Europe's Labour Markets and the Crisis

The *New* New Labour Market Reform in Spain: Objectives, Instruments, and Shortcomings

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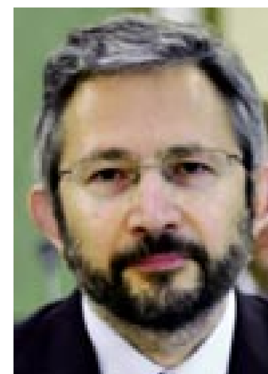
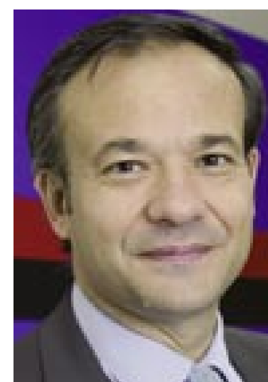
Introduction: a dysfunctional labour market

Spain's chronic labour market problems have become more evident during the Great Recession. After converging to the EU average during the long boom that started in the late 1990s and ended abruptly in 2007, the unemployment rate surged to almost 23 percent by the end of 2011. Moreover, it may reach 25 percent by the end of 2012, marking the third time since the arrival of democracy (1978) that such unbearable heights have been reached. Thus, the Spanish unemployment rate is not only very high, but also very volatile relative to other countries, as shown in Figure 1, where it is plotted alongside the rate in France, which is representative of the Euro Area average. The main culprits for such an unfortunate state of affairs are the dual nature of the Spanish labour market – on average, 33 percent of employees had a temporary job before the crisis, and currently 25 percent do, after massive job losses since 2007– and the rigid collective-bargaining system.

The combination of a dual Employment Protection Legislation (EPL) and both nominal and real wage rigidities leads to adjustment to negative shocks always taking place mostly through dismissals rather than through wage moderation – as in the UK – or via working time reduction and labour hoarding – as in Germany. This time, the increase of 3.1 million unemployed between 2008 and 2011 has been the result of a 2.6 million job loss (1.4, 0.6, and 0.6 million among temporary, permanent, and self-employed workers, respectively) plus a 0.5 million increase in the labour force (mainly due to large immigration inflows since 2000, which receded only in 2011 (Bentolila, Dolado and Jimeno 2008a).





Admittedly, a significant part of the job shedding has been due to the bursting of a big housing bubble that started around 2000 and has led to the destruction of 1.4 million jobs in the construction sector since mid-2007. Yet, according to Figure 2, this stark response is out of line with what has happened in other countries that have also been affected by a construction boom and a subsequent bust. Despite the fact that Spain's main natural resources – good weather and touristic resorts – call for a higher share of employment in the housing sector (it reached 13 percent in 2006, against 7.2 percent in 2011), the investment boom that took place in this industry, fuelled by the large drop in real interest rates as a result of joining the Euro in 1999, is also closely related to Spanish labour market regulations. Rigid labour contracts proved inadequate for specializing in more innovative industries, where higher labour flexibility is required to accommodate the higher degree of uncertainty typically associated with producing high value-added goods (Saint-Paul 1997). Hence, a more mature sector, compatible with the use of less skilled labour through temporary contracts was chosen. Moreover, the prevalence of industry-wide collective bargaining agreements resulted in a slowing down of job creation in high-productivity sectors, but increased job destruction very significantly when the crisis hit (Jimeno and Thomas 2011).

The origins and the aftermath of ineffective labour market reforms

The peculiar structure of the Spanish labour market can be explained in terms of the industrial relations inherited from the Francoist era. During that long period of forty years, wages and productivity were low and jobs were highly protected to maintain

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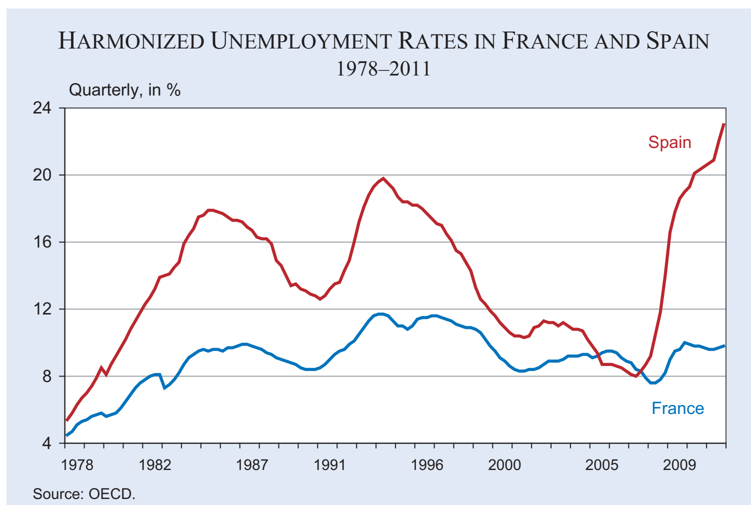
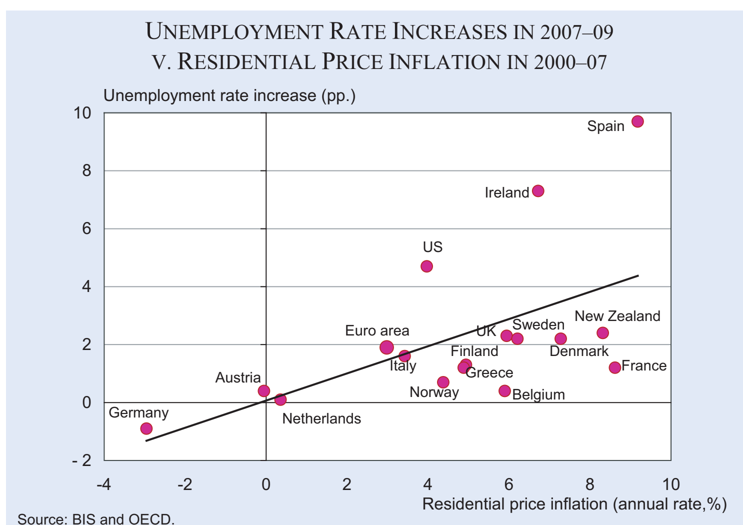
Figure 1



Source: OECD.

Figure 2



Source: BIS and OECD.

Francoist regime, led to the first big surge in unemployment. To avoid social unrest, a labour market reform was introduced in 1984 allowing the use of very flexible temporary contracts for all regular activities, while leaving the EPL of permanent contracts unchanged.

As explained in Dolado, García-Serrano and Jimeno (2002) and Bentolila, Dolado and Jimeno (2008b), this reform created a large EPL gap between permanent and temporary workers, thus leading to a quick rise in the temporary employment rate, from 12 to 33 percent, thereby creating a highly segmented labour market. An insider-outsider model of industrial relations has become well-entrenched since then. Several regulations have helped to maintain it. For example, by law workers in firms with less than six employees and temporary workers with less than one-month of tenure cannot vote in firm-level union elections. This rule excludes almost 30 percent of potential voters, who are likely to be against dual EPL. This suits the unions, which protect permanent workers (their median voters) and are thus able to press for larger wage rises. They do so because they anticipate that firms will respond by dismissing temporary workers with low firing costs rather than the highly protected permanent workers (Bentolila and Dolado 1994) – as has indeed been the case during the Great Recession. The main employers' association (CEOE), in which small and medium-sized (SMEs) enterprises are scarcely represented, has an incentive to go along, to some extent. The reasons is that large firms can afford higher wages due to their higher productivity levels and can therefore use collective bargaining as a tool to restrict competition.

social peace. Trade unions were illegal and collective bargaining, mainly dominated by employers, was predominantly at the province/industry level. When the democratic transition took place in the late 1970s, the newly-legalized unions' support for the process was guaranteed by maintaining to a large extent the prevailing EPL and by awarding union delegates a high degree of power at all collective bargaining levels (state, province, and firm), setting a very low representativeness threshold – namely, 10 percent at the national level. The aim was to extend the coverage of collective bargaining to hitherto uncovered workers in the shortest possible time. Wage pressure ensued, precisely at the time of the second oil price shock. This event, together with the transition from agriculture to manufacturing and services, and the labour shedding from the oil-intensive industries (e.g., mining and shipbuilding) that had been favoured by the

Seven important labour market reforms (1984, 1994, 1997, 2002, 2006, 2010, and 2011) and 52 additional minor legal changes have tried to correct this

course of events. Their main objective has been to reduce the EPL gap, either by constraining the use of temporary contracts in sequence or by slightly cutting the severance pay for permanent contracts while simultaneously increasing the 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 (Saint-Paul 2002; Dolado, Felgueroso and Jansen 2010) or when there was a favourable impulse from an external source, like joining the European Community in 1986 or the Euro area in 1999.

The current scenario is different. Firstly, there is no external impulse, as international demand remains subdued. Secondly, devaluations, which were pursued in the early 1980s and 1990s, are not available anymore; and thirdly, the level of indebtedness – with public debt close to 70 percent of GDP, private debt at around 290 percent, 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. The need to restore fiscal sustainability also limits the scope for a fiscal devaluation (Farhi, Gopinath and Itskhoki 2011), whose medium and long-term effects would, in any case, be conditional on the response of wages and prices to such measure.

Trying to cope with this situation, the previous socialist government initially decided that a labour market reform was not needed. However, when the Euro crisis erupted and the external pressure from international institutions and financial markets intensified, it abruptly changed its views. As a result, an agreement with social partners was attempted twice, in 2010 and 2011, but failed on both occasions. Consequently, the government – which remained unconvinced – implemented a series of reforms that appeared to be quite comprehensive in scope, but were in fact quite shallow. The key changes affected the following areas (see Bentolila, Dolado and Jimeno 2011 for more details).

Severance pay. The causes justifying fair dismissals for economic reasons were defined explicitly. Advance notice was reduced from 30 to 15 days. A new permanent contract promoting employment was introduced, for which the so-called express dismissal procedure established in 2002 applied. This means paying severance of 33 days' wages per year of service (this clause, relating to days of severance pay, is understood hereafter) so as to avoid going to court, giving advance notice, and paying interim wages altogether (previously, the prevailing route was to obtain these advantages by disguising economic dismissals as disciplinary, but with severance pay of 45 days and a cap of 42 months). An existing fund fed by employer contributions was allowed to reimburse firms eight days' wages in all dismissals of permanent employees. Severance pay for temporary contracts was raised progressively from eight to 12 days (to be attained in 2015).

Collective bargaining. Firm-level agreements were given priority over the corresponding industry-wide agreement, unless explicitly overruled by the latter. Firms in distress were allowed to opt out of the industry collective-bargained wage level by reaching an agreement with their workers, though the corresponding level had to be attained again in no more than three years. Over the subsequent year, any expiring agreement without a consensus renewal being feasible would be subject to arbitration.

Hours reductions. These were subsidized, in line with the German Kurzarbeit program, by reducing social security contributions on firms and restoring workers' entitlements to unemployment insurance.

Active labour market policies. The groups of workers eligible for subsidies on job creation were restricted and private placement agencies were authorized for the first time. Personalized back-to-work paths had to be implemented by the public employment service.

Thus, these two reforms closely followed the same ineffective strategies of the past. As to EPL, they mildly reduced dismissal costs and relaxed dismissal restrictions under the employment-promotion permanent contracts while doing the opposite for temporary contracts. As for the regulation of collective bargaining, they retained the principles favouring industry-level bargaining, while marginally lifting some restrictions on opt-out clauses.

The *new* new reform

The new right-wing Government elected in November 2011 quickly announced that the previous reforms were deemed insufficient, gave a short peri-

od of time for the employers' confederation (CEOE) and the main trade unions (CCOO and UGT) to agree on further proposals for reform, and then introduced a new reform in February 2012, which in most cases follows the same direction as the 2010–2011 reforms. The 2012 reform affected the following areas:

Severance pay. The causes for a fair dismissal for economic reasons – which entitles a worker to severance pay of 20 days' wages, with a cap of one year's pay – are further clarified to include three quarters in a row of declining revenue/sales. Employment-promotion permanent contracts are eliminated and the severance pay for unfair dismissals is unified at 33 days, with a cap of 24 months' pay. The reimbursement of eight 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. Lastly, a new permanent contract for entrepreneurs is created, whereby workers can be hired with a one-year probation period (i.e., with no severance pay) and substantial fiscal subsidies.

These changes reduce firing costs and re-establish the causal nature of dismissals. Dismissals for economic reasons were previously almost fully blocked by labour courts (so that they represented only eight percent of all labour contract expirations in 2010, i.e. including those of temporary contracts). The prevailing 45 days' pay was too high by international standards. The express dismissal (30 percent of expiring contracts) made economic sense (Blanchard and Tirole 2004), but was a legal aberration. Moreover, administrative approval of collective dismissals, which is very atypical in the European Union, was a way to raise severance pay in economic dismissals (on average, up to the level of unfair dismissals), so that they had also been strongly curtailed (amounting only to four percent of contract expirations). This induced an intense use of temporary contracts (accounting for 56 percent of all expirations).

There is a lasting 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 standard 20 days.

Collective bargaining. Priority of firm-level agreements over industry-wide agreements is not subject to overruling by the latter anymore. 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 get 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-bargain working conditions, including wage levels, are further clarified as firms having two quarters in a row of declining revenue/sales. Expired agreements that cannot be renewed by consensus will be subject to compulsory arbitration, and industry agreements can no longer rule out the latter. The maximum duration of working conditions after the expiration of a collective agreement is set at two years (previously unlimited). Administrative approval of collective contract suspensions and work-time reductions is abolished.

The shortcomings of the latest reform

The main measures of the 2012 reform basically amount to a substantial shift in bargaining power away from workers and towards employers. Thus, the reform could potentially achieve the wage adjustments that have not taken place since the start of the Great Recession, and which the Spanish economy badly needs to restore its 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 to sustain internal demand and, hence, restart employment growth. On this second front, the recent reform falls short of what is needed.

One key issue not properly addressed in the latest reform is the suppression of dualism. Temporary contracts nowadays comprise one-quarter of all employees. The reform reduces the firing-cost gap between temporary and permanent contracts, which should encourage firms to use temporary contracts less. However, the incentive at the margin may prove insufficient, since the gap remains large between the 18 days' wages of severance pay of the temporary contracts for the maximum duration of these contracts, i.e. two years, vis-à-vis the 40 days (fair dismissal) or the 66 days (unfair dismissal) of permanent contracts, plus red tape costs.

For this reason, the frictional unemployment created by the volatility of temporary contracts may not subside; and nor probably will their other negative effects, such as the lack of incentives to invest in human capital on the part of both employers and workers, thereby negatively affecting productivity growth.

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 on 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 those 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 on 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 their displacement effects (García-Pérez and Rebollo 2009; Cebrián, Moreno and Toharia 2011). Increased expenditure 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 three percent in 2013.

Moreover, while the reform announces future measures to promote the training of employees, it hardly alters training programs for the unemployed. It breaks up the monopoly that labour unions and employer associations had as beneficiaries of subsidies for training programs and it allows temporary job agencies to also operate as placement agencies, but there are no provisions for a rigorous evaluation of ALMP.

In sum, the 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 actually makes the latter harder to fund. It also lacks significant productivity-enhancing measures. Though the reform represents an improvement and –the second best theorem permitting – will steer the Spanish economy towards a lower structural unemployment rate, it remains unclear how large this reduction will be and whether it will contribute to higher economic growth.

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