

Two-tier employment protection reforms: The Spanish experience

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Introduction

In most countries, Employment Protection Legislation (EPL) gives differential treatment to different groups of workers. In particular, dismissal regulations may vary by age, gender, skill, firm size, and type of contract, creating a wedge in firing costs across workers. This is particularly the case in various European and Latin American countries where attempts to increase labour market flexibility have taken place through marginal changes in EPL that liberalized the use of fixed-term (or temporary) contracts, while leaving largely unchanged the legislation affecting the stock of employees under open-ended (or permanent) contracts (see Dolado *et al.*, 2007).

If one looks for a representative country to examine the different effects of two-tier labour reforms, Spain provides a fascinating case study. In this article we summarize the main EPL reforms which have taken place in this country since the early 1980s and take stock of their effects on several labour market dimensions.

Institutional background

During the late 1970s, the first democratic government in Spain found it hard to dismantle the system of industrial relations prevailing under General Franco's dictatorship, which was based on rigid EPL regulations and the ban of trade unions, in exchange for almost lifetime job security. Despite the creation of a proper collective bargaining system between employers and unions, a parallel significant reduction in EPL did not take place, since it was feared that it could endanger a smooth political transition to democracy. Hence, following the approval of the so-called Workers'

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Statute (*Ley del Estatuto de los Trabajadores*) in 1980, two main institutional features characterized the Spanish labor market at that time: a high degree of employment protection against both dismissals and occupational/geographical mobility, and the prevalence of collective bargaining at the provincial/industry level as the means for setting wages, working hours, and other employment conditions.

Permanent contracts represented more than 90% of all contracts, while temporary contracts could only be used to hire workers performing non-regular productive activities like, e.g., seasonal jobs in agriculture or tourism. Under permanent contracts, firing costs depended on the worker's seniority and on the reasons for dismissal, which comprised: (a) *objective* reasons (worker's incompetence, lack of adaptation to the job), (b) *economic, organizational, and technological* reasons, and (c) *disciplinary* reasons. While the latter did not require advance notice, the other two types required written advance notice of 30 days and entailed a mandatory severance pay of 20 days' wages per year of service (p.y.o.s.) with a maximum of 12 monthly wages (including overtime and other bonuses besides the base wage). Dismissed workers under permanent contracts could appeal to labor courts, where judges would decide whether the dismissal was fair, unfair, or void. In the last case employers were forced to readmit the worker immediately and, in the case of unfair dismissals, to choose between readmission and termination of the contract with payment of 45 days' wages p.y.o.s. (with a maximum of 42 monthly wages). Further, employers had to pay *interim* wages (for two months at most) while labour courts reached their decisions. Collective dismissals could be justified only on reason (b) and required advance notice to the unions and administrative approval.

The initial two-tier EPL reform

In 1984, following the strong impact of the second oil price shock on an economy specialized in energy-intensive sectors (e.g., mining, shipbuilding, and steel), the unemployment rate surged to 20%, leading to large social unrest. A more flexible labor market was urgently needed to improve worker reallocation from decaying to more profitable industries. Yet, given unions' opposition to altering the status quo, the only politically feasible way of implementing significant EPL changes was through the liberalization of temporary contracts, allowing them to be used to hire employees

performing regular activities. These contracts entailed much lower dismissal costs than regular permanent contracts and their termination could not be appealed to labor courts. The so-called *employment-promotion* contract (EPC) had a severance payment of 12 days' wages p.y.o.s. and a maximum duration of 3 years within the same firm, after which the employer had to either terminate the contract or convert it into open-ended. The remaining temporary contracts (training, under probation, fixed-term proper, and replacement contracts) could be terminated at no cost.

As a result of this two-tier reform, the proportion of temporary contracts in dependent employment exploded to almost 35% in the early 1990s (Figure 1). This led to a very high worker turnover rate, which was reinforced by the easy access to unemployment benefits prevailing at that time (requiring only six months of social security contributions and providing a replacement ratio of 80% during the first six months in unemployment). Hence, firms used layoffs as a normal practice, which implied very low conversion rates into permanent contracts (5% in 1994 versus 18% in 1987). The ensuing threat to the financial sustainability of the unemployment protection system triggered in 1994 a reform lowering the initial replacement rate from 80% of the wage to 70%. Since then, this high temporary employment rate has become very resilient, turning Spain into the EU country with the largest share of temporary employees (Figure 2).

[FIGURE 1 AND FIGURE 2]

Four countervailing EPL reforms

In view of this dramatic burst of temporary jobs, a series of countervailing EPL reforms have subsequently taken place in order to offset some of the undesirable effects of the 1984 reform. Their aim was to reduce the incidence of temporary jobs, either by restricting the use of temporary contracts or by reducing mandatory firing costs for open-ended contracts.

The first reform took place in 1994. The conditions for the use of fixed-term contracts were restricted, while the conditions for fair dismissals of workers under permanent contracts were mildly relaxed. Specifically, the EPCs were abolished, except for some

groups of disadvantaged workers (older than 45 years old, handicapped, and long-term unemployed workers hired by small firms). Hence, the remaining temporary contracts no longer involved severance payments at their termination. In parallel, the reasons for objective dismissal (b) were extended to include circumstances where the future (rather than the present) financial viability of the firm could be jeopardized absent further adjustment of its workforce. Lastly, temporary work agencies, which had been previously banned, were allowed to operate.

Despite a slight reduction in the temporary employment rate between 1995 and 1997, the arrival of a conservative government and both the threats and potential gains from Spain's accession to the European Monetary Union pushed the employers' confederation (CEOE-CEPYME) and the two major unions (UGT and CCOO) to agree on a new EPL reform in 1997. The agreement called, for the first time, for the creation of a new permanent EP contract (PEPC), available for the following four years, entailing lower severance pay in case of unfair dismissal (33 days' wages p.y.o.s. with a maximum of 24 months' wages). However, this reform was again of a two-tier nature, since the new contracts could not be used for hiring workers aged 30-44 years old with unemployment spells below one year (about 40% of the labor force and 33% of employment).¹ This exclusion was due to legal reasons, since it would have been against the spirit of the Spanish Constitution to have two open-ended contracts subject to identical labor regulations except for severance pay (45 versus 33 days' wages in case of unfair dismissal), unless the workers hired were disadvantaged. In addition, the government introduced significant rebates of social security contributions for firms either directly hiring workers under the PEPCs or converting temporary into permanent contracts. The rebates ranged from 40% to 60% during the first two years of contracts used to hire workers in some targeted groups (youth, long-term unemployed, and women under-represented in some industries).

Next, in 2001-2002, when the new PEPCs were supposed to expire (for new hires), fearing that their elimination would reduce job creation in the midst of an economic slowdown, the government allowed them to remain in effect and extended their use to some groups of workers who had been adversely affected by the previous reform. Thus,

¹ There was a loophole, however, since employers could first hire workers in that group through temporary contracts and then convert them into the PEPCs. Unions complained and the loophole was eliminated in 2003.

the 2001-2002 reform extended the use of PEPCs to the hiring of workers aged 16-30 years old (instead of 18-29) as well as of the unemployed with more than six months of registered unemployment (instead of one year). In addition, a severance payment of 8 days' wages p.y.o.s. was established for some of the still available temporary contracts. However, the most important change was the abolition of the firm's obligation to pay *interim* wages when dismissed workers appealed to labour courts, as long as the firm acknowledged the dismissal as being unfair and deposited the severance pay (45 days' wages p.y.o.s.) in court within two days of the dismissal.

By the mid-2000s, the share of temporary jobs remained very high (33.5%) and the number of contracts signed each year was more than 20 times the flow of net new jobs (17.2 against 0.78 million in 2005). Their conversion rate into open-ended contracts remained stable around 4% of the total number of contracts (Figure 3) despite the reduction of firing costs for the PEPCs, possibly because the excluded population remained sizeable (28% of temporary jobs). For these reasons, a further EPL reform – the latest one so far – took place in 2006. The first policy adopted was to reopen a window of opportunity for the excluded group of workers, but only transitorily. Temporary workers in the age bracket 31-45 could be hired under PEPCs until the end of 2007. Further, if the conversions took place before the end of 2006, and the PEPC lasted for at least 3 years, the employer would receive a rebate of 2,400 euros in payroll taxes. The reform also included rebates favouring the conversion of eligible temporary workers (outside the 31-45 year-olds) into PEPCs, extending from two to four years the duration of the rebates approved in the previous two EPL reforms. The proportional rebates were replaced by a lump-sum rebate of 1,200 euros per year, with the goal of improving the hiring of low-wage workers, for whom the relative reduction in payroll taxes would be larger. Lastly, this reform also mandated that contracts lasting for two years in the same job with the same firm during a period of 30 months would be automatically converted to open-ended contracts. Since the approval of the 2006 reform, there has been a substantial reduction in the temporary employment rate, from 34.4% in 2006 to 29.4% in 2008:2. Thus, it could be considered as a successful reform. However, as reflected in Figure 3, the effect on the flow from temporary to open-ended jobs seems to have been short-lived, being mostly concentrated in the transitory period in which the rebates were awarded and showing a decrease in the course of 2008 towards the lower pre-reform values. Indeed, part of the five percentage-point reduction in the share of

temporary contracts can be attributed to the large destruction of temporary jobs in the construction industry, due to the burst of the housing bubble since the beginning of 2008.²

[FIGURE 3]

The political economy of two-tier EPF reforms

Understanding of the political determinants of labor market reforms has become one of the key topics of research on European unemployment during the latest two decades (Saint-Paul, 2000). In the specific case of the Spanish EPL reforms, a simple indicator of the *political support* for those reforms is the ratio between the number of workers under permanent contracts and the sum of total employees (permanent and temporary) and the unemployed. Roughly speaking, a value of this ratio above 0.5 means that workers under permanent contracts are the median voters, i.e. the *insiders* whose interests the labor unions will try to protect. Conversely, a ratio below 0.5 signals that the temporary employees plus the unemployed become the median voters dictating the unions' goals. Figure 4 depicts that ratio since 1987. Since the indicator was well above 0.5 in 1984, the introduction of EPCs can be rationalized as the only politically feasible way forward at a time when unemployment was very high and increasing, employment creation was very low, and, hence, there were very few job opportunities for displaced workers. By 1993, with the widespread use of fixed-term contracts and a further increase in unemployment, the indicator fell below 0.5. This suggests the opening of a *window of opportunity* for the reforms that took place in the mid-1990s, helping to explain why the interests of the workers under fixed-term (and new permanent) contracts and the unemployed in favor of higher labor market flexibility led to less stringent EPL. Afterwards, the ratio has been on the rise, reaching a value of 0.62 in 2007, so that new reforms reducing the dismissal costs of permanent contracts do not seem feasible in the near future. This conclusion might be premature, however: if we consider workers under PEPCs as part of the constituency for higher flexibility and

² The adjustment has indeed been harsher, since the temporary employment rate has fallen from almost 36% in 2006 to 30.2% in 2008:3 in the private sector, while it has remained around 26% in the public sector.

exclude them from its numerator, the ratio would reach a value close to 0.5.³

[FIGURE 4]

Lessons from Spain

In what follows, we summarize the main lessons, based on a rather large series of empirical studies, drawn from the Spanish experience since the mid-1980s (see Dolado *et al.*, 2002).

1. There is overwhelming evidence that fixed-term contracts and lower firing costs increase the volatility of employment by raising both the hiring and firing rates. For instance, García-Serrano (1998) finds that a rise of 1 percentage point in the proportion of fixed-term contracts increases the flows from employment to unemployment, unemployment to employment, and employment to employment by 0.26, 0.16, and 0.34 percentage points, respectively, and reduces job tenure by 2.3%, namely, by two months in a mean-elapsed job tenure of nine years. Moreover, in sclerotic labor markets, most of the cyclical volatility in unemployment comes from the unemployment outflow rate, as opposed to the inflow rate (Petrongolo and Pissarides, 2008). This is the case of France –which has high EPL–, where according to these authors the outflow rate from unemployment contributed 91% of unemployment volatility, above the 75% found for the flexible United Kingdom, while the Spanish figure is still lower, 60%.⁴

2. Insofar as the use of fixed-term contracts implies a rise in the hiring rate, they have helped to reduce long-term unemployment, especially in periods of high growth. Bover and Gómez (2004) find that exit rates to temporary jobs are ten times larger than exit rates to permanent jobs, although, as unemployment duration increases, the reduction in exit rates is larger for exits to temporary jobs than to permanent ones. Thus, as the share of temporary workers surged to one-third of all employees between 1987 and 1992, the incidence of long-term unemployment decreased a lot, from 67% in 1987 to 47% in 1992. This was due to the rise in the average unemployment outflow rate following the

³ Official data do not allow us to distinguish between workers under the old and new permanent contracts. Our statement is based on Toharia's (2008) estimate that the share of PEPCs in total permanent contracts was around 15% in 2007.

⁴ We report figures for the latest period available for each country, since the periods do not coincide across countries.

availability of fixed-term contracts for regular activities, since there was a very limited use of active labor market policies (the other main determinant of long-term unemployment) over the period. Subsequently, however, the incidence of long-term unemployment increased from 48% to 56% in the recession of the early 1990s, possibly due to job-to-job flows by temporary workers crowding out the employment prospects of the long-term unemployed who had lost their permanent jobs. Since the late 1990s, there has been a remarkable reduction of the long-term unemployment incidence, which reached 22% in 2007, marking the end of a very long-lasting period of high growth.

3. As is well known, a non-marginal reduction of EPL has an ambiguous effect on average labor demand, since it increases the incentives to both hire and fire workers (Bentolila and Bertola, 1990). Less is known about the effects of targeted reforms, except that the transitional dynamics from a rigid to a two-tier regime tend to be associated with a transitory increase in employment, as firms adjust to a new desired temporary employment ratio (Bentolila and Saint-Paul, 1992) or they fully adjust upwards in upturns and only partly fire workers in downturns, leading to what is known as a “honeymoon” effect (Boeri and Garibaldi, 2007). Also, Dolado *et al.* (2007) argue that two-tier EPL reforms achieve a larger reduction in unemployment when they are targeted to workers with lower and more volatile productivity. However, if wage-setting is adversely affected by the existence of a dual labor market, then unemployment might rise. On the one hand, there is empirical evidence regarding adverse effects of fixed-term contracts on wage pressure in Spain –discussed below– at least until the early 1990s, and possibly nowadays. On the other hand, as pointed out before, temporary contracts helped reduce hysteresis, which was a major determinant of the rise and persistence of the Spanish unemployment rate. Thus, whether temporary contracts are good or bad for unemployment seems to depend on what period one looks at. In the most recent period, fixed-term contracts (but also the new permanent contracts with lower redundancy payments) may have helped reduce the unemployment rate from a high of 20% in 1997 to a low of 8% in 2007. Moreover, the availability of flexible contracts has clearly eased the assimilation of the big immigration boom that has taken place since the mid-1990s (immigrants have gone from representing 1.3% of the labor force in 1996 to 16% in 2008): over that period, 61% of immigrants were on fixed-term contracts vis-à-vis 33.6% of the natives. Indeed, immigration, as discussed in Bentolila *et al.* (2008), has meant the *de facto* most important reform in the Spanish labor market.

However, the prospect of bouncing back to a high unemployment rate during the current recession (the IMF forecast for 2009 is 14.7%) is definitely facilitated by the low firing costs associated with temporary contracts and the observed increasing wage pressure by workers with permanent contracts.

4. A rise in the turnover rate decreases the probability of investing in specific human capital or receiving specific training at the firm and, therefore, may decrease labor productivity and Total Factor Productivity (TFP).⁵ This is particularly so if the conversion rate of fixed-term contracts into permanent contracts is low, reflecting the fact that employers use those contracts more as a flexible device to adjust employment in the face of adverse shocks than as a screening device under asymmetric information. Güell and Petrongolo (2007) have analyzed the determinants of the probability of these conversions, finding two very pronounced spikes at one and three years of duration of fixed-term contracts. The first spike agrees with the screening device rationale and applies mostly to skilled workers, whereas the second just reflects their use as a more flexible alternative for downsizing (coinciding with the maximum legal duration before 1994). With low conversion rates, it is not surprising that investment in on-the-job training seems to be negatively affected by fixed-term contracts. Indeed, the probability of receiving free or subsidized on-the-job training during the 1990s was 22% lower for workers under fixed-term contracts than for workers under permanent contracts, whereas Dolado and Stucchi (2008) attribute one-third of the fall of TFP in Spanish manufacturing firms during 2001-2005 to the disincentive effects of the low conversion rates on temporary workers' effort. Finally, the results in Guadalupe (2003) suggest that temporary employment increases work accidents, which happen to be three times larger for workers under temporary contracts than for workers under permanent contracts.

5. As for the effects on wages, increased dualism in the labor market may imply a higher wage pressure if labor unions protect the interests of permanent workers in wage bargaining. Bentolila and Dolado (1994), using microeconomic data on firms, find that an increase of 1 percentage point in the rate of temporary employment raises the growth rate of permanent workers' wages by about 0.3%. A different effect of fixed-term contracts on wages stems from the observed negative wage differential for workers

⁵ Bassanini *et al.* (2008) find a negative effect of EPL regulation of permanent contracts on TFP growth in OECD countries, but do not find a significant effect of EPL regulation on temporary contracts.

under these contracts relative to workers under permanent contracts. Although, in principle, wage rates cannot be differentiated by contract type, several empirical studies find that, after controlling for observed and unobserved heterogeneity in personal and job-related characteristics, permanent workers earn around 10% more, for men, and about 5%, for women, after controlling for observed skills, occupation, and firm (De la Rica, 2004). The evidence also indicates that the wage gap is associated with employers' decisions to under-classify temporary workers when assigning them to occupational categories (which determine their wage), probably to cut total labor costs. Insofar as more educated workers are more prone to under-classification than less educated workers, that process should lead to a widening of the earnings distribution for the former group, a fact that fits well with the increasing phenomenon of over-education, which affects 21% of Spanish workers with a college degree.

6. Lastly, higher worker turnover leads to increased uncertainty and therefore fixed-term contracts have been found to reduce geographical labor mobility, fertility, and youth emancipation (see Antolín and Bover, 1997, Ahn and Mira, 2001, and Becker *et al.*, 2009, respectively).

On the whole, the Spanish evidence on the labor market effects of two-tier reforms in EPL seems to support the following predictions: (a) a large increase in worker turnover, (b) a reduction in long-term unemployment insofar as the gap between the degree of EPL strictness of permanent and fixed-term contracts is reduced, (c) a fall in investment on specific human capital and a decrease in labor productivity and TFP, (d) a decline in the regional migration, fertility, and youth emancipation rates, (e) a widening of the wage distribution for higher-educated workers, (f) a neutral or slightly positive effect on employment, particularly after the 1997 reform.

Prospects for the future

As discussed earlier, despite the transitory success of the last two-tier labor reform in 2006, the share of temporary jobs in Spain still almost doubles the average share in the EU-15 and more than doubles the share in another economy like the Italian one, with a similar sectoral structure. Thus, there is ample room for improvement in desegregating an embedded dual system of employment protection where workers under temporary

contracts face much higher labor market risks (e.g., unemployment and low human capital accumulation) than those under permanent contracts. The current steep slowdown in the rates of growth of GDP and employment in the Spanish economy, after 14 years of high growth, could jeopardize some of the past achievements and it is very doubtful that new marginal labor reforms will be effective. Instead, a sensible and credible long-term reform should instead aim at closing the gap between the firing costs of permanent and temporary contracts introducing a *gradual EPL*. Job security provisions under the current dual system of regular (45 days' wages p.y.o.s.), PEPCs (33 days' wages p.y.o.s.), and fixed-term contracts (8 days' wages p.y.o.s.) are proving too discontinuous to avoid a large number of dismissals in the near future. This leads employers to convert very few temporary contracts into open-ended ones while they find it cheaper to dismiss temporary workers.

Since workers under permanent contracts are currently the median voters in the potential constituency of unions, a radical reform does not seem to be politically feasible. However, what might be feasible would be to maintain the current average level of job security provisions –i.e., the amount of dismissal costs paid by firms– while changing its distribution so that severance payments increase smoothly as workers accumulate job tenure. Economic theory predicts that a lower differential between those dismissal costs would unambiguously increase employment since it would facilitate contract conversions, thereby reducing worker turnover which often raises unemployment (Cahuc and Postel-Vinay, 2002, and Blanchard and Landier, 2002). One possibility would be to replace the existing system of permanent and temporary contracts for new hires by a single permanent contract with smoothly increasing severance payments, e.g., 8, 12, 15, 20, and 25 days' wages p.y.o.s. during each of the first five years of the contract and 36 days' wages p.y.o.s. afterwards. With these mandated payments, we have calculated that the cost of firing a worker with 10 years of job tenure would be almost identical ($80+5 \times 36=260$ days' wages) to the expected cost under the current provisions (257 days' wages).

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Figure 3

**Conversions of temporary into permanent contracts
as a percentage of total contracts signed**

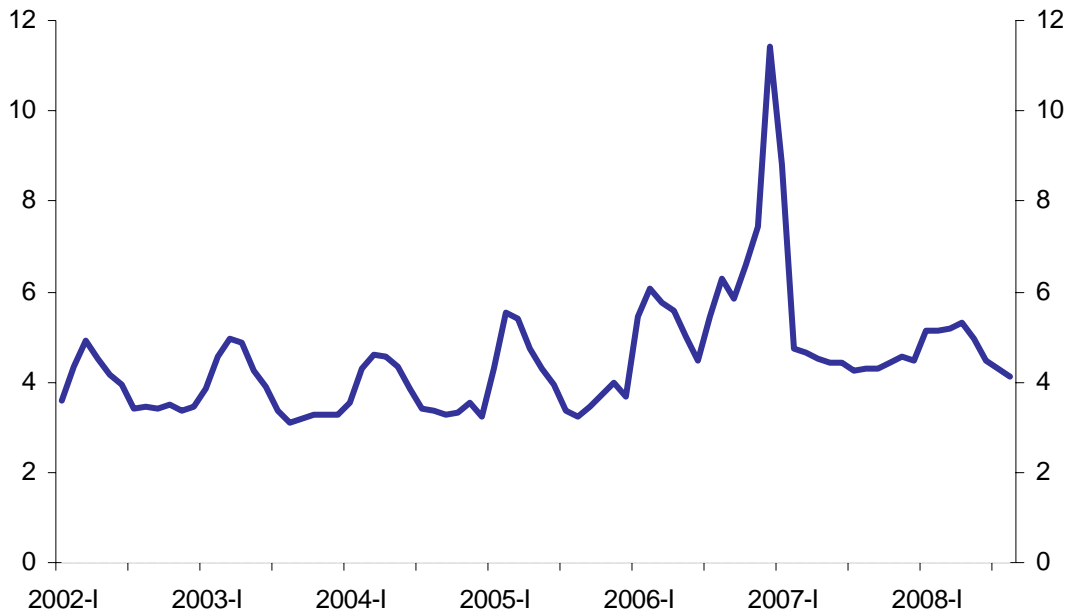


Figure 4

**Indicator of political viability of labor reforms
Permanent employees as a share of employees plus
unemployed**

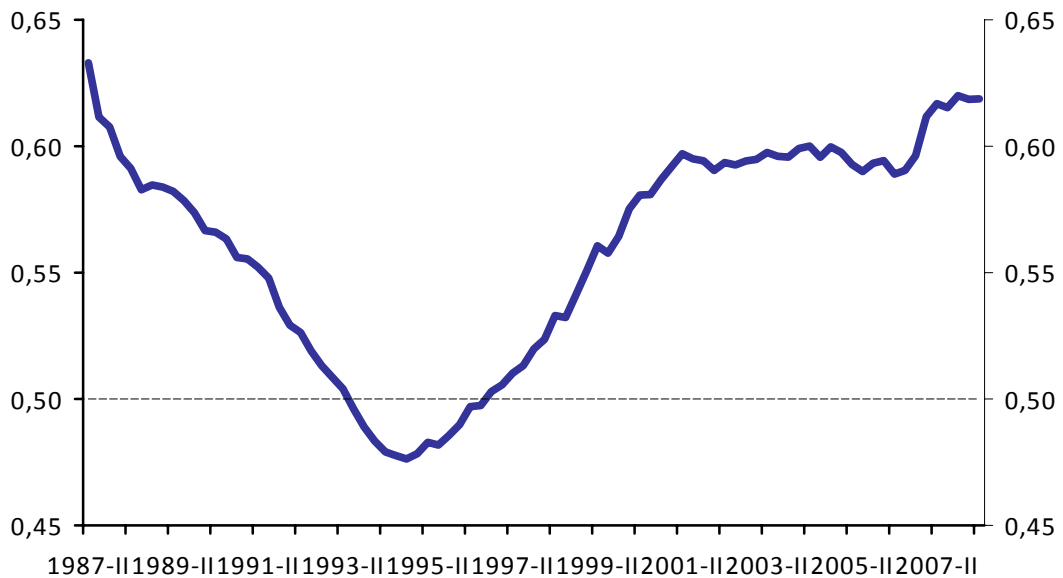


Table 1: Summary of legal measures on permanent and temporary contracts in Spain, 1980-2006

Legal measures	Permanent contracts	Temporary contracts
Workers' Statute (1980)	<ul style="list-style-type: none"> • Individual dismissals: <ul style="list-style-type: none"> - For objective reasons. - For economic, organizational, or technological reasons. - For disciplinary reasons. • Ruling by labour courts upon appeal: <ul style="list-style-type: none"> - Unfair: 45 days' wages per year of seniority (maximum 42 months' wages) + interim wages. - Fair: 20 days' wages per year of seniority (maximum 12 months' wages) + interim wages. - Void: reinstatement. • Collective dismissal: Administrative approval. Same dismissal costs as fair individual dismissals. 	<p>Minor incidence.</p> <p>Only for seasonal jobs (under stringent regulation).</p>
Law 32/1984		<p>Employment Promotion Contract (EPC) (<i>Contrato Temporal de Fomento del Empleo</i>): For any type of job. Minimum length, 6 months; maximum length, 3 years. Severance pay: 12 days' wages per year of service.</p>
Decree 1/1992	Social security contributions rebates for hiring permanent employees.	EPC minimum duration raised to 12 months and maximum duration raised to 4 years (under certain circumstances)
Law 11/1994	New definition of collective dismissals. Extension of the definition of fair dismissal.	EPC abolished. Temporary contracts only allowed for fixed-term duration jobs. Legalization of temporary work agencies.
Law 63/1997	Permanent Employment Promotion Contract (PEPC) (<i>Contrato de Fomento de la Contratación Indefinida</i>). Severance pay for unfair dismissals for objective reasons lowered to 33 days' wages per year of service (maximum 24 months' wages), only for targeted groups.	Strengthening of causality principle in the applicability of temporary contracts.
Law 12/2001 Law 45/2002	Extension of coverage of PEPC. Elimination of interim wages when dismissal is acknowledged as unfair by the employer and severance pay deposited in court.	Severance pay of 8 days' wages per year of service in some temporary contracts.
Decree 5/2006	Extension of coverage of PEPC. New tax deductions for hiring permanent employees	Restrictions to continuation of temporary contracts to same employee.