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Financial incentives and labour market duality☆

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HIGHLIGHTS

- We use a matching model calibrated on France to simulate incentive policies aiming at reducing labour-market duality.
- Introducing taxes on short-term employment decreases their share in total employment but strengthens labour-market rigidities.
- Unemployment spells are longer and transformations of short-term contracts to permanent ones are lower.
- Targeting taxes and subsidies to encourage permanent hiring is more efficient to reduce duality.

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ABSTRACT

The French labour market is divided between workers in permanent jobs and those who alternate fixed-term contracts with unemployment spells. Among other public policies aiming at reducing this duality, financial incentives could induce employers to lengthen contract duration or favour permanent contracts. This article develops a matching model fitted to the French labour market characteristics and calibrated on French data. A gradual decrease in unemployment contributions or a firing tax reduces the share of short-term contract in total employment but increases market rigidity and lowers labour productivity. However, decreasing unemployment contributions gradually is less favourable for new entrants than a firing tax and lengthens unemployment spells. An additional contribution levied on short-term contracts to finance a bonus for permanent-contract hirings also decreases labour market duality and increases activity by 0.13% but without negative impacts on labour market flexibility and productivity.

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1. Introduction

The French labour market is divided between workers in stable jobs with high employment protection and those who accumulate unemployment spells and short-term contracts. These two categories are compartmentalised, inducing a bumpy occupational path for the most precarious workers. Since introducing a unique contract or a convergence of employment protection of both types of contract to reduce duality is socially difficult during crisis periods, this paper aims at comparing the efficacy of financial incentives proposed during public debates.

The coexistence of short-term and permanent contracts leads to an unequal distribution of risks induced by economic conditions. As shown by Saint-Paul (1996), risk exposure is highest for workers under short-term contracts and the most precarious population categories. In case of a shock, short-term contracts are not renewed to reduce the firms' wage–bill. Furthermore, the advantages of a permanent contract extend beyond the labour market, as a stable job facilitates access to housing and loans. Moreover, labour market duality could induce a disconnection between wages and unemployment (Bentolila and Dolado, 1994). Indeed, insiders, working under permanent contracts, are less threatened by unemployment. Consequently, unemployment weighs less on wages.

The empirical literature, in particular Bassanini and Garnero (2013), shows that the phenomenon could be related to labour market institutions and the gap between the employment protection of permanent and fixed-term contracts. To dismiss a worker in a permanent contract is often a long, risky, and costly process. This may explain why firms use short-term contracts to increase workforce flexibility in order to

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cope with economic risks. Indeed, employers seek this flexibility on the margins of the system. The growing use of short-term contracts and temporary work has made the labour market more fluid, increasing job creation and destruction. However, as shown by Picart (2014), this higher employment flexibility, focused solely on short-term contracts, does not seem to have significantly reduced unemployment. It has also helped to reinforce the employment protection of insiders at the expense of the integration of outsiders. Moreover, this duality reduces human capital, and then productivity, because of the reduction in training of workers under a short-term contract and in firm-specific human capital accumulation. A recent survey of adult skills conducted by the OECD points out that temporary contract status has a negative impact on the probability of receiving employer-sponsored training. In particular, this probability decreases by 25% in France. On the contrary, workers under permanent contract benefit from returns to experience and increase their human capital. Therefore, labour turnover relies mainly on workers under short-term contracts. According to the OECD, the three-year transition rate from temporary to permanent contracts in France is around 20%, against 50% in the Nordic countries.

Theoretical analysis confirms these arguments and shows that partial flexibility, focused exclusively on short-term contracts, reduces the share of permanent contracts or CDI (Contrat à Durée Indéterminée) and has an even stronger negative impact on flows into and out of permanent contracts. The imbalance due to a gap in hiring costs between permanent and short-term contracts could be more harmful than the gap in separation costs. Blanchard and Landier (2002) show the negative effect of fixed-term contracts on the functioning of the labour market. Staff turnover and the unemployment rate are higher. Cahuc and Postel-Vinay (2002) highlight the inefficiency of the combination of high employment protection and the introduction of short-term contracts. However, in their model, a majority of workers prefer this inefficient *laissez faire*, an attitude that explains the system's persistence. More recently, Cahuc et al. (forthcoming) point out that strong employment protection under permanent contracts increases short-term job flows. The impact on employment is small but this employment protection significantly reduces the labour productivity, substituting permanent jobs with short-term contracts. To reduce labour market duality, these authors suggest harmonising employment protection for fixed-term contracts with that of permanent contracts, or instituting a single labour contract.[1] However, this would generate legal difficulties and might not win economic and social acceptance. Implementation of such a policy could be problematic, with a difficult transition period.[2] An alternative could be to offer employers financial incentives in favour of stable jobs, either via employment duration or type of contract (CDI versus CDD or temporary work).

In this paper, we examine three proposals for reaching this goal. The first proposal comes from French labour unions. To encourage employers to offer stable jobs, unemployment insurance contributions should decrease gradually, based on the worker's tenure. The additional contribution in the first months or years is roughly equivalent to a hiring tax spread over several months. Second, as suggested by Blanchard and Tirole (2003), we introduce a termination tax to finance unemployment benefits, along the lines of the U.S. "experience rating" system. This tax aims at insourcing the social costs of unemployment into the employer's lay-off decision. Both proposals would increase labour market flow costs, which could induce employers to lengthen average employment duration. The third proposal is based on the Italian labour market reform of 2012. An additional contribution is levied on temporary contracts to discourage short-term hirings. When an employer turns a temporary contract into permanent one, the surtax is partly or fully refunded. Unlike the first two proposals, the penalty on short-term contracts is linked to support for permanent hirings. This approach would generate a milder increase in labour market rigidity than the first two proposals because of hiring incentives. Moreover, by directly targeting the issue, this policy better reduces duality by encouraging transition to permanent contracts.

To study these policies, we use a matching model based on Pissarides (2000), where permanent and short-term jobs are distinct and permanent jobs are endogenously destroyed. Due to the existence of a minimum wage in France, real wages cannot be viewed as perfectly flexible, in particular for temporary unskilled jobs. To allow for this, we split the labour market into skilled and unskilled workers. We calibrate the model on French data and simulate three public policies designed to reduce labour market duality: a hiring tax, a firing tax, and a surtax on fixed-term contracts to finance a bonus for permanent hirings.

The article is organised as follows. Section 2 briefly describes the matching model used and Section 3 details its calibration on French data. Section 4 shows the impact of the three stylised reforms. Finally, Section 5 draws conclusions.

2. Model

To study the impact of these financial incentives, we developed a matching model with endogenous job destruction as described by Pissarides (2000), where firms create only short-term contracts, which are converted to permanent ones or terminated. This approach takes into account the trade-off between the two types of contracts but needs simplification: all permanent hirings follow short-term contracts. Details of the model are in Appendix.

2.1. Assumptions and notations

Jobs are divided into those with a costly separation initiated by the employer (mostly permanent contracts) and those with a reduced termination cost (temporary work, short-term contracts, trial periods, and apprenticeship). For simplicity, we shall refer to the first situation as "CDI" or "permanent contract" and the second as "CDD" or "short-term contract."

Exit flows from permanent contracts are not exogenous. They are determined by productivity shocks, ϵ, so as to capture the effect of a dismissal tax. We model productivity as the sum of a perennial component, which reflects the inherent quality of the job/worker match, and an economic component, which reflects hazards on demand for the firm's products.

Lastly, we need to take into account the effects of the minimum wage on the lowest wages. Cahuc and Zylberberg (1999) highlighted a strong interaction between employment protection and minimum wage: when wages are set by bargaining, dismissal costs have no impact on the unemployment rate because the decrease in hirings is offset by the decrease in breaches of terminations. In particular, employment protection induces lower wages at hiring and curbs the negative effects on hiring. When wages are not negotiated–and especially when they are constrained by the minimum wage–the hiring wage cannot be adjusted. As a result, the negative effect on hiring is not offset by the decrease in terminations. This mechanism concerns earnings at minimum-wage levels but also slightly higher earnings in order to maintain a wage hierarchy.[3]

In order to take it into account, the labour market is divided in two worker categories. In the first part, workers are skilled and wages are always negotiated. In the second part, workers are unskilled and are paid at the minimum wage in short-term contracts, whereas their wage is negotiated when they are in permanent ones. Skill level is subscripted by k, with $k = n$ for unskilled workers and $k = q$ for skilled workers.

[1] See, especially, the reports by Blanchard and Tirole (2003) and Cahuc and Kramarz (2004).

[2] See Lepage-Saucier et al. (2013).

[3] As demonstrated by the diffusion effects when the minimum wage increases—see Koubi and Lhommeau (2007) and, more recently, by Goarant and Muller (2011) and Aeberhardt et al. (2012).

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