

Spain's labor market two years after the reform: A good start, but no room for complacency

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The 2012 labor reform was a necessary first step to address the inefficiencies of the Spanish labor market, but further efforts need to be taken to boost productivity, reduce temporary work and improve active labor market policies.

In 2012, the Spanish government approved an ambitious labor reform in an effort to correct the inefficiencies of the country's labor market, which had devastating consequences for employment during the recent crisis. During the second and third quarters of 2013, the Spanish labor market reached a turning point, demonstrating signs of a positive trend change. Wage moderation helped underpin modest net job creation, although salary adjustments fell mostly on temporary, unprotected, workers. Part of the reduction in unemployment can also be explained by the decrease in active labor force participants, as immigrants return back to their countries and young nationals migrate to other countries in search of jobs. That said, the reform fell short of addressing the duality of the Spanish labor market and more will need to be done on the two key issues of high youth and long-term unemployment. While the recent reform represents a necessary starting point to tackle the problems of the Spanish labor market, additional measures will need to be approved to boost productivity, reduce temporary employment and provide effective active labor market policies if Spain is to truly emerge from its unemployment crisis.

Almost two years have passed since the Spanish Government approved the most ambitious labor market reform since the start of democracy. The February 2012 reform attempted to correct the high rigidity of the Spanish labor market, in an effort to stop the destruction of jobs and the rapid increase in unemployment since 2008.

Two years after the law was passed, the outlook remains challenging. Since the first quarter of 2012, Spain has destroyed an additional 610,000 jobs. Unemployment has increased by 265,000

individuals (or 1.54 percent), an increase that would have been much larger if the number of individuals working or actively seeking a job would not have decreased by more than 400,000. The number of individuals unemployed for more than one year has increased by 633,000. Many of them are young individuals or prime age adults with low education and living in households where all family members are unemployed. Of the newly signed contracts, more than 90% continued to be temporary contracts. Despite claims that the 2012 reform made it easier for firms to adjust wages,

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salaries have continued to increase in industry during most of 2012 and 2013 and have only modestly decreased in services and construction, particularly in the case of part-time workers. This modest wage moderation has not affected equally all income groups, falling disproportionately among the lowest income earners. So inequality has greatly expanded since February 2012. Spain risks losing a whole generation of young individuals. Individuals younger than 25 have a rate of unemployment of 54%, two percentage points higher than when the 2012 reform was passed.

During the second and third quarters of 2013, however, the labor market reached a turning point. Net job creation has been in the order of 100,000 per quarter. Wage deflation linked to the labor market reform could be part of the reason. Yet, this is not enough. Spain destroyed 3.6 million jobs since 2008 and at this rate of job creation it would take nine years to reach the level of employment in 2008. Furthermore, the wage moderation that we saw at the end of 2012 seems to be slowing down in the second half of 2013 just when the overall economic outlook started to improve slightly. Spain needs to continue to reform its labor market. The gap between workers with temporary and permanent contracts continues almost as large as before the 2012 reform. As long as employers are allowed to hire workers temporarily to fill jobs of a non temporary nature, the Spanish labor market will be inefficient, labor productivity will be low and firms will rely little on internal flexibility measures to adjust to economic shocks. A large number of the unemployed have very low levels of education and qualifications. In the absence of another construction sector boom, these unemployed individuals will find jobs only if they get the new skills that the economy needs. The Spanish system of active labor market policies is not providing this kind of assistance. Instead, it focuses on subsidies for the creation of jobs. New jobs that would have been created anyway or that substitute jobs elsewhere. The Spanish government recently passed a law to reform the education system and this was done

in the context of opposition from almost all other groups in Parliament. One third of teenagers don't finish secondary education in Spain, one of the highest rates in the OECD. The Spanish labor market needs to be reformed further, but its education system as well.

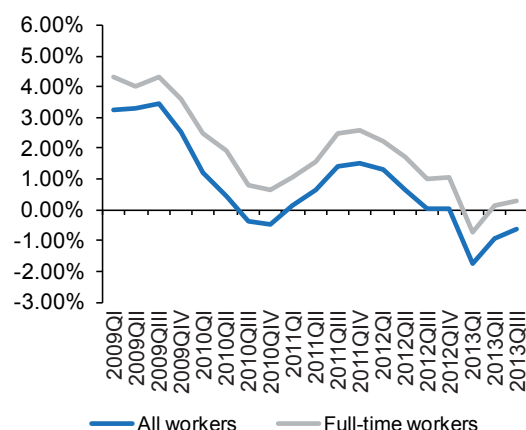
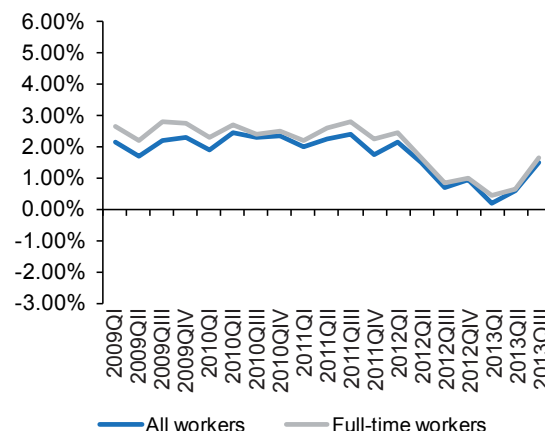
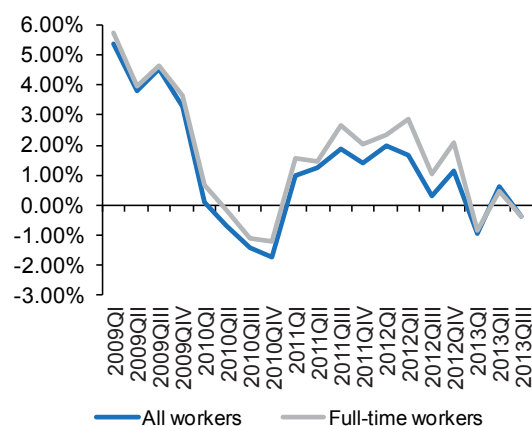
The rest of this article describes in greater detail the evolution of different aspects of the Spanish labor market. The details of the 2012 reform have been discussed elsewhere (Fernández-Kranz, 2013) so in this article the emphasis is placed on comparing the trends before and after the 2012 reform. As stated above, this comparison yields poor results in general, at best just a moderate change of trend, which clearly is not sufficient given the magnitude of the problems that the nation is facing.

Internal flexibility and wage decreases

One of the most common claims in discussions about the impact of the 2012 reform is that firms can now adjust to adverse economic shocks by modifying wages and other work conditions instead of employment (*internal flexibility*). Furthermore, it has been claimed that wages have fallen since the reform was passed. Exhibit 1 shows the percent change of real salaries in Spain since 2009 and until the third quarter of 2013 (across different sectors going from panels b to d). In the Exhibit, wages are deflated by the GDP deflator and therefore the graph shows the real wage change from year to year at each quarter.

Although it is true that real wages have decreased in the last four quarters, this is mainly driven by the surge of part-time work (see Exhibit 2), the decrease of wages of part-time workers and by workers in the services and construction sectors. These last two sectors concentrate a majority of temporary workers in Spain, so the results in Exhibit 1 suggest that the wage contraction has fallen disproportionately on the unprotected workers. In the industry sector, although there is

Exhibit 1

Percent change in real salaries (YoY change)**Panel a. All sectors****Panel b. Industry****Panel c. Construction****Panel d. Services**

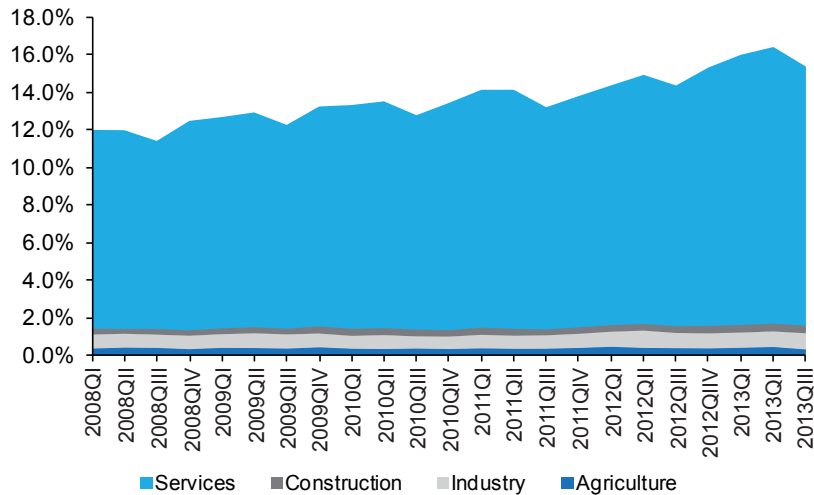
Source: Spanish Quarterly Labor Cost Survey (QLCS).

a clear change of trend post-reform, wages have not decreased, they continued to increase albeit at a lower rate than before 2012.

Wages in the construction and services sectors are highly cyclical and they experienced real decreases also before the 2012 reform, during part of 2010 and 2011. In fact, as economic conditions (in terms of GDP growth) have become slightly better towards the end of 2013, real wage deflation has slowed down in general, with increases of more than 1% in industry.

At best, the results in Exhibit 1 suggest that the 2012 reform has had a moderate impact on the wage setting process in Spain. They also suggest that the effects of this are not evenly distributed across various groups of workers. This is more visible in Exhibit 3, which shows the change in the real labor income in the main types of jobs across deciles of the income distribution. Decile 1 represents the lowest income earners, decile 10, the highest income earners, etc. From top to bottom each trend shows the cumulative change in the real labor income since 2008 and up

Exhibit 2

Workers in part-time jobs (%). Contribution by each sector of activity

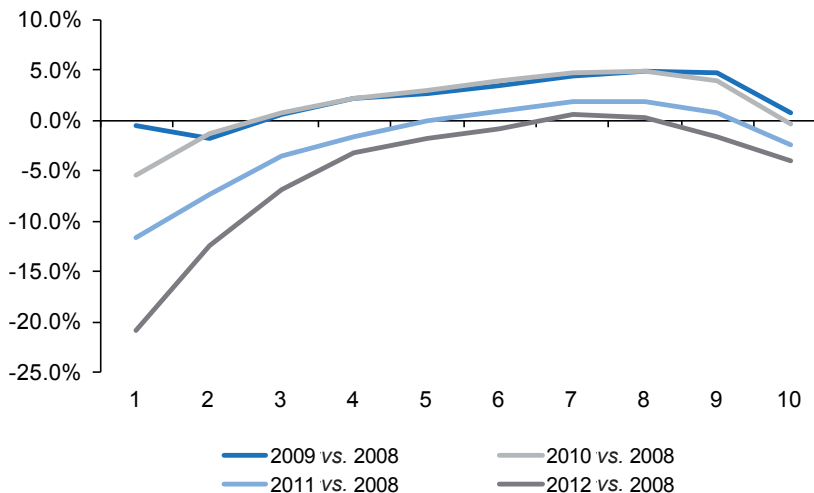
Source: Own calculations using data from the Spanish Labor Force Survey.

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to each year post 2008. It is quite shocking to see how real labor incomes increased for the majority of employed individuals in Spain during 2009 and 2010, when thousands of jobs were being destroyed every day. Since then, and starting in 2011, real incomes fell, but mainly for groups in the

lowest deciles, implying a large increase of income inequality. Because these are incomes from the main types of jobs, the recent surge in part-time work explains part of this, as well as changes in the wage per hour. Furthermore, for the median worker the decrease in wages has been quite

Exhibit 3

Change in real labor income in main jobs, by decile of the income distribution

Source: Spanish Labor Force Survey (LFS).

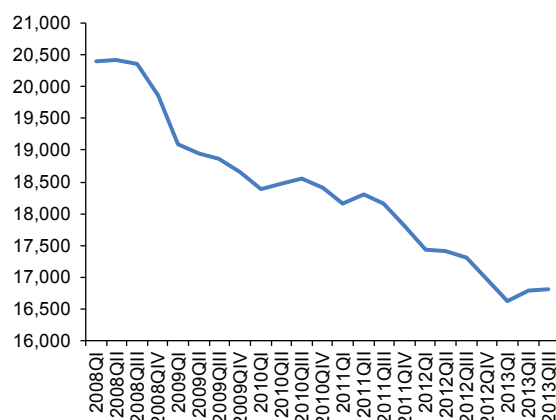
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modest with less than a two percent cumulative decrease in four years, since 2008.

Exhibit 4

Employed individuals ('000s)

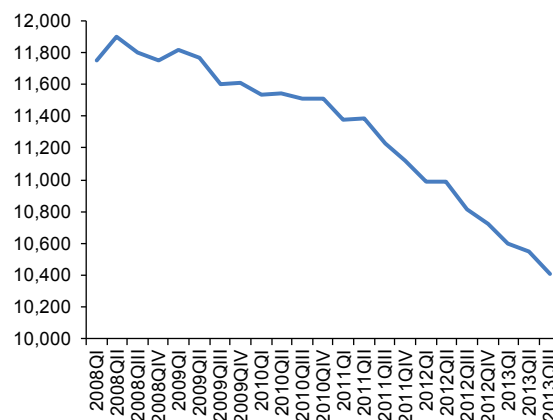
Panel a. All contracts



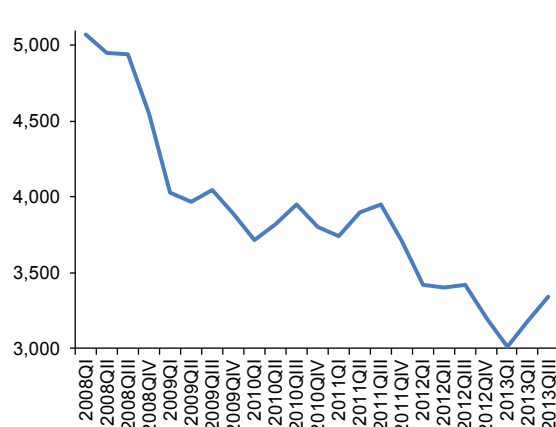
Employment and labor market duality

As mentioned previously, one of the premises of the 2012 reform is that it would induce firms to adjust wages rather than employment in the face of adverse economic conditions. However, job destruction continued to be intense in the quarters after the law was passed (see Exhibit 4, panel a) and only stopped in the second and third quarters of 2013 due to a surge of temporary employment (panels b and c in Exhibit 4). In fact,

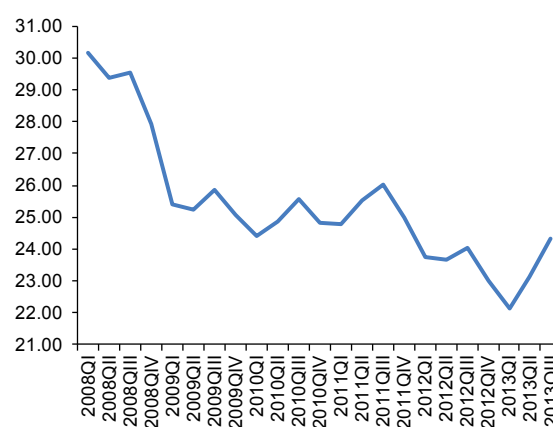
Panel b. Permanent contracts



Panel c. Temporary contracts

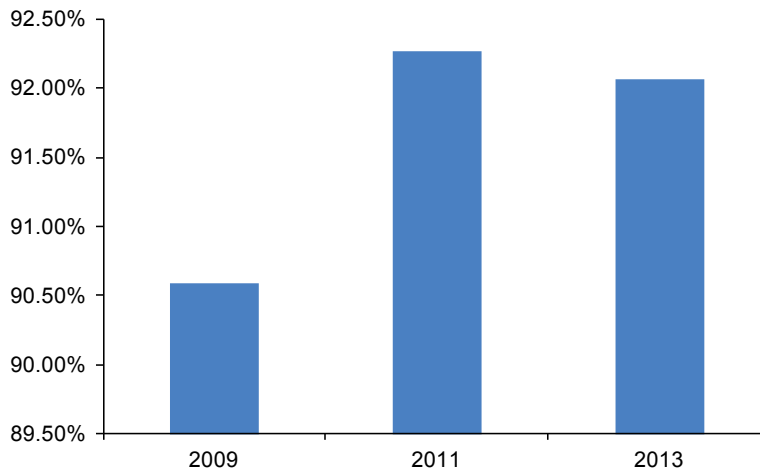


Panel d. Rate of temporary workers



Source: Spanish Labor Force Survey (LFS).

Exhibit 5

Percent of newly signed contracts that are temporary contracts

Source: Spanish Ministry of Employment and Social Security.

of all newly signed contracts in 2013, more than 92% have been temporary contracts (see Exhibit 5). This has always been a feature of the Spanish labor market: the reliance on temporary contracts to adjust both upwards and downwards when economic conditions change. This feature and the corresponding segmentation of the workforce between good jobs (permanent contracts) and bad jobs (temporary contracts), often termed as labor market duality, has always been seen as one of the largest inefficiencies of the Spanish labor market hampering productivity and innovation. According to the data we have available, the 2012 reform has done little to solve this problem. Although the reform reduced the protection of permanent workers, it left basically unchanged the conditions under which firms can hire and fire temporary workers. Therefore, the gap between these two groups of workers continues to be very large and firms continue to rely on temporary workers for any adjustment they need to make. The rate of temporary work, which decreased from 2008 to 2012 due to the massive destruction of these jobs, has increased again in 2013, when hiring started to pick up (see panel d in Exhibit 4).

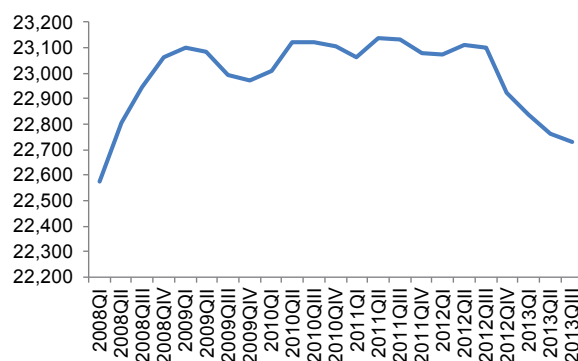
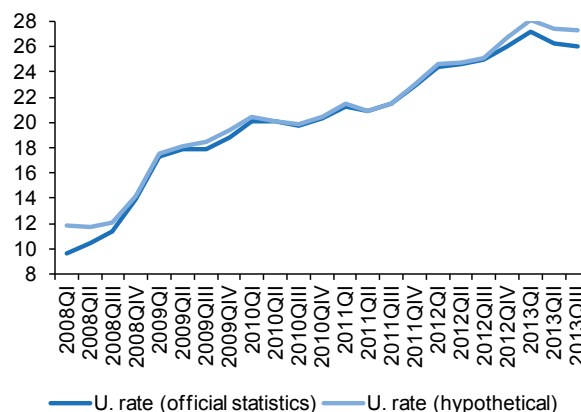
As long as Spanish firms are allowed to hire temporary workers for jobs of a non temporary nature, the burden of the adjustment will fall disproportionately on temporary workers and firms' use of internal flexibility will be modest.

Unemployment rate and active individuals

Unemployment continues to be a key problem. If one looks at the six quarters of available data post February 2012, the problem has gotten worse. The unemployment rate went from 24.44% at the end of the first quarter of 2012 to 25.98% in 2013. It is true that there is a change of trend in 2013, with

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Exhibit 6

Active individuals ('000s) and unemployment rate**Panel a. Active individuals****Panel b. Unemployment rate**

Source: Own calculations using data from the Spanish Labor Force Survey (LFS).

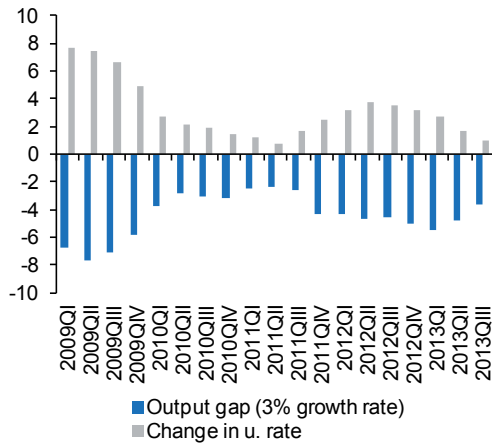
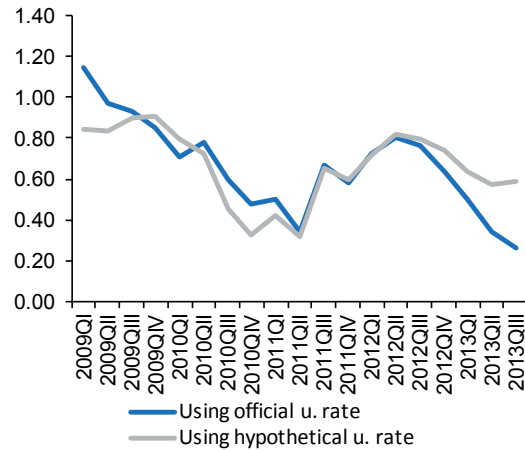
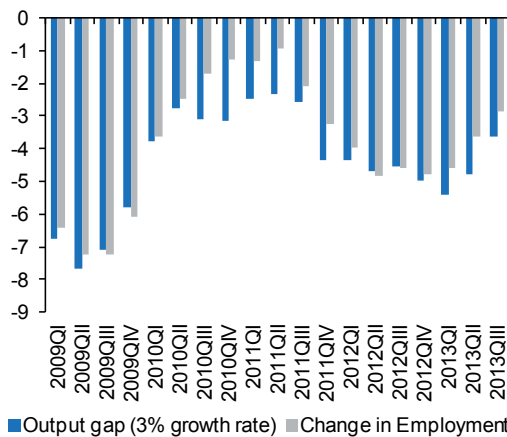
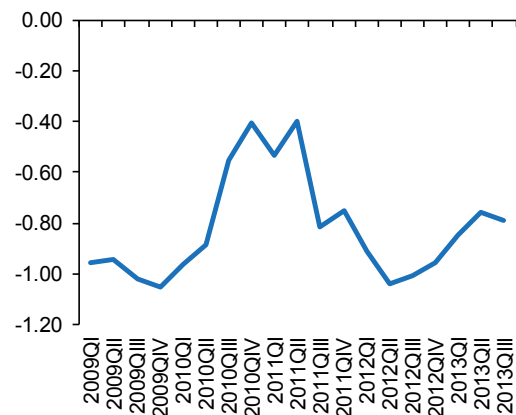
a modest decrease of unemployment, but this is in part due to the fact that Spanish workers have left the labor market in large numbers and they do not qualify as unemployed in official statistics anymore. Panel a of Exhibit 6 shows the number of active individuals, that is, those working or actively looking for a job. The number of active individuals usually rises in the initial stages of an economic crisis because relatives of unemployed individuals decide to go back to the labor market in order to find a job that could compensate the negative household income shock. This is true in Spain among women, for example, and especially so in the context of the current crisis when in the initial years, many men lost their jobs in the construction sector. However, as individuals become long-term unemployed, that is, remain unemployed for many quarters or even years, they become discouraged and may decide to leave the labor market. Some leave the country (such as immigrants that return to their countries of origin, or young nationals that migrate to other countries). Others simply stay but refuse to continue to search for a job. Since 2011, when the number of active individuals reached a peak in the second quarter, the number of

individuals working or looking for a job has fallen by more than 400,000 (see panel a in Exhibit 6). Panel b of Exhibit 6 compares the official unemployment rate with the one that would result from considering unemployed all those individuals that became inactive between 2011 and 2013. As can be seen from the Exhibit, if one removes from the calculation the effect of the decrease of the number of active individuals, the rate of unemployment during 2013 stays practically constant at 27.29% with little visible effect of the 2012 reform.

The relationship between employment, unemployment and GDP

Of course much of the trends we see in the Exhibits could be the result not of the labor market reform but of the cyclical evolution of the Spanish economy. In particular they could be the result of changes in the rate of growth of its aggregate output or GDP. One way to try to assess if the 2012 reform has had an effect on the functioning of the Spanish labor market is to see if there has been a change in the relationship between changes

Exhibit 7

Relation between the output gap and the unemployment rate (u. rate) and employment**Panel a. Output gap versus change in the u. rate****Panel b. Increase in the u. rate per output gap****Panel c. Output gap versus change in employment****Panel d. Decrease in employment per output gap**

Source: Own calculations using data from the Labor Force Survey and INE.

in the GDP on the one hand and changes in the employment and unemployment rate on the other. Is the Spanish labor market now more resilient to decreases in GDP? Does the level of employment or unemployment respond now differently than before when aggregate demand or GDP changes? Economists traditionally have looked at this issue by considering that an economy creates or destroys jobs (reduces or generates

unemployment) when its GDP increases above or below a threshold where employment is stable (Okun's Law). This threshold varies from country to country, usually between 2% to 3%. That is, when GDP grows at 2% to 3% employment is stable, but when it grows above (below) that rate the economy creates (destroys) jobs. Exhibit 7 shows the results of a simplified version of this type of analysis for the period between 2009 and

2013. In that analysis, an output gap is defined as the difference between the yearly rate of growth of GDP and a rate of 3% (the analysis could be done using other benchmark rates of GDP growth and the results would be quite similar).

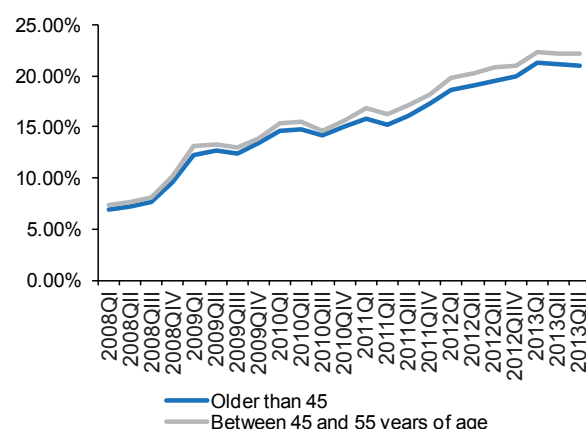
Panels a and b in Exhibit 7 show the results for the unemployment rate. A positive result of the 2012 reform would show up in a lower relation between changes in unemployment and the output gap (panel b). Although it is true that after the reform there is a relatively low increase in the

unemployment rate when GDP grows less than 3%, it is also true that this relationship is highly cyclical and it was also low in 2010 and 2011. It is difficult to infer a clear change of trend post 2012, especially when one looks at the unemployment rate assuming that those 400 thousand active individuals that left the labor market between 2012 and 2013 had remained active (that is, using the hypothetical u. rate). If one looks at the relation between the output gap and the level of employment (panels c and d) the conclusion is even less positive. Note that by construction, the

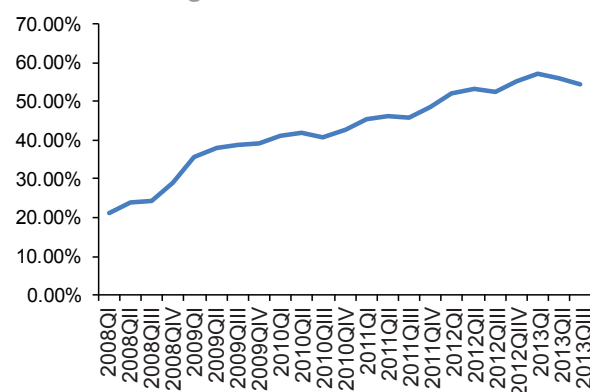
Exhibit 8

Unemployment rate and level of education of the unemployed by age group

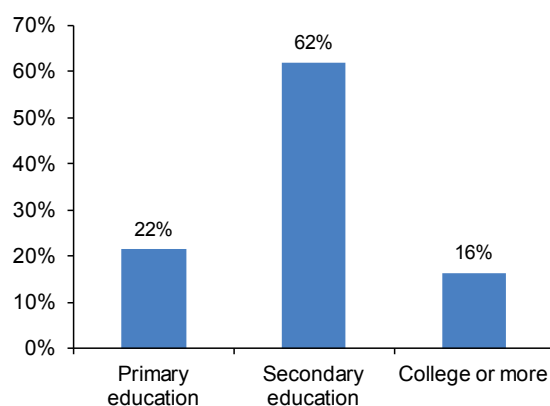
Panel a. Between 45 and 55 years of age



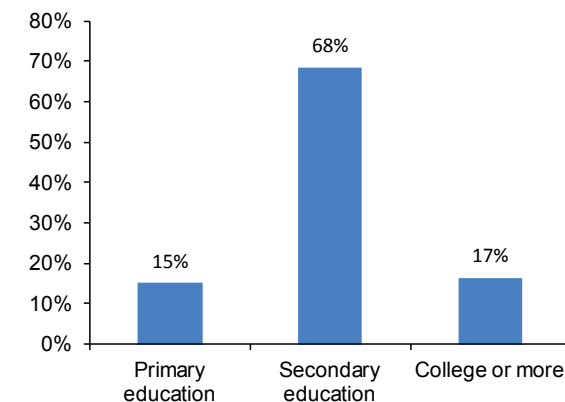
Panel b. Younger than 25



Panel c. Between 45 and 55 years old

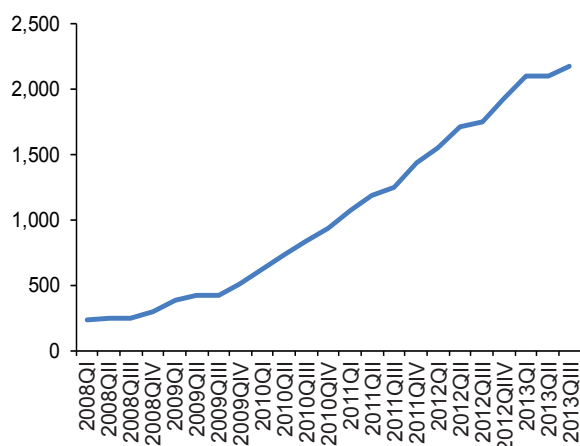
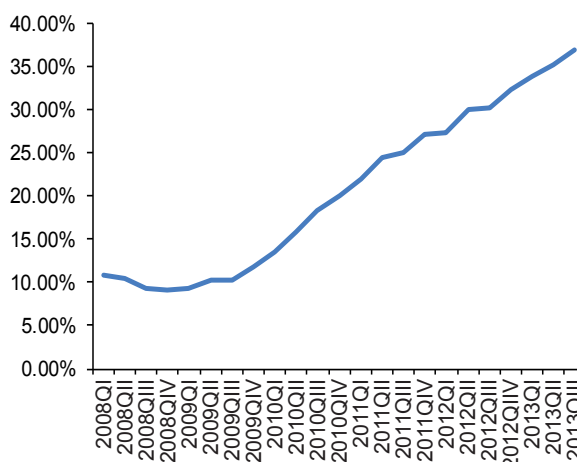


Panel d. Younger than 25



Source: Spanish Labor Force Survey.

Exhibit 9

Long term unemployment (looking for a job more than 2 years)**Panel a. Total Number of individuals****Panel b. As % of the unemployed**

Source: Spanish Labor Force Survey.

evolution of the level of employment is not affected by changes in the number of active individuals. According to the Exhibit, the rate of job destruction per output gap after 2012 is among the highest in the series although it has improved slightly at the end of 2013.

The two biggest challenges: Youth and long-term unemployment

Apart from the unresolved issue of labor market duality, there are at least two other aspects of the Spanish labor market that need urgent attention and that the 2012 reform seems not to have addressed. One is the extraordinarily high rate of youth unemployment. The other is the increase in long-term unemployment. Youth unemployment remains high after the 2012 reform. Since the law was passed, that rate of unemployment increased from 52% to 54% (Panel b of Exhibit 8). There has been a modest decrease in the last two quarters of 2013, however part of this is due to the fact that thousands of young individuals are migrating to other countries to find better job opportunities. Neither the contract for young entrepreneurs, nor

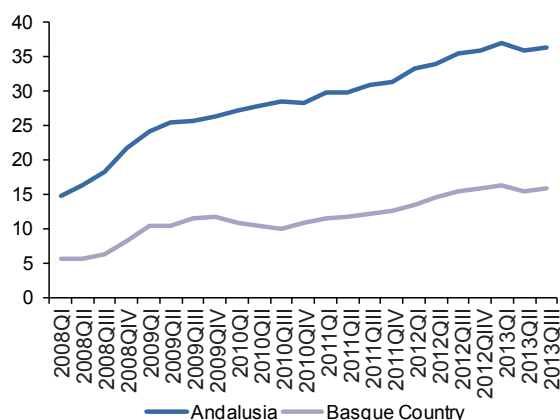
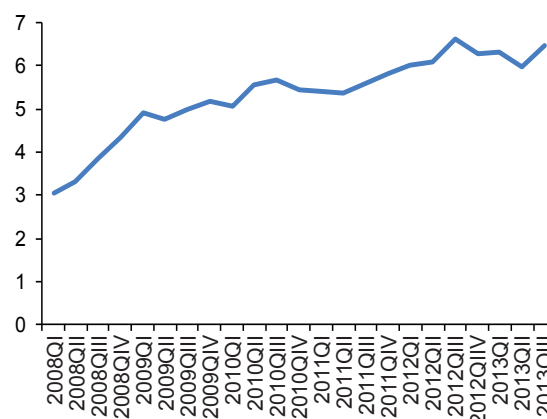
the economic incentives to hire young individuals included in the 2012 reform seem to have helped reduce this very high rate of unemployment.

Long term unemployment, defined as looking for a job during more than two years, has increased significantly since the 2012 reform was passed, from 27.4% of all unemployed in the first quarter of 2012 to 36.8% at the end of 2013 (See Exhibit 9, panels a and b). As opposed to other variables, long-term unemployment shows no change of trend in 2013 since it continued to increase during the first three quarters of the year. More than 80% of these unemployed individuals have just secondary education or less and therefore face a high risk of permanent exclusion from the labor market.

Conclusion: The solution must come from improvements in productivity

Spain faces a difficult situation. Of the six million unemployed individuals, more than two million have been jobless for more than two years, almost one million have less than 25 years of age and a large

Exhibit 10

Large disparities in unemployment rates across regions**Panel a. Unemployment rate in Andalusia and Basque Country****Panel b. Standard deviation of rates of unemployment across Spanish regions**

Source: Spanish Labor Force Survey.

percent lack the skills and qualifications that the market demands.

The solution cannot come only from internal flexibility measures and wage moderation. And yet this seems to be the strategy that the 2012 reform has emphasized, with modest results. A more comprehensive solution must target improvements in labor productivity. In the long run, Spain needs to reform and improve its education system. In the short term, it needs to improve its active labor market policies. So far, this set of policies has failed to redirect jobless workers to the few vacancies that exist in the Spanish labor market. Only two percent of the new contracts signed are the result of the intermediation services of public employment agencies. The large disparities in the rates of unemployment across Spanish regions is inconsistent with a flexible and efficient labor market (see Exhibit 10, panel a). The fact that there are 17 different public employment agencies (one for each region) is not helping and disparities in unemployment rates across regions have increased significantly since 2008 (see Exhibit 10,

panel b). The Spanish government approved this past summer the Annual Plan of Employment Policies. One key measure is that the budget of public employment agencies will now depend to a large extent on the success of each of these agencies in achieving their objectives. We do not know, however, how the government will measure this rate of success. Other measures include a bigger role for private employment agencies in coordination with public ones and a bigger emphasis on individual itineraries for training and education. These are steps in the right direction, but, again, more needs to be done. In its recent report about the Spanish labor market reform (OECD 2013), the OECD recommends that active labor market policies be more closely linked to passive labor market policies (mainly, unemployment benefits). Spain needs to improve not only the regulation of its labor market but also those policies that have a direct effect on labor productivity, such as active labor market policies and education. The 2012 reform is a good first step but more needs to be done.

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