Labor market duality: The unresolved issue of the 2012 reform

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Despite recent reform efforts, empirical evidence suggests little progress to reduce firms' reliance on temporary contracts to adjust to shocks.

The creation of the temporary contract in 1984 has given rise to one of the most important problems of Spain's labor market today - duality. Several recent reforms have tried to address this issue, including the latest in February 2012, however unsuccessfully. This reform aimed to shift workers' and firms' incentives away from external flexibility and towards internal flexibility. Unfortunately, initial evidence suggests that still high severance costs for unfair dismissal and legal uncertainty have led to firms' continued preference for the temporary contract. The resulting buffer of temporary employees is reducing willingness of permanent workers to accept internal flexibility and thereby hindering progress of the reform overall.

Employment protection legislation has generated a dual labor market in Spain, in which temporary contracts represent bad jobs that belong to a secondary sector while permanent contracts are part of good jobs in a primary sector. Moreover, there are some barriers to mobility between the temporary and permanent jobs, even within a given firm.

The duality of the Spanish labor market has its origins in the introduction of employment legislation reform in 1984 that liberalized the use of temporary contracts allowing employers to use these contracts to hire employees performing regular activities. The reform was made by the creation of a new type of contract, the so-called employment-promotion contract. This contract had much lower dismissal costs than permanent contracts (8 days' wages per year of service instead of 45) and its termination could not be appealed to labor courts. Also, these contracts had a maximum duration of 3 years within the same firm. After that period, the employer could choose between terminating the contract and converting it into a permanent contract. As a result of this reform, temporary employment surged to almost 35 percent in the early 1990s. The rampant growth in the use of temporary contracts and the low conversion rate of these contracts into permanent contracts (5 percent in 1994 *versus* 18 percent in 1987), led to the introduction of a series of countervailing reforms during the following decades that imposed some restrictions on the use of temporary contracts and reduced the costs of new permanent contracts.

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In spite of these later reforms, Spain has continued to have about one third of its workforce employed in temporary contracts, one of the largest shares in the European Union, and a low conversion rate of about 4 percent of the total number of contracts signed. Furthermore, less than 10 percent of these temporary contracts relate to seasonal jobs. Temporary employment has been found to especially affect some groups of the population such as young workers and females. Evidence from the administrative data of the Spanish Social Security shows that almost 90% of female workers' first contract is a temporary contract and that 50% of these women still work under a temporary contract five years after their first entry into the labor market.

Extensive empirical evidence shows that in Spain temporary contracts are associated with worse employee outcomes than permanent contracts. Workers under temporary jobs have been found to receive lower on-the-job training, lower wages, to face worse working conditions and to be subject to higher accident rates. In addition, temporary contracts in Spain are very unstable with a large likelihood of leading to unemployment and relatively low prospects of transition to permanent work.

One of the most important consequences of duality is that firms in Spain rely disproportionately on external flexibility (dismissals) rather than on internal flexibility (wage flexibility and reduced work time arrangements). This is so because Spanish companies always find it easier to adjust by not renewing temporary contracts rather than by implementing wage cuts or reduced work arrangements. Furthermore, workers under permanent contracts (and their representatives), knowing that there is always the buffer of

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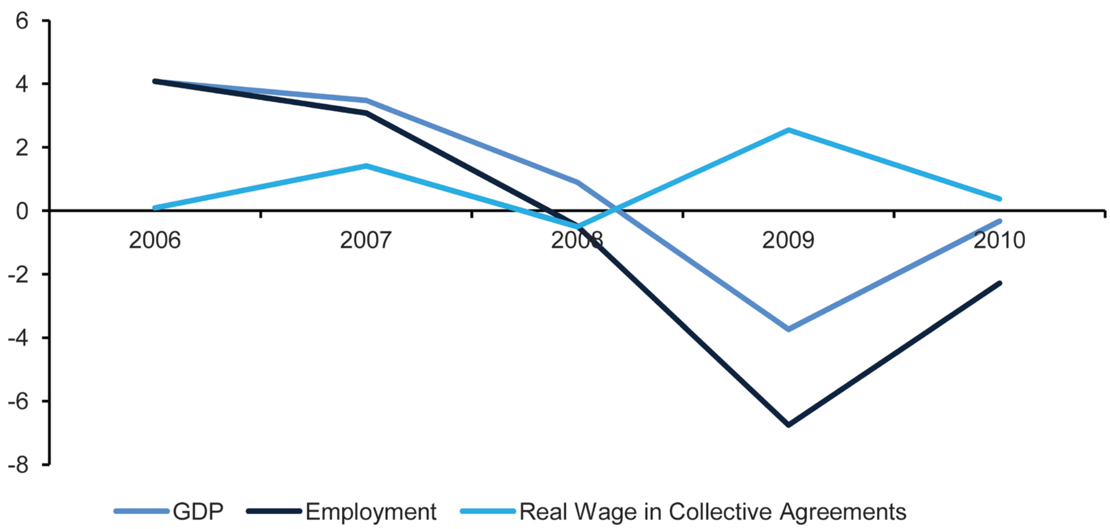
Exhibit 1

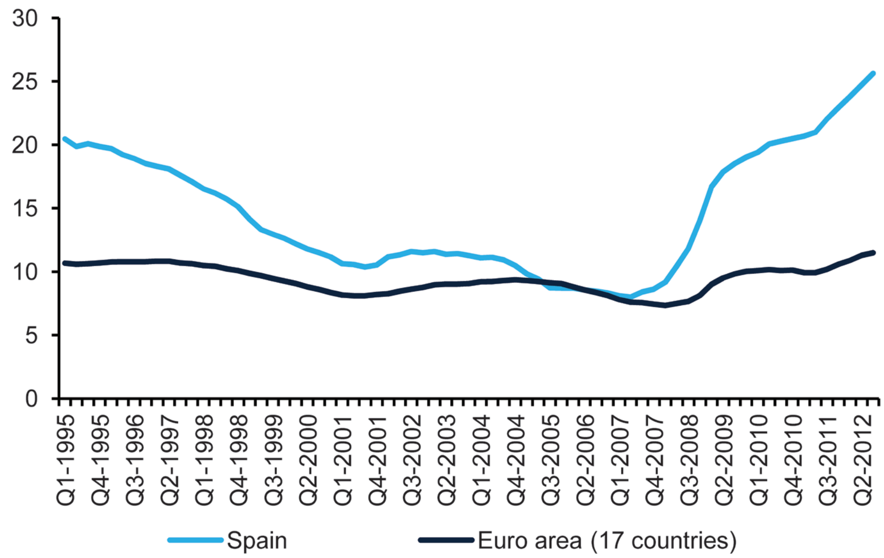
Percent change of GDP, employment and real wages in collective agreements: Spain



Sources: I.N.E. for GDP and employment data and Ministry of Labor for Collective Agreements data.

Exhibit 2

Unemployment rate. 1995-2012 (3rd quarter). Spain versus the Euro Area (17)



Source: O.E.C.D. harmonized unemployment rate.

temporary jobs, are reluctant to accept downward adjustments to their wages or other working conditions even in very tough economic times. In Exhibit 1, for example, we can see how real wages agreed under collective agreements increased more than 2% in 2009, at a time during which the Spanish economy was destroying thousands of jobs every day. In general, Exhibit 1 shows that wage conditions from collective agreements bear little relationship with the situation of the labor and goods markets. Also, not surprisingly, the Spanish labor market has been always characterized by a high and extremely volatile unemployment rate (see Exhibit 2). The high level of the unemployment rate has to do with the fact that in a dual labor market, the high rate of destruction and creation of temporary jobs leads to frictional structural unemployment. The high volatility has to do with the fact that in periods of expansions, firms hire extensively through the use of temporary contracts and in downturns firms destroy massive numbers of temporary jobs.

The 2012 labor market reform: Only half way through the problems

In February 2012, the Spanish government passed the most ambitious labor market reform since 1984. The critical situation of the Spanish labor market, with rampant job destruction and a 25% unemployment rate, led the Spanish government to approve with little resistance a series of important changes transforming the way the Spanish labor market would operate. In particular, the 2012 reform aimed at shifting the incentives of firms and workers away from external

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flexibility and towards internal flexibility. That is, its goal was to give firms and workers incentives to accept adjustments to their wages and other work conditions and stop relying on job destruction as the preferred mechanism for accommodating to adverse market shocks. Also, the reform was supposed to set the basis for a healthier labor market in the future, allowing it to maintain a higher and more stable level of employment but also a higher rate of labor productivity growth.

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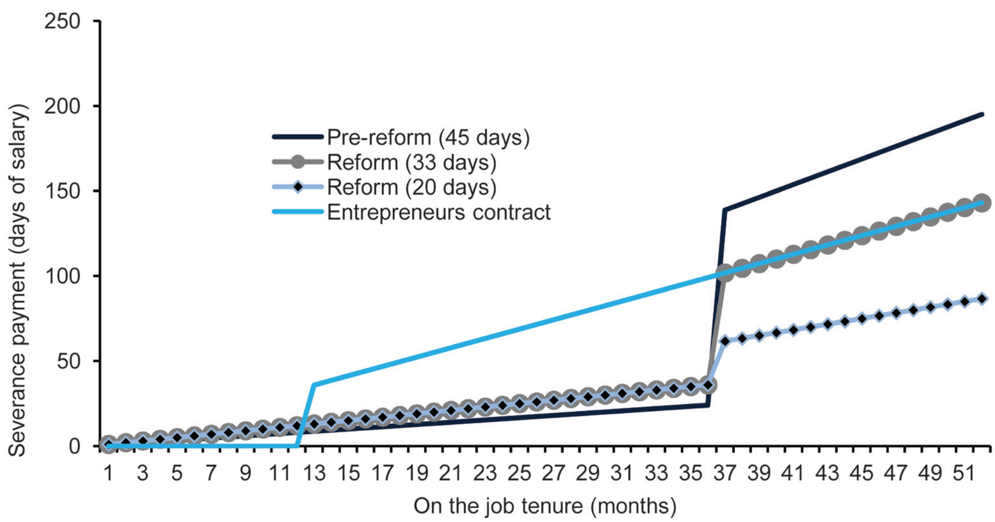
External flexibility: Reduced costs of terminating permanent contracts

This was achieved through four different measures. One, the law reduced the severance payment for terminating a permanent contract with no objective reason (unfair dismissal). The severance payment has decreased from 45 days of salary per year worked (up to a maximum of 3.5 years of salary), to 33 days of salary per year worked (up to a maximum of 2 years of salary). Second, it introduced the so-called permanent contract for the support of entrepreneurs (defining an entrepreneur as an employer that employs fifty or fewer workers). This is a permanent contract with the same severance payment as other permanent contracts but with a twist: there is a 1 year trial period, at the end of which the contract can be terminated at no cost for the firm. Third, it clarified and supposedly made it easier for firms to dismiss workers due to bad economic conditions affecting the firm (dismissal due to objective reasons). In this case, workers are entitled to a severance payment of 20 days of salary per year worked (with a maximum of one year of

Exhibit 3
Severance payments before and after the reform



Source: Author's calculations.

salary). The reform states that firms can use this type of dismissal procedure if they can show that their sales and income have decreased more than nine months consecutively. Fourth, it increased the cost of terminating a temporary contract from 8 to 12 days of salary per year worked.

The objective of this set of measures is to reduce the incentives of firms to use temporary contracts as a buffer when economic conditions change. This is achieved by making permanent contracts more attractive relative to temporary contracts because the cost of terminating the former is now less different compared to the cost of terminating a temporary contract. Exhibit 3, depicts the amount of the severance payment at each level of on the job tenure and by type of dismissal and contract, before and after the reform.

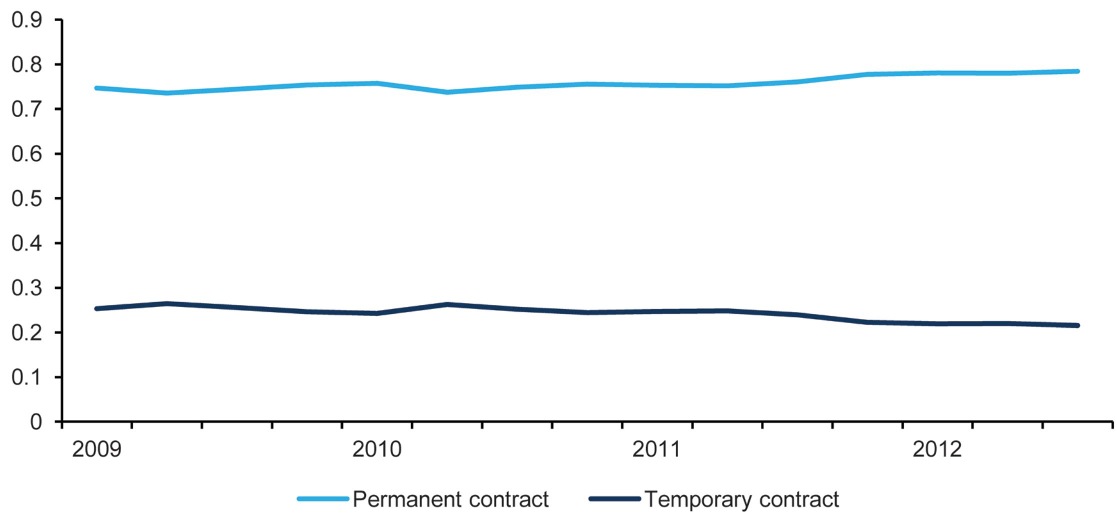
Spanish labor market duality is most signified by the pre-reform (45 days) line. This is the line that shows the severance payment for unfair dismissals, by far the most commonly used type of dismissal used until now in Spain in regards to permanent contracts. The big jump in severance payments that occurs at the end of the maximum duration of temporary contracts (3 years) is what stops many firms from transforming a temporary contract into a permanent one. As a consequence, a large number of workers cannot access a permanent job and instead they get trapped in a sequence of temporary jobs, with negative consequences for wages, productivity and job stability.

The other objective of the 2012 reform has been to reduce the difference in severance payments between permanent and temporary contracts. Has the reform been successful in this regard?

The 2012 reform seems more oriented to facilitate the adjustment of the firm to adverse economic shocks rather than to guarantee the efficient use and productivity of the labor input. This is so because the main novelty of the reform is to facilitate the termination of the permanent contract due to objective economic reasons (20 days of salary as severance payment). The 2012 reform keeps expensive unfair dismissals in permanent jobs (33 days) and the contract in support of entrepreneurs

Exhibit 4

Employment by type of contract in firms of 50 or less employees: 1st Q 2009 to 3rd Q 2012



Source: Ministry of Labor.

(firms with less than 50 employees) raises so many questions of implementation that at least until now it is barely used. In spite of the beneficial aspects of this type of contract (trial period of one year with no severance payment and tax deductions), firms of less than 50 employees prefer to use temporary contracts or traditional permanent contracts. According to official statistics, contracts for the support of entrepreneurs represent less than 10% of new contracts signed by these types of firms. Not surprisingly, as can be seen in Exhibit 4, the employment by type of contract has barely changed in firms of less than 50 employees since the implementation of the reform, with the temporary rate around 20% and declining simply as a consequence of the higher rate of destruction of temporary jobs. If anything, the rate of decrease of the temporary rate has slowed down since 2012.

Also revealing is the fact that of all new contracts being signed in Spain among all firms, 85% are temporary contracts and this rate has not change significantly since the implementation of the reform (see Exhibit 5). Finally, according to official statistics, of all terminations of permanent contracts, close to 30% are due to objective reasons, with this percentage not significantly lower (around 26%) before the implementation of the reform.

It seems that in the initial months after the reform, the Spanish labor market continues to create and to destroy jobs with the same intensity and in the same form as before the reform was implemented. Although it is probably still too soon to make a definite analysis of the effects of the reform, this initial evidence is not very encouraging and suggests that firms in Spain still view temporary contracts as the preferred mechanism for adjusting to economic shocks.

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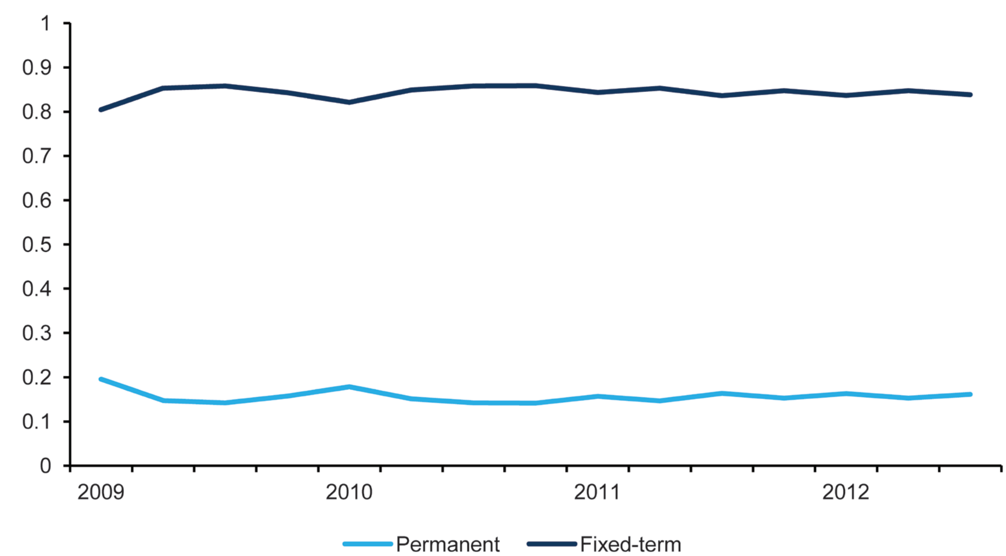
Exhibit 5

New contracts by type of contract. All firms. 1st Q 2009 to 3rd Q 2012



Source: Ministry of Labor.

One of the most controversial aspects of this reform, which may explain the scarce use of the new possibilities for terminating permanent contracts, is that there is still a large amount of legal uncertainty. For example, in the case of dismissals due to objective reasons, courts have to ratify that the firm is facing an adverse economic shock, defined as a period of reduced sales of three consecutive quarters or more. But it is not clear what interpretation judges will make of this rule. For example, are they going to look at sales in nominal terms, or in real terms? How will they consider a context in which prices are declining or costs are increasing? If firms fear long and complex judicial processes then they may be tempted to use the quicker but more expensive option: the unfair dismissal with 33 days of salary per year worked.

Internal flexibility: Easing the conditions for decreasing wages and for using reduced work arrangements

The February 2012 Reform introduces some provisions that facilitate the adaptation of firms to economic shocks by making it easier to change wage and work time conditions of already employed workers. First, the reform increases the importance of collective wage agreements at the level of the firm rather than at the sector or national level. Second, it eliminates the automatic extension of old collective wage agreements in those situations in which there is no agreement between the company and the employees. Third, it makes it easier for firms to modify (downwards) the wages of workers if the level of wage compensation for those workers was above the level set by collective wage agreements and if the firm is facing adverse economic conditions (defined as declined sales during a period of two quarters or more). Fourth, and also in the context of adverse economic shocks, it establishes clear conditions and makes it easier to convert full-time contracts into part-time contracts (for a fixed period of time).

The objective of internal flexibility could be jeopardized by the still high degree of labor market duality. This is so for two reasons. First, firms may still prefer to use temporary contracts as the preferred mechanism for adjusting to economic shocks. Second, permanent workers will be reluctant to accept negative changes of their wage and work-time conditions if they know that the firm still has the buffer of temporary employees.

Although there has been negative real wage growth in Spanish collective agreements in 2012 (see Exhibit 6), the rate of wage decline is not significantly different than in 2011 or in 2010. And this rate of wage decline has not been enough to stop the increase of unemployment in Spain during 2012. Furthermore, and surprisingly, since the reform has been approved, real wage declines have been more intense in collective agreements at the sector or national levels than at the level of the firm, contradicting one of the forecasts of the reform. Once again, this evidence suggests that Spanish firms and permanent workers make no extensive use of internal flexibility in order to adjust to adverse economic shocks.

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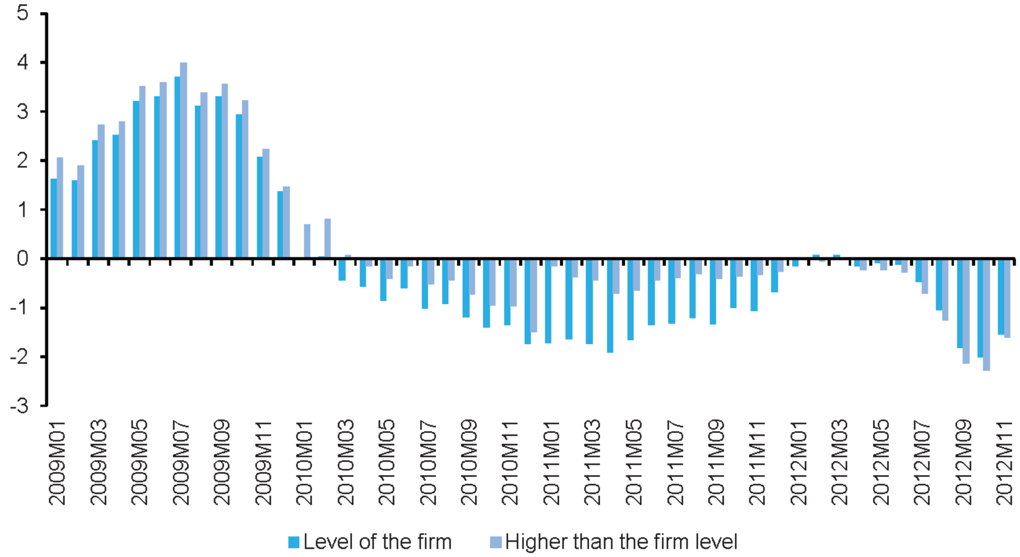
To sum up, despite efforts to make the Spanish labor market more efficient and flexible, the February 2012 Reform has not solved the problem of duality. This unresolved issue could jeopardize the whole reform. The existing evidence is not very encouraging and suggests that firms and permanent workers in Spain still mainly rely

Exhibit 6

Real wage growth in collective agreements at the level of the firm and at higher than the firm level



Source: Ministry of Labor.

on temporary employees to adjust to adverse economic shocks. We will have to wait for future evidence in order to confirm this analysis. In the meantime, many are listening again to those that advocated in Spain for the implementation of a single contract ("contrato único") for all workers in which the severance payment increases linearly with tenure since the first month of employment. This type of contract would solve the problem of duality and therefore policymakers should consider its implementation if future evidence confirms the current pessimistic outlook.