THE FUNCTIONING OF THE LABOUR MARKET AND UNEMPLOYMENT GROWTH IN SPAIN

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The authors of this article are Ángel Estrada, Mario Izquierdo and Aitor Lacuesta, of the Directorate General Economics, Statistics and Research.

Introduction

The unemployment rate is proving to be the key manifestation of the severity of the crisis affecting the Spanish economy. According to EPA (Spanish Labour Force Survey) data, the unemployment rate rose from 9.6% at the beginning of 2008 to 17.9% in 2009 Q2, topping the 4 million mark.[1] The rate of job destruction is higher than in other developed countries, even taking into account some of the singularities of the Spanish case. Thus, in countries facing a similar contraction in activity, but with a lower rate of growth in the labour force and with no comparable construction sector expansion, the unemployment rate has risen only slightly since the start of 2008 (for example, in France, by 1.3 pp according to Eurostat) or has even remained stable (for example, in Germany), although unemployment will foreseeably rise in these countries in coming quarters. However, when compared with countries that share similar characteristics in terms of property market developments and demographic trends, such as the United States, the United Kingdom and Ireland, Spain's unemployment growth continues to stand out: the unemployment rate has risen by "just" 4 pp in the United States, slightly more than in the United Kingdom, and by 6.4 pp in Ireland, as opposed to more than 8 pp in Spain.

This suggests that the Spanish labour market's mechanisms for adjustment in the face of adverse shocks are not functioning correctly, as employment is bearing the brunt of the adjustment and this entails a high cost, in terms of long-term economic growth and social well-being. Moreover, these distortions are not only seen in periods of recession, but also in economic expansion phases, in the form of highly temporary and precarious employment, low productivity and real wage growth and an unemployment rate that has failed to converge with that of the euro area countries. These shortcomings in the functioning of the labour market reflect, inter alia, a lack of adaptation of the institutional framework. When it comes to determining how the labour market functions and its capacity to adjust in the face of serious macroeconomic shocks, there are four key labour market institutions: unemployment protection schemes, understood in the broadest sense (including unemployment benefits and severance payments); wage-setting mechanisms (the collective bargaining system); active labour market policies (designed to raise the employability of the labour force); and labour market intermediation mechanisms (the agencies that help match persons looking for work with firms offering work).

The fact that employment is bearing the brunt of the adjustment is probably chiefly due to the first two of these institutions, i.e. the unemployment protection schemes and the wage-setting mechanisms.[2] Moreover, several studies have demonstrated that the interaction between these two institutions is also key to understanding the labour market's reaction to shocks:[3] in fact it is clear that protection systems may affect the result of collective bargaining, and vice versa, that the degree of wage adjustment in light of a shock makes it essential for unemploy-

1. To give an idea of the magnitude of the problem, it should be noted that, in like-for-like terms, the all-time high for Spanish unemployment was 18.2% in 1994 Q3, although as it was then calculated, the unemployment rate reached 24.5%. **2.** This does not mean that the role of the other two institutions is insignificant. In fact Denmark is the most paradigmatic example of the effectiveness of powerful active and well-designed labour market policies and of the important role public and private employment services can play to prevent the unemployed from becoming stigmatised. **3.** Blanchard and Wolfers (2000) analyse the importance of the interaction between labour market institutions and different economic shocks for analysis of labour market behaviour.

ment protection schemes to come into play. In this respect, the reasons that warrant the existence of these labour market institutions should not be forgotten: they provide guaranteed income for workers (who are thus able to maintain a more stable spending profile over time), they transfer part of the risk from individuals to firms, they oblige firms to assume the social cost of worker dismissals, they enable the unemployed to find work more suited to their skills and they balance the bargaining power of workers and firms, inter alia. All this explains why these institutions must be well designed, to ensure that labour market adjustments are efficient and entail the lowest possible social and economic cost. However, it should also be borne in mind that for these design improvements to yield optimum results, firms will have to operate in a more competitive environment on the product markets, to ensure that the consequent decline in corporate margins is passed through to final consumers.

Accordingly, the next two sections of this article contain an overview of the existing unemployment protection and wage-setting institutions in Spain, placing them in an international context and aiming to identify their main shortcomings. There follows a review of some of the labour market reforms undertaken in other European countries that may serve as a reference framework for Spain. In particular, Germany and Austria made extensive changes to the design of their unemployment protection schemes in the 1990s and are, for the time being, demonstrating considerable resilience to unemployment growth, while Sweden is a paradigmatic example of how a collective bargaining system mid-way between past excessive centralisation and wage bargaining at company level may have an adverse impact on unemployment. Finally, the last section summarises the main conclusions.

Employment protection in Spain. The effects of excessive labour market segmentation

Most developed countries operate a combination of two basic mechanisms to ensure that workers receive income throughout their working lives and to enable them, if made redundant, to secure a new job that matches their skills, namely severance pay and unemployment benefits. In Spain, the Workers' Statute contains the regulations on severance pay following termination of a permanent employment contract. In simplified terms, there are two channels that firms may use to dismiss individual employees: objective reasons (Articles 52 and 53 of the Statute) or disciplinary grounds (Articles 54 and 55). In either case, if an appeal is filed, an employment tribunal may declare the dismissals to be fair, unfair or null and void. In the case of dismissals for objective reasons, firms must give employees one month's notice and severance pay amounting to 20 days' salary per year worked, up to a maximum of 12 months' pay; if the dismissal is subsequently declared to be unfair, employees will be entitled to 45 days' salary per year worked, up to a maximum of 42 months' pay. In 1997 this was reduced to 33 days' salary per year worked, up to a maximum of 24 months' pay, for certain groups of workers via the creation of the permanent employment-promoting contract. Dismissals on disciplinary grounds are effective immediately and grant no entitlement to severance pay if they are considered fair; if they are deemed unfair by the tribunal, in this case also employees will be entitled to 45 days' salary per year worked, up to a maximum of 42 months' pay.[4] Lastly, should the tribunal rule that the workers have been discriminated against and that the dismissals, whether for objective reasons or on disciplinary grounds, are null and void, the employees must be readmitted.

To place these figures in an international context, the data compiled by the World Bank for its Doing Business Index is used, given the uniformity between countries.[5] In these statistics, the

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4. By contrast to the case of dismissals for objective reasons, the permanent employment-promoting contracts brought no changes in these conditions. **5.** Specifically, one of the components of this Index reflects the cost of termination for economic reasons (corresponding to termination for objective reasons in the Spanish system) of the contract of a 42-year old, full-time, non-management employee, with 20 years' service, earning the national average wage, in a company with 201 employees, in the manufacturing industry, which is subject to a collective bargaining agreement (even if it takes no direct part in the bargaining process).

SEVERANCE PAYMENTS IN OECD COUNTRIES TABLE 1

	Severance pay (weeks' salary)		Severance pay (weeks' salary)
Denmark	0	United Kingdom	22
New Zealand	0	Greece	24
United States	0	Ireland	24
Austria	2	Finland	26
Australia	4	Sweden	26
Japan	4	Canada	28
Italy	11	France	32
Iceland	13	Hungary	35
Norway	13	Mexico	52
Poland	13	**Spain**	**56**
Slovakia	13	Germany	69
Switzerland	13	Korea	91
Belgium	16	Turkey	95
Netherlands	17	Portugal	95
Czech Republic	22		
OECD	25.8		

SOURCE: Doing Business (World Bank).

cost of dismissal in Spain in 2008 was 56 weeks' pay, based on fair dismissal, for objective reasons, of an employee with 20 years' service. As Table 1 shows, this sum is more than double the average for the countries of the OECD (25.8 weeks). In fact, only four developed countries top this figure: Germany, Portugal, Korea and Turkey. Nevertheless, these figures may possibly not be an adequate reflection of effective severance payments in Spain, as most terminations of contracts are made, not for objective reasons that are considered fair, but on disciplinary grounds that are subsequently considered unfair. In this case, for the employee considered in the World Bank's Index, the cost of dismissal would be 128 weeks' pay, far higher than that of any of the other countries analysed.

Unfortunately in Spain there is no accurate information available on final rulings on terminations of contracts. However, from a number of approximations it is possible to affirm that the great majority of permanent contracts terminated in Spain grant entitlement to maximum severance (45 days' pay per year worked). In fact, combining the information on individuals accessing unemployment benefits by source of entitlement with the judicial statistics on worker dismissals, it may be seen that firms acknowledge from the outset that dismissals are unfair[6] in slightly more than 70% of cases, and that of the cases that go to employment tribunals (the remaining 30%), approximately 30% result in agreed settlements and more than 20% in rulings favourable to the workers. Accordingly, the proportion of permanent contracts terminated in Spain that grant entitlement to the maximum severance pay established in the Workers' Statute may be close to 90%.[7]

In any case, it is important to note that this legislation only affects employees with permanent contracts, who represent approximately 70% of Spanish dependent employees. By contrast,

6. Under Law 45/2002, firms are no longer obliged to pay wages between the date of dismissal and the date of the conciliation hearing, in cases in which they acknowledge that dismissal on disciplinary grounds, as of the date thereof, is unfair and they grant the workers the corresponding severance pay. **7.** There is no detailed information on severance payments made in the case of redundancy programmes; however, even in the present circumstances, these programmes affect only a very small percentage of workers.

UNEMPLOYMENT BENEFITS TABLE 2

	Replacement ratio (% of salary)		Replacement ratio (% of salary)
Turkey	48	Italy	66
Greece	48	Slovakia	68
Australia	48	Canada	68
New Zealand	48	**Spain**	**69**
United Kingdom	51	Norway	69
Korea	53	Netherlands	70
Ireland	54	Finland	70
Hungary	55	Sweden	72
Poland	61	Germany	73
United States	62	France	74
Japan	62	Denmark	74
Belgium	62	Switzerland	81
Iceland	62	Portugal	85
Czech Republic	63	Luxembourg	86
Austria	64		
OECD	64.3		

SOURCE: OECD.

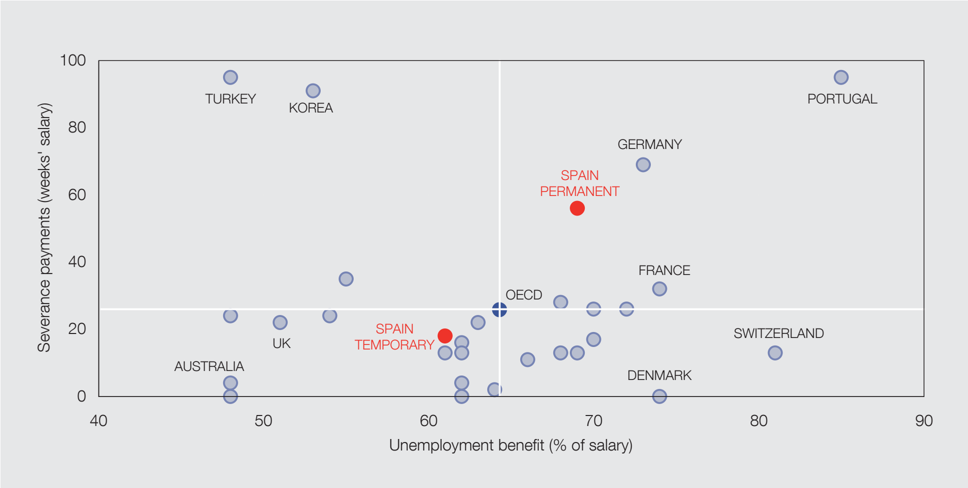
employees with casual contracts or with contracts for specific tasks or services that are not renewed are entitled to just eight days' pay per year worked, or 22 weeks' pay in the terms of the World Bank's Index (were it possible for a temporary employee to have 20 years' service in one company). Employees with other types of temporary contracts (around 20% of the total or 1.2 million people) have no entitlement to severance pay when their contracts end. This would place all employees without permanent contracts below the OECD average, in a comparable position to all dependent employees in the Czech Republic or the United Kingdom, where workers without permanent contracts account for just 9% and 6%, respectively, of the total.

In most countries, unemployment benefits, the second institution providing income for workers who lose their jobs, are managed by the public sector and financed by firms' and workers' contributions. They are generally defined by two parameters: their maximum duration and the percentage of salary they represent. However, the system is generally somewhat more complex, as there are floors and ceilings on the benefits effectively received, the benefits may decline over time and certain groups of workers may be entitled to unemployment assistance when their unemployment insurance is exhausted. Given these complexities, to place Spain among the developed countries, Table 2 shows the average percentage of salary that unemployment benefits represent for persons who were earning 67%, 100% and 150% of the average wage in the economy before becoming unemployed and who have been unemployed for less than a year.

From the table, Spain looks to be one of the OECD countries with the most generous unemployment benefits in relative terms, almost 5 pp above the OECD average. However, as in the case of severance payments, these figures may be misleading as a result of labour market segmentation. In effect, as temporary workers become unemployed more often, they accumulate fewer rights, and this drives down the effective replacement ratio. Taking this into account, Spanish temporary workers rank below the OECD average, with a level of protection slightly below that of the United States.

SEVERANCE PAYMENTS AND UNEMPLOYMENT BENEFITS

CHART 1



SOURCES: World Bank, OECD and Banco de España.

Thus, combining the data contained in Tables 1 and 2 and adding in the disaggregation between permanent and temporary workers in the case of Spain, the developed countries may be plotted in the four quadrants shown in Chart 1, according to the different combinations of these two institutions for worker protection. The chart clearly illustrates the duality in the Spanish labour market, as Spain appears in two opposing quadrants: on the one hand, Spanish workers with temporary contracts appear among the countries with severance pay and unemployment benefits below the OECD average, along with all the Anglo-Saxon countries, while Spanish workers with permanent contracts appear among the countries with severance pay and unemployment benefits above the OECD average, along with Portugal and Germany, inter alia. In the other two quadrants, the Nordic countries (specifically, Denmark and Norway) stand out, as unemployment benefits are above average but severance pay has virtually been eliminated, as do Turkey and Korea, for the opposite reason, as severance pay is high but unemployment benefits are low.

This excessive segmentation of the labour market is a result of the introduction, in 1984, of the temporary contract allowing unrestricted dismissal. Very likely this was the only way, without modifying the terms of stable contracts, to encourage job creation by reducing severance payments – in fact they were almost eliminated completely – for new hires, at a time when the unemployment rate was rising sharply and the majority of those who had lost their jobs were facing long-term unemployment. This reform helped reduce the numbers of long-term unemployed and helped new groups of workers enter the labour market. It also increased labour mobility, permitting reallocation of workers, from sectors in decline to up-and-coming sectors, at a time of large-scale restructuring of numerous industrial sectors. However, the continued coexistence of two forms of employment contracts with such big differences in terms of employment protection has resulted in excessive labour market segmentation and this is having an adverse effect on the functioning of the labour market, especially because, in the face of any kind of economic shock, it passes the burden of adjustment by firms on to employment, and particularly temporary employment.[8]

Thus, as Chart 2 shows, labour mobility is concentrated, almost exclusively, on workers with temporary contracts. Accordingly, even at times of economic expansion, these workers are

8. In fact, the aim of almost all the labour reforms introduced in recent years (most notably in 1997, 2001 and 2006) has been precisely to reduce the duality in the labour market, endeavouring to encourage permanent hires.

EMPLOYMENT FLOWS BY CONTRACT TYPE

CHART 2

SOURCE: INE.

much more likely to become unemployed than permanent workers (in fact approximately 8% of temporary workers in one quarter become unemployed in the next). In turn, the unemployed who find work are most likely to be offered temporary contracts. In addition, it is very rare for workers with permanent contracts to change jobs, thus limiting the potential productivity gains stemming from labour mobility. This concentration of flexibility on a specific group of workers also leads to excessive turnover, as temporary workers combine very short periods of work with repeat episodes of unemployment, thus further detracting from productivity.[9] Finally, in the face of a crisis such as the present one, and as the chart also shows, the intense employment adjustment experienced in the Spanish economy is restricted almost exclusively to temporary workers, whose employment exit rates have doubled in recent quarters, while those of permanent workers have barely changed. Although it is highly probable that more permanent employees will eventually be dismissed, the workers with the most precarious employment conditions and who, in addition, are less well protected against this eventuality, are bearing the bulk of the adjustment.

Overall, therefore, as it stands, the labour market presents serious operating inefficiencies that amplify the effect of economic shocks – however short-lived – as too much of the impact is passed through to employment levels. As Table 3 shows, this results in higher employment

9. See, for example, Blanchard and Landier (2002) for theoretical models of these effects.

VOLATILITY RATIOS RELATIVE TO GDP AND CORRELATIONS (a)

TABLE 3

	US	Germany	France	UK	Italy	Spain	Sweden
				Volatility relative to GDP			
Total hours worked	0.96	0.75	1.25	1.46	0.82	1.67	1.01
Employment	0.71	0.78	0.70	1.06	0.86	1.41	1.01
				Correlations with GDP			
Total hours worked	0.88	0.81	0.39	0.72	0.32	0.70	0.84
Employment	0.85	0.70	0.81	0.72	0.32	0.89	0.78
Hours per capita	0.70	0.19	-0.07	0.50	-0.03	-0.11	0.14
Wage per capita	0.52	0.42	0.21	0.11	0.27	-0.27	0.01
Hourly wage	0.19	0.39	0.21	-0.19	0.24	-0.14	-0.05

SOURCES: Eurostat and Banco de España.

a. Correlations and volatilities are calculated on the cyclical component of each series.

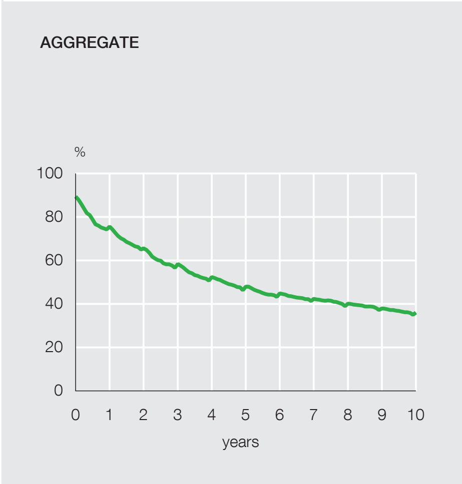
volatility relative to GDP in Spain in comparison with other developed countries. This tends to amplify economic fluctuations and is a consequence, in part, of the scant sensitivity of real wages to cyclical economic conditions. In fact, as the table shows, Spain is the only country in which, on average, real wages per capita tend to rise in recessions and fall in growth phases, exacerbating the employment adjustment in the event of a demand shock. Moreover, Spain is also the only country in which the correlation between hours worked and the cyclical component of activity is lower than the correlation between employment and said cyclical component, suggesting that fewer hours are worked per capita in growth phases and more hours per capita in recessions, which goes against the aim of achieving stable employment.

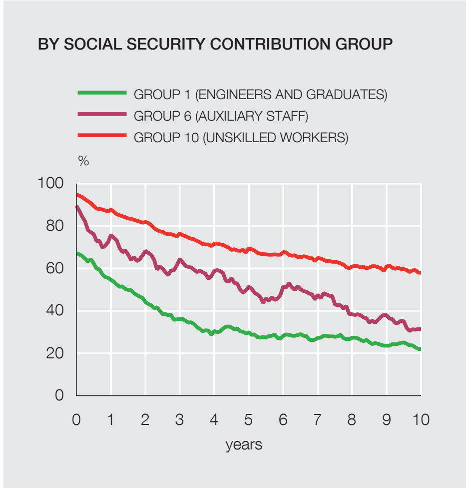
This recourse to external flexibility, rather than internal flexibility in the form of adjustments in the number of hours worked or in wages, has a major impact on the pattern of economic adjustment in the face of a shock of any kind, as it immediately results in changes in numbers employed and, therefore, in unemployment. This has an evident social cost for those who lose their jobs and for society as a whole, but it also has a significant impact on agents' confidence, as unemployment is the key determinant of household expectations.

Moreover, from a long-term view, this segmentation of the labour market has a negative impact on incentives for workers to accumulate human capital and for firms to provide training. This is vital, as workers' human capital, that is, their training and skills, are clearly their best protection in the event of economic slowdown. It is common knowledge that the most highly-trained segments of the population enjoy not only higher wages but also lower unemployment, even though they represent a higher proportion of the participation rate. The link between labour market segmentation and investment in human capital stems from the fact that temporary workers currently lack the necessary incentives to acquire company-specific knowledge in the firms in which they work, considering the high probability that in a few months' time they may have changed or lost their jobs. Firms are likewise reluctant to invest in effective training for temporary workers, in light of the risk that this training may benefit their competitors.[10] Moreover, in some cases this may also have an adverse impact on permanent workers, for whom the

10. Albert et al (2005) show that temporary workers are less likely to obtain employment in firms that offer training to their employees, and that those who do so are less likely to receive this training. Also in this respect, Dolado and Stuchi (2008) find that temporary employment has an adverse effect on productivity growth, especially in firms that employ a high proportion of temporary workers.

PERCENTAGE OF TEMPORARY WORKERS BY WORK EXPERIENCE CHART 3





SOURCE: Ministerio de Trabajo e Inmigración.

fact of being seemingly protected from fluctuations in activity may reduce the incentives for them to undertake on-the-job training.

Lastly, the duality in the Spanish labour market is particularly damaging for certain groups of workers, fundamentally new market entrants such as young people, women and immigrants. This causes significant problems of equity, as these workers bear the brunt of market adjustments. This would be less of a problem if temporary workers soon became permanent workers, that is, if temporary employment was a gateway into the labour market, ahead of transition to improved employment conditions. However, the evidence shows that this transition is very slow, and that a considerable percentage of temporary workers remain trapped. In effect, as Chart 3[11] shows, more than 80% of workers start their working lives with a temporary contract. This percentage declines over time, but very slowly. Thus, after ten years in the labour market, 40% of workers still have temporary contracts. This appears to be the consequence of the huge difference between severance pay in temporary and permanent contracts, which becomes a decisive factor in firms' decisions to offer permanent contracts to temporary workers.

Clearly this does not affect all workers alike; in effect, it is the less-privileged and less-skilled workers who endure precarious employment conditions for longer. As the right-hand side of Chart 3 shows, the higher the level of educational attainment, the lower the probability of starting out with a temporary contract. Furthermore, the transition period is much longer for workers with a lower level of educational attainment, although in no case is the move to permanent employment particularly quick. And it is a considerable problem, as even in the case of engineers and graduates, 20% still have temporary contracts ten years after starting work.[12]

Collective bargaining in Spain. The effects of the predominance of intermediate bargaining levels

The economic literature generally uses three indicators to assess the economic impact of collective bargaining on the labour market: coverage, degree of coordination and level of centralisation. Union density, that is, the proportion of workers with trade union affiliation, is the most straightforward approximation to coverage, as workers are formally represented by trade unions in the collective bargaining process. However, there are reasons to believe that this

11. Compiled using data on the working lives of men who started work in 1986. **12.** Toharia and Cebrián (2008) conduct a highly detailed analysis of the problem of the temporary employment trap for different groups of workers. Their results show that a high percentage of the population (approximately one third) remain in this trap for some time, with disastrous consequences, for example, for Social Security contribution levels, as temporary employment goes hand in hand with frequent episodes of unemployment.

UNION DENSITY AND COLLECTIVE BARGAINING COVERAGE

CHART 4

SOURCE: OECD.

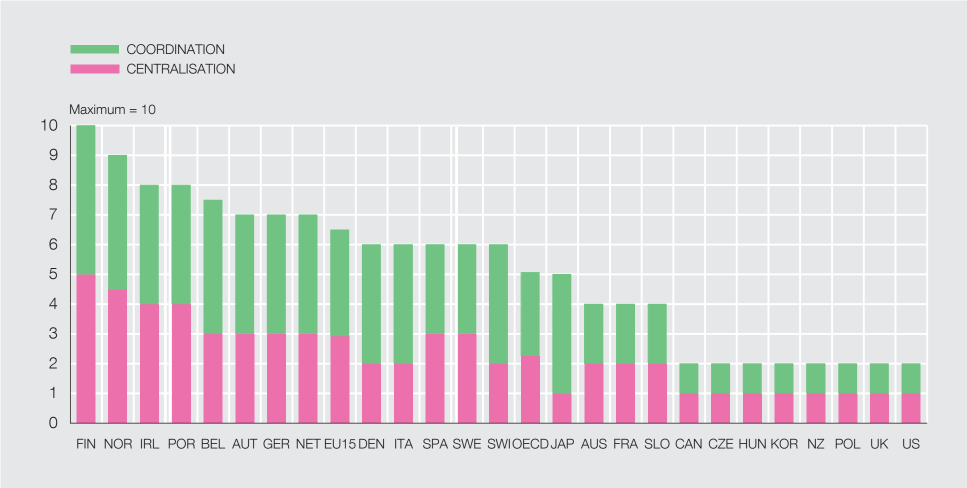
approximation underestimates coverage, due to the existence (as in Spain) of legal mechanisms that extend these agreements to workers or their representatives who have not necessarily taken part in the bargaining process. Accordingly, collective bargaining coverage, which measures the proportion of workers whose wages are set by the process, is generally used as an additional yardstick.

As Chart 4 illustrates, Spain, together with France, is one of the economies with the lowest union density and the highest collective bargaining coverage (between 80% and 90% of Social Security registrations since 1990), and thus with the biggest difference between the number of active participants in the bargaining process and the number of workers finally affected by it. By contrast, there are no such differences in the Nordic countries (where both indicators lie between 80% and 90%) or in the Anglo-Saxon countries (in the United Kingdom the indicators barely rise above 30%). The situation in Spain is a consequence of two fundamental principles of the collective bargaining process: the *automatic general effectiveness* of the agreements reached, meaning that all agreements that are not company-specific must be applied in all firms and to all workers in the corresponding geographical area and industry, irrespective of whether or not they have taken part in the bargaining process; and the *legitimacy for bargaining,* based on electoral majorities to determine the worker representatives forming part of the bargaining committees (companies, for their part, are represented by the majority employer associations). The problem here is that there are groups of workers (temporary workers, the unemployed, etc.) and firms (the smallest ones) that are under-represented in the bargaining process, which thus tends to be less "sensitive" to their special needs. In addition, another singular feature of the Spanish system is that the opt-out clauses, which define the circumstances in which firms in difficulties may choose not to apply the terms of a sectoral collective agreement, are generally highly restrictive, preventing their application even in extremely difficult circumstances for firms.

Just as important as content and coverage, in terms of economic impact, is the level of centralisation and coordination of the collective bargaining process, although these concepts are difficult to specify and even more difficult to quantify. According to OECD indicators, the level of centralisation and coordination of the collective bargaining process in Spain has declined since the mid-1980s and is currently at an intermediate level (see Chart 5), similarly to most other European economies (Germany, Denmark, France, Italy and Sweden, inter alia). The remaining Nordic economies (Finland and Norway), Ireland, Portugal and Belgium have the highest levels of coordination and centralisation, while the eastern European economies (the Czech

CENTRALISATION AND COORDINATION OF COLLECTIVE BARGAINING

CHART 5



SOURCE: OECD.

COLLECTIVE BARGAINING COVERAGE

TABLE 4

Percentage of workers affected

	Firm	Sector			
		Total	Provincial	Regional	National
2000	15.2	84.8	58.1	11.3	15.5
2001	12.8	87.2	53.8	7.6	25.8
2002	11.5	88.5	54.8	9.5	24.2
2003	11.5	88.5	54.4	10.4	23.6
2004	10.8	89.2	54.7	10.2	24.4
2005	11.8	88.2	52.7	10.2	25.3
2006	12.1	87.9	52.3	10.0	25.6
2007	12.8	87.2	52.8	7.9	26.5
2008	10.6	89.4	54.6	6.8	28.0

SOURCE: Ministerio de Trabajo e Inmigración.

Republic, Hungary and Poland) and the Anglo-Saxon countries (Canada, the United States, New Zealand and the United Kingdom) are the most decentralised.

Spain's position in these two indicators is firstly a result of the principle of the automatic general effectiveness of collective bargaining agreements, together with the fact that the regulations on conflicts between different agreements significantly restrict the possibility of lower-level agreements amending the terms of higher-level ones. This means that company-specific agreements are the minority, even though collective agreements may be negotiated at this level. As Table 4 shows, most collective agreements signed in Spain are sectoral agreements at a provincial level; nationwide sectoral agreements represent a quarter of the total, while regional and company-level agreements each account for some 10%. Moreover, this structure has remained relatively stable since the beginning of the decade. This suggests an intermediate level of centralisation of collective bargaining, which, in accordance with economic theory, is more prejudicial to the level of structural unemployment and wage growth than if the system was fully centralised (as in the Nordic countries) or decentralised (as in the Anglo-Saxon countries), as demonstrated by Calmfors and Drifill (1988) at a theoretical level, and by Izquierdo et al (2003) empirically for Spain.

This institutional framework for collective bargaining means that wages are highly inflexible in Spain, hindering adjustment to different kinds of economic shocks. Thus, from an aggregate

WAGE SETTING AND INFLATION TABLE 5

Percentage of workers affected	Spain	Euro area	France	Italy	Belgium
Automatic link to past inflation	38.4	16.3	8.9	1.2	98.2
Automatic link to expected inflation	16.4	4.1	2.0	0.5	0.0
Indirect connection with past inflation	10.9	9.7	21.2	2.6	0.0
Indirect connection with expected inflation	5.0	5.5	8.0	1.5	0.0
No inflation link	29.3	64.4	59.9	94.2	1.8

SOURCES: Banco de España and Druant et al (2008).

standpoint, wages in Spain have a low level of sensitivity to economic conditions and a high level of indexation to past inflation. In this respect, the results of a fairly uniform survey conducted in most European countries on the wage-setting process corroborate, in general, the high level of indexation in the Spanish collective bargaining system and the lower level of sensitivity to the prevailing economic conditions. These results, presented in Table 5, show that some 70% of Spanish firms apply wage policies that take direct or indirect account of inflation. This figure is much higher than in most other European countries.[13] In fact, for 54% of the Spanish firms there is a direct and automatic link to either past or expected inflation, as opposed to the euro area average of approximately 20%. This high wage indexation clearly has an impact on wage adjustment mechanisms in the face of different shocks; for example, it makes it more difficult for external shocks, such as an oil price rise, to be absorbed. In addition, the process is asymmetrical, as it comes into effect only when actual inflation is higher than forecast inflation, but not when it is lower.

Regarding rigidities in labour cost adjustment, the Banco de España (2008) showed the low level of sensitivity displayed by wages set via the collective bargaining process to the economic situation, measured in terms of the unemployment rate. In addition, a very high percentage of collective bargaining agreements span several years and are, therefore, even less influenced by economic conditions. From an international perspective, the results of the survey mentioned above show, for example, that Spanish firms have much less room for manoeuvre than their peers in other countries when it comes to adjusting costs; for example, in the face of an increase in the cost of an input, only 45% of Spanish firms say that they adjust their labour costs, in comparison with more than 70% for the European aggregate.

However, the Spanish collective bargaining system not only causes aggregate rigidity in the time dimension of real and nominal wages, but also a lack of transverse flexibility, that is, insufficient connection between wages and other matters subject to collective bargaining agreements and the specific circumstances of firms and sectors. In effect, wage growth is highly uniform between sectors, meaning, for example, that the correlation between real wage growth and total factor productivity (TFP) for the different branches of activity is one of the lowest of the developed countries. As Chart 6 shows, Spain is one of the countries with the lowest correlation between wage growth at sector level and TFP growth, typical of countries with more centralised collective bargaining systems, and far removed from the Anglo-Saxon countries with decentralised systems. This signifies that relative wages across sectors are a poor indicator of the reallocation of resources that is required of an economy in the event of shocks, providing further backing to the view that, in the case of Spain, the adjustment may be a more painful and a lengthier process.

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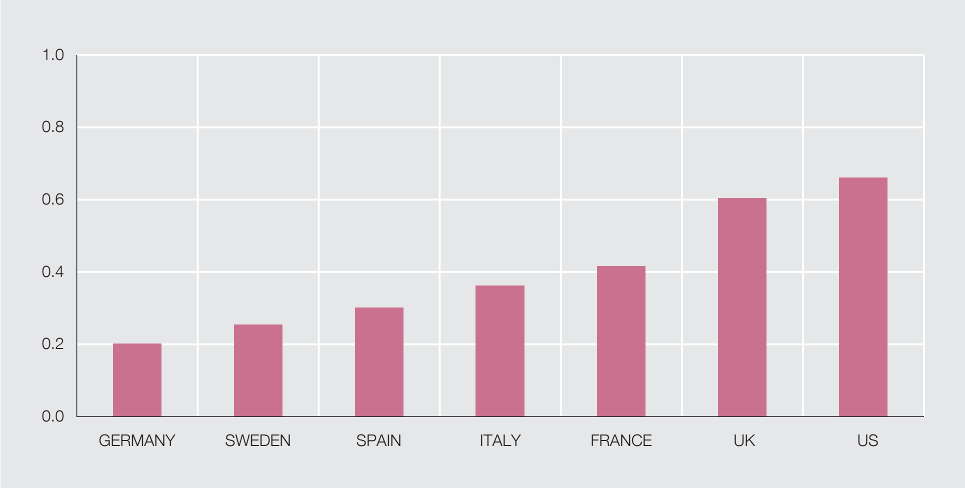
13. See Druant et al (2008), although comparison of the firms' responses between countries may be affected, to some extent, by their different institutional frameworks.

SECTORAL CORRELATION BETWEEN REAL WAGE GROWTH AND TOTAL FACTOR PRODUCTIVITY

CHART 6



SOURCES: EU-KLEMS and Banco de España.

Recent labour market reforms in Europe

This section presents a brief overview of some of the most notable labour market reforms introduced in Europe in recent years. It should be noted, however, that as a consequence of the crisis, most countries have implemented measures connected with the labour market, designed to support employment through temporary programmes, subsidised, in full or in part, by the public sector, and to sustain the income levels of groups affected by job losses. In this respect, Spain too has introduced a number of measures, primarily aimed at raising the protection for certain groups of workers (those affected by redundancy programmes) and at getting people back into work.

Over the past decade, various European countries have introduced important labour market reforms, aiming to achieve greater economic competitiveness and dynamism within the framework of the Lisbon Agenda.[14] In this respect, numerous policies have been implemented to provide markets with more flexibility and to raise the degree of utilisation of the labour factor, in line with the recommendations contained in the Agenda. Below, three very specific cases are highlighted by virtue of their significance, although it should be noted that, in general, many reforms have been introduced in Europe, tending, by various means, to provide firms with greater room for manoeuvre for adjustment in adverse circumstances, without having to resort to dismissing workers or to not renewing their contracts. This is the case, for example, of countries such as the Netherlands or France, which have made their labour legislation more flexible, encouraging firms to use part-time contracts and to adjust their working hours.

EMPLOYMENT PROTECTION SYSTEM REFORMS: GERMANY AND AUSTRIA

Germany is the country that has undertaken the most radical and extensive transformation of its labour market institutions and social protection system in recent years, through the *Hartz* reforms, implemented successively between 2003 and 2005.[15] The three main objectives behind these reforms were: to improve the public employment services, modernising their organisation and functioning; to encourage active job-seeking by the unemployed, reforming the social protection system, based on a new balance between rights and duties; and to increase labour demand, removing restrictions from the labour market via a reduction in the level of protection in the temporary employment segment.[16]

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14. For a more in-depth analysis of labour market reforms in Europe between 2000 and 2006, see Moral and Vacas (2009). **15.** *Hartz I* and *II,* on 1 January 2003, *Hartz III,* on 1 January 2004, and *Hartz IV,* on 1 January 2005. **16.** For a more in-depth analysis of the *Hartz* reforms and of their effects in Germany, see Jacobi and Kluve (2006) and Ward-Warmedinger et al (2008).

The placement system for the unemployed was improved by introducing market-based competition elements into the public employment services. The placement agencies were set quantitative targets and were given greater discretion regarding the choice of appropriate active policies for the unemployed, made on the basis of personal interviews between the unemployed and the placement counsellors assigned to them. The active policies for the unemployed now depend on the likelihood of their finding work. The active programmes were also redesigned and are now subject to rigorous and continuous assessment. Moreover, if the public employment service fails to offer an unemployed person a job within a period of six weeks, this person may decide to go to a private employment service, which will receive public subsidies based on its placement rate. Training courses may also be given by private agencies via subsidies.

Regarding the incentives for active job-seeking, the German system is now based on the principle of "rights and duties". In this respect, access to benefits largely depends on willingness to work. The unemployed are entitled to unemployment benefit for a period of between 6 and 12 months; the benefit received depends on the contributions made. Thereafter they receive only means-tested benefit, which is subject to penalisation in the event that they fail to demonstrate willingness to look for work. To encourage private-sector hiring, two new types of employment contracts were created – "Minijobs" and "Midijobs" – targeting lower-paid workers[17] and entailing lower Social Security contributions (the lower the wage, the lower the contribution). Moreover, to encourage firms to hire workers over 50, the State subsidises half the difference between their new and former pay packets throughout the period during which they would have been entitled to unemployment benefit.

Lastly, restrictions were removed from the labour market, liberalising temporary hires, which had been tightly regulated since 1972, and obliging temporary employment agencies to ensure that collective bargaining agreements were applicable to temporary agency workers, to prevent them being discriminated against in comparison with permanent workers. A public agency was also created to help provide temporary employment for groups of workers that were particularly difficult to place, and firms with fewer than ten employees were made exempt from statutory severance payments.[18] The different reviews of this reform seem to show that it has been instrumental in cutting the unemployment rate and raising the employment rate [Jacobi and Kluve (2006)].

In addition to this new regulatory framework, other measures were introduced to reduce the impact of the present crisis on employment. This has meant that, to date, a great many firms have been able to adjust to declining demand without having to resort to more redundancies, helped by wage moderation and by the enhanced incentives for short-time working arrangements *(kurzarbeit).* Thus, instead of laying off workers, firms may decide to cut working hours, partially or completely, for up to a maximum of six months, during which time the State pays workers 67% of their former wage. In general, firms may implement *kurzarbeit,* provided that their works councils accept the decision and that it involves a reduction of at least 10% in working hours for at least one-third of the employees. The German government's second anti-crisis package, implemented as from February of this year, extended these measures, which no longer need apply to at least one-third of employees and which may now last for up to a maximum of two years. In addition, firms receive a 50% allowance in workers' Social Security contributions, rising to 100% in the event that training programmes are conducted. Although

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17. The first, for jobs paying less than €400 per month; the second, for jobs paying between €400 and €800 per month. **18.** This exemption was previously for firms with fewer than five employees. It should be noted that the data contained in Table 1 refer to a firm with 201 employees.

this instrument is similar, in formal terms, to the Spanish temporary redundancy programmes, it has traditionally been much less used in Spain.[19] This may be due to a variety of factors, in particular the easier it is in Spain for firms to adjust worker numbers by cutting temporary contracts. This relieves firms from the need to pay severance and shields permanent workers from the prospect of job losses; however, it is these workers who are chiefly represented in the bargaining process with employers for introduction of temporary redundancy programmes, which will, in any case, entail a drop in earnings.

Austria has also introduced a significant labour market reform, in this case of the unemployment protection system. In June 2002, the Austrian parliament approved a legislative change in severance pay applicable to all contracts terminated as from January 2003, with the exception of all contracts in force as at that date which would continue to be governed by the previous system. Under that system, only workers with more than three years' service who were unfairly dismissed were entitled to receive severance pay,[20] which rose in line with the number of years' service, up to a maximum of 12 months' pay after 25 years in the same firm.[21] This was, therefore, considerably less than the severance currently payable in Spain to permanent workers, as an employee with 25 years' service would receive total severance of 37.5 months' pay. The reform was considered necessary because, as the system stood, many workers who lost their jobs had no entitlement to any benefits whatsoever and it discouraged labour mobility and investment in human capital, reducing the rate of growth of productivity of the productive system overall.

Under the new rules, firms must contribute 1.53% of employees' gross monthly wages, as from the second month of employment and up to termination of the corresponding contract. These contributions are held in a fund in the employee's name and may be withdrawn, at no fiscal cost, when a firm decides to terminate the contractual relationship, provided in all cases that the worker has been employed for more than three years. Workers who are never made redundant throughout their working lives may withdraw the funds upon retirement. Workers who decide to leave their present employer will not be entitled to withdraw the funds in cash, but they will maintain full rights over them and may continue to accumulate cash from contributions from a future employer. This system, which is still pending evaluation, has, in any case, been instrumental in ensuring that all workers have rights in the event of dismissal as from the day on which they are hired. The system also enables them to preserve these rights even if they change jobs voluntarily, and this should encourage worker mobility between firms.

COLLECTIVE BARGAINING SYSTEMS: SWEDEN

Although there have been no far-reaching reforms of collective bargaining systems in Europe over the past decade, there has been a tendency towards greater decentralisation (especially at company level). This has been evident in the eastern European countries, where bargaining was predominantly centralised, and in Germany, where the use of opt-out clauses, enabling firms in difficulties to opt out of sectoral agreements, has become more widespread. There have also been some changes in wage indexation systems, to reduce their high inertia; for example, in Slovenia, where the system now takes into account expected, rather than past, inflation, and in Greece, where the indexation clauses have been abolished [Du Caju et al (2008)].

19. Clearly, there are other differences between the two institutions that may encourage this reduced level of use. In Spain, temporary redundancy programmes must be approved by the corresponding regional government, or by the national government in the case of firms that operate in more than one region, after consultation with the union representatives. During the period of inactivity, workers receive unemployment benefits (70% or 60% of their former salary). Firms may apply for these programmes provided they affect at least 10 workers (firms with fewer than 100 workers), 10% of the workforce (firms with between 100 and 300 workers) or 30% of the workforce (firms with more than 300 workers). **20.** Save in the event of unfair dismissal, workers were only entitled to severance pay when they retired (and then only if they had more than ten years' service). **21.** Each year firms were obliged to make annual provision for at least 50% of potential severance pay for all their employees. Severance pay was taxed at 6%.

All these changes aim to help firms survive in adverse macroeconomic conditions, without having to sacrifice the long-term allocation of productive resources in a free market environment. Sweden is a paradigmatic example: the problems caused by centralised bargaining prompted increased decentralisation at sector level, but the crisis of the early 1990s showed that an intermediate level of centralisation was not the answer, revealing the need for nationwide agreements on earnings in the face of difficult circumstances.

With union density verging on 80% in Sweden, wages were traditionally set via centralised collective bargaining without active government participation, even though government measures affected union strategy.[22] All in all, this system resulted in extremely high wage compression, together with wage moderation that prevented unemployment from rising significantly.[23] Nevertheless, low wage dispersion began to have an adverse impact on Swedish firms' capacity to attract highly-skilled workers, and on investment in human capital by Swedish workers. The system became slightly more decentralised as from 1983:[24] this had positive effects in the shape of high productivity and real wage growth, it raised the incentives for reallocation of productive resources towards higher-quality sectors and it enhanced the educational returns [Edin and Topel (1997)].

However, the crisis of the 1990s revealed the problems caused by this intermediate level of decentralisation, as wage demands achieved in some industries took no account of the associated costs in others, meaning that, on aggregate, wage increases were excessive in light of the crisis. This prompted the government to demand a return to centralisation and, despite its history of non-intervention, a commission (the Rehnberg Group) was created to track the bargaining process. The government also proposed a ceiling on wage growth resulting from collective bargaining, which proved quite credible as the government enjoyed sufficient parliamentary support. This strategy was successful in achieving wage moderation during the early 1990s, leading to a significant reduction in the unemployment rate, but the collateral cost was enormous. Public finances were severely damaged and the government was forced to cut a number of public programmes, at the same time as it raised taxes. In this setting, it was clear that workers would not be prepared to accept further cuts in real wages, and accordingly, as from 1995, high sector-wide wage rises again became the norm, moderating the rate of decline of unemployment.

Accordingly, the Swedish experience shows that decentralisation of the collective bargaining process was positive in the long term, thanks to the incentives it generated in terms of reallocation of resources to higher quality industries and enhanced incentives for human capital formation. However, from a short-term view, as the bargaining process remained mid-way between total centralisation and negotiations at company level, it proved insufficient, at a time of crisis, to halt the deterioration in the labour market, making it essential to resort to an income agreement to moderate growth in margins and wages, to make a significant contribution to economic recovery.

Conclusions

Comparison of the main characteristics of the Spanish employment protection and wage-setting systems with those of other countries demonstrates the excessive degree of segmen-

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22. Traditionally in Sweden the unions defended wage moderation, supported by tax cuts or higher welfare-related benefits that ensured that net earnings were not adversely affected [Mares (2006)]. **23.** The main aim of wage concentration, in what was known as the Rehn-Meidner model, was to increase the costs of less productive firms until they were forced out of the market, forcing their employees into more productive employment. The model worked, in part, although it also prompted extensive internal migration from the north of Sweden, where the productive system was more traditional, to the south of the country. **24.** When the industrial union Metall and the engineering industry employer association Verkstads Förening, which represented large corporations such as Volvo, Saab and ABB, signed an agreement separate from the centralised bargaining process.

tation of the Spanish labour market, which combines very high protection for permanent workers with very limited severance terms for workers with a wide range of temporary contracts, resulting in a labour market with an extremely high temporary employment ratio (in fact the highest in Europe). This imbalance in labour market flexibility has adverse consequences for the functioning of the labour market, and for the Spanish economy in general, in terms of both efficiency and equity. Possibly the clearest reflection of this is the intensity of the employment adjustment in the face of the present crisis, as this adjustment is proving significantly more far-reaching than in other countries and is concentrated on temporary workers, whose numbers fell by more than 20% in 2009 Q1. This adjustment also entails higher unemployment: the jobless figures have risen by more than 1.8 million in one year and the unemployment rate by 9 pp, recording the highest level of all the OECD countries. As indicated above, this labour market segmentation also has adverse effects on both training decisions and productivity.

Moreover, the present collective bargaining system tends to exacerbate some of the implications of this labour market segmentation, resulting, as has been seen above, in a labour market marked by a high level of indexation to inflation and scant wage sensitivity to cyclical conditions. Furthermore, it is an intermediate level bargaining system, which encourages highly uniform wage rises that take little or no account of company-specific economic conditions, and which makes it impossible for relative wages to act as a mechanism for reallocation of resources to sectors with greater future potential.

Overall, therefore, a more appropriate design of the labour market institutions could enhance the capacity for reallocation of resources between sectors, firms or regions, permitting a more rapid exit from the ranks of the unemployed for the large numbers currently in this position. Improvements in this respect would be vital to establish the bases for sound economic recovery, to ensure that when demand recovers it does not lead solely to an increase in inflation and limited and precarious employment growth. Moreover, the design of the labour market is possibly the key factor in bringing about a change in the productive model that was prevalent throughout the last economic cycle. If the labour market institutions are designed so that they encourage firms and workers to take the appropriate training decisions, so that they represent a correct pointer for allocation of resources, so that they facilitate labour mobility between firms and sectors and so that they enhance the capacity for adjustment in the face of different economic shocks, then a new more sustainable economic specialisation profile may be achieved, more quickly and at lower cost.

In this context, reference to the experience of other countries that have undertaken labour market reforms, aimed at achieving more efficient adjustment to aggregate shocks and encouraging human capital formation, becomes even more relevant. The design of the labour market institutions must be oriented towards attainment of these two objectives. For this purpose, hiring mechanisms should permit an appropriate combination of employment protection for workers and flexibility for firms, to ensure that the labour market can adjust, more efficiently and more equitably, to different economic shocks. This would also result in greater incentives for investment in human capital, and consequently in productivity growth. The collective bargaining system should also be designed to ensure that wage growth and all aspects connected with work organisation and worker training are better adapted to the specific circumstances of individual firms and sectors, and to ensure greater flexibility in terms of timing of the agreements reached.

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