Firing costs, dismissal conflicts and labour market outcomes*

Maia Güell

1 Introduction

Firing costs are often blamed for malfunctioning of the labour market, particularly in Europe. Indeed, regulated firing costs are among the most prevalent institutional differences between the US and Europe. However, their effects are still largely misunderstood. A casual supporting observation is that, since the 80s, in several European countries, reforms tackling firing costs have been — in one way or another[1] — rather unsuccessful in reducing unemployment.[2] At best, when reforms have somehow worked, the underlying reasons are not fully understood. Thus, even today, despite numerous reform attempts, labour market deregulation is in the political agenda; firing costs being at the centre of debate on labour regulation.

Indeed, as I am writing this *Opuscle*, I have just received an email from the OECD announcing a new book which starts with the following paragraph: "Unemployment poses a key challenge to many OECD countries. This thorough analysis of the European labour market shows how high levels of market regulation critically affect unemployment rates and the performance of the labour market".

Despite the popular view — especially among policy advisors — that firing costs harm employment, the academic consensus is not so clear-cut. Both theoretical models and empirical studies lead to ambiguous results when analysing the effect of firing costs on aggregate employment. One reason for this ambiguity could be that theory and empirics abstract from the complexity and uncertainty that exist around employment protection legislation, although this appears to be precisely what firms complain about the most (see, for instance, Blanchard and Tirole, 2003).

The goal of this *Opuscle* is to discuss some recent research on the effect of complex and uncertain employment protection legislation on aggregate employment. First, I will describe how adopting a wider view of employment protection legislation than is usually taken in the literature can lead to the emergence of dismissal conflicts. By dismissal conflicts, I refer to the fact that the worker does not agree with the terms of the dismissal initiated by the firm and thus he is likely to sue the employer in court. Dismissal conflicts shape court outcomes, making the cost of dismissal uncertain. Second, I will revisit the effects of firing costs on labour market outcomes in a framework with dismissal conflicts. Finally, I will discuss the policy implications derived from this analysis.

---

* I am grateful to Sevi Rodríguez Mora for very useful discussions and suggestions. I also thank him, Robert Zymek and an anonymous referee for very useful comments on the first draft.

1 As I will discuss in section (6.2), a common way has been the introduction of temporary contracts with negligible firing costs.

2 For instance, in Spain, firing-cost-free temporary contracts were introduced in 1984. However, despite the high incidence of this reform, a decade later, at comparable points of the business cycle, the unemployment rate was still at pre-reform levels, around 20% (see Güell (2003) and Güell and Rodríguez Mora, 2008); a parallel story happened in France (see Blanchard and Landier, 2002).

A preview of the main message of this *Opuscle* is that, indeed, firing costs are most likely bound to have negative effects on employment, but the reason behind this is not so straightforward. The reason does not lie so much on the indemnity that firms have to pay to workers, but on the fact that the outcome of dismissals conflicts can be uncertain, which in turn, as I will discuss, will imply a higher cost for firms of providing incentives to workers — for example, higher wages .

A preview of the two main policy implications of this analysis is: first, the magnitude of the effects of reducing firing costs on employment depends crucially on the degree of uncertainty around the outcomes of dismissal conflicts. Second, introducing temporary contracts as a way of reducing firing costs for new hirings can have perverse effects and result in even higher unemployment.

2 Employment protection legislation in a nutshell

This section does not attempt, by any means, to provide an exhaustive nor a specialist description of employment protection legislation (EPL, hereafter). Instead, I will discuss some general features of the law, especially with regards to dismissal conflicts between the employer and the employee.

Typically, European EPL distinguishes between two main types of dismissal motives, say category 1 and category 2.[3] The key distinction between these categories is their associated indemnities. The law imposes that the firm has to compensate the worker upon dismissal for causes in category 1. The amount of the compensation is fixed by law. For convenience, I will refer to this indemnity as the "default indemnity". No compensation is required when the worker is fired for causes in category 2. Causes under category 1 are those considered unrelated to the worker and this is why he is entitled to compensation. Causes under category 2 are considered the "worker's fault", thus he is not entitled to any compensation.

Some examples might be useful. Imagine a reduction in the demand of the product that the firm is producing, which might require to lower production for the firm, or a technological change, which might require personnel reorganization at the firm. These would be causes under category 1. If as a result of these changes the firm fires a worker, compensation (i.e., the "default indemnity") has to be made since these causes are not related to the behavior of the worker at the workplace. By contrast, a reduction in the firm's output due to a worker's misconduct or absenteeism at work would be causes under category 2. In these cases, if the worker is fired no compensation is necessary since it would be considered "the worker's fault". For convenience, I will refer to the first type of causes as "economic dismissals" and to the second type as "disciplinary dismissals".

Having opposite interests, employer and employee are likely to disagree over a dismissal. While they might agree on the actual cause of the dismissal, they are likely to disagree on the magnitude of such cause, and thus on whether the dismissal is justified or not. In this respect, the law generally does not specify how large the reduction in product demand has to be in order to justify an economic dismissal, nor does it specify how many days of missed work justify a disciplinary dismissal.

If a worker disagrees with the dismissal, he can always sue the employer. Prior to going to court, there is generally an established process of settlement and reconciliation. If everything fails in this process, the case then goes to court.

---

3 In this *Opuscle*, I am leaving out dismissals that involve more than one worker at once. These are often referred as "collective dismissals".

In court, the firm can be proved right and thus the worker loses the case.[4] In this situation, this would be the end of the story. However, if the firm is proved wrong in court and thus the worker wins the case,[5] then the firm has to pay a larger indemnity with respect to the no-conflict indemnities. For convenience, I will refer to this as the "larger indemnity". One can consider to be this larger indemnity a form of punishment of the firm for trying to fool the law.

Briefly, it is useful to think of European EPL at two levels. At a first level, it simply says that the law establishes the aforementioned default indemnity for workers in case of job loss for reasons beyond the worker's control; and no indemnity for workers in case of job loss for reasons related to his (bad) behaviour. At a second level, the law establishes the aforementioned larger indemnity for any case that is taken to court in which the court decides in favour of the worker.[6]

In contrast, the USA largely operates under the "employment-at-will" doctrine, which allows employers and employees to terminate their employment relationship without having to pay any indemnity nor having to demonstrate any cause. There are however important exceptions within the USA which limit employers' discretion to dismiss their employees.[7] Still, the USA ranks lowest in terms of EPL among OECD countries (see OECD, 2004).

3 Mixed results in existing literature

The classical way in which economists have modelled EPL is simply as a fixed indemnity that firms have to pay to dismissed workers. This indemnity is fixed and imposed by law. These models leave out the possibility of dismissal conflicts. This approach just focuses on the first level of EPL mentioned in section (2) and so, implicitly, just on the default indemnity. This implies that disciplinary dismissals are costless and, therefore, it is natural to ignore them in the analysis. More generally, in the absence of the possibility of dismissal conflicts, there is no point in modelling different reasons for dismissals nor different levels of indemnities.

Despite the prevalent idea, especially among international organizations, that firing costs have a negative effect on employment, there are very different views in the academic literature depending on the type of model used. In models that leave out dismissal conflicts, firing costs can have ambiguous effects, neutral effects or even positive effects.

The prevalent idea of the negative effects of firing costs on employment comes mostly from

---

4 This is normally referred as the case being declared "fair".

5 This is normally referred as the case being declared "unfair".

6 Generally, these indemnities take the form of a fraction of the worker's monthly wage per year of service. Moreover, in some countries, the larger indemnity can take the form of the worker being reinstated at his job. A minimum and a maximum compensation are also generally established. For instance, as of 2003, a worker with 20 years of tenure is entitled to a default indemnity of 4 months of pay in France, 20 in Portugal and 12 in Spain. And the corresponding larger indemnity would be 16, 20 and 22 in France, Portugal and Spain, respectively, with Portugal having a higher extent of reinstatement than France and Spain (see OECD (2004) for more details).

7 Since the late 70s, many USA state courts recognized exceptions and established different causes under which employers have some limited ability to fire workers. This allows employees to sue employers, which can potentially translate into a costly dismissal for firms (see Autor, Donohue III and Schwab (2004) for a detailed explanation of these changes and an analysis of the effects of these changes on employment). Additionally, the USA unemployment insurance system is experience-rated, which links employers' social security contributions to the layoff history of the firm (see OECD (2004) for details) making firing decisions not completely cost-free.

the circumstantial evidence regarding the comparison of the USA and Europe in terms of unemployment rates and their degree of labour market regulation. The common arguments that would support this view are as follows. First, firing costs make labour a more expensive factor of production, especially in unstable environments. Second, firing costs may allow incumbent workers to ask for higher wages since they become expensive to replace; so, similarly, in the so-called insider-outsider models, firing costs make labour a more expensive input. As I explain below, dynamic and general equilibrium models can reverse these common arguments.

3.1 Models with ambiguous effects of firing costs

The seminal work by Bentolila and Bertola (1990) provides a natural first step for thinking about the effects of firing costs on employment beyond the common arguments used above. Firms that anticipate any future negative shock will hire fewer workers in the presence of firing costs. Thus, everything else being equal, unemployment will be higher with firing costs. However, at the same time, when facing a negative shock, firms would also fire less workers if this is costly. Thus, everything else being equal, fewer workers will lose their jobs and unemployment will be lower with firing costs. Thus, the effect of firing costs on aggregate employment is unclear as it depends on which of the two effects is larger. Firing costs unambiguously make employment more stable, but their effect on the level of employment is ambiguous. That is, the overall effects of firing costs depend on whether these reduce more the flows to or from unemployment.

Note that, in the previous argument based on worker flows, wages are taken as given, and thus are not affected by firing costs. An important further step for analysing the effect of firing costs is to incorporate wages in the picture, as in Bertola (1990) and Lazear (1990).

3.2 Models with neutral effects of firing costs

Lazear (1990) makes an important insight: under some conditions (that I explain below), firing costs would have no effect on employment. In other words, they would be neutral. The reason is that, under such conditions, it would be possible that the employer and the employee agree on an reallocation of payments over time in which no one would lose with respect to the situation without firing costs. Lazear's argument can be seen by considering just two periods. Note that the presence of firing costs makes being employed more attractive for workers (and less for firms) than when there are no firing costs. So, there is some room for making workers pay a fee when they start working so that their expected compensation is the same as in the absence of firing costs. And, later on, workers would get such a fee back. If the size of this fee is equal to the legislated firing indemnity, then the firm's employment decisions are the same as in the absence of firing costs. A useful caricature of this inter-temporal reallocation of payments is as follows. Imagine that firing costs are worth 999 Euros for a worker. The first day of work, the worker writes a cheque for the employer worth 999 Euros. The employer takes it and keeps it untouched in a drawer in his desk. In the event of the worker being fired because there is a downturn, then the employer returns to the employee the original cheque worth 999 Euros. Therefore, the firm can take decisions ignoring the firing cost. To put it bluntly, workers would implicitly be financing their firing indemnity. But they would have no loss in income with respect to an economy without firing costs. More importantly, in this case, the effects of firing costs on worker flow rates suggested by Bentolila and Bertola would be undone and, thus, the level of employment would be the same as if there were no firing costs at all.[8]

The cheque caricature is useful to understand Lazear's point, yet we rarely observe

8 Note that this actually could imply higher income levels for workers as they would spend less time in unemployment than if they did not reach such agreement with theiremployer.

employees making payments to employers. In reality, such a cheque could take the form of lower initial wages and, later on, workers could recover foregone initial payments in the form of a firing indemnity (if the worker is dismissed) or as higher wages (if the worker stays employed).

Under which conditions would this reallocation of payments over time be feasible? First, it should be the case that workers would be indifferent about transferring income across periods. Second, capital markets should work perfectly so that workers could borrow enough in order to smooth their consumption over time. Third, all the payments should be between the firm and the worker. If the process of firing involved payments to another party, then they could not be neutralized as the amount in the cheque could only be the amount that the worker would eventually get back.

Bertola (1990) also shows that firing costs may be neutral on employment in a model in which workers can bargain their wages every period. Firing costs give some bargaining power to workers who have already been employed for one period, i.e. the insiders. If the firm wants to replace them by an unemployed worker this will cost the firing costs. Thus, insiders can ask for a higher wage without risking to lose their jobs. They can ask to increase their wage as much as it would cost to replace them. So workers start with an entry wage that later gets increased by the amount of the firing cost. If the story were to end here, as in the original insider-outsider models, firing costs would reduce employment as they would make workers more expensive in terms of their wages. Now, unemployed workers might be willing to work for a quite a low wage, in which case they would reduce the entry wage. Anticipating that later on they will be costly to replace and, thus, will have higher wages, they will ask for an entry wage that makes them indifferent between being employed or unemployed. This means that entry wages will be lower in a magnitude proportional to the firing costs. Again, there is a redistribution over time of labour costs which has no real effects on employment. And, under some conditions, the effect of firing costs can be undone by lower starting wages.

An important condition for the neutrality of firing costs is that wages have to be perfectly flexible so that these can be lowered upon hiring. Note that, depending on the relative magnitude of firing costs, the reallocation of labour cost over time could imply that initial wages would have to be quite low, potentially negative.[9] Imagine the presence of a regulated minimum wage, as in most OECD countries. In this case, wages cannot fall too much and therefore, it may not be feasible to have workers receiving lower wages in one period even if later they will receive higher wages. Therefore, firing costs would not be undone and these could have employment effects.[10]

Recapitulating, the different models that introduce wages in the analysis of firing costs indicate that such an analysis should incorporate an increasing wage profile (i.e. lower initial

9 This can be the case if the expected cost of firing in terms of wages is higher than the actual wage which, given the legislated indemnities, is especially likely to happen if the chances of the worker winning the case in court are large enough.

10 For instance, in Spain, the default indemnity and larger indemnity are, respectively, 20 and 45 days of wages per year worked. And the probability of a case being declared unfair is around 0.7 (see Galdón-Sánchez and Güell, 2006). This means that the total expected cost of firing is around 2/25 the monthly wage per month worked. Doing a back-of-the-envelope calculation and not accounting for discounting, then workers' wages would have to be lowered to 23/25 of their usual amount in order to neutralize the effect of firing costs. Following this example, for workers receiving a wage at least 1.1 times the minimum wage, their wage could be lowered (i.e. the minimum wage would not be binding) and, therefore, firing costs could be undone. But for workers receiving a wage less than 1.1 times the minimum wage, this would not be possible.

wages and higher later wages). In turn, the effect of firing costs on worker flows would be neutralized. The reason is as follows. First, at given wages, firing costs make firms hire less workers. But since firing costs also make initial wages lower, this boosts hiring. Thus, overall hiring would be the same as without firing costs. Second, at given wages, firing costs make firms fire less workers. But since firing costs also make later wages higher, this boosts firing. Thus, overall firing would be the same as without firing costs. Consequently, firing costs would have no real effect on aggregate employment.

Analysing the effects of firing costs without taking wages as given provides a first important lesson. Take a country with a regulated minimum wage. The reallocation of payments over time would be hard to implement in this case since initial wages would not be able to fall below the regulated level. Thus, the combination of firing costs and the minimum wage could generate unemployment. But the reason would not be the firing cost by itself, but its interaction with the minimum wage. A similar argument would follow for a country with capital markets that do not work perfectly.

3.3 Models with positive effects of firing costs

So far, we have seen that firing costs can have an ambiguous effect on employment. We have also seen that, under some circumstances, the effects of firing costs can be undone by reallocating payments over time. The models summarised above implicitly assume that firms have a very negative view of firing costs, that is, that these increase the cost of labour. However, there is some other important research that offers a radically different view of firing costs. These models highlight situations in which firms voluntarily offer firing costs to their employees. The reasons usually lie in the form of some other problem or labour market imperfection that firing costs can help improve. For instance, imagine that in order to work in a firm, investment in some very specific skills (only valuable at that firm) is required. A well-known problem in this context is that, unless the worker and the firm promise each other that they stay together, such investment would not take place. Firing costs can help here in the sense that they would make employer-employee separations more costly. Thus, firing costs can provide some commitment that the employer-employee relationship will last long and, consequently, help that the investment takes place. Another example in which firms might voluntarily offer firing indemnities to workers is when workers are risk averse. Firms could act as insurers of workers against shocks and offer them a lower (yet more stable) source of income.

A fundamental question here is how the level of firing costs that firms would happily choose compares to the one imposed by the legislation. If the latter was lower, then legislated firing costs would not be relevant anymore.

These considerations are not purely theoretical. In reality, we do observe some firms voluntarily offering employment protection to their workers in countries where firing costs are nonexistent or highly unregulated. A classical example is the New Deal of International Business Machines Corporation (IBM), which is one of the earliest (since the 1930s) and most important providers of employee benefits in the USA. In fact, as I am writing this *Opuscle*, IBM has appeared in the news because it has created a company to sell employee-benefit services. Another interesting example from the USA is Google. During its first years, while still making losses, the dot-com firm had to fire several workers, yet decided to voluntarily provide them with some indemnity in the form of stocks. Another example is the stylised Japanese model of human resources.

This last view of firing costs gives another important insight in terms of policy. In the absence of legislated firing costs, there can be some room for employment protection to emerge naturally from the initiative of firms and workers, especially in the presence of market

imperfections. This would suggest that leaving the market totally unregulated would not necessarily lead to workers being totally unprotected in the case of job loss.

Putting the different views reviewed together we get the following interesting picture. If all markets functioned perfectly and there were no other forms of regulations on wages (such as the minimum wage), then the effect of regulated firing costs would be undone and there would be no effect on employment. But otherwise, regulated firing costs would not be neutral; yet, in this case, firms could actually find it worthwhile to offer firing costs voluntarily.

To summarize, to the extent that not all markets function perfectly and/or there are wage regulations, the theoretical results regarding the effect of firing costs and unemployment are inconclusive. Now, what is the empirical evidence regarding the relationship between firing costs and labour market outcomes? [11]

3.4 Empirical evidence

Empirical analysis using data for several OECD countries finds a quite clear relationship between measures of EPL[12] and labour market flows.[13] Countries with more stringent regulations are found to have, everything else being equal, more employment stability. At the same time, in these countries, unemployment duration is also higher. However, the results are more mixed when analysing empirically the relationship between measures of firing costs and unemployment rates. In general, the effect of firing costs on unemployment is found to be small, not always significant and sensitive to different specifications. The usual explanation given for these results is that the theory predicts ambiguous effects of firing costs. Another explanation by Bertola, Boeri and Cazes (2000), in line with the rest of this *Opuscle*, is that the measures of EPL are highly imperfect measures and, in particular, they fail to incorporate the complexity of legal provisions.

As mentioned earlier, a common feature of the three views reviewed in section (3) is that they model EPL simply as an indemnity without the possibility of dismissal conflicts in their analysis. In the next section, I will revise some of my work that takes a wider view of EPL, allowing for dismissal conflicts and explaining the consequences in terms of the effects of firing costs in that framework.

4 Dismissal conflicts

As mentioned before, firms do not seem to complain so much about having to pay a fixed indemnity to dismissed workers. However, they do complain about the additional, often convoluted, provisions of the law. Additionally they complain about the uncertainty around EPL. In fact, the models revised in section (3.2) also predict that, if the inter-temporal reallocation of payments is feasible, the fixed indemnity *per se* does not need to be problematic for employment.

In this section, I revise some of my research (Galdón-Sánchez and Güell, 2003) that has taken a wider view of EPL. In particular, we have incorporated the fact that the law also establishes the aforementioned larger indemnity for cases taken to court ruled in favour of the worker. Conflicts between employers and employees can arise for very different reasons. Our research has focused on a particular source of potential conflict, namely that related to the structure of EPL itself.

For a moment, ignore the possibility that dismissal cases can be taken to court. A crude summary of EPL is that depending on the cause of dismissal claimed by firms, firing can either

11 See also Kugler (2007) for a further review on the empirical literature of firing costs, which also includes several works that exploit natural experiments in specific countries.

12 Normally an index constructed by the OECD.

13 Although international comparisons may be difficult if data are not comparable — see, for instance, Blanchard and Portugal (2001) and OECD (2004).

be costly (if it is an economic cause) or it can actually be free (if it is a disciplinary cause). That is, there is a costly way to fire workers but there might be a cost-free way as well. In order to have a cost-free dismissal, the firm should claim that the reason of dismissal is somehow related to "the worker's fault". Thus, in the absence of the possibility of the worker suing the employer, the firm would be tempted to always go for the cost-free dismissal, since it is simply a cheaper strategy.

Of course, if we allow for the possibility that the worker sues the firm, then it would seem less relevant to think along these lines. The reason is that if the firm claims the cost-free dismissal in order to save the firing costs, then the worker would take the case to court. Recall that the worker is compensated with the larger indemnity if he is proved right in court.

Now, notice that the causes of dismissals may be very hard to observe by a third party, say a judge. It can especially be hard to prove that workers have actually misbehaved or shirked in their jobs. Thus, given that there is noise in the underlying real cause of dismissals, even if it is possible for workers to sue employers, firms would again be tempted to try the cost-free dismissal since there is a chance they get away with such a strategy. In other words, firms would be tempted to claim that all the dismissals are of a disciplinary nature. Similarly, for opposite but symmetric reasons, workers would also be tempted to always take a dismissal to court since they may end up receiving the larger indemnity.

In general, whether it is worthwhile or not for the firm to claim that a dismissal is disciplinary instead of economic depends on how large is the difference between the larger indemnity and the default indemnity, as well as on the expected chances that the court will rule in its favour. Everything else being equal, the smaller the gap between these indemnities, the more the firm would be inclined to claim dismissals as disciplinary. The intuition is that the larger indemnity can be thought of as a kind of a punishment for the firm. So, if it is not high enough relative to the default indemnity, then the firm will tend to claim dismissals as disciplinary. Note however, that from the worker's point of view it is always tempting to take the case to court since there is nothing to lose.[14]

There is some evidence that supports that, in reality, this does happen to some extent. Disciplinary dismissals are very much used in some European countries to fire a worker in, what could be considered, a disproportionate proportion. In France, for instance, for the period between 1982 and 1998, individual dismissal conflicts represented, on average, 60% of all labour conflicts that arrived in court. And, as much as 80% of these dismissals that arrived in court involved disciplinary disputes.[15] In Spain, many authors have studied how disciplinary dismissals have been widely used instead of economic dismissals (see Bentolila, 1997; Malo, 1998; Malo and Toharia, 1999).

There is an immediate implication in terms of court outcomes of the tendency, on the one hand, for firms to try the cheaper way of firing and, on the other hand, for workers to always take the cases to court. That is, in general, the evidence taken to court would not be perfectly correlated with reality. Therefore, court decisions, based on whatever evidence is presented by

14 I am omitting from consideration the cost for individuals of going to court. In general, the argument would go through for low enough costs of going to court. These are usually measured in terms of the time (capturing forgone wages) that it takes for a case to be resolved in court. For instance, in Spain, between 1996 and 2003, this cost was estimated to be around 2.5 months on average (see Galdón-Sánchez and Güell, 2006). Given the estimated expected indemnity (see footnote 10), this would make workers with tenure above 2.5 years finding it worthwhile going to court.

15 Source: Ministère de la Justice.

the two parties, would tend to be imperfect.[16] In other words, dismissals (and the cost of dismissals) will be more uncertain given the noise in the evidence. For convenience, I will refer to dismissals in the presence of conflicts as "noisy dismissals", since it is unclear to the court what the real cause is.

Noisy dismissals have important consequences. First, notice that the goal of EPL of protecting workers from economic shocks might have been negated. Imperfect court decisions imply that sometimes workers being fired because the firm is going through some bad economic times will not be compensated, although it was intended that they should; while, some other times, workers being fired because they misbehaved at work will get compensated, although this was not intended. Second, the presence of imperfect court decisions, or noisy dismissals has important consequences for the understanding of the effects of firing costs on employment. In the rest of the *Opuscle*, I will focus on this last point.

5 Revisiting the effects of firing costs

In this section, I revisit the effects of firing costs on labour market outcomes in a framework with dismissal conflicts as explained in the previous section. In other words, I explain the consequences of noisy dismissals in terms of the effects of firing costs on employment.

Recall that noisy dismissals imply that there is some chance that workers get compensated with an indemnity even if fired for disciplinary reasons. This has an important *real* effect: if workers can get an indemnity even when they have not provided enough effort at work, the cost of misbehaving at the workplace becomes lower. This has a dramatic consequence for firms, as it will be more difficult for them to induce their workers to provide the required effort in the job. In other words, motivating workers at the workplace becomes more expensive as noisy dismissals imply that it is not possible to perfectly discriminate between workers fired for one reason or another. This is the same as if firms had a worse monitoring technology.

As I will explain below, noisy dismissals will tend to translate into lower employment levels. A first general intuition for this is as follows. There are different ways to provide incentives to workers. A common personnel practice used by firms in order to motivate their workers to provide high levels of effort is to pay them 'high' wages. If firms are using such high wages for incentive reasons, and if dismissals are noisy, then firms would have to pay even higher wages than in the absence of firing costs. There would be an additional fixed component in wages due to firing costs, which would tend to translate into higher unemployment.

Let's go back now to the different views of firing costs from existing literature explained at the beginning of this *Opuscle* in section (3). In what follows, I will revisit each of these views considering and explaining in more detail why noisy dismissals (as opposed to a fixed indemnity) lead to higher unemployment.

The first view of firing costs based on worker flows and fixed wages featured that the effect of firing costs (seen as a fixed indemnity) was ambiguous because it reduced both flows in and out of unemployment (see section (3.1)). How does this prediction change if we allow for noisy dismissals? If dismissals are noisy, as explained above, then the cost of shirking for workers is lower and firms have an additional cost in order to induce workers to provide effort. If firms use high wages to motivate workers, in the presence of noisy dismissals, they will have to pay even higher wages. But, more generally, firms will face an additional fixed cost per worker as firing costs make the existing monitoring technology in the firm become worse. Therefore, in terms of

16 In general, if it were only workers taking cases to court to try to get higher payments (or similarly, only firms for the opposite reason) then it would be harder to argue that court decisions would be imperfect, as this would reveal relevant information.

hiring, firms would employ even less workers compared to the situation with a fixed indemnity because workers are more expensive. In terms of firing, firms would fire more with respect to the situation with a fixed indemnity, because it is more expensive to keep workers as there is the additional cost of motivating them.

Comparing the situation with noisy dismissals to that of a fixed indemnity, firms hire fewer workers and they fire more workers. Of course, they would hire even more workers if there were no firing costs at all. Likewise, they would fire more. However, notice that there is now a more severe effect of firing costs on hiring. This then points in the direction of predicting that firing costs would affect employment negatively. In other words, considering noisy dismissals breaks the original ambiguity predicted by this type of models. The reason why the prediction of these models changes when considering noisy dismissals can simply be summarized by the real effect that firing costs have on the cost of workers (in terms of motivating them).

The second view of firing costs proposed by Lazear featured that if a reallocation of payments over time was feasible, firing costs (seen as a fixed indemnity) would have no effect on employment (see section (3.2)). How is the feasibility of this inter-temporal reallocation of payments affected if we allow for noisy dismissals instead of a fixed indemnity?

Imagine that legislated firing costs are again worth 999 euros, so the first day of work workers can hand to the employer a cheque for this amount, which they get back upon being fired. The problem now is that, even if the cheque were feasible, firing costs have generated an additional cost (in terms of worker's motivation) that cannot be compensated with a cheque. It is not possible to reallocate over time the cost of motivation because it is a real cost that has to be paid every period by firms in order to induce workers to provide effort. Now, the cheque worth 999 Euros that finances the future firing indemnities would not solve the fact that the firm has to pay more for motivating workers because firing costs have increased the cost of incentives. The key problem is that the upfront cheque can only be written for the amount that regulated firing costs are worth. The additional motivation cost is a by-product of firing costs, but of course, the law does not say that the worker is entitled to that. It is pure economic cost.

A simple way to summarize the effect of noisy dismissals in this type of model is that it is as if the inter-temporal reallocation of payments were more difficult than when simply considering a fixed indemnity. So, even if the cheque would be feasible in the situation of a fixed indemnity, noisy dismissals could imply that firing costs reduce employment. Notice that the reason would not be the fixed indemnity itself but the effect that firing costs have on labour costs. Therefore, even if wages are flexible enough to undo the fixed indemnity — by the 'trick' of the cheque — this still does not guarantee that firing costs have no effect on employment because they affect the cost of providing effort.

The third view of firing costs proposed by Bertola challenged the idea that firing costs reduce employment because these increase insiders' wages (see section (3.2)). If redistribution over time of labour costs were feasible, then firing costs (seen as a fixed indemnity) would have no effect on employment as they would be undone with lower initial entry wages. How does this prediction change if we allow for noisy dismissals instead of a fixed indemnity?

We can think that a lower cost of shirking would be equivalent to an increased bargaining power for insiders, which could translate into higher wages. The key here is that this decreased cost of shirking affects all workers, also those who were just hired. This is not the case with a fixed indemnity, as it only affects insiders, and this is why the entry wages are lower than later wages. Here, if firms use 'higher' wages to motivate workers, these higher wages must be paid every period. If workers are paid less, they would shirk and produce nothing. Therefore, again, it is not possible to reallocate over time this additional cost. Therefore, firing costs would reduce employment.

The last view of firing costs featured that firms could find it worthwhile to offer voluntarily

firing costs (see section (3.3)). Clearly, if firing costs also imply an additional cost to firms in terms of motivating workers, then it is less likely that firms would naturally offer workers such an indemnity.

Finally, the existing empirical studies featured mixed results regarding the relationship between measures of EPL and unemployment (see section (3.4)). The usual measure of EPL is an index that tries to include several aspects of the law; yet, there is no theory about how each aspect of the law should be included in such index. Therefore, in general, it is hard to interpret empirically the effect of such an index on unemployment. For instance, from the discussion above, the regulated default indemnity should matter empirically for unemployment to the extent that there is some wage rigidity and/or capital markets imperfection. Another example from the discussion above is that, to the extent that there are no sufficient penalties for firms and workers for losing cases in court, noisy dismissals (and thus uncertainty around dismissal costs) might become relevant. In this case, the regulated larger indemnity would be the relevant one empirically for studying the effect of EPL on unemployment. An index of EPL is likely to include both the default indemnity and the larger indemnity as well as other aspects of the law. Yet, it is unlikely to capture the aforementioned effects if it is considered as a single conglomerate as well as if it is considered in isolation with the aspects that make firing costs relevant.

In the last section of this *Opuscle*, I will review the policy lessons that we can learn by having introduced noisy dismissals in the analysis of the effects of firing costs on employment.

6 Policy implications

In this section, I will use the firing cost framework characterized by noisy dismissals reviewed in section (5) in order to draw some policy lessons. In particular, I will consider two different types of policies. The first one would be a reduction in the level of the firing costs. The second one would be the so-called "flexibility at the margin" which consists of introducing firing-cost-free contracts for new hirings, namely temporary contracts.

6.1 Reducing firing costs

From the previous discussions, we can conclude that there are two main reasons by which firing costs can affect employment and, from these, we can draw two main lessons in terms of policy.

The first reason has to do with the impossibility of reallocating firing costs over time, for whatever reason. As discussed, this can be thought of as initial lower wages and higher future wages. It follows that a first lesson in terms of policy is that a fixed indemnity to be paid to workers upon firing does not need to be so problematic *per se*, to the extent that there is enough wage flexibility. In other words, if initial wages could be low, then the effect of firing costs would be frozen through the 'trick' of the cheque explained earlier. However, if there are large wage restrictions, typically from minimum wage laws, then the reallocation of payments over time would not be feasible and firing costs would affect firms hiring and firing decisions, and potentially unemployment.

In terms of policy lessons, it is crucial to understand that a crucial (first) reason why firing costs could affect employment comes from the combination of *both* the indemnity to be paid to workers as well as lack of wage flexibility. Note that in this case the relevant indemnity would be the default indemnity. Imagine a reform that reduces firing costs somewhat (but not too much), while keeping the same regulation on wages. In particular, the reform is such that firing costs cannot be completely undone with lower initial wages. But the required reduction in initial wages is lower than before and thus this would tend to increase employment as a larger fraction of the regulated firing costs could be undone. However, the unchanged wage inflexibility puts a bound

on how successful such a reform can be. The reason would be that, given the minimum wage, the lower level of firing costs could still be too high to make a full reallocation of payments over time happen. In this sense, the first lesson is that it is important to think in terms of the tandem firing indemnities and wage flexibility. Any combination of the two that would move in the direction of making the reallocation of payments feasible would tend to result in improvements in labour market outcomes.

The second reason why regulated firing costs can affect employment is somewhat harsher. Even if the interplay of firing indemnity and wage flexibility reversed the effects of firing costs because the inter-temporal reallocation of payments would be feasible, unfortunately, this is not the end of the story. EPL is more complex than a fixed indemnity, as firms rightly complain about. As we have seen, taking a broader view of EPL than simply seeing it as a fixed indemnity is useful in terms of understanding how dismissal conflicts can arise; and, in turn, how the cost of dismissals can become uncertain. More crucially, these noisy dismissals can have real economic effects because they affect the cost of motivating workers. That is, a fundamental (second) reason why firing costs can be problematic for labour market outcomes is because they reduce the penalty of shirking for workers and, thus, impose that a higher cost be paid by firms in order to induce the right incentives to workers. Note that in this case the relevant indemnity would be the larger indemnity.

In this sense, there might be at some level a simple policy implication. To the extent that dismissals are noisy, then reducing the larger indemnity will reduce how much workers can get even if they have misbehaved at work. Therefore, this will reduce the impact that firing costs have on the cost of monitoring workers and reduce labour costs. How successful such reform would be in bringing down unemployment depends on how much firing costs affected the cost of shirking in the first place.

Note, however, that to the extent that the larger indemnity is also playing a punishment role for firms then reducing it might not be such a good idea. Policies aiming at tackling the uncertainty around dismissals would be more complicated. On the one hand, firms should not find it worthwhile it to declare all dismissals of a disciplinary nature, just to try to save on the firing costs. On the other hand, workers should not find it worth it to take all cases to court to try to get the larger indemnity all the time. Note that the difference between the default indemnity and larger indemnity acts both as a penalty to firms and as a prize to workers. Therefore, a change in one of these indemnities alone is unlikely to improve things. Similarly, modifying the gap between the two indemnities is unlikely to solve the problem. This calls for two different instruments to penalize both firms and workers when taking cases to court and being proved wrong. The larger indemnity could play this role for firms; and for workers, this could, for instance, take the form of reduced unemployment benefits. Alternatively, some form of taxes for any individual proved wrong in court could also work.

6.2 Introducing temporary contracts

A common way in which several European countries in the last two decades have tried to reduce firing costs is by allowing, even for non-seasonal jobs, fixed-term or temporary contracts with negligible firing costs. The introduction of these contracts has taken place while keeping existing permanent contracts with high firing costs unmodified. The rationale behind these types of reforms is that it is often politically unfeasible to reduce firing costs across the board because already employed permanent workers would oppose it. Thus, the compromise is to allow firms to choose for new hirings between the existing contract or these new temporary contracts without firing costs. Countries that have implemented this type of reform have seen, since their introduction, temporary contracts play an important role in the labour market as these account for

most new hirings and are used in all sectors and occupations (see OECD, 1993). However, despite the intensive use of more flexible contracts, these types of reforms have been rather unsuccessful in bringing down unemployment.

In this section, I will review some of my research (Güell (2003) and Güell and Rodríguez Mora, 2008) in which we have studied the effect of these types of reforms. As I will explain below, we find that these reforms not only may be ineffective in reducing unemployment, but worse than that, they can actually generate higher unemployment levels.

Since these reforms were introduced with the goal of trying to obtain a reduction of firing costs, it is tempting to think about the potential effects of temporary contracts simply as a reduction of firing costs. However, doing so would not be very useful if we want to explain why these reforms have failed to work. Moreover, there are other features of temporary contracts that do not make these contracts equivalent to a lower level of firing costs. In particular, in most countries, fixed-term contracts cannot be used continuously and indefinitely. There is a maximum length of these contracts. And, thus, firms have to convert temporary contracts into permanent ones or fire the worker at their expiration.

What can we expect from temporary contracts in terms of reducing unemployment? Let's depart from a situation in which permanent contracts with firing costs look as described in the previous sections. That is, there are noisy dismissals, which imply that the cost of motivating workers is higher than in the absence of firing costs. This can translate into higher wages for permanent workers than in the absence of firing costs. In other words, the starting point is that firing costs reduce employment. So, potentially there is room for reforms tackling firing costs to boost employment.

Let's now introduce temporary contracts. The fact that these contracts do not involve firing costs makes them attractive and firms would prefer them to permanent contracts for all new hirings. Since temporary contracts cannot be used continuously and indefinitely, this means that workers on average hold quite short contracts. In our work, we argue that temporary workers will be motivated to work hard if they have some meaningful perspective that by doing so they will improve their chances to get their temporary contract converted into a permanent one. In other words, if the temporary contract ends for sure with unemployment, then paying high wages to temporary workers will not be enough in order to avoid that they shirk. The important implication of this, in terms of the effects of the reform, is that it is not possible to have temporary contracts and permanent contracts isolated from one another, even if temporary contracts are designed at the origin to affect new hirings only. Temporary contracts and permanent contracts (and thus all the effects of firing costs) are linked through the incentives that need to be provided to workers.

Therefore, since hiring a temporary worker implies some promise that there is a chance that the contract will become permanent, this means, in turn, that firms will find it worth to use temporary contracts by paying them lower starting wages. Lower starting wages while a temporary worker and higher future wages while a permanent worker sounds a bit like the 'trick' of the cheque mentioned earlier. Indeed, one can think of temporary contracts as acting as cheques in terms of future income in permanent contracts (higher wages and firing costs). In this case, the cheque is being returned only if the temporary worker is not fired and converted into a permanent one. Workers accept such a deal because going through a temporary contract is the only way to get to a permanent contract, since firms only offer temporary contracts to unemployed workers. Following a similar argument as earlier in section (3.2), the extent to which temporary contracts will help reduce unemployment depends crucially on how low starting wages in a temporary contract can be. Indeed, introducing temporary contracts while not putting any restrictions on how low initial wages can be would actually solve the unemployment problem in this context. Albeit this would be with negative initial wages (i.e., workers would pay to get

their job and thus the possibility of getting a permanent contract). The reason is that these low wages in temporary contracts undo the future effects of firing costs. In this case, all workers are motivated since going through a temporary contract is the only way to achieve a permanent contract; and permanent workers want to keep their job in order to avoid starting again with a low paid temporary contract. But if there is a legislated minimum wage, wages of temporary contracts cannot be below the legislated level. Thus, introducing temporary contracts while leaving other restrictions on wage flexibility unchanged may be an ineffective policy.

More importantly, we show that if the minimum wage is high enough, then temporary contracts can actually increase unemployment. This is an important policy lesson. Recall that we have introduced temporary contracts in the presence of noisy dismissals, that is, in this situation, reducing firing costs would actually help increase employment. Thus, temporary contracts can increase unemployment even in a world where reducing firing cost would reduce it. The reason for this is as follows. To some extent, temporary contracts are like lower firing costs and thus their introduction would lead firms to hire more workers as well as to fire more workers. However, in the case of temporary contracts, we can have a better idea of the magnitudes of each of these flows and, thus, on the overall effect of introducing temporary contracts.

Let's start with the firing decisions. Temporary contracts imply a new additional source of flows into unemployment, which has to do with the non-renewal at the end of the contract. As mentioned before, temporary contracts cannot be used forever and, for incentive reasons, some will have to be converted into permanent ones. Therefore, the extent of firing will be fixed and determined by the magnitude of incentive problems. It will not be affected by the minimum wage. Given the noisy dismissals, firms will convert as little as possible since permanent contracts are expensive. In other words, firms will fire more than in the absence of temporary contracts. Therefore, everything else being equal, temporary contracts will imply higher levels of unemployment.

Let's look now at the hiring decisions. The fact that incentives in temporary contracts are solved with the conversion rate into permanent contracts means that firms will pay low wages to temporary workers, since wages for temporary workers do not play an incentive role. How low firms can go with starting wages will determine how much hiring firms will be doing. In general, firms will hire more compared to the situation in which only permanent contracts were available, since the latter are more expensive contracts (because firms pay high wages to motivate permanent workers and because noisy dismissals impose even higher wages). However, firms will hire less the higher the minimum wage is. The reason is that a higher minimum wage does not contribute to undo the future effect of firing costs in permanent contracts. In fact, if the minimum wage is too high, then the increase in new temporary hires will be quite low. This low level of hiring will not compensate for the fact that firms are firing more and, in turn, will result in higher unemployment.

A way of seeing the pervese effects of temporary contracts on employment in the presence of high minimum wages is by realizing that in this case temporary contracts tend to increase the happiness of unemployed workers, thus increasing the incentive problems that the economy faces. In the presence of temporary contracts, firms need to pay even higher wages to permanent workers. Thus to create firms becames less profitable from which it follows that less production will take place. Thus, increasing unemployment. In this sense, this policy is akin to an increase in unemployment insurance.

7 Summary and conclusions

This *Opuscle* has reviewed existing work on the effects of firing costs on employment. A general lesson is that firing costs cannot be understood in isolation of other labour market variables.

When considering firing costs as a simple indemnity that firms have to pay to workers upon firing, it is crucial to consider the interplay between such indemnity and the degree of wage flexibility. Ultimately, this will determine the extent to which firing cost will have an impact on unemployment or not. Taking a broader view of employment protection legislation and allowing for dismissal conflicts is useful for understanding how firing costs can become uncertain. This has important economic consequences as uncertain outcomes in dismissal conflicts imply lower costs of shirking for workers and thus impose on firms a higher cost of motivating workers. Again, in order to understand the effect of firing costs on the labour market, it is important to look beyond the firing indemnity and watch for effects on wages. Putting these elements together can help us understand why some reforms tackling firing costs have been rather unsuccessful in bringing unemployment down.

In this *Opuscle* I have considered dismissal conflicts that arise due to the structure of employment protection legislation itself. Current research on dismissals conflicts is still limited in considering other sources of conflict between employers and employees (for instance, as a result of the fact that legislation can be somehow ambiguous). Further theoretical work on the implications for labour market outcomes would be most welcome. Similarly, more empirical research that tries to incorporate better measures of employment protection legislation capturing dismissal conflicts and possibly the effects of these would be very useful in order to assess possible policy considerations.

References

[1] Autor, D. H., J. J. Donohue III and S. J. Schwab (2004). "The employment consequences of wrongful-discharge laws: large, small, or none at all?" *The American Economic Review Papers and Proceedings*, 93(2), 440-446.

[2] Bentolila, S. (1997). "Las decisiones judiciales sobre despidos en España: una perspectiva económica". *Cuadernos de Información Económica*, 128/129.

[3] Bentolila, S. and G. Bertola (1990). "Firing costs and labour demand: how bad is Eurosclerosis?" *Review of Economic Studies*, 57, 381-402.

[3] Bertola, G. (1990). "Job security, employment and wages". *European Economic Review*, 34, 851-886.

[3] Bertola, G., T. Boeri and S. Cazes (2000). "Employment protection in industrialized countries: The case for new indicators". *International Labour Review,* 139 (1), 57-72.

[6] Blanchard, O. and A. Landier (2002). "The perverse effects of partial labour market reform: fixed-term contracts in France". *Economic Journal, Features: Symposium on Temporary Work*, F214-F244.

[6] Blanchard, O. and J. Tirole (2003). "Contours of employment protection reform". MIT Department of Economics Working Paper No. 03-35.

[8] Blanchard, O. and P. Portugal (2001). "What hides behind an unemployment rate: comparing Portuguese and U.S. labor markets". *The American Economic Review*, 91 (1), 187-207.

[9] Galdón-Sánchez, J.E. and M. Güell (2003). "Dismissal conflicts and unemployment". *European Economic Review*, 47, 323-335.

[10] Galdón-Sánchez, J.E. and M. Güell (2006). "Let's go to court! Firing costs and dismissal conflicts". Mimeo.

[11] Güell, M. (2003). "Fixed-term contracts and unemployment: an efficiency wage analysis". CREA. Working Paper 18.

[12] Güell, M. and J. V. Rodríguez Mora (2008). "Temporary contracts, incentives and unemployment". Mimeo.

[13] Kugler, A. (2007). "The effects of employment protection legislation in Europe and the

USA". *Els Opuscles del CREI*. Num. 18.
[14] Lazear, E.P. (1990). "Job security provisions and employment". *Quarterly Journal of Economics,* 105, 699-726.
[15] Malo, M.A. (1998). *Las indemnizaciones por despido, un problema de negociación*. Editorial ACARL. Madrid.
[16] Malo, M.A. and L. Toharia (1999). *Costes de despido y creación de empleo*. Ministerio de Trabajo y Asuntos Sociales. Madrid.
[17] OECD (1993). *Employment Outlook*. Paris.
[18] OECD (2004). *Employment Outlook*. Paris.