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Flexicurity in Belgium: A reform proposal based on economic principles

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Abstract. *Belgium's systems of unemployment insurance and employment protection legislation were set up in the context of typically enduring and stable relationships between workers and firms. Economic globalization and rapid technological and organizational change, however, are now demanding more flexibility of both workers and firms. As a result, current labour market institutions are in urgent need of reform to reconcile such increased flexibility with adequate security for workers. Though the call for a "flexicurity" approach is not new, there is no single view of what institutional model the latter implies. This paper proposes a reform explicitly guided by economic principles.*

Like many other labour market institutions, unemployment insurance (UI) and employment protection legislation (EPL) were born of an economic environment in which relationships between workers and employers were typically long-lasting and stable. Globalization of the economy and rapid technological and organizational change now require more flexibility of both workers and firms, which, in turn, has led to increased volatility of career paths, within and between firms. Those institutions thus require urgent reform to deliver more

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flexibility for firms and security for workers. Though the call for "flexicurity" is not new, there is no unanimity on how it should be implemented in practice.[1]

Rather than proposing an adjusted replica of foreign institutions, this paper takes a distinctive approach grounded in the articulation of explicit economic principles on which to base the design of employment protection legislation and an efficient system of unemployment insurance. Then, after outlining Belgium's current labour market institutions, the second part of the paper translates those principles into concrete guidelines for reform.

General principles for the design of labour market institutions

Employment protection

> Let us begin with a broad principle: Economic agents can be given discretion provided that they bear the cost that their decisions impose on other agents. This 'internalization of externalities' ensures that the decision-maker in question reflects others' preferences and is therefore accountable. For example, it is widely accepted that polluters ought to pay for the social cost of their pollution.
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> The translation of this broad principle in the matter of employment is that firms ought to pay for the cost they impose on society when they lay workers off. This cost includes the financial cost borne by the unemployment insurance (UI) fund and the psychological and other costs borne by the dismissed worker (Blanchard and Tirole, 2004, p. 4).[2]

The premise is thus that firms should pay for the costs that dismissals impose on society. It is important to note that the financial costs borne by the UI fund include the cost of the active labour market programmes (ALMPs) needed to return the unemployed to employment. Another social cost induced by a dismissal that the above quotation does not mention is the loss of tax revenue for financing public goods and transfers other than unemployment benefits.

Blanchard and Tirole (2003, 2004 and 2008) admit that their broad principle needs refining to take account of real-world imperfections. For instance, firms can shift the increased cost of dismissals onto workers by refusing to hire disadvantaged workers at high risk of unemployment or by paying them lower wages.[3] Furthermore, financially fragile firms can be bankrupted by an increase in their liabilities, or indeed evade responsibility, notably by relocating or deliberately reducing their capitalization. Because of such complications, Blanchard and Tirole conclude that firms should be considered only *partially* responsible for

[1] For a recent discussion on flexicurity from an international perspective, see the special issue on flexicurity in the *CESifo DICE Report, Journal for Institutional Comparisons,* Vol. 6, No. 4, Winter 2008. Available at: http://www.ifo.de/pls/guestci/download/CESifo%20DICE%20Report%202008/CESifo%20DICE%20Report%204/2008%20/CESifoDICEreport408.pdf [accessed 20 July 2010].

[2] Collective redundancies in a depressed area may impose further substantial costs on local communities.

[3] This problem can be partially resolved by providing firms with hiring subsidies for these workers specifically, though abuse of such measures may be difficult to prevent.

the costs they generate by dismissing workers. The current state of knowledge, however, precludes determination of *the* optimal compensation an employer should pay for dismissing a worker. Even though it is thus not possible to establish the employer's optimal degree of liability, a general principle of incentive pay – the "informativeness principle" (Milgrom and Roberts, 1992, p. 219) – dictates that employers' liability should increase to the extent that one can exclude components of the overall costs of dismissal which are not imputable to them. Indeed, dismissals can be a consequence of external factors beyond the control of the individual firm, such as the fall in aggregate demand caused by the recent financial crisis. The degree of liability should therefore increase if compensation for dismissal can be related to the difference between the dismissal costs induced by the firm and average dismissal costs across the economy.

Once economic agents are made responsible for their actions, they "can be given discretion". For example, this means that firms should not be required to justify redundancies in court, as is the case in France.[4] Legal proceedings are inefficient because it is extremely costly for a judge to gather all the information required to determine whether a dismissal is justified on economic grounds.

What form should the firm's compensatory contribution take? Should it be a lump-sum severance payment to the worker or a contribution to the UI fund financing unemployment benefits and ALMPs? On this point, economic principles provide some fairly clear-cut policy guidance. It would obviously be inefficient for the firm's contribution to take the form of a lump-sum transfer to the dismissed worker covering the average cost of unemployment because (i) the amount would be too high when unemployment duration is shorter than average and too low when it is longer, and (ii) jobseekers have only partial control over the duration of their unemployment. This is why the UI fund insures workers against unemployment risk. A lump-sum payment to workers is justified only in so far as it compensates for the psychological costs of "*becoming* unemployed" (e.g. loss of a familiar work environment, work relationships, etc.), which are unrelated to the cost of "*being* unemployed". For most workers, however, the economic costs of unemployment are without doubt much greater than its psychological costs. A contribution to UI is therefore needed in addition to severance pay, the latter being relatively less important than the former (Blanchard and Tirole, 2003, pp. 22–23).

In cases where workers voluntarily take up alternative employment or withdraw from the labour force immediately after being dismissed, the firm should arguably pay only the severance payment making up for the psychological cost of unemployment, not the contribution to the UI fund. It is important to realize, however, that such a scheme would give the firm an incentive to pay for outplacement services if they are cheaper than the UI contribution for dismissal (Cahuc and Kramarz, 2004, p. 162).

Finally, economic principles provide a justification for advance notice of dismissal (Pissarides, 2001). While severance payments can, in principle, perfectly

[4] But the courts should still protect workers against arbitrary dismissals.

insure workers against job loss, advance notice insures them against the risk of not being rehired after dismissal: during the notice period, workers can find another job and avoid loss of income. In theory, this justifies a notice period of, say, a few months. Yet such advance notice of dismissal is costly since a worker on notice loses the incentive to be as productive as before. This is why employers in Belgium often choose not to respect the notice period and to pay equivalent wages in lieu. Instead of requiring advance notice of dismissal, it may therefore be more efficient to require adequate UI entitling the worker to benefit immediately upon dismissal.

Efficient unemployment insurance

The UI fund should finance (i) unemployment benefits to compensate for income loss from dismissal and (ii) the cost of remedying the loss of firm-specific human capital consequent upon dismissal and the loss of general human capital over the duration of unemployment. Since job-search effort is imperfectly assessed by the UI fund administrators, unemployed workers cannot be fully insured against the loss of earnings. Full insurance, however, would drastically reduce the incentive to look for another job and accept job offers. Incentives can be financial – e.g. declining benefits over time, a hiring bonus or tax on the worker (see Hopenhayn and Nicolini, 1997) – or non-financial, including job-search training and intermediation services, job-search requirements and/or monitoring of responses to suitable job offers.

To compensate for loss of human capital, the worker should participate in suitable training programmes. If training is too costly, say, because the worker is close to retirement, she or he could receive a wage subsidy to compensate for lower productivity. Since the social benefits of investment in human capital exceed the worker's private benefits, it may be necessary to subsidize training to lower its cost, or even make it mandatory.

As the foregoing discussion clearly shows, national employment services have a specific mandate to fulfil.[5] Since individual workers underestimate the social value of employment,[6] determination of the appropriate allocation of funds between unemployment benefits and ALMPs cannot be left to the worker; it ought to be up to the government, acting through the employment services. The latter should aim to maximize the expected lifetime welfare of unemployed workers, subject to budgetary constraints. This, in turn, requires aligning the work of employment service staff on the pursuit of that objective, notably by means of appropriate incentive contracts. The design of such contracts, however, is complicated by the difficulty of measuring attainment of that objective (see, for example, Cockx, 2000).

[5] The national employment service is the institution responsible both for the payment of unemployment benefits and for the administration of ALMPs. In Belgium, the two functions are separate, however: the federal unemployment office is responsible for payment of benefits, and regional public employment services are in charge of providing ALMP services (their decentralization is discussed in Cockx and Van der Linden, 2009).

[6] In addition to their private gains from employment, increased employment means that society as a whole has to finance fewer benefits and can collect more taxes.

Employment protection and unemployment insurance in Belgium

Current institutional framework[7]

There are essentially two institutions that protect workers against job loss in Belgium: unemployment insurance (UI) and employment protection legislation (EPL). Employers are not required to justify their grounds for individual dismissals, but they must give workers sufficient prior notice.[8] The notice period need not be served if the employer compensates the worker by paying the wages she/he would have earned during that period (which then effectively amount to severance pay). In Belgium, the notice period is much longer for white-collar workers than for blue-collar workers, and it varies according to the provisions of applicable industry-level collective agreements, the type of contract (open-ended, fixed-term, etc.) and worker status (probationary or not). Collective redundancies are subject to special procedures, which are complex: the employer must give notice to the workers, their trade unions and the regional public employment agency, providing a justification for the dismissals. The unions then have time to raise questions and recommend alternatives to dismissal, though employers and unions are not actually required to reach an agreement. Except for some categories of workers, the severance payment is larger than in the case of an individual dismissal. In some circumstances, moreover, firms must finance outplacement services for the workers they dismiss.

Belgium has two UI schemes: a scheme for temporary lay-offs and the general UI scheme.[9] Until recently, only blue-collar workers were eligible for the temporary scheme, but temporary UI has now also been extended to white-collar workers on a provisional basis.[10] Firms laying off workers temporarily are exempted from severance payments since their contracts of employment remain in force. Firms can avail themselves of this scheme when their business temporarily slows down for external (particularly economic) reasons, such as a temporary drop in demand. Workers are then entitled to a constant level of unemployment benefits until they are recalled to work.

Workers with a sufficiently long record of employment are entitled to benefits under the general UI scheme if their employment is terminated against their

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[7] For more detail, see the web site of the Department for Federal Public Service Employment, Labour and Social Dialogue Department at: http://www.emploi.belgique.be/home.aspx and the AngloInfo page on employment contracts in Belgium at: http://belgium.angloinfo.com/countries/belgium/contracts.asp [accessed 21 June 2010].

[8] Workers are more or less protected against unfair dismissal. Moreover, there is also a long list of protected workers (see, for example, De Vos and Konings, 2007).

[9] Replacement rates and/or caps were revised upwards in January 2009.

[10] This scheme, however, differs on two accounts from the one covering blue-collar workers: it requires both a collective agreement to be in force and the company to have been recognized as being “in difficulty”. For more information, see http://www.restructurations.be/restructuration/fr/homepage/index.html [accessed 21 June 2010].

will.[11] Their entitlement to benefits starts on expiry of the notice period (even if this period is not effectively worked). The amount of the benefits depends on the claimant's household status (head of household, single, or dependant of the head of household) and is calculated as a fraction of wages, subject to a floor and a cap. Heads of households are indefinitely entitled to the same level of benefits, while benefits for singles and dependants decrease with duration of unemployment down to a flat rate. Since 2004, the job-search efforts of the long-term unemployed have been monitored and, if deemed insufficient, their entitlement to benefits may be forfeit (see Cockx, Dejemeppe and Van der Linden, 2007).

What is wrong with Belgium's current unemployment insurance system?

Belgium's UI system has gradually evolved from an insurance scheme to an assistance scheme, with low replacement rates for high-wage workers (who are highly protected by EPL if they are white-collar) and high replacement rates for low-wage workers. The scheme lacks transparency and leads to "unemployment traps", especially for low-wage workers. A more transparent scheme could partially or entirely replace the system of severance pay in lieu of prior notice by a system of unemployment compensation based on a *single* replacement rate, initially set much higher than the current one, but gradually tapering off to lower rates the longer the duration of unemployment in order to give the unemployed an incentive to seek new employment.[12] The long-term unemployed and low-wage workers would be guaranteed a minimum income. But since the financial incentive to find employment would no longer work in this case, minimum income recipients should be eligible for low-cost ALMPs (subsidized or even free), or be subject to compulsory job-search requirements and/or verification of acceptance of suitable job offers, depending on which measure is the most effective.

Belgium's UI scheme is currently financed by contributions unrelated to dismissal.[13] This does not encourage employers to internalize the social costs of their dismissal decisions whereas severance payments do make them accountable for dismissing workers on open-ended contracts. As argued above, however, this is not an efficient way of insuring workers against unemployment. In

[11] If their employment record is too short, they are only entitled to a guaranteed minimum income provided by the social assistance scheme. School-leavers are also entitled to unemployment benefits after a waiting period (for more on this specific entitlement, see Van der Linden, 2007).

[12] In order partially to offset the drop in the level of benefits, an additional incentive could be provided in the form of a bonus paid out to workers who find employment. However, this bonus should not be the same for all recipients. It should decrease with unemployment duration *and* become negative – i.e. a tax – when unemployment lasts too long (Hopenhayn and Nicolini, 1997).

[13] Since 2005, a notable exception has been the "accountability contribution" paid by construction-sector firms which temporarily lay off workers for more than 110 days per year. From 2000 to 2002, a similar contribution was applicable to all sectors for firms making excessive use of temporary UI, but this scheme was not extended. See, for example, http://www.securex.eu/be/lex-go.nsf/vwNews_fr/791FD09EF44C23F5C1257108002E56C1?OpenDocument [accessed 21 June 2010].

Belgium, moreover, the level of employment protection varies substantially not only according to seniority in the firm and wages, but also according to type of employment contract. "Advance notice payments" – i.e. wages paid during the notice period or the severance pay settled when that period is not served – are generally high for "well-paid", white-collar workers on open-ended contracts.[14] In contrast, blue-collar workers and all workers not (yet) employed under open-ended contracts are poorly protected by international standards. Workers on fixed-term contracts enjoy relatively strong protection until the expiry of their contract, whereupon the employer can dispense with their services at no cost. Such differentiation of EPL by contract type is socially inefficient because it cannot reflect differences in the social costs of dismissal.

Finally, another feature of Belgium's EPL gives rise to concern: the level of severance pay for some white-collar workers is not set in advance, but must be determined by mutual agreement between the worker and the employer.[15] This creates uncertainty and may give rise to legal costs where no agreement is reached. Efficiency would therefore be enhanced if the level of these payments were specified in advance.

Suggested guidelines for reform

Same liability for all types of contracts

We see no theoretical justification for differentiating levels of advance notice payment by type of worker (blue-collar or white-collar) or contract (temporary, open-ended, etc.). We therefore plead for imposing on firms the same liability for dismissing workers of *any* kind. Firms could continue to employ workers through temporary employment agencies, provided that the latter's contracts with those workers are standard with regard to liabilities in case of dismissal. The standard level of liability should at all events be set below that currently applicable to "well-paid", white-collar workers.

UI contribution for dismissal

The level of firms' financial liabilities should be proportional to the social cost of dismissals. However, since dismissals for which individual firms can be held accountable are hard to identify, the proposed UI contribution for dismissal should be only *partially* related to social costs: it should increase with wages (since both the level of unemployment benefits and the amount of lost taxes increase with wages), job tenure (since loss of firm-specific human capital increases with tenure) and the expected duration of unemployment (since benefits and lost tax revenue increase with unemployment duration).

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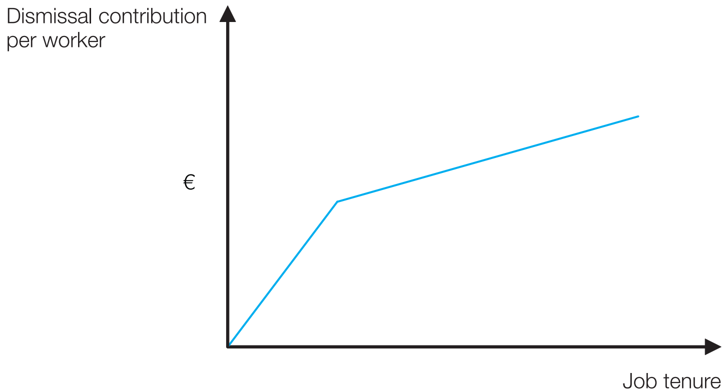
[14] The "well paid" are those whose annual gross wages amount to at least €29,729, i.e. net monthly wages of about €1,500 (as at 1 January 2009).

[15] For details, see: http://www.emploi.belgique.be/defaultTab.aspx?id=3566 [accessed 21 June 2010].

Figure 1. Profile of the proposed dismissal contribution for a given wage rate



As each dismissal entails a fixed social cost (administrative costs related to the payment of unemployment benefits and the organization of ALMPs),[16] the proposed UI contribution should in principle contain a fixed component. But this would make short-term job creation very costly. Following Cahuc and Kramarz (2004), therefore, we would propose that the amount of the UI contribution for dismissal should increase at a higher rate during the initial period of employment.[17] Lastly, as an incentive for firms to invest both in prevention of the adverse consequences of dismissals and in workers' employability, the UI contribution would not be due where the worker voluntarily accepts employment in another firm – or voluntarily withdraws from the labour force – immediately after dismissal.

For practical purposes, however, we propose that the UI contribution should meet only the following two conditions: proportionality to the worker's cumulative past earnings in the firm, and a higher rate of increase in the amount of the contribution during the initial phase of employment (as illustrated in figure 1). So as to avoid discouraging recruitment of disadvantaged workers (who generally remain unemployed for longer), the proposed contribution would thus not depend on the expected duration of unemployment. Rather, it would depend on average unemployment duration across the labour force as a whole. But since this would exaggerate the social cost of temporary lay-offs – because these last less than the average duration of unemployment – a separate scheme is required for temporary lay-offs (the issue is taken up below).

Three refinements should be considered. First, according to the "informativeness principle", the UI contribution paid by a given firm should reflect the difference between the dismissal costs induced by that particular firm and average dismissal costs across the economy. This can be worked out retrospectively

[16] The fixed "psychological costs" of dismissal are considered to be directly covered by the severance pay received by the worker (see below).

[17] In their report to the French Government, Cahuc and Kramarz (2004) recommend that this period should cover the first 18 months of employment.

on the basis of the firm's dismissal record. Second, since financially weak firms might be bankrupted by such liabilities for dismissals, smaller firms should pay a lower UI contribution. Third, in order to account for the higher social costs of collective redundancies, the UI contributions payable in such cases should be higher than those due in respect of individual dismissals. Also, legislation should continue to allow trade unions to recommend alternatives to collective redundancies. As argued above, however, the current system of compensation based on severance pay for collectively dismissed workers without contribution to the UI fund is unsatisfactory.

A relatively small severance payment

According to the principles discussed earlier, severance pay should only cover the psychological cost of job loss. This obviously depends on personal circumstances, which are too heterogeneous to be taken into account. But for most workers, this cost is likely to be relatively low. Since insurance provides more efficient protection against unemployment risk than severance pay, we therefore plead for converting the bulk of severance payments into contributions to the UI fund.

Improved UI coverage

The additional resources accruing to the UI fund from the proposed new contribution could be used both to extend entitlement to workers whose contributory record is insufficient *and* to top up current benefit levels for workers who have contributed sufficiently. The latter's UI coverage could indeed be improved by abolishing the current cap on benefits and raising the replacement rate. As an incentive for recipients not to remain unemployed, the benefit supplement could decrease gradually as unemployment lasts, until the current level of unemployment benefits is attained.[18]

Additional funding for ALMPs

The additional income of the UI fund should also be used to pay for training or employment subsidies that would make up for the loss of firm-specific human capital. This would be a key improvement on the current scheme, in which the worker receives only financial compensation at dismissal and is left alone to decide how much to invest in active measures. Since the worker does not take into account the social benefit of re-employment, under-investment is bound to occur from a social perspective. Explicit allocation of part of the proposed UI contributions to ALMPs would thus lead to a more efficient labour market.[19] Since Belgium's ALMPs are essentially managed at local-government level, a sensible rule would have to be established for sharing the additional funds among

[18] In addition, one could perhaps introduce hiring bonuses, the amount of which would decrease with unemployment duration (see note 12 above).

[19] The design of such programmes is crucial but difficult to optimize, and beyond the scope of this paper. For a discussion of some of the issues involved, see Cockx (2000); and for a proposed scheme for monitoring the unemployed, see Cockx, Dejemeppe and Van der Linden (2007).

the country's regional employment agencies (see Cockx and Van der Linden, 2009, for a discussion).

Temporary lay-offs

How can Belgium's temporary lay-off scheme for blue-collar workers – and its temporary extension to white-collar workers – be reconciled with the foregoing recommendations? If the proposed UI contribution were proportional to the social cost of dismissal, including the expected duration of unemployment, no distinction would need to be made between temporary and permanent redundancies.[20] However, the proposed UI contribution for dismissal should, as we have argued, be independent of expected unemployment duration: calculated on the basis of the average duration of unemployment, the contribution would indeed be too high for temporary lay-offs whose duration is typically shorter. It would thus make sense to supplement the regular UI scheme with one which provides benefits to workers laid off for less than a specified number of days per year. Workers covered by this scheme would still be contractually employed and would know in advance when they are due to be recalled by the employer. And if a worker is not recalled, the employer would have to pay the UI contribution for dismissal. In order to ensure accountability for the extent to which employers make use of the system, we would propose a system of retrospective "experience rating", similar to that used for funding UI in the United States.[21] Employers' contributions to the temporary employment scheme would be proportional to the use their employees make of it, thereby ensuring that they resort to it only for relatively short spells of unemployment.[22] The lack of experience rating (except in the construction sector)[23] is an important drawback of the existing scheme for blue-collar workers. Besides, there is no economic reason to exclude white-collar workers from the scheme.

Individual savings accounts are no solution

The Austrian system of individual savings accounts has recently become a model for EPL reform (OECD, 2006; European Commission, 2006; Sels, 2008; De Vos, 2009). Under this scheme, the employer contributes a proportion of employees' wages to individual accounts. Workers who lose their job after a minimum number of years in employment (three years in Austria) can choose to withdraw money from their savings account as from the time of dismissal, accumulate further savings until a subsequent dismissal, or eventually use their account as a supplemental pension fund to top up their pension on retirement.

[20] Coverage of temporary lay-offs for other reasons (climatic conditions, mechanical failure, fire, etc.) can be maintained and even generalized to white-collar workers, because such lay-offs are beyond the control of the firm and their grounds are easily verifiable.

[21] There is no single experience-rating scheme in the United States. For a description of how each state administers its own separate scheme, see OECD (2004) and Fath and Fuest (2005).

[22] A refinement would consist in reducing (or increasing) the amount of employers' contributions in step with the business cycle.

[23] See note 13.

There are two main reasons why we would oppose such a scheme. First, since saved-up "severance pay" accrues from contributions paid into each account *before* dismissal occurs, the scheme goes against the principle of accountability for the social costs of dismissal and is therefore conducive to a socially inefficient increase in the number of dismissals. Second, because it relies on individual savings, such a scheme is less efficient than an insurance scheme: workers with insufficient savings remain unprotected, while others will save up more than they need for retirement. Proponents of the system of individual savings accounts would retort that an insurance scheme provides disincentives for work, while an individual savings account does not. However, a UI scheme that provides for unemployment benefits to decline over time and/or for monitoring and counselling programmes can compensate for these disincentives without prejudice to the main advantages of insurance.

Conclusion

Economists see job destruction as part of the process of innovation and growth (hence, the expression "creative destruction"). But for most workers, being dismissed is a tragedy and an injustice. The reform proposed here for Belgium takes into account both points of view: it would make both employers and employees more conscious of their responsibilities towards society as a whole.

We recommend converting the bulk of the severance payment currently paid to a dismissed worker into a *uniform* dismissal contribution paid into the UI fund, regardless of the type of worker (blue- or white-collar) and contract (temporary or open-ended). A relatively small severance payment should be maintained as compensation for the psychological cost of dismissal. In order to make the firm accountable for the costs it imposes on society, the dismissal contribution should be proportional to the cumulated wages it has paid to the worker since his or her recruitment. This contribution would not only constitute a supplement to the financing of unemployment benefits, but also help finance ALMPs for the unemployed. Belgium's current scheme of temporary unemployment benefits for blue-collar workers should be generalized to white-collar workers, with employers' contributions to the scheme subject to "experience rating" in order to make firms accountable for the social costs induced by temporary lay-offs as well.

Further work will be needed to operationalize these principles into a directly implementable reform package and to estimate its social value. This will be the next step.

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