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The Pros and Cons of the Latest Labour Market Reform in Spain

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Abstract: In this paper, I analyze the main novelties of the new labour market reform approved in Spain in 2012 in relation to the changes that were already introduced in the preceding short-lasting reforms of 2010 and 2011. On the positive side, it is argued that the new reform goes in the right direction in achieving higher internal flexibility as a means of adjustment to business cycle fluctuations. However, on the negative side, it fails to be transformational enough in other relevant areas, like suppressing dualism, improving the effectiveness of active labour market policies, enhancing productivity and maintaining the overall level of social protection of Spanish workers. Given these limitations, it is unlikely that this will be the ultimate reform curing once and for all the Spanish labour market "disease".

Keywords: Labour market reform, dualism, severance pay, political economy, Great Recession.

JEL codes: H29, J23, J38, J41, J64.

I. The negative consequences of a highly dysfunctional labour market

The chronic problems of the Spanish labour market have dramatically reappeared during the Great Recession. Having converged during the preceding long expansionary phase to the EU average of 8% in 2007, the unemployment rate has jumped to 24.4% in 2012q1. Further, it is very likely that it will exceed 25% before the end of 2012, marking the third time since the advent of democracy that such socially unbearable heights have been reached. Besides being astonishingly high, another prominent feature of the Spanish unemployment rate is its extreme volatility relative to other countries. This is illustrated in Figure 1 where it is plotted alongside the French rate, a representative of the Euro Zone (EZ) average. As pointed out by a large body of available evidence, two main institutional factors seem to behind the persistent problems of the Spanish labour market.[1] On the one hand, it is a highly segmented labour market characterized by excessive worker turnover —historically, 33% of employees had a temporary job, and currently 24% still do, even after massive job losses since 2008— and, on the other, it suffers from a rigid collective-bargaining system which prevents the use of internal flexibility as a means of adjustment to shocks.

In effect, the combination of dual Employment Protection Legislation (EPL) and both nominal and real wage rigidities leads to adjustment to negative shocks mostly taking place via dismissals, rather than through wage moderation —like e.g., in the UK— or working time reduction –as e.g., in Germany. During the Great Recession, the increase of 3.5 million unemployed between 2008q1 and 2012q1 has been the result of a 3.0 million job loss (0.76, 1.72, and 0.52 million among permanent, temporary, and self-employed workers, respectively) plus a 0.5 million increase in the labour force (mainly due to large

[1] See, Bentolila *et al*. (2011) for an overview of the relevant literature.

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Figure 1. Harmonized unemployment rates in France and Spain, 1978-2011.

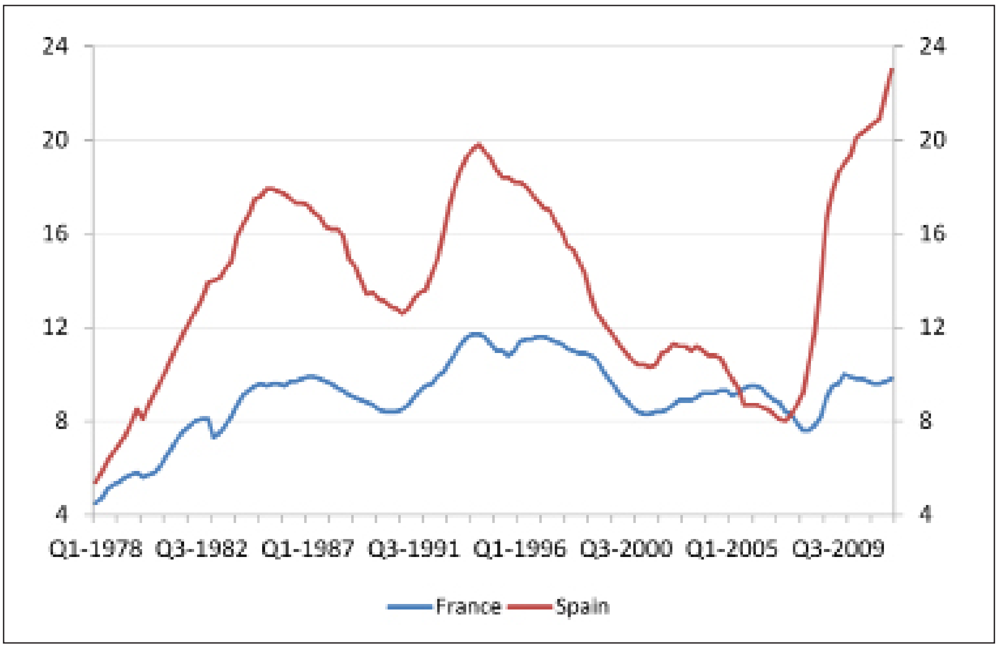
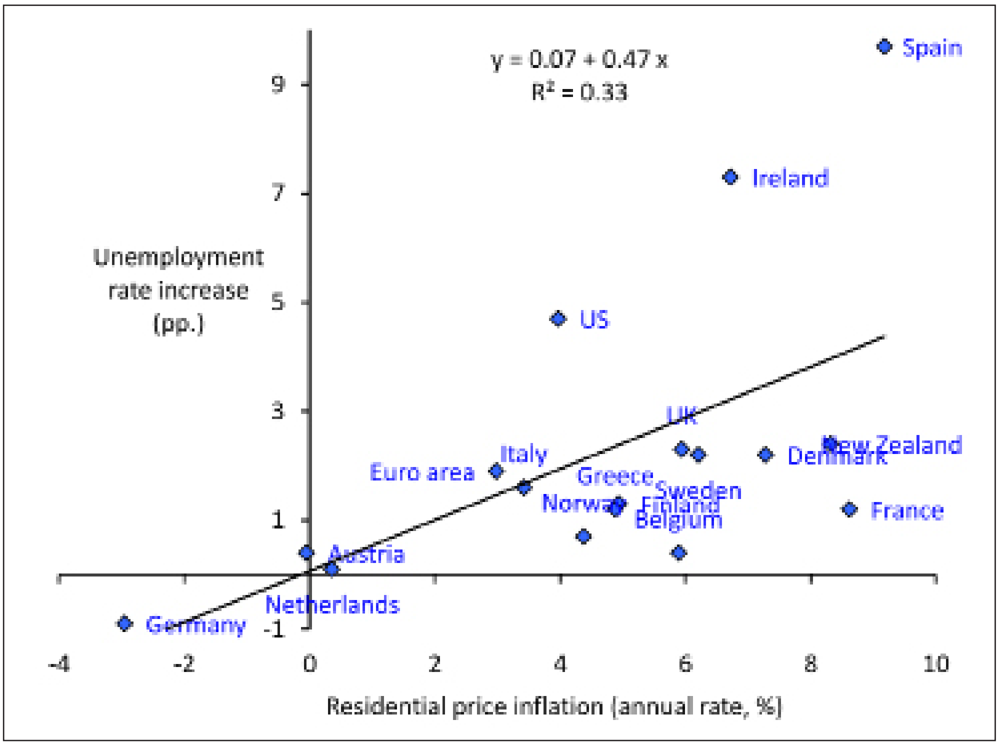


Figure 2. Unemployment rate increase in 2007-09 vs. Residential price inflation in 2000-07.



immigration inflows since 2000, which receded only in 2011).[2] Admittedly, a significant part of the job shedding has been due to the bursting of a big real-estate bubble that started around 2000 and which has given rise to the destruction of 1.5 jobs in the construction sector since 2007. Yet, as shown in Figure 2, this stark response is out of line with what has happened in other countries that have also witnessed booms

[2] See Bentolila *et al.* (2008a) for an analysis of the effects of these large demographic changes on the labour market.

and subsequent busts in this sector, as is the case of Denmark, Ireland or the UK. Despite the fact that Spain's main natural resources —good climate and tourist resorts— call for a higher share of employment in the construction sector (it reached 13.5% in 2007, against 6.8% in 2012q1), the investment boom that took place in this industry —triggered by the large drop in real interest rates as a result of joining the EZ in 1999— is also closely related to Spanish labour market regulations. In effect, rigid labour contracts turn out to be inadequate for specializing in more innovative industries, where labour flexibility is required to accommodate the higher degree of uncertainty typically associated with producing high value-added goods (see Saint-Paul, 1997). Hence, more mature sectors, compatible with the use of less skilled labour through flexible temporary contracts were chosen by Spanish investors. This is clearly illustrated by looking at what happened in Finland, another country which shared with Spain a large fall in real interest rates when accessing the EZ. In contrast to Spain, Finland not only had a much less segmented labour market but also a much more efficient educational system, as has been later confirmed by the well-known PISA studies. While Spain invested heavily in bricks and mortars, Finland did so in IT industries. Moreover, the prevalence of industry-wide collective bargaining agreements in Spain resulted in a slowing down of job creation in high-productivity sectors, while it increased job destruction very significantly when the crisis hit (see Jimeno and Thomas, 2011).

II. A long sequence of ineffective labour market reforms

As explained in Dolado *et al.* (2002) and Bentolila *et al*. (2008b), the Spanish government reacted to the burst in unemployment during the early 1980s by introducing a large gap in EPL between permanent and temporary workers in the two-tier 1984 labour market reform. Political-economy constraints in the smooth political transition process from dictatorship to democracy implied that flexibility could only be introduced at the margins (only for newcomers). This was achieved by extending the use of temporary contracts with very low dismissal costs to hire employees performing regular activities, rather than just seasonal/replacement ones. As a result of this reform, the temporary employment rate increased from about 12 % of employees before 1984 to 33% in the early 1990s.

Later on, an *insider-outsider* model of industrial relations became well entrenched, with several regulations helping to maintain it. For example, as documented in Dolado *et al.* (2010), by law both workers in firms with less than six employees and temporary workers with less than one-month of tenure are not allowed to vote in firm-level union elections. This regulation, which rules out almost 30% of the potential electorate more likely to oppose labour market segmentation, suits the unions in their goal to press for larger wage rises for permanent workers (their decisive/median voters in the elections for workers' representatives). This happens because unions anticipate that firms will respond to unjustified wage pressure by dismissing temporary workers with low firing costs rather than highly protected permanent workers (see Bentolila and Dolado, 1994) —as has indeed been once more the case during 2009-2010. Likewise, the main employers' association (CEOE), in which small and medium-sized (SMEs) enterprises are scarcely represented, also has an incentive to go along in keeping the *status quo*, to some extent. This is so since typically large firms can afford higher wages due to their greater market power and therefore use collective bargaining as a barrier to prevent free entry into those industries where they have a dominant position.

Preceding the 2012 reform, there have been seven other important labour market reforms (1984, 1994, 1997, 2002, 2006, 2010, and 2011) and 52 additional minor legal changes that have tried to correct this course of events. Their main goal has been to reduce the EPL gap, either by constraining the use of temporary contracts in sequence or by slightly cutting severance pay for permanent contracts while mildly increasing legal indemnities paid at the termination of temporary contracts. These reforms have mainly taken place when workers under permanent contracts felt the risk of losing their jobs (see Saint-Paul 2002 and Dolado *et al.* 2010) or when there was a favourable impulse from an external driver, like joining the European Community in 1986 or entering the EZ in 1999.

The current scenario is quite different. First, there is no positive external impulse, as international demand remains subdued and devaluations, which were often pursued in the early 1980s and

1990s, are not available anymore in a single-currency area. If anything, there is the need to avoid the negative threat of being intervened, like Greece, Ireland and Portugal. Secondly, the level of indebtedness —with public debt approaching 80 percent of GDP, and net external debt close to 100 percent— and the resulting difficulties for external financing prevent the use of further fiscal stimulus, which in any event proved fairly inefficient during 2008-2009. Finally, the need to restore fiscal sustainability also limits the scope for a fiscal devaluation (consisting of a rise in VAT and a reduction in social security contributions; see Farhi *et al*. 2011), whose medium and long-term potentially favourable effects would be, in any case, conditional on achieving a downward adjustment of input costs and price margins.

Trying to cope with this situation, the previous socialist Government initially decided that a labour market reform was not required. However, when the euro crisis erupted and external pressure from international institutions and financial markets heated up, it abruptly changed its views. As a result, an agreement with the social partners was attempted twice, in 2010 and 2011, which predictably failed. Consequently, the socialist Government —which remained unconvinced of their necessity— implemented two consecutive reforms that appeared to be quite comprehensive in scope but were in fact quite shallow. The key changes affected the following areas (see Bentolila *et al.* 2011 for more details):

Severance pay. The causes justifying fair dismissals for economic reasons were defined more explicitly. Advance notice was reduced from 30 to 15 days. The employment-promotion permanent contract introduced in the 1997 reform was extended to almost every worker (except for prime age workers with short unemployment durations), for which the so-called *express dismissal* procedure established in 2002 now applied. This meant paying severance of 33 days' wages per year of service so as to avoid the red-tape costs of going to court, giving advance notice, and paying interim wages altogether (previously, the prevailing route was to get these advantages by disguising economic dismissals as disciplinary, but with the highest severance pay of 45 days and a cap of 42 months). An existing fund (Fogasa) fed by employer contributions, which had accumulated a surplus of about one billion euros, was allowed to reimburse firms 8 days' wages in all dismissals of permanent employees. Severance pay for temporary contracts was raised progressively from 8 to 12 days (to be attained in 2015).

Collective bargaining. Firm-level agreements were given priority over the corresponding industry-wide agreements, unless explicitly overruled by the latter. In practice (e.g., in the collective agreement for the construction sector which was signed soon after this reform), this meant an insurmountable obstacle for many small firms in distress willing to opt out of the higher-order agreements. Further, those firms that were allowed to opt out had to reach a previous agreement with their workers and the corresponding wage level agreed at the industry level had to be attained in no more than 3 years. Over the subsequent year, any expiring agreement that could not be renewed through consensus would be subject to arbitration.

Thus, broadly speaking, these two reforms closely followed the same ineffective strategies of the past. Regarding EPL, they mildly reduced dismissal costs and relaxed dismissal restrictions under the employment-promotion permanent contracts while they slightly increased severance pay for temporary contracts. Yet, the EPL gap remained high. As for the regulation of collective bargaining, they upheld the principles favouring industry-level bargaining, while marginally lifting some restrictions on opt-out clauses.

III. What is new in the 2012 reform?

The new conservative Government elected in November, 2011 soon announced that the previous reforms were deemed as insufficient and gave a short period of time for the employers' confederation (CEOE) and the main trade unions (CCOO and UGT) to agree on further proposals for reform. A bilateral pact on wage moderation and the use of early retirement as the main tool of employment adjustment was presented in late January 2012. However, once more, no substantial agreements were reached on either reducing labour market segmentation or facilitating internal flexibility for firms in distress. The government found this unsatisfactory and immediately announced a new reform in February 2012, which in most cases follows the same direction as the 2010-2011 reforms but with more drastic changes. In a nutshell, the 2012 reform aims at increasing overall external flexibility (facilitating dismissals for workers with permanent contracts) with the hope that this threat will enhance internal flexibility (i.e., adjustments in wages and working time). Specifically, it affected the following areas:

Severance pay. The causes for fair dismissal for economic reasons have been further clarified to include 3 quarters in a row of declining revenue/sales relative to the same quarters in the previous year. The difference between regular and employment-promotion permanent contracts is eliminated and the severance pay for unfair dismissals is unified at 33 days, with a cap of 24 months' pay, i.e., the cap introduced in the 1997 reform for the latter type of indefinite contacts. Those workers dismissed under unfair conditions with job tenures starting before February 2012 would be entitled to a weighted average of the former regulation of 45 days and the new one of 33 days, with a cap of 720 days' wages under the previous EPL regime. The reimbursement of 8 days' wages in dismissals of permanent employees is now limited to fair dismissals in firms with less than 25 employees. The *express dismissal* procedure (see above) and the administrative approval of collective dismissals are both abolished. Training contracts are extended to workers up to 30 years of age (previously 25 years). Lastly, a new permanent contract for entrepreneurs is introduced for firms with less than 50 employees. Workers hired under this new contract are subject to a one-year probation period (i.e., with no severance pay), while firms using these contracts will enjoy substantial fiscal subsidies insofar as the workers remain employed for at least 3 years. Once the probationary period is over, workers are entitled to 20 or 33 days ´wages per year depending on the fair or unfair nature of dismissals, with retroactive effects on the first year. Hence, e.g., a worker with this type of contract who happens to be dismissed after 3 years in the job, would receive either 60 (=20x3) or 99 (=33x3) days wages.

Collective bargaining. Priority of firm-level agreements over industry-wide agreements is no longer subject to overruling by the latter. Employers are allowed, for reasons related to competitiveness or productivity, to unilaterally change working conditions, including wages, as long as these are above the industry collective-agreement level (the worker may then quit and receive the severance pay for economic dismissals or else challenge the changes in court). The causes allowing firms in distress to opt out of the industry collective-bargaining working conditions, including wage levels, are further clarified as firms having 2 quarters in a row of declining revenue relative the same quarters in the previous year. Expired agreements that cannot be renewed by consensus will be subject to compulsory arbitration, and industry agreements will no longer be able to rule out this eventuality. The maximum duration of working conditions after the expiration of a collective agreement is set at one year (previously being unlimited). Administrative approval of collective contract suspensions and work-time reductions is abolished.

Overall, these changes reduce firing costs and re-establish the causal nature of dismissals. Note that dismissals for economic reasons were previously almost fully blocked by labour courts (so that they only represented 8% of all labour contract expirations in 2010, i.e. including those of temporary contracts). Thus, even during a very deep and prolonged recession, firms preferred to avoid legal uncertainty and the red-tape costs associated to presumably fair dismissals. Instead, they ended up paying the prevailing 45 days' pay for unfair dismissals, which was too high by international standards. The *express dismissal* (30% of expiring contracts) made economic sense (see Blanchard and Tirole, 2004) but turned out to be a legal aberration. Lastly, administrative approval for collective dismissals, which is very atypical in the European Union, was ultimately a way to raise severance pay in economic dismissals (on average, up to the level of unfair dismissals) as well as a source of revenue for unions who often charged workers a fee related to legal assistance. As a result, collective dismissals had also been strongly curtailed (amounting only to 4% of contract expirations). This induced an intense use of temporary contracts (accounting for 56% of all expirations).

There is a continuing risk that labour courts will not apply the new criteria justifying economic dismissals mechanically, leading to an increase in uncertainty about firing costs and in litigation by workers trying to obtain the 33 days severance pay, rather than the lower 20 days.

IV. The shortcomings of the new reform

The main measures of the 2012 reform basically amount to a substantial shift of bargaining power from workers to employers. In this fashion, it has the potential to achieve the wage adjustments that have not taken place since the start of the Great Recession, nor in the previous downturns, and which are badly needed to restore competitiveness. However, in a context of high indebtedness, substantial productivity growth is also required, not only as a complementary way of restoring competitiveness but also as a means to sustain internal demand and, hence, restart employment growth. It is on this second front where the recent reform falls short of what is needed unless, as will be argued below, the internal flexibility mechanism is activated soon.

Once again, a key issue not properly addressed in the latest reform is the suppression of dualism. For instance, this could have been achieved through the introduction of a single open-ended contract (the so-called Equal Opportunities Contract, or EOC in short) at the same time that temporary contracts were abolished --with the exception of replacement contracts for maternity or sickness/disability leaves. The key feature of the EOC is that it has no ex-ante time limit (unlike fixed-term contracts) and that severance payments smoothly increase with seniority (unlike current open-ended contracts), instead of having the same indemnity per year of service applying from the start of the contract. Hence, in contrast with the current regulation of permanent contracts, the EOC provides a sufficiently long entry phase and a smooth rise in protection as job tenure increases. The rationale for the gradually increasing severance pay is that the longer a worker stays in a given firm, the larger is her/his loss of specific human capital.

Recent research based on simulation exercises (see, e.g., Garcia-Perez and Osuna, 2011 and Conde Ruiz *et al*., 2011) points out that, e.g., an EOC which starts with a severance pay of 10 -12 days' wages and grows by 2-3 days per year up to a maximum of 33-36 days' wages could have greatly reduced the huge worker turnover rate that leads to the very large frictional unemployment rate in Spain. This contract is badly needed because, even after the massive destruction of temporary contracts since 2008, currently they still comprise almost one-quarter of all employees and about 93% of the total labour contracts signed each month.

It is true that the new reform reduces the EPL gap between temporary and permanent contracts, especially for future hires, and that this should encourage firms to use temporary contracts less. However, once again the incentives at the margin to reduce the widespread use of precarious contracts seem to be insufficient. For illustrative purposes, let us compare the expected firing costs for a firm deciding on whether to hire a new worker under a temporary or a permanent contract. For simplicity, we assume that the job lasts for two years, which is the longest duration of fixed-tem jobs. In this first case, at the termination of the contract, the firm will have to pay 18 days' wages (=2x9 in 2012), while in the second case it would have to pay either 40 (=2x20) or 66 (=2x33) days, depending on whether the dismissal is considered to be economic or unfair. The EPL gap, amounting to 22 or 48 days (plus red tape costs if there is an increase in workers' appeals to labour courts) still remains rather high relative to the 2 or 3 extra days of wages entailed by the EOC. For example, Bentolila *et al.* (2012) find through a calibrated model that, had the previous Spanish government implemented a reduction of 73% in the firing cost gap in the mid 2000s (adopting the extant EPL regulation in France), the rise in Spanish unemployment during the subsequent slump would have been 45% lower than what it has actually been (i.e., it would have risen from 8% to 17% rather than to 24%). The reason is that a much lower EPL gap decreases the worker turnover rate while it increases job creation flows as well as job mobility. Since the reduction of the EPL gap for new hires in the new reform amounts to about 33%, a "back of the envelope" prediction based on previous simulations is that, all else being equal, the unemployment rate may fall by 20% in the medium term (from 24% to 19% in 2015). By any measure, this reduction seems insufficient.

Nevertheless, it is worth highlighting that the EPL gap and the average level of firing costs in general would be rather irrelevant for employment if bargained wages become sufficiently flexible. As Lazear (1990) has argued, the insight for this result is that one of the main roles of EPL is to serve as an insurance device against the risk of job loss. Consequently, the risk-neutral firm and the risk-averse worker may agree in the wage bargain to design an optimal contract which neutralizes the effect of job protection. For example, suppose that the expected duration of a job is again two years and that severance pay is X euro in total. Then, the worker and the employer could agree to reduce the wage during the first year by X euro and give this amount back to the worker at the end of the second year (if the interest rate is say 5%, the wage in the last year should raise by approximately 1.1 times X euro). The employer will not experience a rise in its labour costs and the worker will succeed in getting higher income to smooth out consumption when it is most needed, namely, when he/she becomes unemployed. However, this efficient wage scheme will become unfeasible if bargained wages have a floor that does not allow them to go down by X euro during the first year of the contract. In other words, whenever wages are downward rigid, the effect of EPL on employment may be detrimental.

Will wages become more flexible after the new reform?. As discussed earlier, this reform arguably facilitates small firms' opting out from the wage levels bargained at industry-wide collective agreements. Yet, it seems that the administrative costs of doing so remain quite sizeable. For example, a small firm in distress willing to avoid bankruptcy will have to obtain the sequential approval of four legal institutions to be allowed to opt out from a higher-level agreement.[3] It is quite likely that many small and medium sized firms may find all this paperwork insurmountable and therefore will prefer to remain in those collective agreements. Hence, if the reform does not succeed in achieving enough internal flexibility, the frictional unemployment created by the volatility of temporary contracts may not subside. For example, 1.2 million contracts were signed in May 2012, out of which 8% were indefinite contracts, a proportion that is 7% smaller than in May 2011, before the reform was passed.

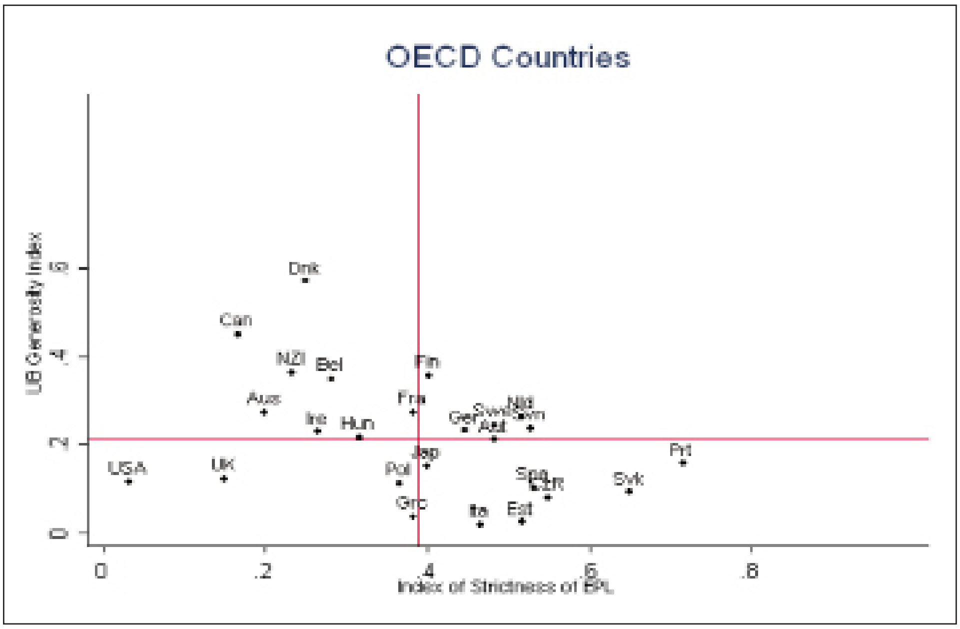
The second important shortcoming is the lack of changes in unemployment insurance and the very limited nature of the changes in active labour market policies (ALMP). The reform relies once more on generous job creation subsidies in both a new training contract and the contract for entrepreneurs, favouring youth, older workers, women, and the long-term unemployed. The share of ALMP going to these subsidies in Spain was already 32 percent in 2009, vis-à-vis 16 percent in the average OECD country (OECD Stats. Extracts), while the shares spent in training were 22 and 29 percent, respectively. Job subsidies have a negligible impact on job creation in Spain, due to their large deadweight losses and substitution/ displacement effects (see García-Pérez and Rebollo 2009). Increased expenditures on job creation subsidies will prove too costly against the backdrop of a planned reduction in the Government budget deficit from 8.9 percent of GDP in 2011 to 3 percent in 2014.

Moreover, while the reform announces future measures to promote the training of employees, it scarcely alters training programs for the unemployed and it fails to ask for a rigorous evaluation of the effectiveness of ALMP, a practice that is almost unknown in Spain. Nonetheless, it does break up the monopoly that labour unions and employer associations had as beneficiaries of subsidies for training programs, a situation that led to a lot of fraudulent practices in the past, and it allows temporary job agencies to operate also as placement agencies.

Lastly, and related to the previous point, a third problem is that the reform ignores the possibility of maintaining workers' overall level of social protection by compensating the effect of the reduction in the level of employment protection (lower severance pay) through a rise in the protection offered while unemployed (more generous and shorter unemployment benefits, UB, to provide a buffer stock against bad states while avoiding the moral hazard problems associated with UB long duration). Notice that both types of social protection are somewhat substitutes, in the same way as an automobile insurance company could provide insurance to a driver either by offering periodic checkups of the state of the car or, in the case of breakdown or accident, by providing the customer with another car. As Figure 3 shows, with the exception of the fully flexible anglosaxon labour markets (UK and US), there is a clear negative relation between the generosity of UB and the degree of strictness of EPL. Spain is clearly among those countries where EPL is more rigid and UB are not so generous while, other economies like Austria or Denmark, the promoters of the so-called *flexicurity* scheme, have chosen the opposite route. The fact that this last group of economies have experienced much lower unemployment rates than the former both before and throughout the recent slump indicates that their mix of labour market regulations is a much more successful one.

[3] *Comisión Paritaria*, *Acuerdos Interprofesionales*, *Comisión Consultiva* and *Arbitraje*.

Figure 3. The Trade-off in workers´ social protection (2005-2009).



V. Concluding remarks

In sum, the latest reform has advanced towards *flexicurity* only in the *flexi* side (firing costs and internal flexibility), but does very little regarding passive and active labour market policies and it actually makes the latter harder to fund. It also lacks significant productivity-enhancing measures. Though the current reform represents an improvement over the past ones and it may steer the Spanish economy towards a lower structural unemployment rate, once the financial crisis is overcome, it remains yet unclear how large this reduction will be and whether it will contribute to higher economic growth. Given these limitations, it is quite likely that this will not be the ultimate labour market reform curing the "Spanish disease" and that, sooner rather than later, another more ambitious reform will need to be approved.

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