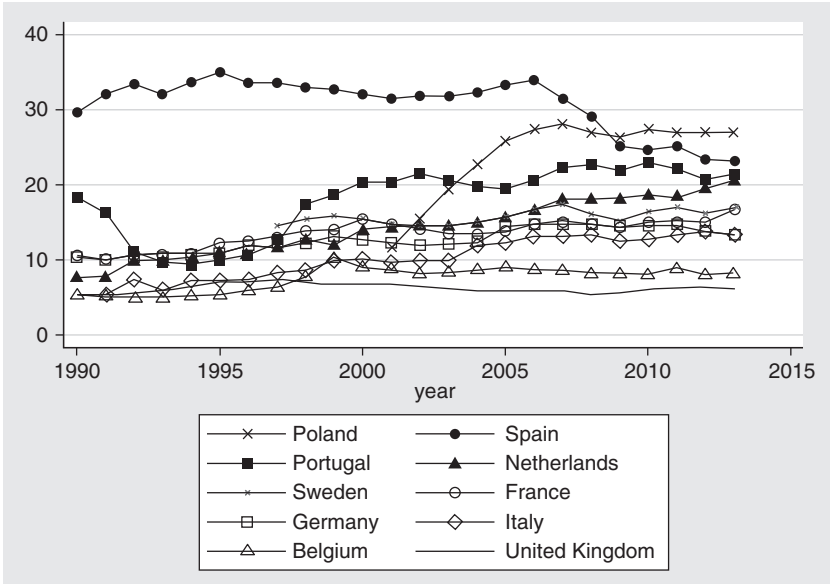


Figure 2.8 Share of temporary work in EU countries (OECD, 2014).

market just after the total liberalization of TC in Spain in 1984, experienced worse labour market outcomes than cohorts that had just preceded them.

Specifically, they spent 200 days at work (i.e., a 7% drop) less than the control group, whereas their wages drop by about 22 per cent in the long run. Lacking any major changes in EPL legislation, these effects are bound to materialize again in the future. Yet, the negative side of TC becomes especially marked once the economy enters a recessionary period. Relying again on the Spanish experience, employment fell by 18 per cent between 2007 and 2013, making it evident that the inadequate design of Spanish labour market institutions and their pervasive effect on industrial specialization are key factors in explaining this extremely volatile employment scenario. In effect, as shown in Figure 2.9, the standard deviation of the (HP filter) cyclical component of employment in Spain doubles the one in the US, but with the important difference that inefficient churning in Spain is mostly borne by one-third of the employees, namely those on temporary contracts, rather than by the whole population. Coupled with a rigid collective bargaining system at the sectoral/provincial level (also anchored in the needs of a rapid transition to democracy in the late 1970s), the dysfunctional design of hiring and firing procedures in Spain forces firms to use external adjustment mechanisms (via job destruction) rather than internal adjustment mechanisms (via wage moderation or reduction in working

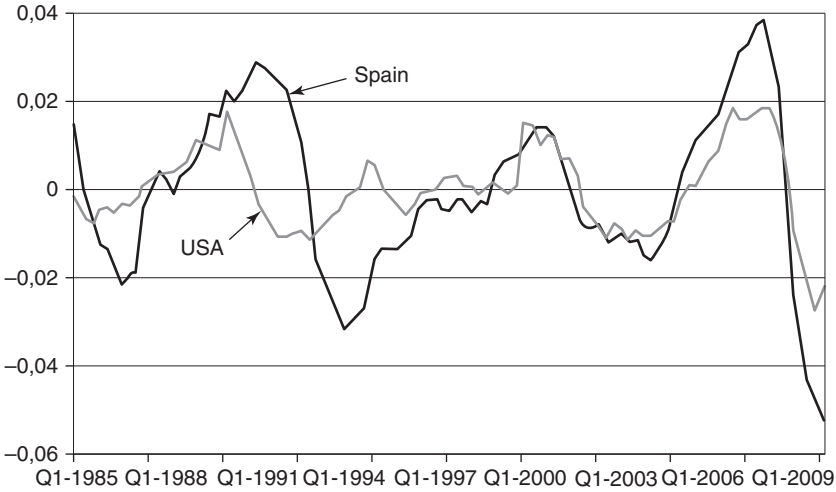


Figure 2.9 Standard deviation of cyclical employment (Spain and US; HP filter, Bentolila et al., 2012a).

time) when hit by adverse shocks. The same happened in Portugal and Greece prior to the GR, before their dual EPL systems were dismantled as part of their memorandums of understanding with the Troika. In contrast, some other EU countries, like, for example, Germany or UK, with similar or greater declines in economic activity, suffered considerably smaller reductions in employment over the GR, basically because of their much lower EPL gaps, higher wage flexibility and less dependent sectoral specialization on low-value added industries. Indeed, before 2010, the EPL gap in Spain between the severance pay of workers with PC (typically 45 days of wages per year of seniority (d.w.y.s) for unfair dismissals) and TC (8 d.w.y.s. or even zero in some cases) was quite substantial. For example, a firm deciding whether to hire a worker on a permanent contract for five years or five workers on fixed-term contracts of one-year each, would pay 225 d.w.y.s. ($= 5 \times 45$) in the first case and 40 ($= 5 \times 8$) in the second case. Furthermore, were the firm to promote a temporary worker to a permanent position after two years, it would bear again a cost of 225 d.w.y.s. in case of dismissal in the fifth year, since the corresponding redundancy pay scheme for PC after the third year also applies to the initial two-year period on TC. Thus the EPL gap would rise to slightly above half a year of wages ($225 - 40 = 165$ days) making the firm reluctant to upgrade temporary contracts. To those gaps, one should add sizeable red-tape cost stemming from the frequent appeals to labour courts by workers dismissed for fair (economic) reasons to get higher mandatory redundancy pay for unfair reasons (see Galdon-Sánchez and Güell,

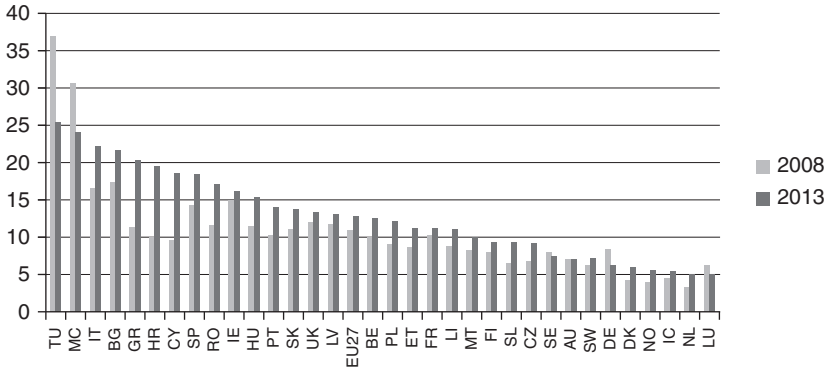


Figure 2.10 Share of temporary work in OECD countries (OECD, 2014).

2003). In this respect, there is concluding evidence showing that almost 45 per cent of the astonishing surge of the Spanish unemployment rate (from 8% to 23%) over 2007–2011 could have been avoided had the EPL gap in red-tape cost been halved to reach the levels in other countries with milder segmentation, as is the case of France (see Bentolila et al., 2012b).[4]

2.6 Dual Labour Markets and Youth Unemployment

It is not surprising that that the countries with the highest youth unemployment and NEET ('not in education, employment, or training') rates in the EU are the olive-belt countries (see Figures 2.10 and 2.11). Greece is a case apart because of its dramatic real GDP contraction of 29 per cent between 2008 and 2013, a fall about five times greater than that experienced in the other three laggard economies (−4.7% in Italy, −6.5% in Portugal and −6.4% in Spain). Yet, Italy, Portugal and Spain share segmented labour markets. Introducing TC for regular activities was key in reducing youth unemployment in otherwise rigid labour markets, since the low employment protection for these contracts made them useful in creating (and destroying) jobs. However, as discussed earlier, the high EPL gap in these countries has led to excessive churning, underemployment and poor training, especially among youth, as reflected by NEET rates among the 15–24 population exceeding 20 per cent in some instances. Yet, there are interesting differences among these countries. Figure 2.12 displays the ratios between youth (15–24) and adult (25–54) unemployment rates as of 2013. As can be observed, the reported ratios are above 3.5 in Italy (also in Sweden and the UK) and close to 3.0 in Portugal, while they lie between 2.0 and 2.5 in Greece and Spain. Notice also that countries with strong dual vocational training systems – like Austria, Germany and Switzerland – exhibit the

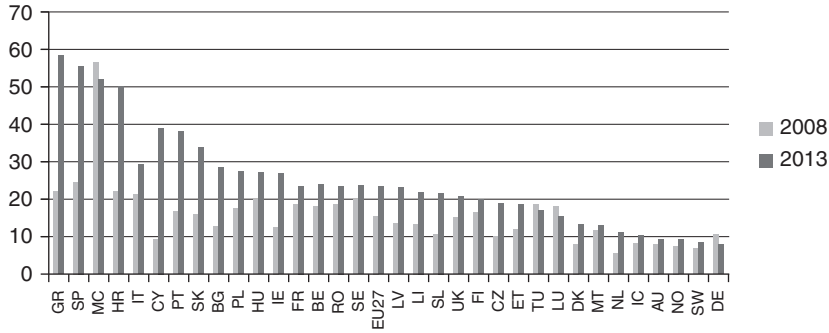


Figure 2.11 NEET rates in OECD countries (OECD, 2014).

lowest ratios. Thus, a lesson to be drawn from this evidence is that in some countries youth labour market problems just reflect general difficulties (Greece and Spain), while in others there is a specific issue about youth (Italy and Portugal).

At any rate, all of the olive-belt countries share a poorly designed vocational training (VT) system. A large share of small firms hinder the use of apprenticeships, lack pre-apprenticeship tracks and the use of Active Labour Market Policies (ALMP) based subsidized permanent contracts is widespread. This has limited impact due to the large substitution effects suggesting that the

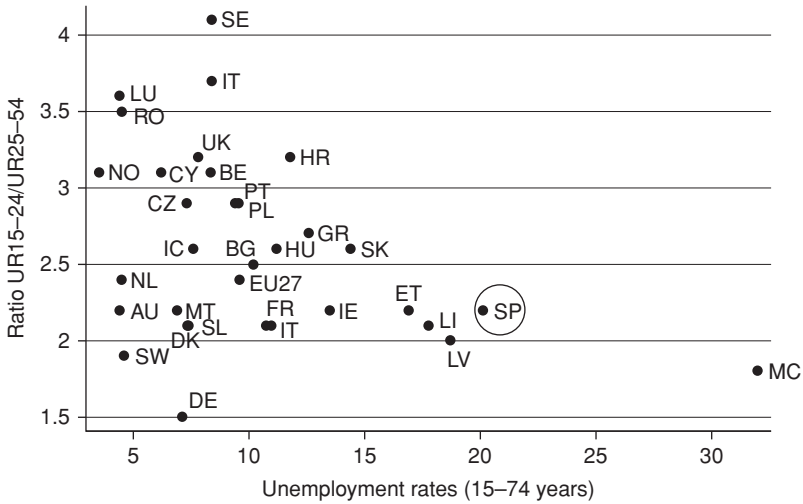


Figure 2.12 Ratio of youth to adult unemployment rates in EU countries (own ellaboration from EU LFS data).

scarring consequences of the GR for youths in these countries are bound to be long-lasting. Further, the recent strong signs of recovery in the Portuguese and Spanish economies have been mostly based on the creation of temporary and part-time jobs so that one cannot discard that in a few years we may observe a repetition of some of the episodes of the past.

The concern that there may be a lost generation led the European Commission to launch the Youth Guarantee (YG) scheme in 2013 as a pledge by member states to ensure that youths under 25 (whether or not they are registered in the public employment services, PES) receive an offer of employment, continued education, an apprenticeship or training within four months of becoming unemployed or leaving formal education. Relying on the successful experiences of some Nordic countries, the YG aims to combine early intervention with activation policies, involving public authorities and all social partners, in order to improve school-to-work transition and the labour market outcomes of youths, especially in the crisis-ridden countries. The EU will top up national spending on YG schemes through the European Social Fund earmarked to help NEETs in regions with youth unemployment exceeding 25 per cent. In comparison with the annual needs, this is clearly an insufficient amount. Yet, as in the case of the Junker Plan for investment in infrastructure, the hope is that the leverage multipliers will be large.

It is too early to evaluate the effects of the YG, but past experience of similar schemes in Scandinavia and elsewhere (Card et al., 2010, 2015) indicates that the expected gains from its introduction are not too large, at least in the short run and in the absence of an agenda to stimulate growth in Europe. Further, there is a risk that the introduction of the YG may delay the adoption of more politically sensitive reforms, such as measures to reduce labour market dualism in the peripheral countries.

Nevertheless, the YG contains elements that may improve the labour market outcomes for youths in Europe. The most important of these is having a specific target in the form of NEETs, rather than a blurred target. The lessons drawn from some successful experiences in Scandinavian countries should be applicable to the rest of Europe. Some will be easier to implement, like the introduction of pre-apprenticeship tracks in the education system or a fruitful collaboration between the PES and private agencies. In exchange for reasonable fees for each difficult NEET that receives one of the above-mentioned offers, the latter could help PES (dealing with the easier cases) in achieving training and job sustainability, initially for disadvantaged young people but later also for older starters. What the YG should definitely avoid is providing unlimited subsidies to firms that rarely translate into stable jobs and lead to a lot of churning due to their deadweight and substitution effects (see García-Pérez and Rebollo, 2009). It should also avoid handing control of training funds over to trade unions and employer associations without strict surveillance by

public authorities. As proven in Spain, where there have been several big scandals relating to the mishandling of these funds, this is not a good strategy. Further, the difficulty in implementing apprenticeships and traineeships in small firms could be circumvented by encouraging large (and profitable) firms to support this type of action targeted at small firms.

Finally, a drastic reform of EPL in dual labour markets is paramount. As mentioned earlier and as will be further discussed in the next section, marginal reforms do not seem to work, and the introduction of a single/unified contract with severance pay smoothly increasing with job tenure (up to a cap), or the combination of this and a so-called '*Austrian capitalization fund*' (i.e., workers' notional accounts involving a few percentage points of payroll taxes, which can be used along the lifecycle and not necessarily when a dismissal takes place) should be prioritized before the YG funds reach the countries concerned. The recent approval in Italy in December 2014 of a draft law involving a single open-ended contract shows that the usual excuses from other governments for blocking its introduction – under the claim that it is against their constitutions are not justified. A few fixed-term contracts (e.g., replacement contracts) should be allowed to persist, since they may play a role in rapid job creation when the economy picks up speed (Lepage-Saucier et al., 2013). Even in countries that signed Convention C158 of ILO requiring a cause for termination of employment at the initiative of employers there could be two different profiles of SOEC: one related to economic dismissals and another to unfair dismissals with minimal intervention by judges.

2.7 How to Dismantle Dual Employment Protection Legislation

2.7.1 Recent EPL Reforms

Given the pervasive effects of large EPL gaps documented above and the weakness of dual labour markets during recessions, there has been a growing pressure to close the gap between the severance payments of permanent and temporary contracts.[5]

For example, this was the basic strategy adopted in the last labour market reform in Spain in early 2012, and the recent ones in Greece and Portugal following the intervention of these last two countries by the Troika.[6] In Greece, recent legislation has abolished PC for new employees in all public enterprises and entities though it still needs to rebalance employment protection for different occupations, in particular reduce high severance costs for white-collar workers, in order to bring them in line with those for blue-collar workers.

As for Portugal, the severance payments for PC have been aligned to those of TC (20 d.w.y.s., with a cap of 12 months in total), while a mutual fund to partly finance severance payments has been created. Redundancy pay for the

new open-ended contracts has been reduced from 30 to 10 d.w.y.s. plus 10 additional days to be paid by the mutual fund. The preexisting minimum redundancy allowance of three months is eliminated. Total severance pay for fixed-term positions has been reduced from 36 to 10 d.w.y.s for contracts shorter than 6 months and from 24 to 10 d.w.y.s. for longer contracts, again with an additional 10 days from the mutual fund. Finally, in consultation with social partners, the definition of fair individual dismissals for economic reasons has been eased, and the reform of severance payments has been extended to all current contracts, without reduction of accrued-to-date rights.[7]

With regard to Italy, Article 18, which required employers with at least 15 employees to reinstate permanent employees whose employment had been unlawfully terminated, has been changed in the recent Jobs Act reform. Now reinstatement only applies to employees who are dismissed for discriminatory reasons. In contrast, those subject to other unlawful terminations (e.g., due to economic reasons), will only be entitled to mandatory redundancy pay (60 d.w.y.s., with a min. of 4 months' salary and a max. of 24 months), not reinstatement. In addition, project-based employment contracts (co-co-co's), which were often misused by employers, are now prohibited. Finally and foremost, a new type of open-ended employment contract has been introduced including gradual protections for new employees that increase with the employee's job tenure. This contract will be subject to further discussion below.

In Spain, besides other important changes regarding unemployment benefits and collective bargaining, reforms have tried to reduce the EPL gap. However, the gap continues being quite substantial: after the approval of the latest labour market reform in 2012, compensation for end of fixed-term contracts is currently 12 d.w.y.s. (8 d.w.y.s. before), while the mandatory cost of unfair dismissals for all new permanent contracts was set equal to 33 d.w.y.s. (45 d.w.y.s. before), while the cost of fair dismissals remained the same (20 d.w.y.s.). Existing permanent contracts keep the accrued-to-date rights up to the implementation of the 2012 reform, with a cap of 720 d.w.y.s., and the new one afterwards. Additionally, a new PC has been designed for firms with below 50 employees (entrepreneurship contracts) with a probationary period of one year during which firms can lay off workers without a cause and at zero cost. Beyond that period, workers are entitled to the same redundancy payments as workers on ordinary open-ended contracts. The flaw in the design of this contract is the fact that dismissal costs are effectively zero during the first twelve months. This means that the discrete jump in employment protection after twelve months is bigger than the EPL gap between PC and TC. Moreover, this probation period may come after several years of employment on fixed-term contracts, implying that many workers may still be trapped during extended periods on precarious contracts. Overall, this reduction in the gap has not been large enough and the incentive of employers to hire on a permanent contract is still very low (only 8.1% of all contracts signed in 2014 in Spain have been permanent).

2.7.2 *Single/Unified Contracts in Theory*

As mentioned earlier, the alternative to partial reforms could be to achieve a full convergence through the elimination of most fixed-term contracts and the introduction of a *single open-ended contract* (SOEC) with termination costs smoothly increasing with job tenure (up to a cap) and applied to all workers in line with the Portuguese reform. In principle, the level of termination costs could be chosen in a way that matches each country's social and political preferences for worker protection, thus not necessarily implying convergence towards low degrees of employment protection.[8]

One of the first proposals in this vein was made by a group of Spanish economists (see Andrés et al., 2009 and Dolado, 2012) where they asked for a drastic simplification of the available menu of labour contracts in Spain (more than 40 types) and the implementation of a SOEC with the characteristics listed above. The Spanish proposal is an example of an *extended single contract with reduced dismissal requirement* but with stringent rules for the use of fixed-term contracts. These are allowed for replacements and to contract workers from a temporary work agency. Agency contracts can be used to cover peaks in demand, but the contract between the worker and the TWA would be subject to the same restrictions as the ordinary employment relationships between a firm and its employees. These contracts can also serve to cover seasonal fluctuations in labour demand, but if the firm wishes to hire the same worker several years in a row, they should use what is called a discontinuous open-ended contract that allows for interruptions. Finally, the regulation should include the possibility of training contracts for labour market entrants.

Its basic goal was to prevent massive redundancies before the deadline when firms face the decision of converting TC into PC (between the second and the third year in Spain, depending on the contract type). To avoid legal uncertainty, they propose creating a SOEC with two scales of compensation – corresponding to fair and unfair dismissals (see Bentolila and Jansen, 2012). In particular, they suggest that compensation for TCs should be higher than at present and grow at a moderate rate until it reaches a value similar to the average severance pay in EU countries (around 21 d.w.y.s.). Furthermore, in order to maximize the social and economic benefits of the introduction of the SOEC, they argued that a high degree of legal certainty should be reached in dismissal procedures. Finally, this contract could be part or full-time and should be the basic hiring contract for all firms (some other contracts could also be needed: for example a well-designed training contract and an interim contract that could cover most of the companies' needs to train and/or replace workers). Firms could use Temporary Help Agencies, which should also hire their workers under this SOEC to accommodate their short-term hiring needs. Figure 2.13 presents an example for a SOEC which begins with severance payments as it is currently the case for a TC in Spain (12 days) after seven years, and ends up with the same rate

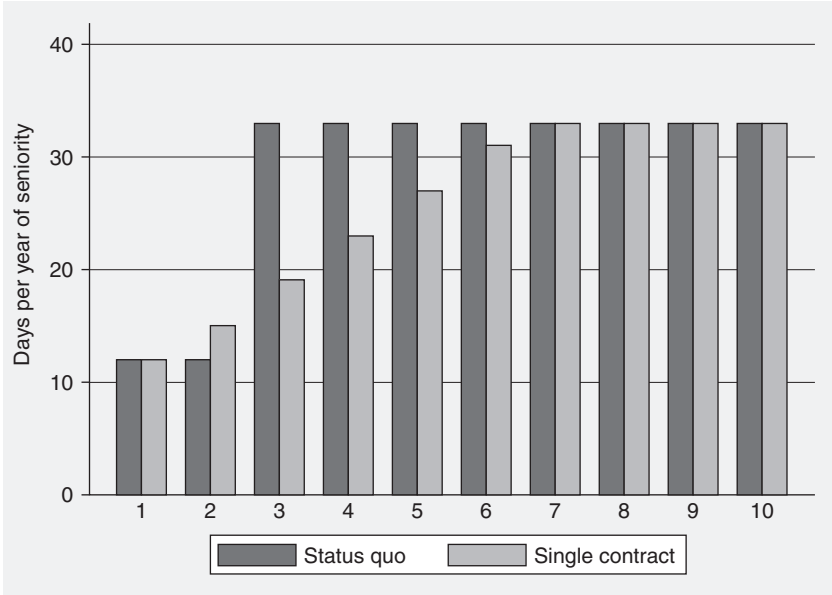


Figure 2.13 Severance pay in Spain (Bentolila et al., 2012a).

as it is currently the case for permanent contracts, under unfair dismissals (33 days).

García-Pérez and Osuna (2014) have recently quantified the steady-state effects of introducing a similar SOEC in Spain. In particular, they simulate the effects of the so-called '12–36 Single-Contract' (12–36 SOEC), where compensation starts as before from 12 d.w.y.s. and smoothly increases by 2 days for each additional year of tenure, until it reaches a cap of 36 d.w.y.s. (see Figure 2.12).[9] The main goal of this simulation is to compare the steady-state effects of introducing this SOEC with the EPL rules prevailing in Spain until 2012 (status quo), when a new EPL reform was implemented (see further below in this section). The main findings are that both unemployment (by 21.0%) and the job destruction rate (by 28.0%) decrease substantially with the introduction of the aforementioned SOEC. What is most interesting is that the tenure distribution could be smoother than under the status quo, as 22.5 per cent more workers could have job tenures exceeding three years, whereas there would be 38.5 per cent fewer one-year contracts. The insight for these results is that the job destruction rate of the TC rate was still rather high under the status quo because the EPL gap induced massive firings at the beginning of the fourth year in order to prevent the high future severance costs of PCs in the event of a contract conversion. Under the proposed SOEC, however, the probability of

being fired on contracts with tenure equal to or below three years is reduced substantially (from 26.7% to 6.1%) because, with the smoother tenure profile of redundancy pay, the pervasive incentives to destroy jobs at the termination of fixed-term contracts (beginning of fourth year) are largely diminished.

Regarding welfare consequences, see García-Pérez and Osuna (2014), a transition exercise is also presented that shows that the SOEC would be highly beneficial for the majority of workers, especially for the unemployed, because their prospective job stability increases quite substantially. According to their calculations, less than 5.5 per cent would experience reduced tenure as a result of this reform, while 24.6 per cent would not be affected, ending up with the same severance payments and tenure as if the system remained unchanged. For firms, this contract would not necessarily increase the average expected severance cost because job destruction is lower than under current legislation. In fact, the average compensation (weighted by the job destruction rate for any duration) decreases by 9.1 per cent. Another advantage from the firms' point of view would be the reduction in the degree of uncertainty due to the much simpler schedule of dismissal costs under a SOEC. However, for this to be true, it would also be necessary to redefine the legal reasons for firing so that uncertainty over the type of firing and over the official decision on its fairness is reduced.

There have been similar proposals for introducing SOEC in France (see Blanchard and Tirole, 2004, and Cahuc and Kramarz, 2005), Italy (see Boeri and Garibaldi, 2008 and Garibaldi and Taddei, 2013), Poland (see Arak et al., 2014) and Portugal (see Portugal, 2011). Although the details vary (see next section), most basic features are common. First, the distinction between a fixed-term and an open-ended contract in terms of workers' protection disappears and, secondly, the tenure profile of compensations under the SOEC increases gradually rather than abruptly.

However, it is interesting to distinguish three types of single-contract proposals.[10] A first type would consist of introducing a new open-ended contract for new hires with an '*entry*' phase (say 4 years), during which worker entitlements in the case of dismissal are reduced and identical in the case of both fair and unfair dismissal, and a '*stability*' phase, during which the worker would obtain the standard PC with no changes in his/her rights in case of termination.[11] As explained in OECD (2014), the main problem of this proposal resides in the difficulty of eliminating the discontinuity induced by passing from the '*entry*' to the '*stability*' phase, to the extent that worker rights in current open-ended contracts are different in the case of fair and unfair dismissal. Therefore, employers would generally face a strong disincentive to keep their employees beyond the '*entry*' phase.

A second type of single-contract, like the one advocated by Andrés et al. (2009) explicitly aims at avoiding discontinuities in severance payments and,

thus, proposes a smooth increase of the job tenure profile coupled with a redefinition of unfair dismissal, which should be restricted only to cases of discrimination and prohibited grounds. One shortcoming of this type of proposals is that, by tying workers' rights to the firm where they are working, it is likely to reduce efficient turnover and prevent mobility across jobs. In order to address this problem, the idea of a SOEC based on experience-increasing rights to severance pay has also been explored (Lepage-Saucier et al., 2013). In this case, for the whole duration of the employment relationship, employers would pay additional social security contributions into a fund tied to the worker, as the one in place in Austria since 2003, which could be carried across jobs when the worker changes employers. Then if the worker is dismissed, the fund would finance his/her severance pay. However, as explained in Blanchard and Tirole (2008), this system may create excessive firing (i.e., inducing a social cost), which could be prevented by financing unemployment benefits by layoff taxes (as in the US experience-rate system) deposited in a Mutual Fund. An alternative based on a mixed model where severance payments and a capitalization fund coexist has been proposed for Spain by Conde-Ruiz et al. (2011). The main objective here is to restrict the standard application of LIFO (*last in, first out*) rules in the firms' firing decisions by reducing the marginal cost of dismissal for all workers, thus making continuation easier in the firm, especially for younger workers.

An important caveat in the aforementioned proposals is that suppressing all fixed-term contracts would run the risk of introducing excessive rigidity in hiring decisions and could lead to less employment growth, especially during recovery upturns, given that not all temporary jobs would be substituted by permanent ones. Furthermore, it may also foster the use of other types of atypical contracts, as the ones mentioned above, that is an even less protected form of employment. In this case, an alternative could be what Cahuc (2012) calls a *unified contract* with the same termination costs applying to all contracts, except in cases of discrimination and prohibitive grounds, irrespectively of whether they are TC or PC but embedded in a unified contract. In other words, the new contract can be formalized as a fixed-term contract or a regular open-ended contract, and upon termination the firm needs to pay redundancy pay to the worker and a solidarity contribution to the state. This layoff tax would yield resources to mutualize the reallocation costs of displaced workers and induce firms to internalize the social cost of dismissals, without any need of reinstating workers, if set at a sufficiently high level (Cahuc and Zylberberg, 2008). Payment of the solidarity contribution frees the firm from the obligation to offer reintegration or outplacement services to dismissed workers. These costs are mutualized and the assistance to the unemployed is provided by the PES. The unified contract combines essential features of the existing fixed-term and open-ended positions in France. Firms that sign fixed-term contracts are committed to pay the wages

until the pre-fixed end of the contract. This means that an employer must pay the employee until the end of the contract in case of a premature termination (except in case of *force majeure*). Moreover, French employers are obliged to pay workers on fixed-term contracts a bonus equal to 10 per cent of the worker's gross salary at the moment of termination to compensate the employee for the instability of the relationship.

Relying on these ideas, recent research by Dolado et al. (2015b) develops an equilibrium search and matching model to investigate the effects of introducing a SOEC in a labour market subject to EPL discontinuities, such that its tenure profile is chosen according to some pre-specified welfare function. A distinctive feature of this model is that workers are risk averse and therefore demand insurance to smooth out consumption in the presence of productivity shocks. In addition, their model has a lifecycle structure where young and older workers coexist in the labour market. Both receive severance pay but differ as regards the use they can make of this compensation. While young workers are modelled as living from hand to mouth, and therefore consume dismissal compensation upon reception (say, because of binding credit constraints associated to lower job stability), older workers are allowed to buy annuities in order to smooth out their consumption until retirement. The latter feature captures the fact that older workers often have a hard time re-entering the labour market close to retirement. In this way, job security provided by EPL can play an important role in bridging the gap until full retirement.

Optimality is defined in terms of the welfare (defined in terms of consumption-equivalent units) of a newborn in a steady state but the average welfare across the current population at the time of the EPL reform is also considered when taking into account the transition from a dual EPL system to the chosen SOEC. In particular, during the transition workers with existing matches have redundancy pay according to the accrued-to date rights until the date when the reform is approved, while later on the new redundancy profile applies. For illustrative purposes, the model is calibrated to the Spanish labour market before the GR, at a time when the unemployment rate in this country was similar to the EU average rate, namely about 8.5 per cent, which seems to be a reasonable estimate for a steady-state equilibrium. An alternative insurance mechanism to SOEC is provided by an unemployment insurance (UI) system that is financed through social security contributions. Using conventional values for the coefficient of risk aversion, UI replacement rates, quit rates (not entitled to EPL) and share of red-tape costs, they find that an initial '*entry*' phase of one year (with no redundancy pay in case of termination) and a slope of 14 d.w.y.s. maximize the chosen welfare criterion. Figure 2.14 shows the status quo (cumulated) tenure profile in 2008 (8 d.w.y.s. for the first two years and 45 d.w.y.s. later on, with a cap of 42 months),[12] at the onset of the GR, and the optimal SOEC.

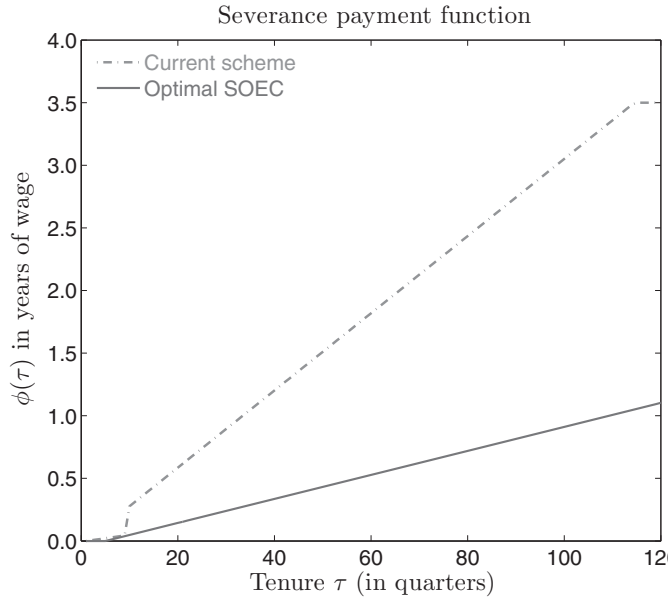


Figure 2.14 Severance pay in Spain (2008) and optimal SOEC (Dolado et al., 2015b).

This profile is rather robust to the above-mentioned parameter values, except when risk aversion increases and the slope becomes 11 d.w.y.s. or when quits or the share of red-tape costs increase, in if which case the slope goes down up to 4 or 5 d.w.y.s. Compared to the status quo in a steady state, this SOEC implies an increase in welfare of 2.8 per cent, an increase in output of 1.1 per cent and, foremost, a reduction in the job destruction rate of about 1 percentage point (pp.) and a rise in the job creation rate of around 3 pp. It is worth noticing that during the transition, job destruction increases initially due to the lower slope of the SOEC but then converges to a lower steady-state value after two years (see Figure 2.15).[13] By contrast, the job finding rates immediately jumps to a much higher steady-state value (see Figure 2.16).[14] Overall, youth unemployment and the nonemployment of older workers go down by about 10 and 15 per cent, respectively. Furthermore, using the welfare function for the whole population at the time of the reform, Table 2.2 shows the fraction of each group of workers (defined by age and labour market status) who would benefit from the implementation of this SOEC and who therefore would be in favour, against or indifferent to this EPL reform.

Finally, a comparison is made between the welfare gains of implementing SOEC and the reduction of the gap in severance pay that took place in the 2012

Figure 2.15 Job destruction rate during transition (Dolado et al., 2015b).

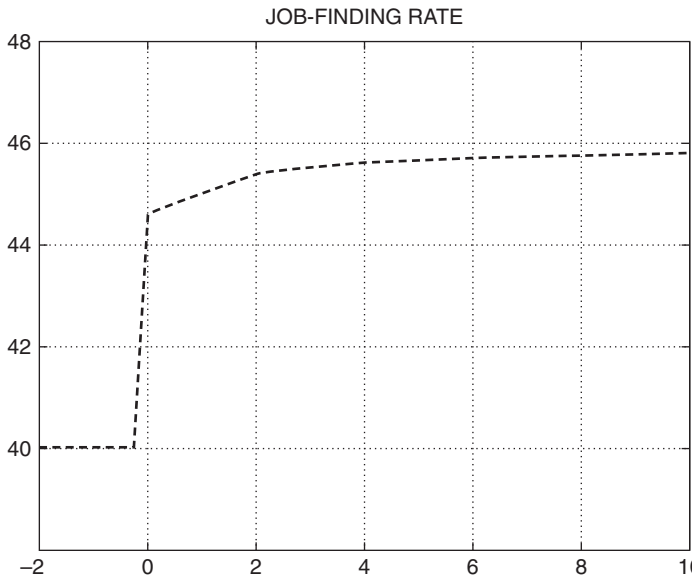


Figure 2.16 Job finding rate during transition (Dolado et al., 2015b).

Table 2.2 *Political support for transition to SOEC (Dolado et al., 2015b)*

		Pro	Con	Indiff
Young workers	Employed	100[a]	0	0
	Not employed	100	0	0
Older workers	Employed	31.7	68.3	0
	Not employed	0	0	100
Overall		79.7	10.2	10.1

[a] All numerical entries refer to population measures in per cent.

EPL reform, when EPL for unfair dismissals of workers on PC went down from 45 d.w.y.s. to 33 d.w.y.s, whereas compensation for nonrenewal of TC went up gradually from 8 d.w.y.s. to 12 d.w.y.s. The main finding is that while SOEC will bring in a welfare gain (in terms of consumption equivalent units for the current population at the time of the reform) of 1.93 per cent, the 2012 reform would imply half of that gain.

2.7.3 Single/Unified Contracts in Practice

Nonetheless, a key requirement of all these proposals is the restriction of the definition of unfair dismissal to false reasons, discrimination and prohibited grounds. In other words, any economic motive or personal reason related to the worker's performance (such as reduction of individual productivity or unsuitability) would be a fair and justified reason for dismissal, with the judicial review of courts restricted to just assessing that the purported reason is not in fact masking prohibited grounds. However, implementing this requirement might be very difficult in countries whith a long tradition of judicial review of employers' decisions (see Ichino et al., 2003 and Jimeno et al., 2015).[15] For this reason, since the aim of SOEC is to ensure that open-ended contracts become the default option of firms, they should include a probation period to screen applicants, as Dolado et al. (2015b) suggest. The objective is not to eliminate short-duration jobs, but rather to avoid the rotation of temporary workers on the same job as a means to save costs. Nonetheless, it is clear that the termination of an open-ended contract is more costly and/or time-consuming for the firm than the expiration of a fixed-term contract. This is true even if redundancy pay were equalized across TC and PC. Workers on PC must receive an advance notification explaining the motive for the dismissal and they have a right to challenge this decision in court. Moreover, the dismissal of several workers within a short time may entitle the worker to higher compensation or additional services as part of a collective dismissal procedure. None of these obligations exists in

case of fixed-term positions when the relationship is terminated at the scheduled date or in accordance with the predetermined conditions for termination. Hence proposals that advocate the abolishment of most TC and their replacement by a SOEC with increasing severance pay at ever slower rates would face the problem that almost any worker could appeal to labour courts, so that the labour market would end up being run by judges making it more rigid rather than more flexible.

One solution to this problem may be provided by the introduction of a new open-ended contract with slowly increasing redundancy pay in the recent Jobs Act reform in Italy (see Ichino, 2014). The Jobs Act comes on top of two earlier reforms that restricted the application of the right to reinstatement (Article 18) and that exempted firms from the obligation to state a cause for the temporary nature of the employment relationship. The main advantage of the newly created contract is the fact that it eliminates the discrete jump in dismissal payments for unfair dismissals. After the Monti-Fornero reform in 2012, firms had to make redundancy payment between 12 and 24 for months for an unfair dismissal for economic motives. The Jobs Act replaces this severance pay with a smooth schedule and introduces a fast-track settlement. While a legal decision entitles the worker to redundancy pay of 60 d.w.y.s. (min. 4 months and max. 24 months) subject to income taxation, the *fast-track* settlement guarantees redundancy payment of 30 d.w.y.s. (min. 2 months and max. 18 months) exempted of income taxation. Figure 2.17 illustrates the job tenure profiles of the two modalities of single contract in terms of monthly wages. Furthermore, offering this single contract for new hiring entails a reduction of employers' social security contribution for three years (with a cap of € 8,060). Besides new hiring, the new contract can be offered to workers after conversion from a TC. In parallel, fixed-term contracts entail no redundancy pay to workers upon termination of the contract. One could argue that this is equivalent to a unified contract as firms are not obliged to pay an indemnity in case of a fair dismissal either, but the fast-track settlement may lead to a situation in which firms prefer to pay an indemnity after any dismissal to avoid the cost and uncertainty associated with lengthy legal procedures. If so, then the economic costs of terminations are clearly not equalized across all contingencies.

A similar contract to the Italian '*fast track*' has been used in Spain since 1980 under the slightly different labelling of '*express dismissal*'. In order to avoid lengthy legal processes in labour courts and the associated payment of interim wages, firms in Spain can deposit the mandatory amount of compensation for unfair dismissal (33 d.w.y.s. nowadays and 45 d.w.y.s. before the 2012 reform) in the labour court within two days of the redundancy and, in case of withdrawing this deposit, the worker is not be entitled to appeal to a labour court. A noticeable difference with the fast-track contract is that the two tenure profiles in Figure 2.16 would be reduced to a single profile in Spain, namely, one that

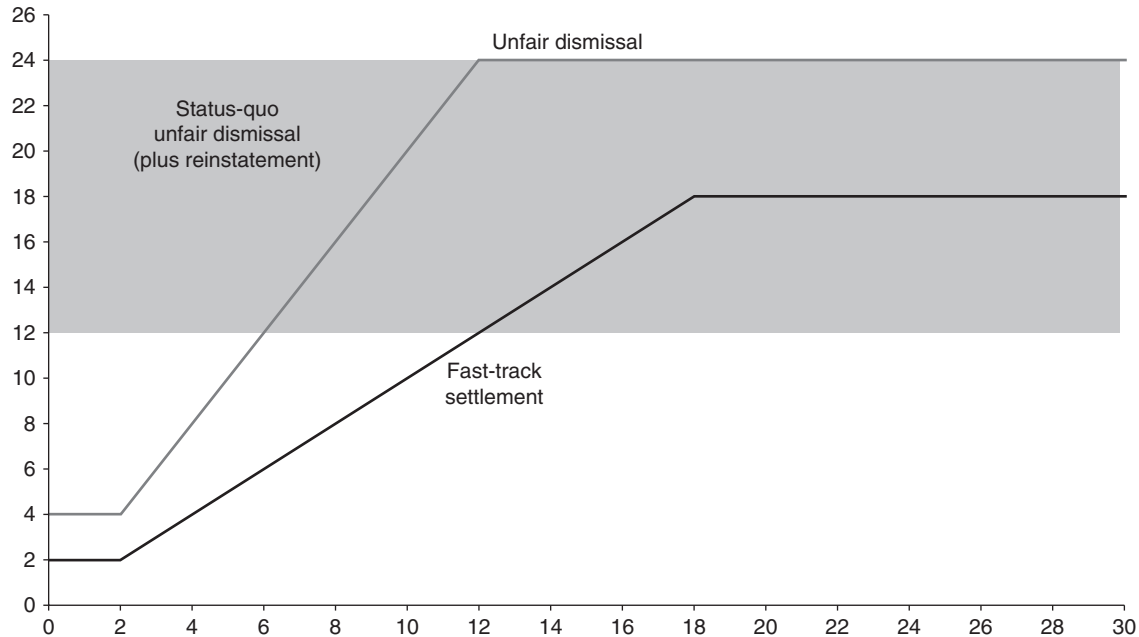


Figure 2.17 Jobs Act Single Contract in Italy (Ichino, 2014).

involves the highest redundancy pay. Although Spanish employers could avoid paying expected red-tape costs in case of appeal, the '*express dismissal*' led them to layoffs for unfair reasons even in the deepest troughs of the business cycle; for example above two-thirds of individual dismissals in Spain during the GR were filed under this category, although it was a period where redundancies for economic reasons should have been the norm rather than the exception.

The Italian '*fast-track*' contract avoids this shortcoming by both cutting the firm's conventional costs of unfair dismissals and benefiting workers, since the after-tax '*fast-track*' compensation is likely to be more attractive than the gross mandatory one, at least for workers with long tenures.[16] Yet, in light of the results in Dolado et al. (2015b), albeit in a model calibrated for Spain, the mandatory severance pay in both options of the unified contract seems excessive: 30 d.w.y.s. in the '*fast track*' is about the same as the unfair dismissal rate in Spain after 2012 (33 d.w.y.s.). Yet, it reaches a cap of 12 months after 18 years while in Spain the cap of 24 months is reached after 22 years. By the same token, a rate of 60 d.w.y.s. for the conventional unfair-dismissal option is about twice the corresponding rate in Spain, but again the cap of 24 months is reached much earlier (in 12 months) than in Spain. At any rate, recent evidence on the Italian unified contract is positive: the share of PC in all contracts signed each month has doubled since its implementation, going up from 17 per cent to 35 per cent. In contrast, the corresponding share in Spain still remains below 10 per cent.

In addition, as in Spain, the new contract in Italy is heavily subsidized in the first three years. Though it is still too early to evaluate its success, a key question is whether its promising start in early 2015 will continue once the subsidies are phased out. The conclusive evidence in Spain about considerable substitution (employees with nonsubsidized contracts replaced by others with subsidized contracts) and deadweight (employers would have hired workers irrespectively of the subsidies) is likely to apply to Italy as well, given the step tenure profile of redundancy pay chosen for the new contract. Moreover, the Jobs Act does not involve any employer's contribution to a capitalization fund, as in Austria, to inhibit the low labour mobility in this country. In this respect, a potentially good idea for countries with high youth unemployment and NEET could be that a fraction of redundancy pay should go to financing training courses. This amount should be transferred to a notional account in the name of the dismissed worker and its availability to the worker should be conditional on having found a job. In this way, there would be an incentive for job search so as to maximize the remaining balance in the notional account that the worker could receive in cash (see Garcia-Perea and Molinas, 2015).

A final issue to consider is the role that higher wage flexibility may bring about in reducing the employment turnover effects of dual EPL. Reforms following the crisis in southern European countries have made wages much more

flexible than before. Even if the scars of the GR have made individuals more risk averse than in the past, it may be conjectured that EPL in general and dual EPL in particular may have smaller real effects than in the past.

2.8 Conclusions

This chapter has tried to show how both theoretical models and good empirics can help identify the features of labour market models with contractual diversity that push them to become dual labour markets, and the pros and cons of dualism. Our emphasis has been on how a combination of historical facts, politico-economic models and search and matching models can deliver testable predictions and also policy recommendations which help describe the past in a coherent way and improve the future. Where do we see the research on Dual Labour Markets moving over the near future? A first direction is to have better datasets combining information reflecting incentives for temporary and permanent workers. For instance, there are no longitudinal datasets on the relative productivity of workers under PC and TC, nor on the probability of the latter being upgraded. This is important because, according to that view, TC is a screening device and tournament considerations should be quite relevant. For example, temporary workers could end up exerting more effort than permanent workers, and employers may react by offering them more training, like in the *stepping stone* hypothesis. Having this data available would help understand how multiple equilibria can arise and identify the best possible way of transiting from a bad equilibrium (dead end) to a good one (springboards).

A second avenue of research is to investigate further the dynamics of social partners. How do the characteristics of pivotal workers in trade unions and employer associations' election change with the business cycle or with reforms entailing more or less duality? In this way, we would be able to characterize the dynamics of political support to different types of reforms, we would know when are they triggered and who the winners and losers are.

A third avenue of research is to dig deeper into the role of labour market dualism into technology adoption. It is often argued that temporary contracts arise because of the sectoral composition of some economies (e.g., those where the weather is better and tourism or construction is a leading sector) but, as argued above, maybe causality is also relevant the other way around: EPL regulations provide incentives to invest in specific sectors which are profitable in the short run but may be more vulnerable in the medium and longer runs.

Finally, we need more theoretical work to evaluate the different proposals in relation to single/unified contracts in setups where workers can have insurance against job losses through a variety of mechanisms: savings, unemployment insurance, EPL, etc.

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Appendix

Summary of Proposals

Single Contract

Spain

The original Spanish proposal Andrés et al. (2009), known under the name of Contrato Unico or Contrato de Igualdad de Oportunidades, contemplated the introduction of a single contract with a unique severance pay schedule for economic dismissals that increases gradually with tenure, starting at a level comparable to the one that firms in Spain need to pay upon termination of a fixed-term position and ending at a level somewhere in between the costs associated with fair (20 days of salary p.y.o.s) and unfair dismissals (45 days of salary) for the existing open-ended contracts.[17] This first proposal suppressed the distinction between fair and unfair dismissals for economic dismissals. As this suppression could be interpreted as a violation of the right to legal protection against unfair dismissals, a later version proposed separate schedules for fair and unfair dismissals (Bentolila and Jansen, 2012). Under the legal fast track that existed at the time (despido expres Law 45/2002), employers could opt to pay the indemnity associated with unfair dismissals to bypass legal control on the economic causes of the dismissal. In practical terms, the two proposals therefore had the same implications.

Italy

Boeri and Garibaldi (2008) launched an alternative proposal for a single contract with an extended trial period known under the name of Contratto Unico a Tiempo Indeterminato. Their proposal is an example of a single contract with an extended trial period. An employment relationship would start with an entry stage of up to three years in which workers would only be entitled to a redundancy payment in case of an unfair dismissal, equal to 5 days of salary

per month of work (60 days of wages p.y.o.s) and a maximum of six months of salary (180 days). After this entry phase, the contract enters the stability phase in which the worker is entitled to the full employment protection of the existing open-ended contracts. At the time, this included the right to reinstatement after an unfair dismissal for economic motives if the worker was employed in a firm with more than 15 employees (Art. 18). This discontinuity would have induced a strong discontinuity in the level of protection that would probably have caused considerable churning around the three year threshold as it is comparable to the costs associated in Italy with the conversion of fixed-term into open-ended contract. However, it should be stressed that the right to reinstatement has been severely limited in Italy since the adoption of the Monti-Fornero reform in 2012.

The proposal of Boeri and Garibaldi (2008) does not foresee the elimination of fixed-term contracts or freelance contracts, but rather than specifying specific tasks or contingencies for the use of nonregular contracts, their use is restricted on the basis of salary thresholds. Fixed-term contracts would be allowed in jobs with an annual gross salary above € 20,000 and freelance contracts for workers who earn more than € 30,000 per year. In other words, Boeri and Garibaldi propose the introduction of a single contract for low-paid workers as these are the workers that are most exposed to the risk of lengthy periods of employment in precarious contracts. By contrast, for skilled workers the proposal preserves the choice between fixed-term and open-ended positions.

It is clear from the above discussion that the Italian proposal is more conservative than the Spanish one. In part this can be explained by the much higher incidence of fixed-term contracts in Spain since their use was liberalized in 1984. Moreover, workers in Spain are not entitled to reinstatement after an unfair dismissal for economic motives and the fast track mentioned above offered a secure (but expensive) procedure for dismissals.

Unified Contract

France

Economists in France have formulated several proposals for the introduction of a unified contract. The most recent and detailed proposal is the recent proposal for a unified contract by Cahuc (2012). It is based on a 2005 proposal of Francis Kramarz and Pierre Cahuc. Cahuc proposes the introduction of a new contract in which the legal cost of termination depends exclusively on seniority. The new contract can be formalized as a fixed-term contract or a regular open-ended contract, and upon termination the firm needs to pay a redundancy compensation to the worker and a solidarity contribution to the state. Payment of the solidarity contribution frees the firm from the obligation to offer reintegration or outplacement services to dismissed workers. These costs are

mutualized under Cahuc's proposal and the assistance to the unemployed is provided by the Public Employment Services.

The unified contract combines essential features of the existing fixed-term and open-ended positions in France. Firms that sign fixed-term contracts are committed to pay the wages until the pre-fixed end of the contract. This means that an employer must pay the employee until the end of the contract in case of a premature termination (except in case of *force majeure*). Moreover, French employers are obliged to pay workers on fixed-term contracts a bonus equal to 10 per cent of the worker's gross salary at the moment of termination to compensate the employee for the instability of the relationship.

By contrast, workers on open-ended contracts are entitled to redundancy pay for tenures above 18 months. The unified contract combines both monetary compensations in a single redundancy pay schedule for economic dismissals. During the first 18 months of any contract the worker is entitled to a redundancy payment of 10 per cent of the gross wages and from then onwards the redundancy payment grows at the same rate as in the existing open-ended contracts (20% of a monthly salary for each year of service until 10 years of tenure and a third of a month salary per year of service for job tenures above 10 years). Moreover, after any separation the firm has to pay a solidarity contribution which equals 1.6 per cent of the total wage sum.

The proposal creates a single redundancy pay schedule without any breaks as the difference between fair and unfair dismissals for economic motives is suppressed. In Cahuc's proposal, the redundancy payment is the only legal protection against dismissals for economic reasons. Together with the solidarity contribution, they force firms to internalize the social costs of a dismissal, and the legal intervention of judges should therefore be restricted to avoid violations of fundamental rights. Similarly, there is no distinction between the level of protection between individual and collective dismissals. The costs of outplacement services are mutualized through the solidarity contribution, and the assistance to displaced workers is provided by the public employment services.

Italy

In the case of Italy, the best-known example of unified contract proposal is the one formulated by labour law expert Pietro Ichino. His proposal is part of a wider legal initiative to simplify the Italian labour code (see Ichino (2014)). Ichino's proposal foresees the introduction of a new open-ended contract with gradually increasing employment protection that firms can use in future hiring. The contract starts with a probation period of six months. After that time, the right to reinstatement (Art. 18) applies to dismissals due to discrimination, disciplinary motives (when proved unfounded) and dismissals due to other illicit motives. Only economic dismissals entitle the worker to an economic compensation.

The economic motives for dismissals are unified. During the first two years of an employment relationship, being either of a temporary or permanent nature, the worker is entitled to a redundancy payment of one month of salary per year of service. In addition, in case of a dismissal due to economic reasons beyond the third year the worker is entitled to an additional contribution on top of the redundancy payment and the statutory unemployment benefits introduced after the Monti-Fornero reform. This additional component is supposed to bring the replacement rates of the worker during the first months of unemployment to levels comparable to the level prevailing in a country like Denmark, but this point is not essential.

The true value of Ichino's proposal is his defence of redundancy pay as a valid legal instrument against unfair dismissal. The costs associated with dismissals prevent that firms dismiss a worker without some ground and the intervention of the judges should be limited to preventing that these grounds are illicit, that is, judges should not be asked to perform an in-depth review of the economic motives for a dismissal. Thus his views are close to the view of economists who interpret firing costs as a Pigouvian tax that helps to align the private and social costs from separation.

Ichino's proposal does not include outright restrictions on the use of fixed-term contracts. After the introduction of severance pay obligations for fixed-term contracts, the new open-ended contract should offer sufficient advantages to employers and workers to become the voluntary default option in the vast majority of hirings. In that sense, the proposal is less ambitious than the one formulated by Boeri and Garibaldi. By contrast, Ichino is in favour of much stronger limitations on the interventions of judges.

Notes

1. EPL is multidimensional and includes regulations pertaining to severance pay and advance notice of layoffs, restrictions on valid reasons for individual and collective dismissals, rules governing the use of fixed-term contracts, and restrictions concerning temporary work agencies. EPL may affect labour cost directly (via mandated severance pay) or indirectly via red tape costs.
2. See Autor and Houseman (2010) for a more negative view on the role of temporary help-jobs relative to jobs placements through direct-hire employers in the US.
3. Almost 92 per cent of all new hires in Spain over the last two years have relied on temporary contracts. The same happens in Italy (83.4% in 2013 according to Garibaldi and Taddei, 2013).
4. According to the Spanish Labour Force Survey, two-thirds of workers dismissed during that period in Spain had a TC.
5. The evidence offered in García-Pérez and Rebollo (2009) shows that five years of seniority and more than seven contracts were required on average until the year 2008

to earn a PC. Furthermore, almost 40 per cent of the workers who have a TC at the age of 20 still have one at the age of 40.

6. The Netherlands is another EU country where there is widespread use of atypical contracts and which is moving towards a unified contact. The last initiative in this respect is the Wet Werk en Zekerheid (Law on Employment and Security) that became effective on July 2015. This country has traditionally counted on two separate dismissal procedures: (i) administrative approval with no right to redundancy pay, and (ii) dismissals approved in court with a right to redundancy pay according to a pre-established formula ('*kantonrechtersformule*'). The most recent reform creates a single route for all economically motivated dismissals and entitles all workers, irrespective of the fixed-term or open-ended nature of their contracts, to redundancy payment (*transitievergoeding*/transition compensation).
7. The definition of economic dismissals in Portugal has been broadened to include 'unsuitability of the worker'. The latter implies that fair dismissals are not limited to situations of the firm's economic difficulty. Workers may be laid off if they are no longer suited to perform their task. The latter comes very close to the definition of fair dismissals in the UK.
8. In the Annex, we provide further details on the different proposals.
9. There exists a maximum compensation of two years of wages.
10. The following classification is due to Chapter 4 in OECD (2014), where all single contract proposals have been precisely surveyed.
11. This is the proposal Boeri and Garibaldi (2008) made for Italy.
12. For example, the red line in Figure 2.14 indicates that a worker suffering an unfair dismissal after 10 years (40 quarters) of job tenure in a firm, would get a severance package of 1.23 his/her yearly wages ($= 45 \times 20/365$), etc.
13. In the horizontal axis of Figure 2.15 there is time in years prior to the SOEC reform ($t < 0$), at the time of the reform ($t = 0$) and after the reform ($t > 0$). The vertical axis displays job destruction rates in percentage.
14. The meaning of the horizontal axis in Figure 2.16 is as in Figure 2.15. The vertical axis displays job finding rates in percentage.
15. For example, some of the provisions in this respect in the 2012 labour reform in Spain have been restated by some recent court decisions.
16. Assuming an average income tax of 30 per cent, the '*fast track*' compensation would be preferable to the '*unfair*' dismissal compensation when a worker exceeds 16.8 years of employment($= 24$ years $\times 0.7$). Before that it is doubtful unless other administrative costs associated with the appeal, and borne by the worker in case of losing are large.
17. Most of this Appendix has been drafted by Marcel Jansen to whom I am very grateful.

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