J. IGNACIO GARCÍA PÉREZ
Universidad Pablo de Olavide and FEDEA, Spain

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World of Labor
Evidence-based policy making

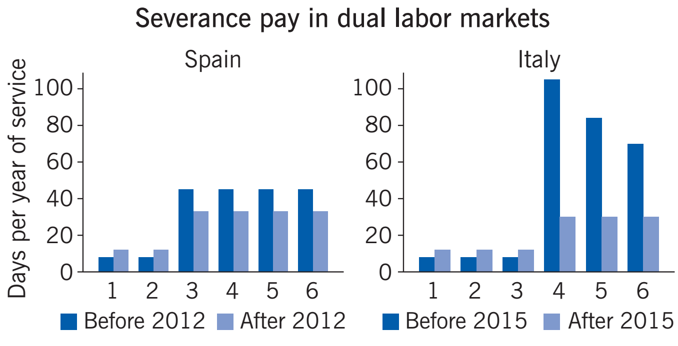
Should severance pay be consistent for all workers?

Single, open-ended contracts with severance pay smoothly rising with seniority can decrease both unemployment and job losses

Keywords: single contract, permanent and temporary contracts, severance pay, dual labor markets

ELEVATOR PITCH

The trend towards labor market flexibility in Europe has typically involved introducing legislation that makes it easier for firms to issue temporary contracts with low firing costs, while not changing the level of protection that is in place for permanent jobs. This has created a strong "dualism" in some European labor markets, which might affect turnover, wage setting, and human capital accumulation. In view of this, some economists propose replacing the existing system of temporary and permanent contracts by a single open-ended contract for new hires, with severance pay smoothly increasing with tenure on the job.



Note: The level of severance payments in this figure takes into account the rules in place in Spain before and after the 2012 reform. With respect to Italy, the Fornero reform is considered the status quo situation before the recent approval of the Job Act reform (2015).

Source: Author's own calculations based on OECD data. Online at: https://data.oecd.org/

KEY FINDINGS

Pros

- Eliminating temporary contracts will improve productivity as a result of the positive effect permanent contracts would have on workers' morale and involvement in the firm.
- Employer-provided training would increase under more permanent employment relationships.
- A single contract would help to reduce the excess turnover suffered by young workers with low seniority rights, which would also reduce income inequality.

Cons

- Introducing a single contract would still lead to inequality in seniority rights and may not eliminate "dualism" in the labor market.
- Removing temporary contracts would lead to adverse employment effects if employment protection associated with permanent contracts remains unaffected, especially during recessions.
- Eliminating temporary contracts may foster the use of other types of atypical contracts.
- The implementation of a single contract might be in conflict with some legal conventions that require a valid reason to terminate an employment relationship.

AUTHOR'S MAIN MESSAGE

A key driving force behind firms' hiring and firing decisions is the large gap in severance pay between temporary and permanent contracts, which leads to the tendency to favor adjusting the number of employees instead of adjusting prices or wages. If, however, temporary contracts were eliminated and replaced by single, open-ended contracts with severance pay increasing proportionately according to seniority, or length of service in the firm, both unemployment and job destruction (particularly during the first three years of employment) might decrease.

MOTIVATION

Over the last three decades, the fight against unemployment in Europe has amongst other things focused on introducing more flexibility in the labor market. Typically, reforms have been designed to make it easier for firms to use temporary or fixed-term contracts with low firing costs, without significantly changing the protection of open-ended or permanent contracts.

However, there are also other forms of “non-regular” employment contracts, such as “freelance” contracts (used in Italy) or “contracts for services” that are regulated by commercial law in some countries (such as Poland), where the employment protection for regular, open-ended contracts is too restrictive. The main goal of all these atypical contracts is to improve the labor market outcomes of disadvantaged or marginalized workers in countries where employment protection is very stringent.

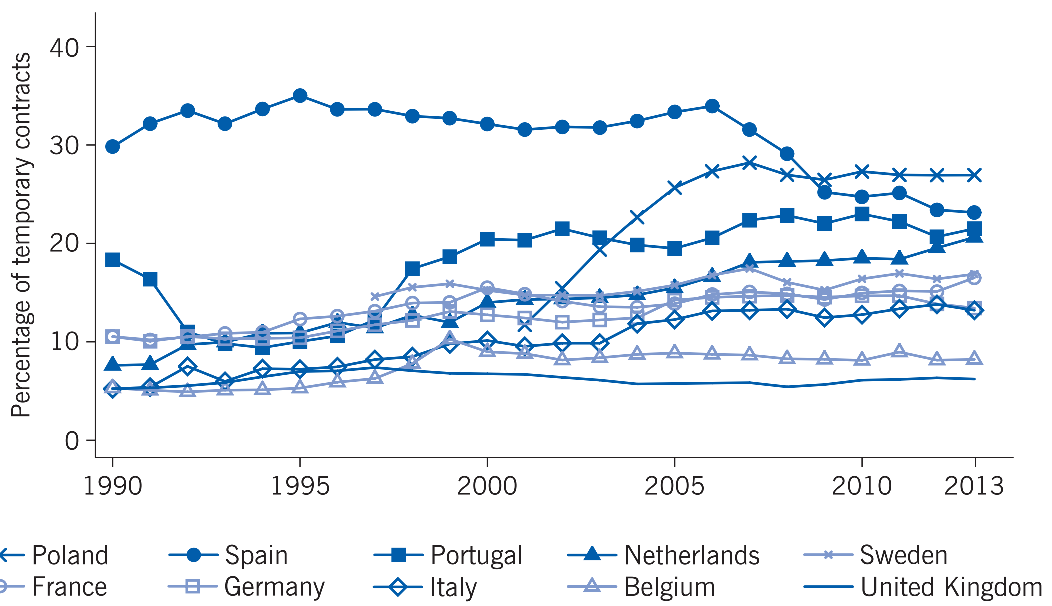
But do temporary contracts really help? In theory, these contracts, by decreasing firing costs, can help some workers accumulate human capital and/or job experience as a result of them frequently changing jobs. However, there is also the risk that the consequence of workers moving from one fixed-term contract to another is lower overall employment stability and no transition for those individuals into a better job in the future [1].

DISCUSSION OF PROS AND CONS

Main features of dual labor markets

Spain provides one illustration of the effects that temporary contracts might have in the long term. For decades, more than 30% of Spanish employees have worked under temporary contracts—although the rate is currently around 25% as a result of massive layoffs made during the great recession, which primarily affected temporary workers (Figure 1). Poland, Portugal, the Netherlands, Sweden, and France are also well above the EU average of 12.8%

Figure 1. Temporary work in some European countries, 1990–2013



Source: Data from Eurostat. Online at: http://ec.europa.eu/eurostat

(2013). It would be fair to assume that without substantial changes, temporary contracts will continue to be the predominant entry route into employment in Spain and, when the economy recovers, that temporary employment will rise once again. This indeed appears to be the case, as almost 92% of all new hires in Spain during 2014 were based on temporary contracts. The same is also true for Italy, where the corresponding figure was 83.4% in 2013.

As shown in the illustration on p. 1, Spain and Italy are typical examples of dual labor markets, in which temporary and permanent contracts substantially differ. One of the most notable differences between the two types of contract is the level of employment protection each one entails. Indeed, during the first two years "on the job" in Spain, and the first three years in Italy, severance payments are based on eight days per year of service. The 2012 reform in Spain and the 2015 Job Act in Italy amended this to 12 days. Once the duration of the job goes beyond the maximum allowed by the law (which is two years in Spain and three years in Italy), severance payments in both countries jump to more than 30 days per year of service. One study shows that this large gap in severance costs between these two types of workers makes employers reluctant to transform temporary contracts into permanent ones—and it is this which effectively forms the basis of the "dual" character of these two labor markets [1].

The study also shows that the large discontinuity created by conventional Employment Protection Legislation (EPL) schemes in dual labor markets has negative consequences for unemployment, human capital, and innovation, as the discontinuity leads to excessive turnover in the labor market. Empirical evidence of the impact of temporary work on labor market outcomes shows that, in general, temporary contracts do not improve access to permanent contracts and, furthermore, that such contracts create excessive wage pressure, low training investments by firms, and the adoption of mature rather than innovative technologies [2], [3], [4], [5].

Thus it is quite well established that dualism in the labor market—i.e. the coexistence of workers with quite different seniority rights—has significant negative consequences on wages, human capital accumulation, and even for the political economy of labor market reforms. There is also evidence to show that permanent workers are more productive than temporary workers.

A recent paper that analyzes Spanish social security data finds that groups of native male high-school dropouts, who entered the labor market just after the total liberalization of temporary contracts in Spain that took place in 1984, experienced worse labor market outcomes than similar groups who just preceded them [6]. Specifically, they experienced almost 200 days less in duration of employment (a 7% drop) and their wages were reduced by approximately 22% in the long term. It is for this reason that there are increasing concerns about the role that temporary contracts are playing in this and other European countries. For example, Germany, the Netherlands, and Poland are using these contracts intensively as a way of both reacting to changes in demand and introducing more flexibility into labor relations.

In contrast to this, some other European countries have developed an alternative institutional system that is usually referred to as the "flexicurity model." The essential feature of this model is a combination of two "pillars": first, less rigid EPL affecting all workers equally; and, second, more generous unemployment benefits coupled with well-developed, active labor market policies.

The negative side of temporary contracts is especially evident once an economy enters a recessionary period. Spain lost approximately 18% of its total employment between 2007 and 2013. Although the strong negative shocks experienced around the world as a result of the economic crisis were a very significant factor, it is also the case that poor sectoral specialization played an important part in Spain's employment crash. In addition, it is now quite accepted that the inadequate design of Spanish labor market institutions was one of the main factors behind the extremely volatile employment outcome [7].

In summary, taken together with a rigid collective bargaining system, which sets wages at the sector and regional levels rather than aligning wages with the specific conditions within individual firms, the badly designed contract provision in Spain resulted in its economy being heavily reliant on quantity adjustment rather than price or wage adjustment during the crisis. There is also widespread agreement that the slow response of negotiated wages to the worsening economic climate contributed to the severity of the crisis in Spain.

A similar situation to that which occurred in Spain also took place in Portugal and in Greece. In contrast, however, countries such as Germany and France, which also faced similar or even greater declines in economic activity, experienced considerably smaller reductions in employment than the peripheral countries. The essential difference between the two sets of countries was the prevailing institutional policy for the hiring and laying off of temporary and permanent workers. Indeed, prior to 2010, the difference in Spain derived from the huge gap between the severance pay for workers with permanent contracts versus temporary contracts. For permanent contracts, the number of days of wages per year of service (days "pyos") paid in cases of unfair dismissal was 45; in the case of fair dismissal it was 20 days. In contrast, the equivalent number of days "pyos" for temporary contracts was eight and, in some cases even zero (e.g. for interim contracts). Evidence shows that almost half of the job destruction during the period 2008–2010 was a result of this gap, which eventually led to the elimination of millions of temporary positions during the slump [7].

How to dismantle dual employment protection legislation

Due to the pervasive effects documented in the literature, and the economic inefficiency of temporary and unemployed workers being unable to achieve greater job stability and better future employment prospects, it would seem appropriate that policy should be directed towards closing the gap between the severance pay of permanent and temporary contracts. This has been the basic strategy adopted in the last three Spanish labor market reforms (2010, 2011, and 2012). Apart from other important changes regarding unemployment benefits and collective bargaining, these reforms have attempted to shrink the gap in termination costs between the two types of contract. However, the gap is still quite large: severance pay for temporary contracts is currently 12 days "pyos," and the cost of unfair dismissal for all permanent contracts is set at 33 days "pyos," following the labor market reform of 2012. As expected, this reduction has not been sufficient and the incentive for employers to hire under a permanent contract is still very low. For example, only 8.1% of all contracts signed in 2014 in Spain were permanent.

An alternative to these partial reforms would be to achieve a full convergence of employment policy through the elimination of most fixed-term contracts and the introduction of a single contract with termination costs that smoothly increase with job tenure and which is applied to all workers. In principle, 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. One of the first proposals in this vein was presented in April 2009 by a group of Spanish economists [8].

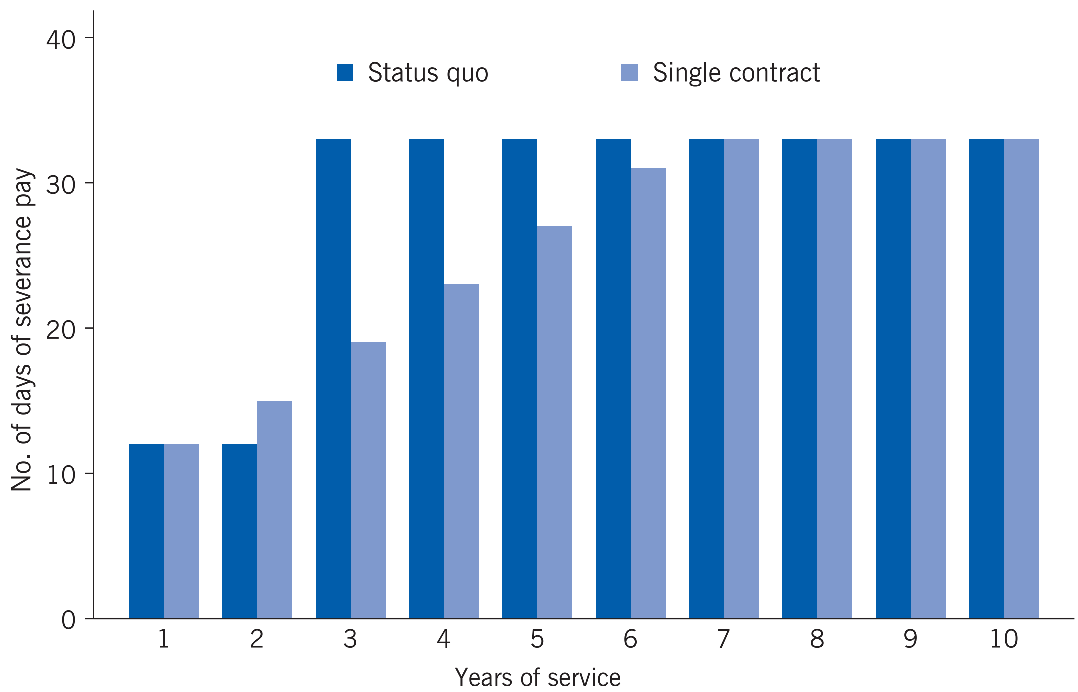
Their basic proposal was to suggest that severance pay should increase smoothly with job tenure (up to a cap) for all workers. The objective was to prevent "almost-sure" redundancy before the deadline at which a temporary contract (TC) has to be converted into a permanent contract (PC). Hence, they proposed replacing the existing system of TCs and PCs with a single open-ended contract (the so-called "single contract") for new hires, with the aforementioned characteristics and two scales of compensation corresponding to fair and unfair dismissals. In particular, they suggested that compensation should be higher than it was at the time for TCs, and grow at a moderate rate (two or three additional days "pyos") until it reached a value that is similar to the average severance pay in EU countries.

They also suggested that in order to maximize the social and economic benefits of the introduction of the single contract, a high degree of legal certainty should be reached in dismissal procedures. A further recommendation was that this contract could be part- or full-time and should be the basic hiring contract for all firms. (Though some other contracts may also be needed: for example, a well-designed training contract and an interim contract that could cover most companies' needs to train and/or replace workers.)

Finally, temporary work agencies, which should also employ the single contract, could be used by firms to accommodate short-term hiring needs.

Figure 2 presents an example of a single contract that begins with the severance pay that currently applies to a TC in Spain (12 days) and concludes, after seven years, with the current severance pay for permanent contracts under unfair dismissals (33 days).

Figure 2. Severance pay in Spain



Source: Author's own calculations

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Similar proposals exist for introducing a single contract in some other European countries [9]. Although the details differ, the basic features are common. First, the distinction between a fixed-term and an open-ended contract, in terms of workers' protection, disappears. Second, the increase in severance pay with tenure is gradual.

However, it is interesting to distinguish between two types of single-contract proposals. The 2014 OECD Employment Outlook surveys all single contract proposals in detail. The first type would introduce a new open-ended contract for new hires with an entry phase, during which worker entitlements, in the case of dismissal, are reduced and identical for both fair and unfair dismissal. It would also involve a "stability" phase, during which the worker would obtain the standard permanent contract with no changes in his or her rights in the case of termination. The main problem with this contract lies in the difficulty of eliminating the discontinuity induced by the transition 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. In general, therefore, employers would face a strong disincentive to keep their employees beyond the entry phase.

The second type of single contract proposal aims explicitly at avoiding discontinuities in severance pay. This idea includes a smooth increase in severance pay along with a redefinition of unfair dismissal, which is restricted only to cases of discrimination and prohibited grounds. One problem with this type of proposal, however, is that by tying workers' rights to the specific firm where they work, it is likely to reduce efficient turnover and prevent mobility across jobs. In order to address this problem, the idea of a single contract based on rights to severance pay increasing with experience has also been explored. 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 has been the case in Austria since 2003), which would be portable across jobs when the worker changes employer. Then, if the worker was dismissed, the fund would finance his or her severance pay. One disadvantage of this system is the creation of "excessive firing." This is the reason why some economists would propose a mixed model, in which severance pay and a capitalization fund co-exist. The main objective of this is to restrict the application of "last in, first out" rules in firing decisions made by firms, by reducing the marginal cost of dismissal for all workers and thus promoting the continued employment of younger workers in the firm.

The OECD survey also explains that the implementation of a single contract might be in conflict with some ILO conventions (e.g. Convention 158) that require a valid reason to terminate an employment relationship and probationary periods of reasonable duration.

Finally, it is sensible to consider that some firms may see the single contract as a barrier to hiring if clear separation rules are not properly defined for short-term positions. In this sense, the strategy recently followed by Italy, which offers a fast-track way of firing workers, seems to be a good alternative in these cases.

Predicted effects of a single contract for Spain

One study presents a model that is designed to measure the effects of introducing a single contract in Spain, which involves severance pay, or compensation that increases in accordance with job seniority [10]. The study simulates the effects of the so-called "12–36

Single-Contract" (12–36 SC), in which the compensation begins at 12 days of wages "pyos" and increases by two days for each additional year worked, reaching a cap of 36 days "pyos" after 12 years of working at the same firm. The main goal of the simulation is to compare the effects of introducing this single contract with the effects of the fixed-term and permanent contracts that co-existed under the EPL situation in Spain prior to the 2012 reform. The main results from this simulation are that both unemployment and job destruction rates fall substantially with the introduction of the single contract. Unemployment drops by 31.5% (from 16.9% to 11.6%) and job destruction by 35% (from 12.6% to 8.2%).

Of particular interest in this study is the change in the job destruction rate for contracts with tenure equal to, or below, three years. In the dual labor market, the job destruction rate is very high because the large gap between the severance costs of TCs and PCs induces massive firings at the beginning of the fourth year in order to avoid the high future severance costs of PCs in the event of contract conversion. However, under the single open-ended contract, the probability of being fired in contracts with tenure equal to, or below, three years is reduced substantially (from 26.7% to 6.1%) because firms are less reluctant to destroy jobs. The reason for this is that it is more costly (12 days "pyos" as opposed to eight days "pyos" in TCs) and because the jump in severance pay (from eight days to 45 days) has been substituted for a smoother increase in severance pay. In other words, the pervasive incentives to destroy jobs at the beginning of the fourth year strongly diminish. The opposite happens, however, to the probability of being fired for workers with tenure of more than three years. Under the single contract, this probability increases from 7.4% to 9%. Hence, it emerges that as severance pay is smoothly increased, so are job destruction rates.

In addition to this, such changes in job destruction rates have a substantial impact on the tenure distribution. Indeed, the number of workers with tenure of just one year is 39.5% lower, and the number of workers with tenure above three years is 22.5% higher, under the single contract These changes are very significant, both in terms of human capital accumulation and experience.

With regard to welfare consequences, the same study also presents a transition exercise showing that the single contract would be highly beneficial for the majority of workers, and particularly for the unemployed, as their future job stability, once employed, would substantially increase. According to these calculations, less than 5.5% of workers would experience reduced tenure as a result of this reform, while 24.6% would not be affected and end up with the same severance pay and tenure as if the system remained unchanged. In fact, the majority of workers already hired under a PC would remain unaffected by the reform. In other words, there is not much replacement of these workers by new workers hired under a single contract. The underlying reason for this is that it is not optimal for firms to fire tenured workers due to the cost this substitution would entail. Furthermore, this contract would not necessarily increase the average expected severance cost for firms because job destruction would be lower than under the current legislation. In fact, the average compensation, weighted by the job destruction rate for any duration, would decrease by 9.1%.

A further advantage, from the firms' point of view, is the reduced uncertainty due to the much simpler schedule of dismissal costs under a single contract. However, for this to be true, it would also be necessary to redefine the legal reasons for firing, so that uncertainty of both the type of firing and the official decision on its fairness is reduced.

LIMITATIONS AND GAPS

As described earlier, an important criticism of all these proposals is that suppressing all fixed-term contracts would run the risk of introducing excessive rigidity in hiring decisions and could lead to lower employment growth, given that not all temporary jobs would be replaced by permanent ones.

Furthermore, eliminating temporary contracts could also foster the use of other types of atypical contracts that offer lower worker protection. In this case, an alternative could be what one study refers to as a "unified contract," in which the same termination costs apply to all contracts, independent of whether they are permanent or temporary. The proposal would be to both maintain all types of contracts and have the same level of termination costs with increasing seniority, or length of service, independent of the type of contract. In the case of termination, firms would have to pay a layoff tax to the public authorities, while dismissals would be unfair only in cases of discrimination and prohibited grounds. If set at a sufficiently high level, this layoff tax would yield resources to mutualize the reallocation costs of displaced workers and cause firms to internalize the social cost of dismissals, without the need to reinstate workers. The main advantage of this proposal is that it would leave the termination cost of short-term contracts unchanged.

In any case, a key requirement of all these proposals is the restriction of the definition of unfair dismissal to cases of false reasons, discrimination, and prohibited grounds. In other words, any economic motive or personal reason related to the worker's performance (such as a reduction of individual productivity or the worker's unsuitability) would be a fair and justified reason for dismissal, with the judicial review of courts restricted to assessing whether the purported reason is not, in fact, based on prohibited grounds. However, implementing this requirement might be difficult in countries with a long tradition of judicial review of employers' decisions. For example, some of the provisions in this respect made in the 2012 labor reform in Spain have been restated by some recent court decisions.

Finally, an alternative to the single contract strategy, particularly in countries with rigid wage bargaining systems, would be to make wages more flexible through internal devaluation processes. Under a scenario in which wages are more flexible, the standard argument on the neutrality of severance pay would predict a lower impact of employment protection on employee turnover, which in turn would reduce the pervasive effects of having a dual labor market. In this case, the introduction of a single contract would be less urgent. In any case, however, a single contract would eliminate most of the costs associated with the asymmetric power in wage bargaining by permanent and temporary workers.

SUMMARY AND POLICY ADVICE

This contribution has presented the main predictions of what might happen if the majority of temporary contracts were abolished and a single open-ended contract was introduced for all new hires in the context of a dual labor market. The findings of one study in particular indicate that a single contract with severance pay which smoothly rises with length of service in the firm decreases both unemployment (by 31.5%) and job destruction, particularly for contracts with less than four years of tenure [10]. The introduction of a single contract would also potentially lower the probability of being fired and would lead to a favorable shift of the tenure distribution, as severance pay is reduced. In addition, the study predicts that 22.5% more workers would enjoy job tenures exceeding three years, and there would be 39.5% fewer one-year contracts. The transition from a dual- to a single-contract labor market shows that the single contract would be highly beneficial for the majority of workers (only 5.5% would be harmed by this reform) because job stability would substantially increase.

However, there are almost no examples of an implemented single contract in OECD countries, and only a few examples of a unified contract. This slow pace of reforms could be due to the perceived risk of discouraging hiring by introducing excessive rigidities in the labor market for volatile and occasional activities. Furthermore, the requirements of light dismissal regulations, or limited judicial review of the dismissal decision, could also be reasons for the non-implementation of single or unified contracts in Europe.

The closest examples to both proposals that are already in place are the 2013 Slovenian and Portuguese reforms, which equalized the level of severance pay across contracts, while at the same time significantly enlarging the definition of fair dismissal.

Although much less extensive, the recent Spanish and French reforms head in the same direction. However, by leading only to a very limited convergence of expected termination costs across contract types, these reforms are unlikely to radically change the functioning of the labor market in these countries.

A more promising strategy is based on the unified contract proposal, which maintains the existing labor contracts, but unifies severance pay for both temporary and permanent contracts [9]. This is essentially the approach adopted in the reform recently introduced in Italy (the Jobs Act) which will provide firms with an open-ended contract that gradually increases the employment protection and becomes the predominant form of hiring. The main goal of this reform is to set a common level of worker protection that gradually increases as the employer's confidence in the worker grows [11]. Note that this strategy is quite different from the one typically in place in Anglo-Saxon countries, where firing costs are quite low, or even zero, in some cases.

The ultimate goal of unifying severance payments for all contracts is to create one of the two pillars of "flexicurity" (i.e. a model of employment that combines labor market flexibility with security for workers) and to encourage its implementation. The other pillar is unemployment benefits. These benefits should also be reformed so that a complete employment and unemployment protection system becomes fully developed [11]. Such reforms have yet to be introduced in most countries.

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Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The author declares to have observed these principles.

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