

# Dismissal costs and job contract conversion rates: the Italian CFL case

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**Abstract:** *This paper uses an Italian linked employer-employee dataset to analyze the effects of dismissal costs on job contract conversion rates. In 1990, unfair dismissal costs were extended to businesses below 15 employees, while bigger businesses were unaffected by the reform. Whether this policy affected the conversion rate of the Italian “Contratto di formazione e lavoro” into permanent contracts in the same firm is ultimately an empirical question.*

**Keywords:** **difference-in-differences, dismissal costs, job contract conversion rate.**

## **1. Introduction**

It is well known that firms often need to carry out screening procedures to evaluate workers' skill levels before stabilizing the firm-worker job relationship, and it is also costly for them to dismiss workers once they are hired. As long as firms cannot make use of any specific tool to evaluate applicants' characteristics, their choice is just to hire or not to hire. Of course this behaviour is inefficient because after a worker has been hired and her unsuitability for the job is understood, a firm has an incentive to dismiss the worker. But since employment protection legislation usually poses some costs on this, firms might be obliged to keep a worker even though her unsuitability. This in turn implies the presence of frictions in firms' hiring procedures.

In the early 1980's, the Italian labour market was experiencing a tough situation, in which the unemployment rate of young workers was too high. The working and training contract program (Contratti di formazione e lavoro, CFL) was introduced in 1985 to overcome this problem by promoting the access to the labour market for young workers and providing them a training background in order to increase their future employability. The CFL programme offered this opportunity by lowering labour and firing costs, and through specific training activities. But on the other hand, firms could have an incentive to repeatedly hire eligible workers to lengthen the beneficial effects of the programme instead of converting existing CFL into permanent positions (potential substitution effect).

Since the programme was first introduced, several subsequent reforms have taken place modifying firms' incentives to use these contracts. In particular, in this study we will look at two potentially relevant policies that are thought to have affected the conversion rate of CFL into open-ended contracts in the same firm. In the 1990 a reform which introduced unjust dismissal costs for small firms (i.e. businesses below the 15 employees threshold) was implemented. This policy might have both directly and indirectly affected small firms' choice of converting working and training contracts into permanent positions. The second reform took place in the same period and came into force on 1<sup>th</sup> January 1991. This reform stated that the right to hire by means of CFL contracts could be claimed only by those firms who had converted at least 50% of the CFL contracts expired in the previous 12 months into open-ended ones. That was clearly an attempt to discourage firms to hire under CFL only to exploit fiscal benefits.

In this paper we use a difference-in-differences research design to isolate the effect of the first

reform on the CFL conversion rate into permanent contracts. To empirically test my research question, I use the Work Histories Italian Panel (WHIP). The dataset is a 1:90 random sample drawn from the Italian Social Security Administration (INPS) collecting information on employees in private firms. From the original data, I build two independent cross sections, one referring to the pre-reform period and the other referring to the post-reform period. In both cases I select workers hired under working and training contracts and follow them up to their first transition in a different labour status. I ended up with two waves, the first one includes 3328 observations, while the second one is made up of 2997 observations. Since the maximum contract length could never exceed two years, I start following workers from 1987 and from 1991. In this way, those who begun working in 1987 are followed up to 1989, and, similarly, those who begun working in 1991 are followed up to 1993. For each worker, I observe the first transition out of the CFL status. I exploit the fact that the WHIP is a linked employer-employee dataset, so it is possible to know whether or not the subsequent job was in the same firm and under a permanent position.

## **2. Dismissal costs and CFL conversion rates**

The effects of higher dismissal costs on small firms can be summarized as follow. An increase in dismissal costs might influence the job contract conversion rate at least in two ways. First, consider a potential direct effect it may exert on job accession. From the firms' point of view, the fall in the net present value of labour services makes hiring new workers less worth. This means that more employment protection should reduce the overall number of new hiring and thus the number of CFL which are converted in open ended contracts. Second, consider a potential indirect effect: as long as the CFL is an alternative recruitment procedure with respect to standard recruitment procedures (direct hiring by means of open ended contracts), an increase in dismissal costs should boost firms to be more aware of the hiring decision. Although the rise of firing costs for small businesses might lower the use of working and training contracts, the profitability of these contracts after the reform should rely more on the firms' screening needs. Since under working and training contracts firms get to know workers' characteristics and abilities, they should prefer this recruitment procedure and so if a worker need to be hired, maybe a working and training contract is a good way to reduce the uncertainty about workers' future performances. According to this claim, the raise in dismissal costs might have increased the number of new hiring preceded by a CFL, so the job contract conversion rate is rising as well. Which of these two effects is dominant is ultimately an empirical question and this paper wants to shed some light on this by following the small firms' behaviour during the period 1988 to 1994 and compare it with that of big (non-treated) firms.