

## LABOUR MARKET

## Measures to promote permanent hiring

Spain unit: Miguel Cardoso, Rafael Doménech, Juan Ramón García and Camilo A. Ulloa

Fundación Sagardoy: Jesús Rafael Mercader and Íñigo Sagardoy

**The reforms passed in early 2012 endeavoured to correct many of the endemic deficiencies in the Spanish labour market. But the current situation still requires additional measures. To promote permanent hiring and protect groups finding it harder to get a job, this document aims to combine an efficient simplification of the number of contracts with a substantial change in the severance payment system, in such a way that permanent contracts become the preferred option for both companies and workers. We propose a mixed system in which part of the severance pay will depend on how long the employee has worked in the firm and the rest on an employee's savings account, similar to the Austrian model.**

**This proposal would mitigate the uncertainty hampering permanent hiring, promote investment in specific human capital, increase productivity, incentivise labour and geographical mobility, encourage sectorial re-assignment of labour, and help to modernise collective bargaining. Finally, creating a capitalisation fund would make financial planning easier for companies, and would increase both worker savings and the incomes of future pensioners.**

### 1. The 2012 labour reform: substantial progress, but not enough

**The labour market reform passed in 2012 represented significant progress compared to the established regulation** in terms of companies' internal flexibility, modernising the system of collective bargaining (decentralising and limiting long-term ultra-activity), rationalising the costs of terminating an employment contract, clarifying fair dismissal causes, strengthening training and learning and promoting labour mediation<sup>1</sup>.

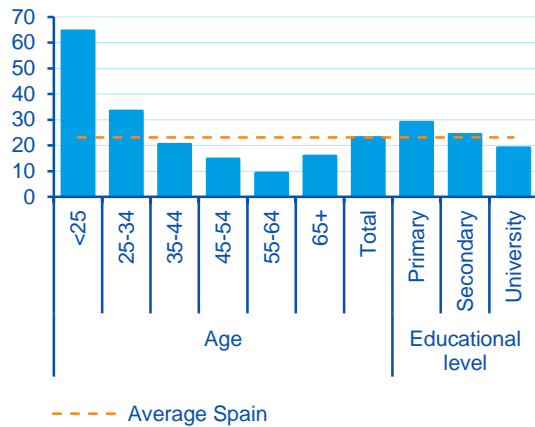
**Since the labour reform came into force, the government has adopted supplementary measures** designed to intensify job searching by unemployed people who receive benefits<sup>2</sup>, to mitigate labour market duality and encourage the use of the part-time contract<sup>3</sup>, offering a temporary subsidy for permanent hiring<sup>4</sup>, to increase the efficiency of active labour market policies<sup>5</sup> and make young people more employable<sup>6</sup>.

Although these were necessary changes and they have helped reduce the deficiencies in the labour market, **the high levels of unemployment and temporary rates require new measures in order for labour regulation to continue to improve.** Spain has a combination of generous severance payment for permanent employees (if compared with other developed economies), and a flexible yet inefficient legislation on temporary hiring (as opposed to permanent hires), which have the result of segmenting workers into two categories depending on whether they have more or less protection, and give rise to what is sometimes known as the *flexi-rigidity* of the Spanish job market.<sup>7</sup> This two-tier system negatively affects inequality. Temporary concentrates on the more vulnerable groups which find it more difficult to get a job (young and low-qualified people, as illustrated in Figure 1)<sup>8</sup>. Furthermore, temporary workers have a much higher likelihood of losing their jobs than permanent employees, which exacerbates the volatility of unemployment's cyclical component.

As well as its pernicious social repercussions, unemployment also has a negative effect on public budgets. According to BBVA Research estimates, for every percentage point (pp) cut from the structural unemployment rate, the public deficit falls by 0.7pp of GDP.

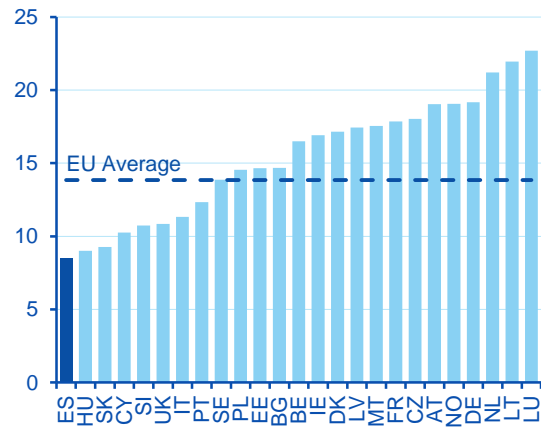
Without neglecting to acknowledge the importance of labour market policies, **this document focuses on a set of measures which would simplify and incentivise hiring, and encourage permanent employment**<sup>9</sup>, as a way of mitigating the current labour market segmentation, preventing it from returning to pre-crisis levels.

Figure 1  
Spain: temporary rates, by age and educational level in 2013 (%)



Source: BBVA Research based on INE

Figure 2  
% of companies with 10 or more employees (over total number of companies with at least one employee, 2012)



Source: BBVA Research based on Eurostat

## 2. Making hiring simpler and incentivising permanent contracts

**At the end of 2013 the government tried to schematize the hiring system**, and created an on-screen help function to guide employers towards the contract best suited to their needs<sup>10</sup>. But making the paperwork more straightforward does not result in an effective drop in the number of contracts' types. It is a **necessary condition for reducing the complexity of the hiring system and the two-tier labour market duality, but it is not a sufficient condition**.

Although it is not the only reason, the Spanish economy's productive structure, characterised by the prevalence of small firms (Figure 2), requires **the number of contract types to be reduced drastically to just three**: an open-ended permanent contract (which ought to be the default type), one to satisfy a temporary requirement and a third for training and apprenticeship which has an in-built incentive to be converted into an open-ended contract once the training process is complete.

All the current types of open-ended contracts ought to be grouped together into a single contract type which can accommodate the existing ones. As such, the criteria making companies eligible to benefit from hiring incentives, which are the main culprits of the current plethora of job contracts, need to be simply and clearly established in the contract. All in all, it would be a good idea to redirect some of the resources spent on hiring bonuses to policies to make workers more employable, especially those with the highest unemployment rates. Spain spends around a third of the resources allocated to active labour market policies on incentivising hiring and maintaining employment, whereas the European Union 15 (EU-15) only spends a quarter. By contrast, spending on training, integration into the workplace and retraining is relatively low in Spain (Figure 3).

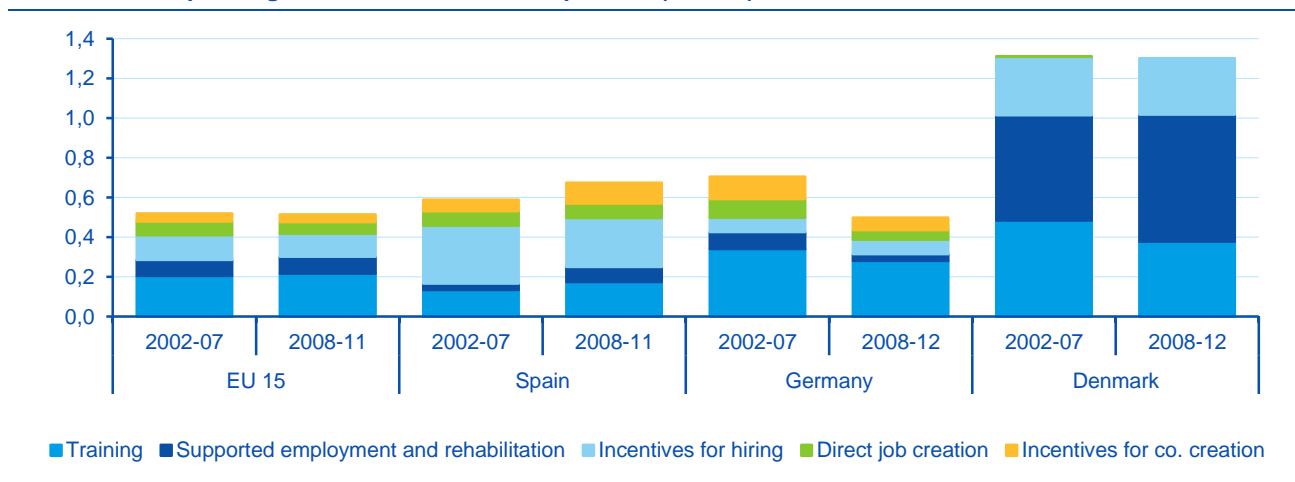
When it comes to **temporary hiring**, it would be desirable for this to have a specific purpose. In order to avoid consecutive temporary contracts, it should not have a duration of more than 24 months.

**Training and apprenticeship contracts** promoted within the company ought to be of an open-ended nature (the firm trains a worker so that the latter can follow a professional career there). Training contracts promoted externally (for example, via collaboration agreements with educational institutions) may be temporary.

**The new types of contract will have the option of being part-time**, so it would be necessary to assess factors which might be preventing them from becoming widespread<sup>11</sup>. Despite the changes introduced in the 2012 reform and the measures<sup>12</sup> adopted at the end of 2013, part-time contracts are seldom used in Spain compared with other European countries: the proportion of part-time workers stood at 16.2% in the first quarter of 2014, 7.7pp less than the EU-15 average.

Finally, we need more oversight on the part of labour authorities in order to **minimise fraud**, whether it is the temporary hires who are carrying out tasks of a permanent nature, or trainees who should be under temporary or open-ended contracts.

Figure 3  
Breakdown of spending on active labour market policies (% GDP)



Source: BBVA Research based on Eurostat and OECD

### 3. Towards a mixed employment protection system

#### Motivation

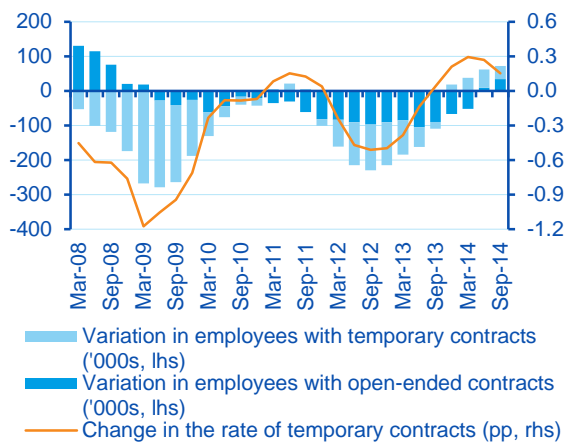
The reduction in the number of types of contract needs to be backed up by a **major overhaul of the severance payment, in order to incentivise stable hiring policies.**

Both the measures taken in the 2012 reform and those passed since then to reduce the endemic fragmentation of the Spanish labour force have been of limited efficacy. As Figure 4 illustrates, **the development of the rate of temporary jobs since 2008 is mainly due to the change in temporary hiring**, while the changes of the open-ended contracts has played a secondary role. In fact, the percentage of temporary contracts signed every month is still over 90% (Figure 5).

Despite recent progress in making employment protection legislation more flexible, **Spain still has one of the highest severance pay in the EU** (Figure 6). This, together with the gap in the costs of severance between permanent and temporary workers, creates a highly fragmented labour market which harms those with temporary contracts, in the main young people and those with fewer educational qualifications, while having a pernicious effect on the productivity of Spanish companies.

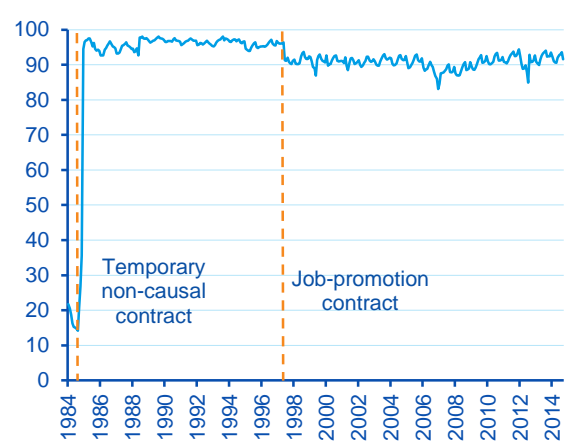
In order to eliminate or, at least, mitigate the labour market duality, the reduction in the number of types of contracts needs **to be bolstered by more modern severance payment system**. For this reason, we propose a **mixed system** in which part of the compensation when a contract is terminated depends on how long the worker has been with the company, and the rest on an employee's savings account, similar to the Austrian model<sup>13</sup>.

Figure 4  
**Spain: trend change in the rate of temporary contracts (4Q moving average)**



Source: BBVA Research based on INE

Figure 5  
**Spain: % of temporary contracts**



Source: BBVA Research based on central bank and Ministry for Employment and Social Security

### The mixed system in detail

**The new severance payment structure would be mandatory for all newly hired employees.** In the case of pre-existing contracts, the transition would be by mutual agreement between the employer and the employees. **All new employees would have an individual savings account into which regular contributions would be provisioned**, equivalent to eight days of wages per year worked (dwyw). We recommend a stable contribution of 2.19% of the gross annual wage<sup>14</sup>. While the contribution to the individual account, like any other component of the gross wage, is a cost for the company, **it must be seen by the workers as part of their total labour compensation**. Given that the employer negotiates the total labour cost and the worker his/her net wage – including the deferred portion – in the end it is irrelevant who pays the contribution<sup>15</sup>.

**In cases where the remuneration is limited by the inter-sectorial minimum wage (IMW), the contribution to the individual savings account will be made by the public administration**, which would be equivalent to giving a rebate of 2.19 points on the employer's Social Security quota for contracting the lowest-paid workers. In order to avoid discontinuities, this rebate would gradually diminish<sup>16</sup> until the worker's wage, excluding the contribution to the individual account, rose to, for example, 1.25 times the IMW.

**Contributions to the individual savings account would be invested in one or several public employee provision funds created for this purpose**, so that the amount of this severance payment would depend on the profits accumulated by the fund<sup>17</sup>. **The worker would be able to access the resources in his/her account when the contract with the company is terminated, whatever the reason for severing the contract.**

**In order for the company to absorb the negative externalities caused by laying off a permanent worker, it must pay a causal dismissal cost, which would add to the capitalisation fund** and which would depend on the reasons for the dismissal and how long the worker has been in the firm (Figure 7):

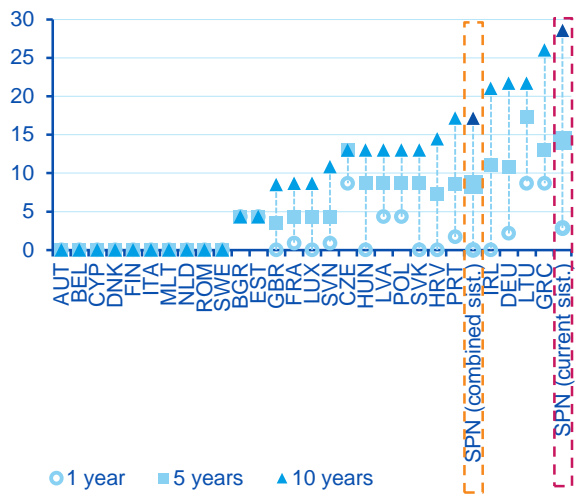
- **For fair dismissal** the cost will be zero *dwyw* if the employee has been with the firm for one year or less, four *dwyw* for two years, eight *dwyw* for three years and 12 *dwyw* for four years or more. As a result, if the employee cashes in the fund, they will obtain eight *dwyw* if they have been with the firm for one year, 12 *dwyw* for two years, 16 *dwyw* for three years and 20 *dwyw* for four or more years.
- **For unfair dismissal** the cost will be four *dwyw* the first year, increasing by three *dwyw* for each year that the employee has worked at the company, up to a maximum of 25 *dwyw*. So, total compensation would be at least 33 *dwyw* for those employees who have been working for a company for eight or more years.

**In the case of the temporary contract**, together with the contribution of eight days of wages per year worked in the individual account, the dismissal compensation would remain at 12 *dwyw*, whatever the cause. Unlike the open-ended contract, in the temporary contract there is no uncertainty about when it will end, so these two amounts can easily be internalised by the worker and the company at the time of hiring. Although the wage negotiated by both parties would be affected, the labour cost borne by the company does not have to rise. In short, **the change proposed to the present system does not affect the gross wage, but can more easily be compared with the severance pay received from an open-ended contract**. When the temporary contract comes to an end, if the worker cashes in the fund they will receive at least 20 *dwyw*. Given that a temporary contract cannot last beyond two years, the amount of the compensation and the contribution to the individual account would not exceed 40 days of wages.

There are at least two **reasons why fair dismissal should result in lower dismissal cost in open-ended contracts than in temporary ones**: it makes them more attractive and penalises companies with an unjustifiably and high turnover of staff. In exchange for a lower compensation pay-out initially, workers will have more stable employment, higher wages and the benefits of a longer-lasting professional career within the company. Here, empirical evidence suggests that, once the composition effect has been stripped out, the wage differential between temporary and open-ended contracts is around 15.4% in Spain<sup>18</sup>.

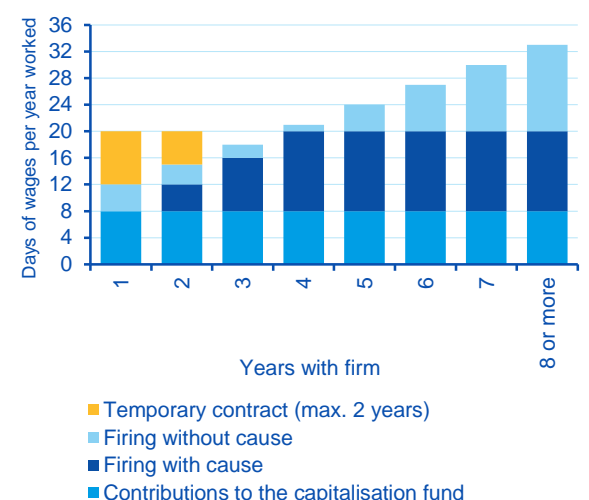
As it is the case in the current system, **dismissal cost paid by the company has a ceiling: 12 months' wages for fair dismissal, and 24 months for unfair dismissal**. . Nevertheless, **the sum received by the worker could be higher**, whether it is because the contributions to their individual savings account are not bounded above, and because of the profitability accruing from the same.

Figure 6  
EU: Severance pay for redundancy dismissal, by years of tenure (in salary weeks)



Source: BBVA Research based on World Bank (*Doing Business 2015*)

Figure 7  
Costs of terminating a job contract in the mixed system (days of wage per year worked)



Source: BBVA Research

#### 4. Advantages of reforming the contractual and severance payment systems

**The uncertainty that hampers permanent hiring would be reduced.** One of the aims of the system proposed is that the prevalence of temporary contracts should diminish. To achieve this, temporary hiring need not be made more expensive, but rather open-ended hiring should become more attractive<sup>19</sup>. In the short term, the rate of converting temporary contracts into open-ended ones would rise, as a consequence of the relative cost-effectiveness of the latter. Furthermore, reduced uncertainty would give momentum to the job market since both, hiring costs for the company and searching cost for the employee, would slow down, reducing the unemployment average duration.

**Young people would benefit most from the change in the hiring and severance payment system.** First, because their attrition rates would fall due to declining temporary rates<sup>20</sup>. Likewise, the permanent job creation would accelerate because of the rebalancing of the cost of firing. Second, because the new system would promote investment in training and in specific human capital so as to reduce labour turnover, which would increase the productivity of young people and, as a result, their employability.

Unlike the current severance pay system, the new one **would not foment a last-in-first-out environment in the event of a transitory drop in activity.** This can be accounted for by the fact that part of the compensation for terminating the contract would have been paid in regularly, so that the marginal cost of firing would be reduced and equitable for different types of employees. As such, its mixed nature allows to avoid the main disadvantage of the pure Austrian model, in which the marginal cost of terminating a contract is zero. In the system we propose, **the marginal compensation is positive and higher when the firing is declared unfair.** As such, companies would absorb the harm caused by the firing, which would reduce the inefficient terminations that would occur under a pure Austrian model.

The change in firing criteria would weaken the negotiating leverage of the traditional *insiders*, which could have **positive effects on collecting bargaining.** The new *insiders* would form a more heterogeneous group – probably with more representation by young people – which could widen the content of wage deals<sup>21</sup>.

Finally, **creating the capitalisation fund would have positive repercussions for companies, employees and the sustainability of the social protection system:**

- **It would make it easier for employers to plan their labour costs** and would reduce the risk associated with the cost of laying off part of the workforce when demand is slack, which would particularly benefit those companies facing liquidity shortfalls.
- Although the dismissal cost paid by the company would have a ceiling, **the amount received by the employee would not be bounded above**, because the contributions into their individual savings account would remain there throughout their working life, and because of the aggregate profitability of the fund in which the money has been invested.
- The capacity to move the savings account between jobs **would be an incentive for labour and geographic mobility of workers, and would aid the necessary sectorial re-assignment of labour.**
- As well as boosting the financial market, **the capitalisation fund would add to the pensions of future retirees.**

## Bibliographic references

Andrés, J. & R. Doménech (2014): "Más y Mejor Empleo", Mimeo. BBVA Research. Presentation available in Spanish here <http://goo.gl/v0Aiig>

BBVA Research (2012): *Spain Outlook. Second quarter 2012*. BBVA. Madrid. Available here: <https://www.bbvaesearch.com/en/publicaciones/spain-economic-outlook-second-quarter-2012/>

Blanchard, O. & J. Tirole (2008): "The Optimal Design of Unemployment Insurance and Employment Protection: A First Pass", *Journal of the European Economic Association*, 6(1), pp. 45-77.

Conde-Ruiz, J. I., F. Felgueroso & J. I. García-Pérez (2011): "El fondo de capitalización a la austriaca: costes y beneficios de su implantación en Spain", Fedea, Colección Estudios Económicos 06-2011. Available in Spanish here: <http://www.fedea.net/documentos/pubs/ee/2011/06-2011.pdf>

De la Source, A. (2012): "Series enlazadas de los principales agregados nacionales de la EPA, 1964-2009", Working Document N° 12/21, BBVA Research. Available here: [https://www.bbvaesearch.com/wp-content/uploads/migrados/WP\\_1221\\_tcm346-358631.pdf](https://www.bbvaesearch.com/wp-content/uploads/migrados/WP_1221_tcm346-358631.pdf)

De la Rica, S. (2010): "La penalización salarial de la temporalidad: ¿Qué efectos tiene en las decisiones familiares?". En Dolado, J. J. & F. Felgueroso (coordinators): *Propuesta para la reactivación laboral en Spain*. Fedea. Madrid. Available here: [http://www.crisis09.es/propuesta/?page\\_id=755](http://www.crisis09.es/propuesta/?page_id=755)

Hofer, H. (2007): "The Severance Pay Reform in Austria", *CESifo DICE Report 4/2007*, pp. 41-48.

Koman, R., U. Schuh & A. Weber (2005): "The Austrian Severance Pay Reform: Toward a Funded Pension Pillar", *Empirica*, vol. 32, issue 3-4, pp. 255-274.

Mercader, J. R. (2013): *El trabajo a tiempo parcial: Situación actual y propuestas de futuro*. Instituto para las Relaciones Laborales y el Empleo (IRLE). Fundación Sagardoy. Madrid.

**DISCLAIMER**

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.



## NOTES

- 1: Box 4 of the Spain Economic Outlook for 2Q12 assessed the job market reform, suggesting areas for improvement, some of which, such as the reduction in the time limit for renegotiating a new collective wage deal, were subsequently included in Law 3/2012, of 6 July, "Urgent measures for the reform of the labour market", available in Spanish here: <http://www.boe.es/boe/dias/2012/07/07/pdfs/BOE-A-2012-9110.pdf>.
- 2: Royal Decree-law 20/2012, of 13 July, with measures for ensuring budget stability and promoting competitiveness. Available in Spanish here: <http://www.boe.es/boe/dias/2012/07/14/pdfs/BOE-A-2012-9364.pdf>
- 3: Royal Decree-law 16/2013, of 20 December, of measures to encourage stable hiring and improve worker employability. Available in Spanish here: <http://www.boe.es/boe/dias/2013/12/21/pdfs/BOE-A-2013-13426.pdf>
- 4: Royal Decree-law 3/2014, of 28 February, with urgent measures for job creation and long-term hiring. Available in Spanish here: <http://www.boe.es/boe/dias/2014/03/01/pdfs/BOE-A-2014-2220.pdf>
- 5: Resolution of 28 August 2013, by the Department of Employment, publishing the Cabinet Agreement of 2 August 2013, approving the Annual Employment Policy Plan for 2013, and Royal Decree 751/2014, of 5 September, approving the 2014-16 Spanish Employment Activation Strategy. Available in Spanish here: <http://www.boe.es/boe/dias/2013/09/10/pdfs/BOE-A-2013-9464.pdf> and here: <http://www.boe.es/boe/dias/2014/09/23/pdfs/BOE-A-2014-9623.pdf>
- 6: Entrepreneurial Strategy and Youth Employment 2013-16, highlighting the National Youth Guarantee System. More information in the Royal Decree-law 8/2014, of 4 July, passing urgent measures for growth, competitiveness and efficiency, available in Spanish here: <http://www.boe.es/boe/dias/2014/07/05/pdfs/BOE-A-2014-7064.pdf>
- 7: See Andrés & Doménech (2014).
- 8: See Bentolilla *et al.* (2012) and Orsini (2014).
- 9: BBVA Research (2009) and Dolado & Felgueroso (2010) contain alternative proposals.
- 10: See [https://www.sepe.es/contenido/empleo\\_formacion/empresas/contratos\\_trabajo/index.html](https://www.sepe.es/contenido/empleo_formacion/empresas/contratos_trabajo/index.html)
- 11: Mercader (2013) summarises the deficiencies of the part-time contract and proposes some improvements.
- 12: Royal Decree-law 16/2013 enables employers to extend the working day with overtime hours (in those contracts with at least ten hours a week averaged over the year), making it easier to distribute working time unevenly by regulating the surplus or deficit of hours with timesheets which can be carried over into the following year. This also makes it possible for entrepreneurs to have part-time open-ended contracts.
- 13: The Austrian system is explained in Koman, Schuh & Weber (2005), Hofer (2007) & Conde-Ruiz, Felgueroso & García-Pérez (2011), among others.
- 14: We propose a contribution rate of 2.19% because this would give a worker with an annual gross wage of EUR24,000 lay-off compensation equivalent to eight dwyw.
- 15: In the wages subject to supra-company collective deals, the contribution to the individual account should not represent an increase in the total wage cost. In corporate wage rounds, this restriction does not apply because it would form part of the negotiation of the company's wage conditions with its workers.
- 16: For example, in a linear manner.
- 17: Details about the management of the capitalisation fund are beyond the scope of this Watch.
- 18: See de la Rica (2010).
- 19: Note that the increase in the compensation for coming to the end of a temporary contract does not have to represent an increase in the labour cost for the company, provided that it absorbs it in the wage negotiation process.
- 20: Note that the rate of temporary jobs among the under thirties was 49.6% in the first quarter of 2014; in other words, one of every three wage-earners with a temporary contract is under 30.
- 21: Conde-Ruiz, Felgueroso & García-Pérez (2011) suggest that the demands of the new *insiders* would be less focused on wage issues, which would enrich the content of collective wage deals.