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Reforming the Labour Market in Spain

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ABSTRACT/RÉSUMÉ

Reforming the labour market in Spain

After steady employment growth since the 1990s, Spain has experienced the sharpest increase in unemployment among OECD countries during the crisis, amplified by structural problems of the labour market. Very high de facto severance payment of permanent contracts has resulted in a rigid dual market with adverse effects on unemployment and productivity. The collective wage bargaining system has hindered firms from adapting to macroeconomic shocks exacerbating their negative effects on the labour market. The recent labour market reform legislation is a positive step to reduce excessive protection of workers in permanent contracts, although some uncertainty remains on how courts will interpret it. It also makes it easier for firms to opt out from higher level collective agreements. The large drop-out rate from lower secondary education is an important factor explaining very high unemployment among young workers. Better access of young people to training is an effective tool to keep them out of a depressed labour market. Finally, the matching of people to jobs, notably through the public employment services, needs to be made more efficient, all the more so under currently tight fiscal constraints. Although the recent reform allows private for-profit firms to provide placement services, more needs to be done. Performance of regional public employment services should be benchmarked and incentives of unemployment benefit recipients to search for a job increased.

JEL codes: J0, J2, J3, J5, J6, I2, E24, E31.

Keywords: Spain; employment protection; collective bargaining system; continuous training; matching process; unemployment benefits.

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Réformer le marché du travail en Espagne

Après avoir connu une croissance régulière de l'emploi durant les années 90, l'Espagne a accusé la plus forte hausse du chômage de tous les pays de l'OCDE pendant la crise, amplifiée par les problèmes structurels du marché du travail. Les indemnités de licenciement très élevées obtenues de facto par les titulaires de contrats permanents ont créé des rigidités et abouti à un dualisme du marché du travail qui a des effets négatifs sur l'emploi et la productivité. Le système de négociation collective des salaires a empêché les entreprises de s'adapter aux chocs macroéconomiques et donc d'en atténuer l'impact sur l'emploi. La législation de réforme du marché du travail devrait permettre de réduire la protection excessive dont bénéficie l'emploi permanent, mais certaines incertitudes subsistent quant à la façon dont ce texte sera interprété par les tribunaux. Ces dispositions permettent plus aisément aux entreprises de ne pas appliquer les conventions collectives de haut niveau. Le taux élevé d'abandon des études au premier cycle de l'enseignement secondaire explique pour beaucoup le très fort chômage qui sévit chez les jeunes. Élargir l'accès des jeunes à la formation serait un moyen efficace de les tenir à l'écart d'un marché du travail déprimé. Enfin, il y aurait lieu d'améliorer l'efficacité des activités de placement, notamment au travers des services publics de l'emploi, et ce d'autant plus compte tenue des contraintes budgétaires actuelles. La réforme récente autorise les entreprises à but lucratif à offrir des services de placement, mais il faut aller plus loin. Dans cette optique, il faudrait soumettre les services publics régionaux de l'emploi à des évaluations de performance et inciter davantage les chômeurs indemnisés à rechercher un emploi.

Classification JEL : J0, J2, J3, J5, J6, I2, E24, E31.

Mots-clés : Espagne; protection de l'emploi; système de négociation collective; formation continue; l'appariement entre offre et demande de travail; prestations de chômage.

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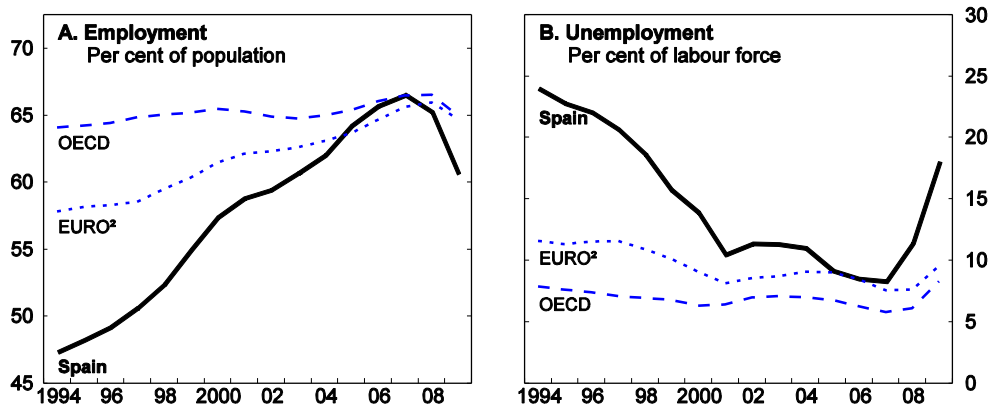
REFORMING THE LABOUR MARKET IN SPAIN

By Anita Wölfl and Juan S. Mora-Sanguinetti[1]

The Spanish labour market in the crisis

Since the 1990s and until 2007, Spain had experienced a prolonged period of impressive employment growth (Figure 1) which successfully absorbed a large and continuous inflow of immigrants (OECD, 2008a). As a result, the unemployment rate had been cut from 25% in the early 1990s to 8% (the EU-average) in 2007, its lowest level since 1980.

Figure 1. **Employment trends**[1]



1. Age 15-64 for euro area and OECD, age 16-64 for Spain. Data for 2009 is estimated.
2. Euro area 12 member countries prior to enlargement in 2007.

Source: OECD (2010), *Labour Force Statistics* (database), November.

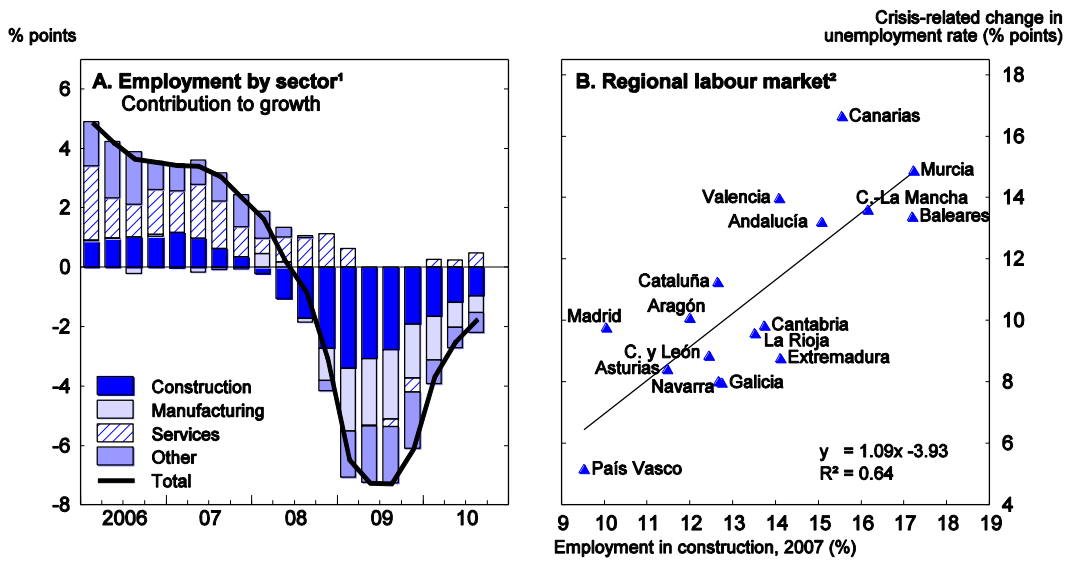
During the crisis however, Spain experienced the sharpest increase in unemployment among OECD countries, amounting to more than 10 percentage points between the fourth quarter of 2007 and the second quarter of 2010. The effect of the crisis on employment is spread across sectors, with construction and some manufacturing sectors being hit most (Figure 2, panel A). The significant loss of employment in the

1 . This paper is based on the Economic Survey of Spain published on 20 December 2010 under the authority of the Economics and Development Review Committee (EDRC). Anita Wölfl is economist in the Economics Department of the OECD and Juan S. Mora Sanguinetti is economist at the Banco de España-Eurosystem (secondee to the OECD Secretariat in the context of the OECD Economic Survey of Spain 2010). The authors would like to thank several OECD colleagues for valuable comments on earlier drafts, notably Pierre Beynet, Andrew Dean, Bob Ford and Andrés Fuentes from the Economics Department, and Ana Llena Nozal, John Martin and Anne Saint-Martin from the Directorate for Employment, Labour and Social Affairs. They would like to thank also Desney Erb, Maartje Michelson and Agustín Redonda for valuable research, statistical and editorial assistance.

construction sector (both residential and non-residential) and in financial and real estate services reflects, among other things, the sharp loss of jobs that had been created during the housing boom.

There were also very large differences in the effects of the crisis on employment across regions (Figure 2, panel B). This can to a large extent be explained by the specialisation of regions on construction or other housing related sectors, as suggested by a high correlation between differences in employment losses across regions and employment losses in the construction sector. There are reasons to believe that this result is further aggravated by the lack of geographical mobility of workers, slowing the reallocation of workers from high- to low-unemployment regions and therefore hampering labour market adjustment overall. Even before the crisis, internal migration rates in Spain were among the lowest in the OECD area, leading to a mismatch between qualified workers and jobs (OECD, 2008a). This mismatch was reflected in much larger disparities in employment and unemployment rates across regions in Spain compared to most other OECD countries (OECD, 2006).

Figure 2. **Sectoral and regional structure**



1. Contributions to year-on-year percentage growth of total employment. Break in series in first quarter of 2009 due to a change in activity classification.
2. The change in the unemployment rate covers the period 2007Q4 to 2010Q1. Regional employment specialisation is measured by the share of the construction sector in total employment in 2007Q4.

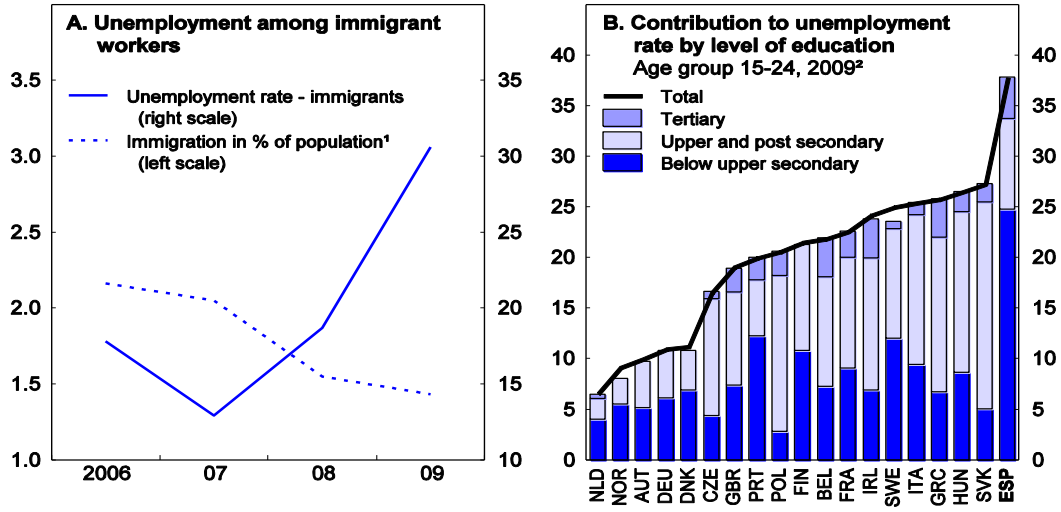
Source: INE (2010), *INEbase* (database), Instituto Nacional de Estadística, November.

The sectoral composition of employment losses, with significant losses in the construction sector, also helps to explain the very strong increase in unemployment among workers with an immigrant background (Figure 3, panel A). While immigrants are among those most strongly hit by the crisis in most OECD countries (OECD, 2010a), the incidence of immigrant unemployment is higher in Spain as a result of the continuously strong inflow of immigrants since the 1990s. Specific policies to integrate immigrants in the labour market are therefore particularly important in Spain and were reviewed in the 2008 *Economic Survey* (see also Annex 1.A2). Immigration had tempered demand pressures on real wages inducing sustained job creation, in particular in the service and construction sectors that require abundant low-cost labour. The overrepresentation of immigrants in construction, retail trade, hotels and restaurants may, in part, also be related to the extensive use of temporary contracts in those industries.

A very high unemployment rate can be found among young people, in particular those between 15 and 24 years old (Figure 3, panel B) with a very low level of education, and youth unemployment has

doubled since the end of 2007. This high level and change in youth unemployment in Spain, as compared to other countries reflects to some degree weak employability of early school drop outs and may also relate to a high incidence of temporary contracts among young workers. Reducing unemployment among young, notably unskilled, workers should be a first priority in order to avoid these people becoming discouraged and withdrawing from the labour force.

Figure 3. **Unemployment among youth and immigrant workers, in per cent**



1. Population of working age (15-64).
2. Age group 16-24 for Spain.

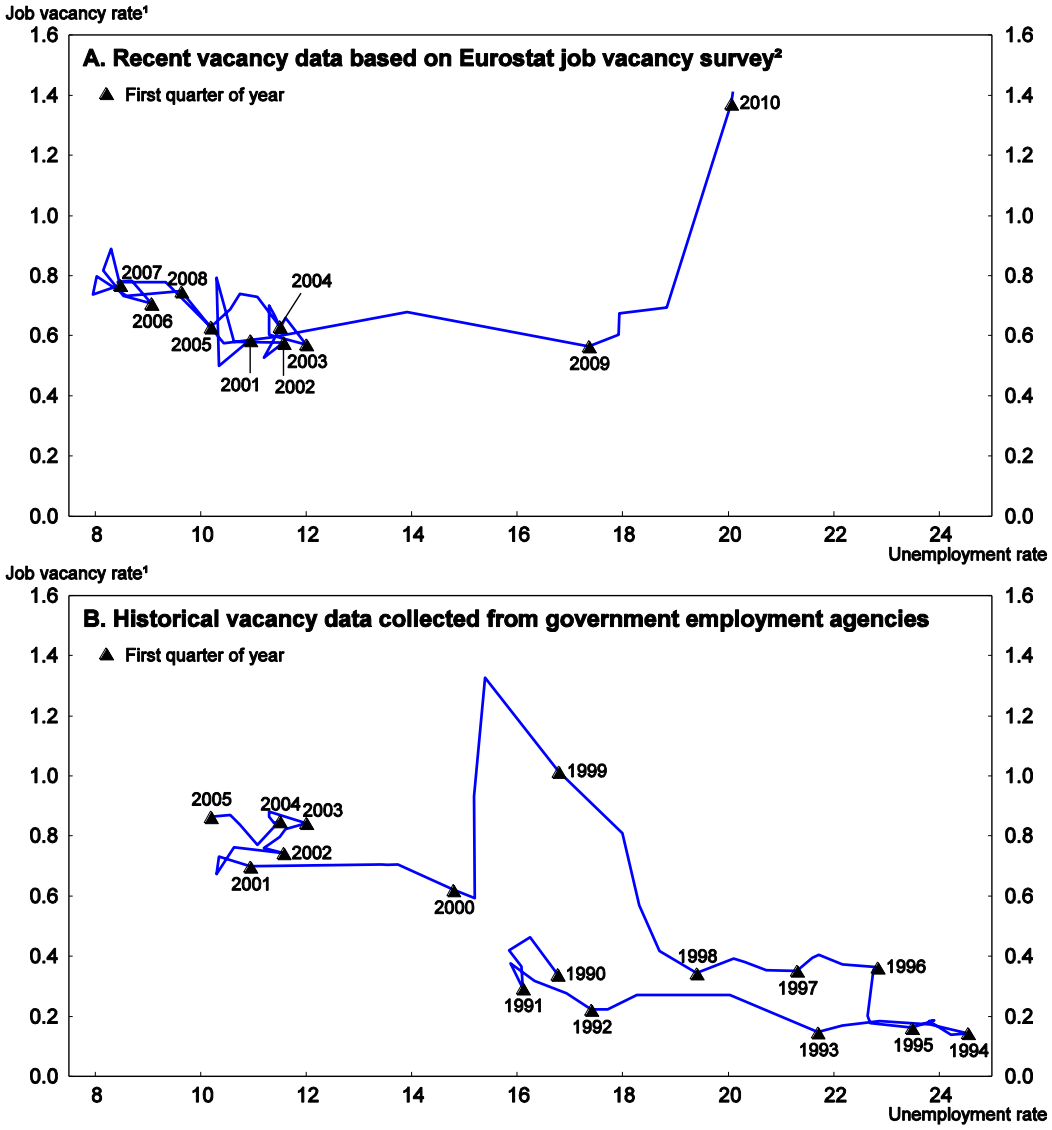
Source: INE (2010), "Encuesta de migraciones", *INEbase* (database), Instituto Nacional de Estadística, September and Eurostat (2010), "Population and Social Conditions", *Eurostat database*, June.

These developments highlight two main structural problems of the Spanish labour market:

- *First*, high structural unemployment does not appear to have decreased much over the past two decades and is likely to have increased during the current crisis. The Beveridge curves (Figure 4) did not clearly shift significantly in the past two decades, suggesting that changes in employment since the 1980s have been to a large extent cyclical.[2]
- *Second*, employment (and indirectly unemployment) reacts in a very volatile way to the cycle as is especially observable in the very strong increase in unemployment during the recent crisis (Figure 1, see also Bentolila and Jimeno, 2003, and Costain *et al*., 2010). While in most OECD countries, the reduction in labour input during the recession was accomplished *via* a combination of employment shedding and reductions in working hours, in Spain employment has played a stronger role in adjusting labour input (OECD, 2010a). The strong reaction of employment in Spain as compared to other countries can to some extent be explained by nominal wage inertia and by frequent use of temporary contracts (see below).

2. Estimations by Bentolila and Jimeno (2003) suggest that the fall in unemployment over the period 1995-2001 is to some extent due to structural factors and driven notably by wage moderation. However, it would be risky to interpret this as if the labour market reforms that were introduced in these years had led to lower structural unemployment. Wage moderation may have reflected the lack of reactiveness of wages to changes in labour market conditions.

Figure 4. **Beveridge curve, in per cent**



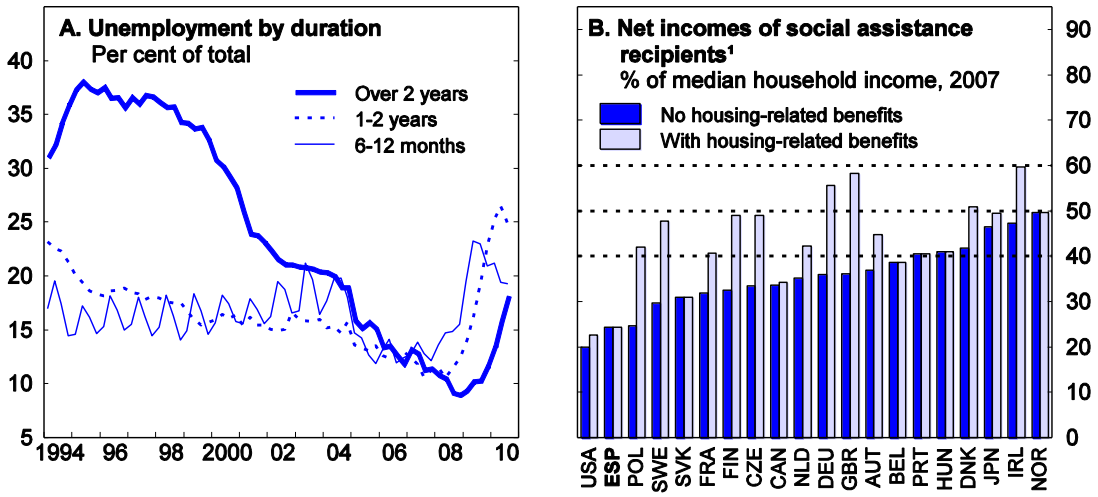
1. Defined as the number of job vacancies in per cent of the total number of occupied and vacant posts.
2. In industry, construction and services (excluding activities of households as employers and extra-territorial organisations and bodies).

Source: Eurostat (2010), "Population and Social Conditions", *Eurostat database* and OECD (2010), *Main Economic Indicators* (database), November

It is important that these structural problems are addressed so as to improve the functioning of the labour market. Allowing wages react in a more flexible way would help the labour market to absorb and reallocate workers. Reducing the mismatch between workers and available jobs would facilitate the shift towards a more export-led economic growth. And reducing the volatility of the labour market would make the labour market more resilient to shocks. Moreover, addressing these structural problems quickly would help to limit the risk of unemployment persistence. Long-term unemployment in Spain was brought down to relatively low levels as compared to other European countries prior to the crisis, but has increased substantially recently (Figure 5, panel A). Moreover, a surge in long-term unemployment risks leading to a rise in poverty as support is low for those unemployed with little unemployment benefit entitlement and

the replacement rate for social assistance is significantly below typical poverty thresholds (Figure 5, panel B). It also risks raising the level of structural unemployment.

Figure 5. **Long-term unemployment and poverty**



1. For a married couple with two children. The horizontal lines on the graph indicate alternative poverty lines. See the *OECD Employment Outlook* Table 1.6 and Figure 1.20 for full details of calculations and coverage.

Source: MEH (2010), *BDSICE* (database), Ministerio de Economía y Hacienda, November and OECD (2009), *OECD Employment Outlook 2009: Tackling the Jobs Crisis*.

Since April 2008, the Spanish government has approved a series of measures to stimulate the economic recovery and to alleviate the negative burden of the crisis on the labour market (Box 1). These include: *i)* wider unemployment benefit entitlements; *ii)* subsidies (basically temporary social security rebates) for hiring targeted groups of unemployed workers on permanent contracts and promoting the creation of jobs in strategic sectors; *iii)* financial incentives to promote self-employment; and *iv)* the extension of the resources of the public employment services.

These measures were appropriate to support the job market during the recession. In particular, hiring subsidies that are concentrated on newly created jobs targeted on groups most affected by the crisis have the potential to be more cost-effective than broad reductions in labour costs. Nonetheless, these measures should be removed as soon as the economic situation improves as they may hinder necessary job adjustments and risk being ineffective in reducing unemployment durably. Furthermore, significant subsidies for hiring on permanent contracts, which are paid over a limited period of time after a worker is hired, will remain after expiry of the crisis-related temporary programmes. As such subsidies may increase turnover further and have proven relatively ineffective in the past, they should be abolished or replaced by targeted active labour market policies.

Box 1. **Immediate policy action in response to the crisis**

Since April 2008, the Spanish government has approved a series of measures, combined later in the larger "Plan E"[1], to stimulate the economic recovery and to alleviate the burden of the crisis on the labour market. Besides new measures, some existing measures were made more generous or applicable to other target groups. The Plan E is centred around four principle axes: *i)* the support of small and medium-sized enterprises through financial incentives; *ii)* employment promotion through hiring benefits and social security rebates for hiring on permanent contracts of unemployed workers with family obligations; *iii)* support of the financial system; and *iv)* further structural reforms in services, transportation, energy and telecommunications, as well as a reform of the pension system.

Within this broader program, more specific measures in order to support existing jobs or the creation of new jobs include the following:

Measures to increase labour demand through lower labour costs:

- Employers' social security contribution (SSC) rebates to promote hiring on permanent and full-time contracts of unemployed workers with family obligations; the rebates are paid for a maximum duration of two years and are applied to new permanent contracts offered before 31 December 2010.
- Employers' SSC rebates for hiring unemployed in social exclusion on permanent or fixed contracts during a maximum of three years.
- Employers' SSC rebates to promote new jobs in strategic sectors and activities (such as research and development and renewable energies).
- SSC rebates to promote self-employment among young people below 30 years old for up to five years.

Measures to support unemployed people:

- A means-tested unemployment benefit for those workers who have reached the end of unemployment insurance and assistance entitlements until the end of February 2011.
- Increase of 40% to 60% of accumulated unemployment benefits for unemployed who opt for the capitalisation of their benefits to start up an enterprise.

Measures to support return to work:

- Special plan to facilitate self-employment of workers older than 45 years.
- Funding worth 1 106 million euros into the 2009 Job Plan for Social Works for direct job creation and to promote training of unemployed.
- Hiring of 1 500 case managers in Public Employment Services to improve placement of workers in sectors that are most affected by the crisis.
- The payment of 350 euros per month in addition to the unemployment benefit to workers in such sectors during the job search period.

According to the recent labour market reform of September 2010[2], firms that hire young and unqualified unemployed, or unemployed older than 45 years, on permanent contracts receive hiring subsidies in the form of social security rebates. These hiring subsidies are limited to a period of three years after the worker is hired and apply to those contracts signed before 31 December 2011. Additional wage subsidies are introduced for hiring on training contracts that are signed before 31 December 2011.

[1] Royal Decree-Law 9/2008 of 28 November 2008 and Royal Decree-Law 13/2009 of 26 October 2009.

[2] Law 35/2010 of 17 September 2010, mainly based on the Royal Decree-Law 10/2010 of 16 June 2010.

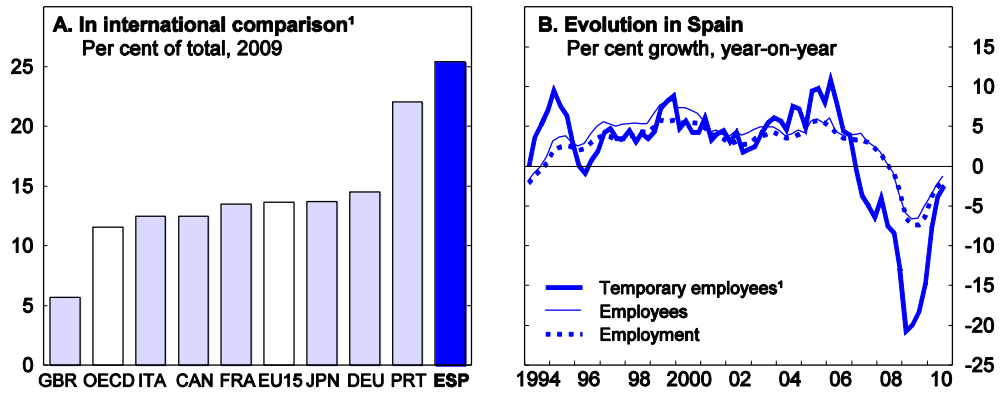
Reducing duality in the labour market

Employment protection of permanent contracts has been very high…

Provisions in the employment protection legislation have led to *de facto* severance payments for workers on permanent contracts that are very high. This resulted in a rigid dual labour market with adverse

effects on unemployment and productivity. In Spain in 2009, about 25% of all workers have been hired on temporary contracts, a percentage that is more than double the OECD average (Figure 6, panel A) and positive or negative employment growth is mainly driven by the creation or cuts of jobs on temporary contracts (Figure 6, panel B).

Figure 6. **Temporary employment**



1. Temporary employees are wage and salary workers whose job has a pre-determined termination date as opposed to permanent employees whose job is of unlimited duration. National definitions broadly conform to this generic definition, but may vary depending on national circumstances. Country-specific details can be found at *www.oecd.org/els/employment/database*.

Source: OECD (2010), *Labour Force Statistics* (database), November and MEH (2010), *BDSICE* (database), Ministerio de Economía y Hacienda, November.

The setting of employment protection legislation (Box 2) and its enforcement has been unfavourable for a flexible labour market for three reasons:[3]

- *First*, while *de jure* dismissal costs were relatively low by OECD standards, even before the 2010 labour market reform, a lack of adequate enforcement and slow judicial procedures in the case of conflicts made firms apply the law in a way that rendered *de facto* employment protection much more restrictive. Workers on permanent contracts who were dismissed for "justified" reasons were entitled to a severance pay of 20 days' wages per year of seniority, which is slightly below the OECD average. However, dismissed workers on permanent contracts have the option to appeal to a labour court and, if the dismissal is judged to be "unjustified", firms have to pay 45 days' wages. In the majority of cases, the dismissals have been judged "unjustified". Moreover, the judicial procedures have tended to be long which has added to the firm costs as they have also needed to pay the interim wages for the entire length of the judicial period. As a consequence, firms have preferred to declare the dismissal upfront as being "unjustified" and to pay 45 days' wages per year of seniority to avoid litigation (including paying interim wages).[4]

- *Second*, a permanent contract with reduced severance pay also exists, the so-called PEP contract (*contrato de fomento de la contratación indefinida*), which entails severance pay of 33 days' wages per year of seniority for unjustified dismissals. However, the use of this contract has been

3. These reasons also help to explain the discrepancy between employment protection legislation (EPL), as reflected in the relatively low score of the OECD cross-country comparative EPL indicator for Spain, and the degree of employment protection that can be observed in Spain.

4. The difficulty of having dismissals justified by the courts may also explain the limited uptake of collective dismissals.

very limited for several reasons, notably because its applicability has been restricted to unemployed workers outside the age bracket of 30 to 45 years and with unemployment spells of more than six months. Firms had limited interest in using the PEPs as it was also subject to the 45 day compensation rule if the firm declared the dismissal as "unjustified" to avoid litigation.

- *Third*, while the overall duration of temporary contracts has been limited by law to a total of 24 months, the law could be easily interpreted in broad ways. The condition for linking together fixed contracts refers to contracts on the same job. Hence redefining the job has been legally sufficient to circumvent the time limit. And contracts under which workers have been hired to perform a certain task or service (*contrato de obra y servicio*) could be extended if it could be proven that performing the task needed more than 24 months.

Box 2. Two-tier reforms of employment protection legislation (EPL) in Spain since 1984[1]

According to the 1980 Workers' Statute[2], the reference point for later labour market reforms, open-ended contracts were the general form of contract; temporary contracts could only be used for seasonal jobs, temporal substitution of permanent workers or temporary increase in activity. Dismissal costs of permanent contracts – still valid until now – depend on the reasons for dismissal. The latter are: *i)* objective (*e.g.* workers' incompetence) and economic reasons; and *ii)* disciplinary reasons. Being dismissed for objective (or economic) reasons implies a mandatory severance payment of 20 days' wages per year of service with a maximum of 12 months' wages. However, workers under permanent contracts can appeal to labour courts. If the dismissal is judged as "unjustified", employers can choose between readmission or termination of the contract with compensation of 45 days per year of service up to 42 months. Furthermore, employers have to pay wages during the judicial period.

Following the second oil price shock, the unemployment rate surged to 20% and the need for more flexibility became evident. The 1984 reform allowed firms to use temporary contracts also for jobs that are not temporary by nature. A new employment-promotion contract was introduced, the *contrato temporal de fomento del empleo* (EP), which entailed a severance payment of 12 days' wages per year of service. The EP contract had a maximum duration of three years, after which it either had to be terminated or transformed into a permanent contract.

As a result of this two-tier reform, the proportion of temporary contracts surged to about 35% in the early 1990s leading to an immense turnover rate. Turnover was reinforced by the easy access to generous unemployment benefits at that time. In order to reduce the share of temporary jobs, a set of countervailing employment protection legislation (EPL) reforms were introduced subsequently which either restrict the use of temporary jobs or reduce mandatory firing costs for open-ended contracts.

In 1994, the EP contract was greatly restricted; it could only be used to hire certain groups of disadvantaged workers, notably workers older than 45 years, handicapped workers, and long-term unemployed who were hired by small firms. Remaining temporary contracts were: *i)* the *contrato de obra y servicio* under which the worker is hired to perform a specific work or service, and *ii)* fixed contracts for jobs of temporary nature. These remaining temporary contracts involved no severance payment. Another element of the 1994 reforms was to extend the reasons for objective dismissal to enable firms to adjust their workforce in the face of future financial liabilities.

In 1997, another partial EPL reform aimed to reduce further the duality of the labour market. A new permanent contract, the c*ontrato de fomento de la contratación indefinida (*PEP contract), was introduced which entails a lower severance payment of 33 days' wages per year of seniority up to 24 months. However, this PEP contract was introduced only: *i)* until 2001; *ii)* for a targeted group of workers that exclude workers between 30 to 44 years old with unemployment spells below one year; and *iii)* for unemployed people, not for workers on temporary contracts. Furthermore, significant social security rebates have been introduced for firms that hired workers on the new PEP contracts or converted temporary contracts into permanent ones.

In 2001 and 2002, in the middle of an economic slowdown, it was decided to extend the use of the (PEP). The age bracket was extended to cover 16-30 years old (instead of formerly 19-29) and those unemployed with more than six months of registered unemployment also became eligible. At the other end, a severance payment of eight days' wages per year of seniority was established for some of the still available temporary contracts. Finally, the reform opened up the opportunity for firms to avoid judicial procedures if they acknowledged that the dismissal was "unjustified" and deposited upfront the severance payment of the regular permanent contract (45 days' wages).

Since the number of temporary jobs remained large and their conversion rate limited, a 2006 reform opened up the conversion of temporary contracts to PEP contracts to workers between 31 and 45 years old if they were hired before the end of 2007. The law also introduced several rebates in payroll taxes if temporary contracts were converted to PEP contracts of more than three years' duration before the end of 2006. At the other end, the law restricted the linking of temporary contracts by requiring that contracts that lasted for two years in the same job with the same firm during a period of 30 months would be automatically converted to permanent contracts.

[1] This box draws on Bentolila, S., J.J. Dolado and J.F. Jimeno (2008), "Two-Tier Employment Protection Reforms: The Spanish Experience", *CESifo DICE Report*, Vol. 6, No. 4, CESifo Group, Munich.

[2] Law 8/1980 of 10 March 1980, currently consolidated in the Royal Legislative Decree 1/1995 of 24 March 1995.

… and this may have had adverse effects on employment, welfare and productivity

Very high *de facto* dismissal cost of permanent contracts makes firms reluctant to convert temporary contracts into permanent ones and hence increases turnover. Even if firms are satisfied with the performance of the worker, it may still be cheaper to fire the worker and search for a new candidate. Empirical evidence suggests that the propensity of employers to terminate employment contracts peaks just prior to employment durations associated with discretionary hikes in accumulated claims for severance pay (OECD, 2001).

Higher turnover is likely to raise unemployment as workers seek new jobs. This may be compounded by limited geographical and occupational mobility of workers, as well as potentially wrong incentives at public employment services and for unemployment benefit recipients. This is confirmed by empirical evidence. For instance, García-Serrano (1998) finds that a rise of 1 percentage point in the proportion of temporary contracts increases the flows from employment to unemployment by 0.26 percentage points.

Increased dualism in the labour market may also increase unemployment through higher pressure on wages. In particular in the context of a wage bargaining system that protects the interests of permanent workers, insiders' power may keep wages for all workers above market-clearing levels. The empirical evidence confirms these effects in the case of Spain. For instance, Bentolila and Dolado (1994) find that an increase in the rate of temporary employment of 1 percentage point raises the wage growth of workers on permanent contracts by about 0.3%.

Even if unemployed workers find a job, they may have to go through many spells of unemployment and low productivity entry-level jobs, before obtaining a regular job. Scarpetta *et al.* (2010) estimate that the probability of a (young) person finding a permanent contract after having had a temporary contract the year before is slightly higher than 20% in Spain, whereas the same probability is around 55% in the United Kingdom. This implies that workers are trapped in situations of low job and income security, hence reduced overall welfare.

Moreover, the dual labour market may hamper human capital accumulation which would slow productivity growth. It is not only firms that have weak incentives to invest in training of workers on temporary contracts. Students with the prospect of starting on and remaining for some time on temporary contracts may have weak incentives to invest in their own education as the return from this investment may be low (OECD, 2008a). In fact, the evidence points to an increasing phenomenon of over-education or over-qualification (see also Bentolila *et al*., 2008; Dolado *et al.*, 2000; and Felgueroso *et al.*, 2010).

Reducing the duality of the labour market has a positive side-effect on public finances, as it reduces the amount of subsidies, in terms of social security rebates or wage subsidies, which the government has been paying so as to make it more attractive for firms to hire workers on permanent contracts. In Spain in 2007, such subsidies amounted to about 0.32% of GDP, although with limited effect in terms of uptake of regular or PEP permanent contracts (García Pérez, 2010).

The recent reform represents significant progress

The recent reform adopted by Parliament in September 2010 (Box 3), should lead to significant progress towards reducing the duality in the labour market.

Box 3. **The EPL-related measures of the 2010 labour market reform**

The labour market reform, approved in September 2010, aims to reduce the duality in the Spanish labour market by implementing several measures.

First, the law expands the conditions under which a dismissal for objective reasons could be justified. In this case, the employer pays 20, instead of 45, days' wages of severance pay per year of seniority. The law clarifies the definitions for "technical", "organisational", or "productive" reasons that would justify collective or individual dismissals. More importantly, it broadens the conditions under which a dismissal can be justified under "economic reasons". This can be in cases of current or anticipated losses or persistent decline in a firms' level of income which may affect its viability or its ability to maintain the volume of employment. Moreover, the firm no longer needs to provide an objective proof, but some evidence that the dismissal decision was needed to preserve the firm's current or future competitive position in the market. Furthermore, the notice period of dismissal for objective reasons is reduced from 30 to 15 days. These provisions apply to all existing contracts whereas the following provisions apply only to new contracts.

Second, the law facilitates the use of permanent contracts with reduced severance pay of 33 days', instead of 45 days', wages in the case of unjustified dismissal (PEP contract). The range of beneficiaries of this contract is extended to: *i)* persons with disabilities; *ii)* persons registered as unemployed for at least one month (instead of six previously); *iii)* unemployed who have continuously been on temporary contracts during the preceding two years; and *iv)* unemployed who have been on a permanent contract in another company during the preceding two years. Furthermore, the severance payment of 33 days' wages is now also applicable in the case in which the employer avoids going to court by acknowledging upfront that the dismissal of a worker on a PEP contract was unjustified.

Third, a worker's capital fund will be established and will enter into force in January 2012. Instead of paying the total amount of severance pay at dismissal, employers would pay regularly an amount equal to a certain number of days' wages per year into this fund; the amount is yet to be specified. The employee may benefit from this fund in the event of dismissal, geographical mobility, for training purposes, or in the case of retirement. The money is kept in the worker's account in the case that the worker changes employers voluntarily.

Fourth, the law makes the use of temporary contracts more restrictive. The compensation paid by the enterprise upon termination of temporary contracts increases from 8 to 12 days. Furthermore, the law introduces a maximum duration of three years for *contratos de obra y servicio* under which the worker is hired to perform a specific task; this limit can be extended by another year through collective agreement. The maximum duration and the conditions under which contracts can be extended remain basically the same for the other types of temporary contracts.

The law foresees some transitory arrangements. The compensation for termination of temporary contracts will increase only gradually and will not reach 12 days before 2015. This is to avoid hindering employment growth in the recovery from the crisis. Until 31 December 2010, companies can transform those temporary contracts that existed at the time of the publication of the law into PEP contracts. Those concluded afterwards or which have a duration of less than six months can be transformed until 31 December 2011. Finally, until the creation of the Capital Fund, part of the severance payment of dismissal of permanent contracts (eight days per year of service) will be funded through recourse to the government (the Wage Guarantee Fund, FOGASA*).

* Royal Decree 505/1985 of 6 March 1985.

The reform aims to reduce the upper range of dismissal costs for permanent contracts and to smooth the difference in dismissal costs between temporary and permanent contracts in three ways:

- *First*, the law aims to make it easier for firms to have dismissals accepted by the courts as justified. If this reform is effective, it will reduce severance payment of firms substantially, from the current practice of 45 days' wages to 20 days' wages.

- *Second*, it broadens the base for which the permanent contract with reduced severance payment of 33 days' wages can be applied and guarantees that this reduced severance pay also applies now

in cases where firms would prefer to declare the dismissal upfront as "unjustified" (to avoid litigation).

- *Third*, the introduction of a capital-funded component, similar to the one introduced in the framework of the Austrian severance pay reform (Box 4), further reduces the one-time costs of dismissal.

Box 4. **The 2003 severance pay reform in Austria***

In Austria until 2002, employers paid severance pay to their employees upon termination of the employment contract, including for retirement, if the employee had worked for this employer for at least three years. The payment amounted to two monthly wages and increased with the duration of the job up to one year's wages after 25 years. This system was criticised for excluding workers on short-term contracts (*e.g.* seasonal workers) and for inhibiting labour mobility as employees lost their entitlement to severance pay in the case of self-termination. Furthermore, it was pointed out that small and medium-sized enterprises might have liquidity problems if they had to make several severance payments simultaneously.

In 2003, the traditional severance pay system was replaced by a system of individual saving accounts. The account of each worker is funded by the employer *via* an untaxed payment of 1.5377% of the gross wage and is managed by an employee fund that invests the balance on capital markets. The payments start in the second month of the employment relationship. If the employee is dismissed after three years of job tenure, he can choose between a cash payment, further investment in the same employee fund or in the employee fund of the new employer, and transferring the respective amount as a one-time payment to a pension insurance fund. The entitlements to severance pay can thus be cumulated by an employee over his or her entire working career, serving as a form of retirement saving. Upon retirement the employee can either claim a cash payment or convert entitlements into an annuity. If the employee leaves the company voluntarily or is dismissed during the first three years of the job contract, no cash payment can be claimed, though the claim is not lost as it can be transferred to the new job.

The reform extended the entitlement to severance pay considerably as entitlement starts after one month and neither depends on the job tenure nor on the way in which the employment relationship is terminated. The level of the payment now depends on the performance of the employee provision fund on the capital market, though the nominal contribution paid by the employer is guaranteed. From an employer's perspective, the new scheme avoids the one-time costs of dismissal and the uncertainty related to the size of the payment at the time of hiring. However, the contributions to the individual accounts add to labour costs.

* This box draws on H. Hofer (2006), "The Severance Pay Reform in Austria" (Abfertigung Neu), CESifo DICE Report, No. 4/2007, CESifo Group, Munich; and Koman R., U. Schuh and A. Weber (2005), "The Austrian Severance Pay Reform: Toward a Funded Pension Pillar", Empirica, Vol. 32, No. 3-4, Springer. See also OECD (2009).

While the law aims to make it easier for firms to have dismissals accepted as justified, it is not clear that it will change the current practice, whereby employers accept dismissals as unjustified upfront in order to avoid legal costs. The law may leave some uncertainty for businesses as to whether the dismissal would eventually be judged to be "justified", as it still leaves a wide range of interpretation to the courts. Further progress in easing the burden on businesses to prove that dismissals are justified may be needed. Steps to reduce the duration of judicial procedures would also help.

Different permanent contracts, some of which with high dismissal pay for unjustified dismissal, will continue existing side-by-side, even for new hires. Even with the planned extension of the 33 days' contract, there still is a large range of cases in which firms would have to pay 45 days' wages in the case of unjustified dismissal. For example, while young people looking for a first job can register in the Public Employment Service, it appears that school leavers are often not registered as unemployed, so are not eligible for the "33 days contract", unless they are now induced to register so as to qualify for this contract. The reform would be more effective if the 33 days contract were to replace the current regular contract of 45 days' wages.

Even with the reduction in severance pay and an extension of the 33 days permanent contracts, firing costs of permanent contracts are likely to remain excessively large. This is particularly applicable if the reform to make it easier for firms to have dismissals accepted as justified turns out to be ineffective. It may therefore be desirable to reduce severance pay for new permanent contracts further. The reform would be more effective if the temporary and permanent contracts converged, for instance, by introducing a single permanent contract for new hires with severance pay that is low initially, but increases gradually with seniority.[5] Such a single contract could also replace the existing system that distinguishes between permanent and temporary contracts and would hence have the advantage of simplifying a highly complex system. Care would still have to be taken to ensure severance payments did not rise too high and unduly restrict the labour market.

There is a risk that the Austrian-type capital-funded component could lead to higher employment costs. This could happen in particular if the money paid into the blocked accounts is not recognised as a wage component in collective bargaining, so that employer contributions to the accounts are not offset by lower wages. This is particularly relevant in the current situation in which employment costs need to be contained. Hence, employers' contributions to the capital fund should be offset, as is planned by the government. This could for instance be funded by higher environmental taxation or a widening of the value added tax base (see OECD 2010b).

Finally, while the planned measures to restrict temporary contracts would in principle reduce the incentive of firms to link temporary contracts, restricting temporary contracts would be risky in the current situation. And this may still be the case if the government postponed the tightening as planned to 2012-15 as these contracts allow businesses to expand employment quickly when demand picks up.

Reforming the collective bargaining system

The institutional setting has adverse effects on employment

The institutional setting of collective bargaining is unfavourable for employment for the following reasons:

- *First*, Spain is characterised by an intermediate degree of centralisation in which collective bargaining takes place predominantly at the sectoral and/or the regional level. About 90% of workers are covered by industry agreements at varying geographical levels and only about 10% are covered by agreements at company level (CCOO, 2010). Such an intermediate system is typically considered to be less favourable for employment as compared to a fully centralised or fully decentralised system (Bassanini and Duval, 2006). In contrast to a centralised bargaining system, an intermediate system would tend to lead to nominal wage rigidity as the inflationary and unemployment effects of wage increases are not internalised through moderate wage demands. Empirical evidence for Spain suggests that this is the case (Izquierdo *et al*., 2003). In contrast to a fully decentralised system, an intermediate degree would not tailor wage agreements sufficiently to the circumstances of individual companies and would tend to diminish wage differentials. Strong relative wage compression would hinder employment of low-skilled unemployed or workers living in low productivity regions.

5. The progression in firing costs would already be achieved with very low, but uniform severance payment. The compensation for a dismissal is typically computed as the severance payment per year of seniority. Hence, dismissing workers with longer years of seniority would also imply the payment of higher compensation. In addition, severance payments are paid based on the last wage before the dismissal. Workers typically move to higher productivity jobs at increasing levels of seniority and hence are paid increasing wages in the course of their career.

- *Second*, collective bargaining is characterised by a complex system of overlapping bargaining at industrial, provincial and firm levels. Lower levels could often only deviate from higher level bargaining outcomes if work conditions, such as wages, were set more favourably for the worker. If work conditions were set less favourably for the worker at lower levels, then deviation was only possible under restrictive requirements.

- *Third*, while union density is low, coverage of collective bargaining is high and this is due to the institutional principles of the Spanish collective bargaining system as fixed in the Worker's Statute of 1980. In particular, the principle of *statutory extension* states that any collective agreement at higher than company level must be applied to all companies and workers forming part of the same geographical or industry level, even if they had not participated in the bargaining process. Small and medium-sized enterprises are most affected by this.

- *Fourth*, it has been very difficult for firms to opt out from collective agreements. Opt-out or opening clauses have typically two positive effects on employment. Opening clauses allow firms to absorb negative shocks by lowering wages instead of firing workers, and should therefore be able to prevent the deterioration of human capital. Additionally, firms with opening clauses may hire more employees in the first place, as they expect to be able to lower their wages when things turn sour.[6] By law, firms had the option to opt out from collective agreements already before the 2010 reform. However, before the reform, opening clauses were part of central collective agreements in which it has been specified when and to what extent firms could deviate from sectoral agreements. Moreover, deviations, *i.e.*, the application of opt-out clauses, were subject to consent by a council of representatives from trade unions and other firms in the same sector.

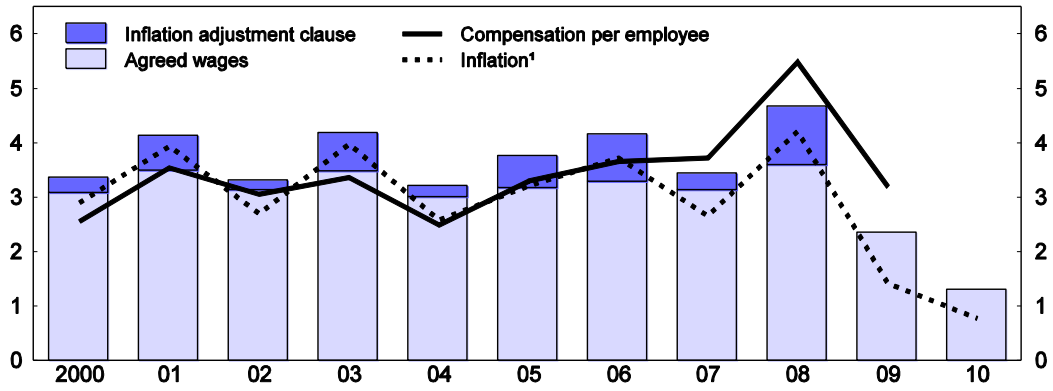
- *Fifth*, wage increases can be fixed through an asymmetric *ex post* wage indexation that may lead to wage inertia (Figure 7).[7] This effect is aggravated by the observation that bargaining agreements take place only every two years or more implying that wages may continue to increase even if inflation was very low (Izquierdo *et al*., 2003 and Du Caju *et al.*, 2008).[8]

6. Brändle and Heinbach (2010) find for Germany that the existence of opening clauses increases employment by 0.8%.

7. The existence of such clauses may result in *ex ante* lower agreed wages. The empirical evidence shows, however, that once inflation is known to be higher than expected, the wages agreed in agreements with *ex post* indexation are typically larger than in agreements in which this clause has not been in place (Izquierdo *et al*., 2003).

8. It is sometimes feared that de-indexation may lead to deflation, a scenario which would not be desirable under the current economic circumstances. The empirical evidence does suggest that in those countries in which indexation had been abolished, inflation shrank substantially – however from very high levels. There is no empirical evidence that de-indexation of wages would have led to deflation under inflationary conditions similar to the ones of Spain.

Figure 7. **The impact of collective bargaining on wages, in per cent**



1. Consumer price index, year-on-year percentage change in December of previous year.

Source: Banco de España (2010), *Informe Anual 2009*.

The recent reforms may be a substantial improvement

The reform of collective bargaining included in the approved labour market reform of September 2010 (Box 5) has the potential to improve the flexibility of the wage setting agreements to macroeconomic and firm-specific effects.

Box 5. **The 2010 reform measures aimed to improve the adaptability of firms to shocks**

Besides reforms of employment protection, the 2010 labour market reform aims also at improving the adaptability of the labour market to shocks.

First, the law changes the conditions under which a firm can opt out *ex post* from collective agreements: it widens the causes under which firms can opt out from lower level agreements as is the case, for instance, for specific company-level pacts. Moreover, it eases the conditions for opting out from higher level collective agreements at sectoral or regional level. In this case, firms that want to opt out no longer need to ask for consent from the social partners (notably trade unions); instead, agreement between employers and their employees would be sufficient. If such an agreement between employers and employees cannot be reached, collective bargaining must provide for solutions through arbitration. Furthermore, firms can now also opt out as regards a larger range of working conditions, beyond wages, including working time and firm organisation.

Second, the law opens up company-internal flexibility in terms of reductions in working time (including short-time work). Such flexibility is now given independently of the number of workers concerned; previously it could be applied only in the case of full suspension of contracts or collective dismissal. In addition, the law extends existing employers' social security rebates in the case of short-time work if such work was combined with training of the workers concerned.

The 2010 labour market reform foresees a reform of the collective bargaining process within six months since the law was passed by Parliament. If social partners do not reach an agreement, the government is willing to adopt necessary initiatives such as to further improve the collective bargaining process.

However, the reform of the collective bargaining process could be made more effective in the following ways:

- Abolishing the statutory extension principle would be desirable. Such a step may however be difficult to reconcile with constitutional law. Alternatively, consideration should be given to replacing the compulsory application of wage agreements reached at higher levels with an opt-in

system that allows employers the choice of whether to adopt the wage agreement.[9] In any case, employers and workers should be able to agree to opt out from collective bargaining without being subject to other conditions. This is intended in the labour market reform of September 2010.

- The system of collective bargaining could be simplified and give more room for wages and other work conditions to be decided at the firm level.

- While the agreement on collective bargaining signed in February 2010 temporarily suspends *ex post* inflation indexation during three years, *ex post* wage indexation rules remain in place. Eliminating *ex post* wage indexation should be encouraged.

Improving the employability of the young and the unskilled

Under the current circumstances, improved access to education or continuous training of young people, in particular those who leave or have left school without a basic degree, would have a double dividend. It would not only increase the skill level of young people, but would also avoid young people being thrown on a depressed labour market where they have little chance of finding a job. Policies to improve access to training or education may also help in particular low-skilled immigrant unemployed, beyond more specific policies for the integration of immigrants into the Spanish labour market (OECD, 2008a).

Recent reform efforts of vocational education will enhance school-to-work transition

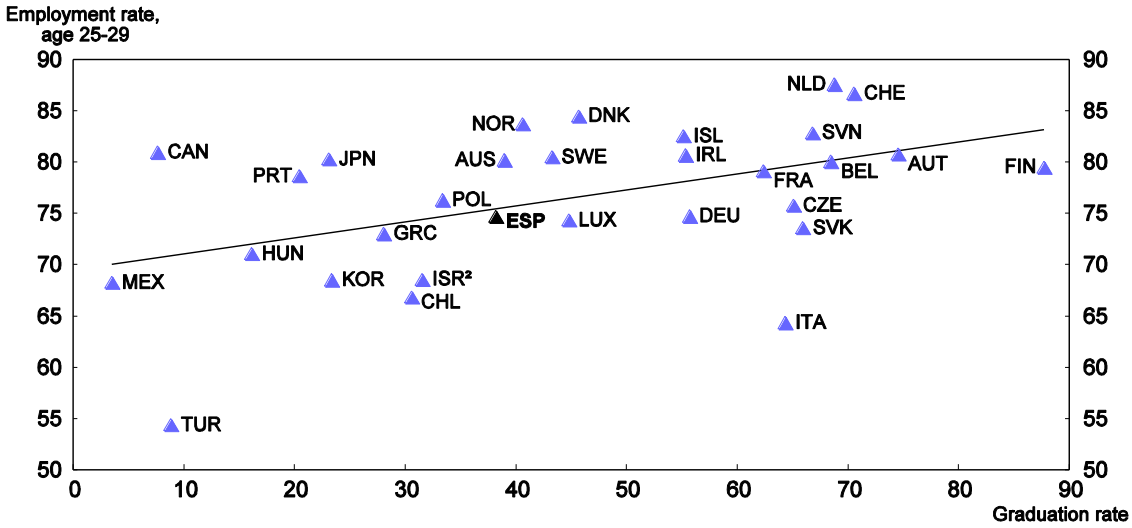
Vocational education allows for an alternative track to keep young people in school until they obtain at least an upper secondary qualification and which provides work-related skills through curricula which emphasise the acquisition of practical skills that are relevant for work (OECD, 2006). The school-to-work transition of young people appears to be smoother in countries with well developed vocational education (Figure 8).

Within the larger framework of the *Proyecto de Ley de Economía Sostenible* (under discussion in Parliament), the Ministry of Education and Culture has very recently proposed several measures that have the potential to make vocational education and training (VET) more attractive, effective and flexible. It is envisaged to: *i)* expand and update the curricula offered; *ii)* ensure that the education offered is closely linked to employers' needs; *iii)* increase mobility between vocational and general upper secondary education as well as with university education; *iv)* promote the development of an integrated system of information and guidance; and *v)* introduce a monitoring and performance evaluation system. Furthermore, the government has simplified the procedures necessary for private training providers to operate as official VET centres.

9. Opting out is particularly important as long as statutory extension is provided, but is also desirable in a bargaining system in which the extension rule was suppressed. Even if firms were participating in an agreement they may be faced *ex post* with an unexpectedly sour situation during the period for which the agreement would apply and due to external shocks that they could not have foreseen before. *Ex post* opting out could help in the renegotiation of wages or working conditions in such a situation.

Figure 8. **Employment rate of young adults and graduation from vocational training**[1]

Per cent, 2008



1. Graduation rates cover those from pre vocational and vocational programmes.
2. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD (2010), *Education at a Glance 2010* and OECD (2010), *Labour Force Statistics* (database), July.

The proposals of the government are also promising in that they aim at introducing evaluation and monitoring systems. Such quality assurance mechanisms increase the effectiveness of VET by reducing the drop-out rates of students and enhancing students' employment prospects later on. The evaluation system could be combined with a system for data and analysis relating to VET, including data on the flow of students through education and on the labour market performance of young people with a VET qualification.

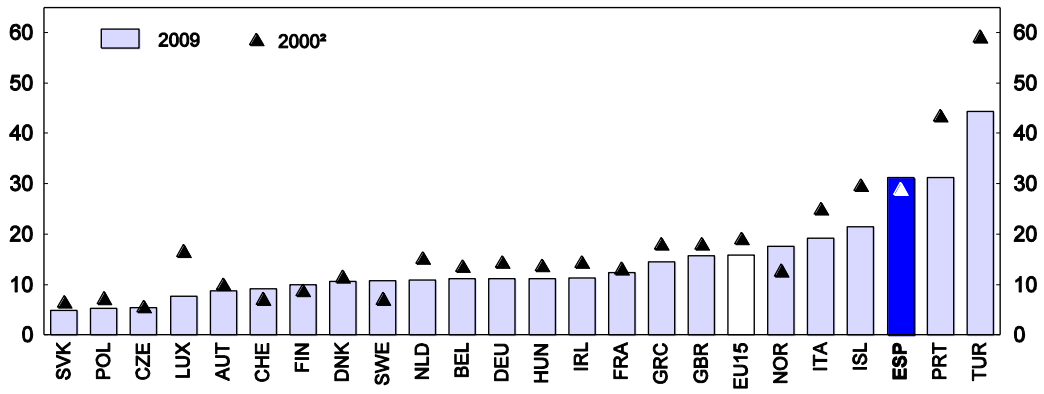
Employment prospects for early school leavers should be improved

In Spain, more than 30% of those in the 15-29 year age bracket leave school with at most lower secondary education (Figure 9) and there has been very little change in this rate over the past decade. In general, employment opportunities are much lower for early school leavers without upper secondary education and it takes longer for employment rates of early school leavers to converge to those of educated or prime age workers. Early school leavers are also more at risk of being trapped in temporary jobs before getting a permanent one and this appears to be particularly so in Spain: five years after leaving school, more than 50% of unqualified young workers are in temporary jobs in Spain as compared to 33% in the average EU10 country[10] (OECD, 2008b).

10. The countries for which this study was undertaken were Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, Portugal and Spain.

Figure 9. **Early school leavers**

Percentage of population with at most lower secondary education, age 18-24[1]



1. Excludes those in further education or training.
2. 2001 for Poland; 2002 for Czech Republic, Ireland and Slovak Republic.

Source: Eurostat (2010), "Population and Social Conditions", *Eurostat database*, September.

There are different ways in which employment prospects for early school leavers could be improved (see also OECD, 2008a).

- *First*, while the government is introducing a wide range of reforms in early childhood and primary education, it may take some time for these measures to show effects. An important reform that would not be costly to public finances, and could hence be introduced more quickly, would be to focus the criteria for granting pupils' promotion to subsequent grades, and hence access to upper secondary education, more narrowly on those core competencies that are needed to follow any type of upper secondary education – as recommended in the 2008 *Economic Survey*. This would reduce grade repetition in compulsory secondary education.

- *Second*, targeted active labour market programmes represent an important option for those school drop outs who are already out of the educational system (OECD, 2006). Within such programmes early activation, notably job-search assistance, has proven to be most effective in terms of positive returns on employment and earnings. However, it is important that such programmes be closely monitored in terms of their success in helping the most disadvantaged youth find a job. Furthermore, such programmes would have to be made available also for youth who are not registered as unemployed such as to reach school drop outs with no working experience. Closer co-operation between schools and public employment services in the form of early career counselling within lower or upper secondary schools, or outreach programmes, could help to identify school-leavers having difficulty in finding a job. Increased active labour market programmes (ALMPs) could be financed through tightening and reallocating unemployment benefits as discussed below.

- *Third*, the recent labour market reform aims to make training contracts more attractive and applicable also for less qualified workers. It specifies that firms can pay less than the minimum wage in the first year of training in the case of the *contrato de formación* (which is aimed at youth with secondary education). In addition, the 2010 labour market reform also makes it easier for firms to opt out from higher level collective bargaining agreements. This may have a positive effect on the attractiveness of training contracts to the extent that firms may then be able to pay youth with secondary education). In addition, the 2010 labour market reform also makes it easier

for firms to opt out from higher level collective bargaining agreements. This may have a positive effect on the attractiveness of training contracts to the extent that firms may then be able to pay wages below minima set in collective agreements (see also section on collective bargaining above).[11]

The institutional setting of continuous training would have to be reformed

An increase in continuous training is associated with a higher ability of workers to stay in employment and to get re-employed after having been laid-off.[12] For instance, Ok and Tergeist (2003) showed that, controlling for individual characteristics among workers who receive training in any given year, the probability of being unemployed three years after training is about 4%. This is 3.5 percentage points less than the probability of workers with comparable individual characteristics who did not receive training. Moreover, empirical evidence suggests that workers' training may increase enterprise productivity and hence has positive effects beyond pure employment effects.[13]

The existence of market failures justify some public co-financing targeted at particular groups.[14] While the Spanish levy system aims to address these market failures and to provide targeting, its particular design may encourage insufficient and inappropriate training. This is in particular linked to the strong involvement of social partners in the decision process (Box 6). Theoretically, involving social partners can be justified in that employers' or workers' representatives are expected to have more in-depth information on skill and training needs than the government. The strong involvement of social partners may have three adverse effects on training provision, though:

- *First*, there may still be aggregate under-investment in training. The individual firm has only very little influence on the selection and may hence try to avoid going through the long, complicated and uncertain process in order to apply for public funding.

- *Second*, it may not reach those firms or individuals with the largest need for public support, but only those firms that are more strongly represented in collective bargaining and which – as a

11. This is related to the fact that minimum wages are already relatively low, but the wage floor negotiated in collective agreements is significantly higher than the minimum wage in most cases, and it is the negotiated wage that also acts typically as the reference wage for training contracts. For instance, the salary on a *contrato de formación* (which is targeted at youth with secondary-school qualifications) has been negotiated in collective agreements and could not be lower than the negotiated minimum wage. For a *contrato en prácticas* (which is targeted at tertiary education graduates) pay must be equivalent to at least 60% of the negotiated wage of the profession in the first year, increasing to 75% in the second year (OECD, 2007b).

12. Both are complementary however, and are in fact linked within the Spanish education system. The 2002 Qualifications and Vocational Training Act, on which more recent reforms are based, states that vocational training includes all training actions that provide access to employment and active participation in social, cultural and economic life and allow workers to carry out their job with the necessary skills. It includes training at the level of initial vocational training, measures for the entry or re-entry of the unemployed into the labour market, and continuous in-company training.

13. For instance, Zwick (2002) shows that for German firms, an increase in the training intensity by 1% raised productivity by 0.3%. Formal internal and external courses appear to have the highest positive productivity impact while the impact of self-induced learning is lower but still significant.

14. For instance, financial constraints and asymmetric information in financial markets may limit financing of training through small enterprises. This may be particularly important for Spain due to the large share of small enterprises. Furthermore, firms typically tend to favour training of skilled workers as the return from this investment in terms of productivity gain may be higher as compared to the one from training unskilled workers.

result of the design of the grant system – are responsible for the selection criteria of the grant applications.

- *Third*, social partners are not only involved in the allocation of grants, but are also responsible for the choice of training provided. As a result, it is not guaranteed that the subsidised training is the most appropriate for the particular grant receiving firm.

Box 6. **The institutional setting of continuous training in Spain***

Continuous training is institutionalised in the form of a tripartite "collective" agreement with a strong involvement of social partners in both the selection of training offered as well as the allocation of co-financing to training plans of firms.

Every company pays a training levy corresponding to 0.7% of payroll into a training fund. The firm can try to recuperate all or part of its payment through applications for grants to finance its training plan. The Ministry of Labour and Immigration issues every year open calls for submission of training plans. Companies with over 100 employees can submit individual plans, while small and medium-sized enterprises need to join forces and submit sectoral or territorial-based group plans. Funding applications have to be submitted to the legal workers' representatives.

The selection criteria applied are based on agreements reached in the so-called Parity Commissions. These are set up at national, sectoral and territorial level, with members coming from main trade unions and employer organisations. The Parity Commission set the framework for what types of training plans will be accepted. They are also involved in *ex post* control.

* This box draws on Ok, W. and P. Tergeist (2003), "Improving Workers' Skills: Analytical Evidence and the Role of the Social Partners", *OECD Social, Employment and Migration Working Papers*, No. 10.

Figure 10 provides partial evidence for some of these arguments.[15] Overall, the current system seems to generate poor results while at the same time raising the tax wedge on employment for three reasons:

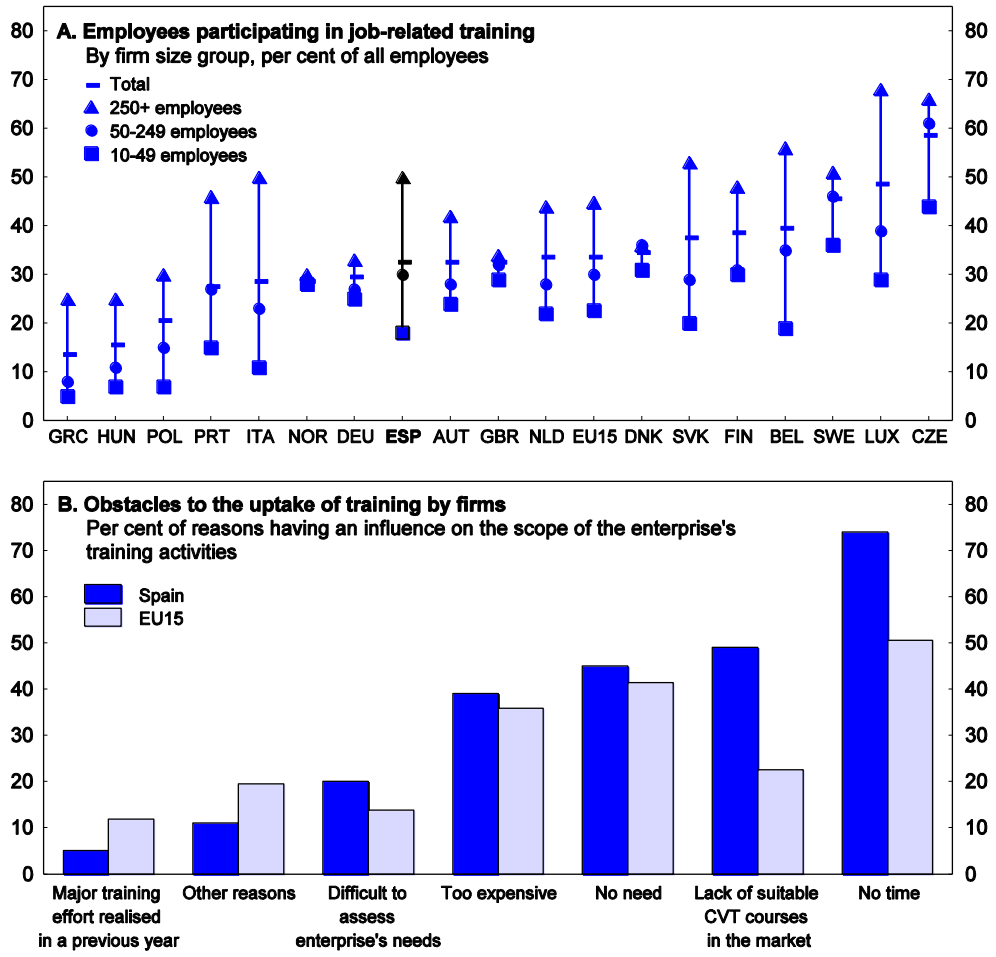
- *First*, in aggregate, Spanish firms invest relatively little in continuous training as compared to other European countries (Panel A). This suggests that there is still room for improvement of the training system so as to raise incentives for investment in training.

- *Second*, the training intensity is much higher in firms with more than 250 employees while it is substantially below the EU-average in firms with less than 50 employees (Panel A). This suggests that government co-funding of training investment has not reached very small firms that may be faced with substantial obstacles in financing training.

- *Third*, a very large share of firms that did not invest in training of their employees claim that lack of suitable training courses was one of the major obstacles (Panel B). This shows that selected training courses do not meet business demands for skills and training.

15. It has to be taken into account, however, that the results in these figures are for 2005 only – the most recent year available – and cover all the training efforts of firms, not only the ones that are subsidised.

Figure 10. **Continuing vocational education, 2005**[1]



1. The EU15 aggregate is an unweighted average excluding Ireland; in panel A it also excludes France

Source: Eurostat (2010), "Population and Social Conditions", *Eurostat database*, May.

The government could make the system of continuous training less complicated and less stringent and facilitate the access of small firms to continuous training, as is envisaged in current government plans for reform. Firms should also have more options as to the choice of training provided in order to ensure that the training meets the actual training needs of the firms, hence rendering the subsidies more effective.

Moreover, the government may think of introducing grants to individual adults, for instance in the form of vouchers covering course fees and/or allowances to cover indirect costs such as foregone wages. Experience from other countries suggests that such schemes facilitate targeting and stimulate competition among training providers by giving individuals greater choice (Kuczera *et al.*, 2008; Rinne *et al.* 2008).[16] This could increase the matching quality between the individual and the training providers and therewith increase the effectiveness of training programs. Moreover, such a step would be especially effective as it encourages general training which is transferable across firms. It is however important that provider quality

16. Rinne *et al.* (2008) find that the voucher system, that was applied for the provision of public training programs within the larger labour market reforms (*Hartz)* in Germany, increased both the employment probability and earnings of the participants.

be ensured and certified. In the Austrian voucher scheme, for instance, vouchers can only be used with providers who meet strict quality standards (OECD, 2005).

Finally, the recent reform initiative within the *Proyecto de Ley de Economía Sostenible* to certify continuous vocational education is welcome as it reduces information costs involved in signalling acquired skills to potential employers, improving incentives to acquire such skills. Certification can provide individuals with a means to achieve a higher education degree after several years of work experience. Young people without basic skills, in particular, should be offered access to continuous training so as to obtain such a diploma or certified qualification. Certification could make voucher systems more effective by making disbursements of vouchers conditional on the successful acquisition of accredited skills.

Improving the effectiveness of the matching process

In order to improve the efficiency of the matching process, remaining disincentives, both on the side of public employment services and on the side of unemployment benefit recipients, should be addressed. This is particularly important in the view of tight fiscal and manpower constraints that make it imperative to get better value for public spending on active labour market policies (ALMPs).

The system of public employment services could be made more efficient

As was pointed out in the 2008 *Economic Survey of Spain*, the division between the financing of unemployment benefits with unemployment insurance contributions at the national level, on the one hand, and the managing and designing of the placement services at the regional level, on the other hand, may distort placement incentives for regional employment offices:

- Regions do not receive the fiscal benefits of a reduction in unemployment; in contrast, since resources are allocated across regions according to the number of unemployed, regions that succeeded in placing the unemployed receive less central government funding.

- Where regional public employment services (PES) have the autonomy to design ALMPs, there is a risk that ALMPs are not designed to promote employability but rather to place recipients in short-term jobs that would re-qualify them for unemployment benefits paid by the central government.

Ideally, the responsibilities for funding unemployment benefits and for managing the public employment services should be assigned to the same jurisdictional level (the central government). If this is not possible, comprehensive monitoring and evaluation of placement services and ALMP implementation at regional level should be introduced, based on quantitative output indicators or targets, similar to what is done in other OECD countries, for instance in Switzerland (Box 7). Quantitative performance management could be combined with qualitative studies in which placement successes and impacts on job-seekers' employability are analysed by following former unemployed or job-seekers over time. Moreover, closer inter-regional and inter-institutional co-operation would encourage exchanges of best practices; for instance it could help understand why some ALMPs have worked well and some have not.

Combining the monitoring and evaluation system with a reward system could help to reduce the disincentive of regional public employment services. For instance, those that performed well could be allocated temporarily additional resources or more responsibilities in the design of ALMPs.[17] The 2010

17. In a reverse sense, one could also introduce a punishment system similar to the model used in the *Instituto Nacional de la Seguridad Social* (INSS). In this case, regional offices have part of their grant withheld if the given objectives have not been reached. The INSS is in charge of sickness benefits.

labour market reform includes some provisions in this sense as the regional public employment services could receive parts of the funds that are saved as a result of their monitoring of unemployment benefit payments.

Box 7. **Performance management of public employment services in Switzerland***

In 2000, the federal and cantonal governments of Switzerland agreed to develop an output-oriented management approach of public employment services (PES) and to set in place a performance rating system based on indicators that measure the attainment of the agreed objectives. This system allows benchmarking of local PES with benchmarking results being collected and published annually. Four main indicators are used to monitor performance:

- Quickness of reintegration of the unemployed into the labour market, as measured by the average duration of unemployment benefit entitlement per unemployed (weighted 50%).
- Prevention of long-term unemployment as measured by the share of those remaining unemployed among those who were registered as unemployment benefit recipients 13 months before (weighted 20%).
- Prevention of benefit exhaustion as measured by the share of unemployed no longer entitled to federal unemployment benefits in the total number of unemployed (weighted 20%).
- Prevention of repeated registration for benefit as measured by the share of previous unemployed who have de-registered but apply again for unemployment benefits within four months (weighted 10%).

By setting the weights as indicated, the system puts a priority on rapid labour market integration. Furthermore, the objectives concern only the placement of unemployment benefit recipients and not long-term unemployed or social assistance recipients who are no longer entitled to unemployment benefits and are more difficult to place.

In order to take into account inter-regional differences in economic conditions for the benchmarking, data on exogenous factors that characterise the economic structure of regions are collected in addition to data on the placement activities themselves. If certain cantons perform badly repeatedly, an in-depth single performance evaluation of this canton is exercised with the aim of finding a solution to improve its performance.

* This box draws on Duell, N. and P. Tergeist (2010), "Activation Policies in Switzerland", *OECD Social, Employment and Migration Working Papers*, No. 112.

Finally, with the surge in unemployment during the recent crisis, regional public employment services may better concentrate on the most important tasks or on particular target groups and "outsource" other activities. This could be done in two ways:

- *First*, all job vacancies could be advertised openly. In Spain, most vacancies are "closed", *i.e.* they are not advertised, but are offered to the job-seeker by the regional PES administrator. While direct referrals can serve important purposes, the more information is attached to a vacancy, the less need there is for a PES intervention to fill it. Hence, it is a good initiative of the Spanish government to set up a nationwide internet-based job search platform so as to provide the possibility for jobseekers to search in the vacancies of all regional PES at the same time.

- *Second*, the reform plan as regards placement through private agencies is welcome, but still could be improved upon. The 2010 labour market reform enlarges the possibility for private agencies to provide placement services by specifying that private placement agencies no longer have to be "non-profit". However, private placement provision remains restricted as private agencies have to ask for an authorisation from the public employment services to operate and are asked to provide feedback on their activities.

Create the right incentives at the level of unemployment benefit recipients

The system of public employment services in Spain follows a mutual obligation approach where, in return for benefits, recipients are required to engage in active job search activities. Registered unemployed need to be apt for placement, undertake pro-active steps to find a job and to be ready to take up suitable work. However, in order for the Spanish mutual obligation approach to be more effective, it should be better enforced by the use of sanctions. This could be achieved in the following ways:

- Entitlement to unemployment benefits should start from the initial time of registration and should no longer be paid retroactively from the registration.

- The first intensive interview should be mandatory at the time of registration. The delay in holding the first interview with a PES counsellor of up to two weeks as in the current activation strategy may result in a loss of opportunities of referral to a vacancy.

- Placement interviews could be combined with a job profiling system that would help to distinguish early on those unemployed who are easy to place from those where help is necessary. Ideally this could be linked with stronger co-operation among regional employment services as well as between schools and employment services.

- While intensive interviews between the job-seeker and an employment counsellor are held regularly, the frequency of such interviews should be increased. Studies from several countries have shown that strong job-search controls can have a considerable impact on re-employment rates (OECD, 2007a). While self-motivated unemployed will look for jobs effectively, for other types of individuals, more intensive job-search assistance and monitoring may be required to ensure that they search actively for work (Duell and Tergeist, 2010).

- The labour reform of September 2010 reduces the number of days of job search after which participation in active labour market policies is obligatory. This is a welcome step as it should help the unemployed to maintain a strong link to the labour market. In particular, as with continuous training mentioned above, training programmes within ALMPs have a double dividend of not only increasing the skill levels of people, but also avoiding them being thrown on a dense labour market with little chance of finding a job.

- The government may consider enforcing the formal requirement that the unemployed should take on a "suitable" job after one year of unemployment. While such an obligation exists in the current activation strategy, the definition of a "suitable" job is very broad. It could for instance be extended to consider also as suitable those jobs that are outside the region in which the unemployed is registered. Enforcing this obligation, however, would require regional PES exchanging information about available jobs.

The government may also consider reducing existing disincentives in the unemployment insurance system by reducing the duration of unemployment benefits, at least once the recovery is in sight. With about two years, maximum unemployment benefit entitlement is long in Spain as compared to other countries and such benefits may have adverse effects on employment. *First*, by reducing the job-search intensity of the unemployed and their willingness to accept job offers, benefits can result in longer periods of unemployment or even effective labour force withdrawal on the part of some benefit recipients.[18]

18. Arellano *et al*. (1998) for instance show, based on longitudinal hazard estimations for a sample of Spanish men in 1987-94, that receipt of unemployment benefits significantly reduces the hazard of leaving unemployment.

Second, by lowering the opportunity cost of not working, they may put upward pressure on workers' wage claims and ultimately reduce labour demand (OECD, 2006).

Shortening the duration of benefits may also not hit those unemployed who would need them most. People on temporary contracts have a higher probability of job loss, yet may accumulate very few benefit entitlements, while people on permanent contracts would be entitled to generous unemployment benefits in case of a dismissal in addition to the already high severance pay. Tightening job search requirements, and requirements for unemployment benefit entitlements for those unemployed who would find a new job easily, could free up resources that could be used for those unemployed who are difficult to place.

The need for a comprehensive reform package

Linkages between different institutions within the labour market as well as between labour and product markets underline the importance of a comprehensive reform.

- Linkages between different institutional settings are particularly important as regards youth unemployment. High drop-out rates of students and limited uptake of continuous training of young people may relate to the dual labour market as well as the bargaining process as discussed above.[19] Hence, the recent reform may also help improving the employability of young and unskilled workers.

- Spain is characterised by weak inter-regional mobility of workers, a factor that may slow the speed of adjustment to the crisis and reduces incentives to invest in human capital as young people have to accept jobs for which they are over-qualified (OECD, 2008a). Geographical mobility could be enhanced through appropriate reforms of the rental housing market.[20] This is more effective with simultaneous reform of the labour market: the uncertainty linked with the high turnover, due to the frequent use of temporary contracts, and the weak coverage through the social safety net of particular groups of workers or unemployed underline the importance of family ties and may reduce geographical mobility even in the presence of a well-functioning housing market.

- Empirical evidence points to a strong interaction effect of labour and product market policies on employment.[21] Nicoletti and Scarpetta (2005) for instance, suggest that anti-competitive regulations tend to be costlier for employment when labour market policies and institutions protect insiders increasing their bargaining power.

19. In Spain, young people typically have to go through a series of temporary underpaid jobs and/or unemployment before they receive a stable job. This reduces incentives for young people to invest in their own education as the direct return from this investment is low.

20 Some reforms have been undertaken recently (see OECD, 2010b).

21. See also Duval *et al*. (2007) as concerns the link between product and labour market rigidities and economic resilience. OECD (2010b) provides a deeper analysis of product market regulations in Spain.

Box 8. **A summary of main policy recommendations to reform the labour market in Spain**

Return to work

- Reduce subsidies for hiring the unemployed on permanent contracts which are paid over a limited period of time after a worker is hired, and replace these subsidies by targeted active labour market policies.

Reducing the duality of the labour market

- If the 2010 labour market reform does not make it significantly easier for firms to have dismissals accepted as justified further progress in easing the burden on businesses to prove that dismissals are justified may be needed. Steps to reduce the duration of judicial procedures would also help.
- It may be desirable to reduce severance pay for new permanent contracts even further. The reform would be more effective if the temporary and permanent contracts converged, for instance, by introducing a single permanent contract for new hires with severance pay that is low initially, but increases gradually with seniority. If designed like this, such a single contract could also replace the current system that distinguishes between permanent and temporary contracts.
- Avoid tightening the regulation of temporary contracts soon. As a minimum, tighten temporary contracts only once the reform succeeds in lowering dismissal pay for permanent contracts and improves hiring on such contracts markedly.
- Introduce steps to offset employers' contributions to the capital fund. The government intends to do this. This could be, for instance, funded by higher environmental taxation or a widening of the value added tax base (for instance by removing some exemptions).

Making the labour market more flexible

- Abolishing the statutory extension principle would be desirable. Such a step may however be difficult to reconcile with constitutional law. In any case, ensure that employers and workers can freely agree to opt out from collective bargaining at the firm level – as is intended in the new legislation. Alternatively, the compulsory application of wage agreements reached at higher levels could be replaced with an opt-in system that allows employers the choice of whether to adopt the wage agreement. Moreover, the system of collective bargaining could be simplified and give more room for wages and other work conditions to be decided at the firm level.
- Encourage the elimination of *ex post* inflation indexation clauses in collective bargaining.

Increasing the employability of the young

- In compulsory education, focus the conditions for granting pupils promotion to subsequent grades and access to upper secondary education more narrowly on those core competencies that are needed to follow any type of upper secondary education.
- Provide the most disadvantaged youth access to closely monitored early activation and job-search assistance programmes. A closer co-operation between schools and public employment services in the form of early career counselling within lower or upper secondary schools or outreach programmes could help to identify school leavers with difficulties in finding a job.
- Make the system of continuous training less complicated and less stringent and facilitate the access of small firms to continuous training. Improve the options of firms as to the choice of training provided in order to ensure that the training meets the actual training needs of the firms, hence rendering subsidies to continuous training more effective.
- Introduce training grants to individual adults, for instance in the form of vouchers covering course fees and/or allowances to cover indirect costs such as foregone wages. For such systems to be effective though, guarantee provider quality, for instance by ensuring that accredited training providers meet strict quality standards.

Improving the efficiency of the matching process

- Ideally, the responsibilities for funding of unemployment benefits and for managing the public employment services should be assigned to the same jurisdictional level (the central government). If this is not possible, introduce comprehensive monitoring and evaluation of employment services at the regional level, based on quantitative output indicators or targets. This could be combined with qualitative studies of placement successes and their impacts on job-seekers' employability following former unemployed over time.
- Benefit payment should not be paid retrospectively for the period prior to registration and the first full interview should be mandatory at the time of registration. Furthermore, increase the frequency of reporting of job search activity. Consideration should be given to reducing the duration of unemployment benefit entitlements.

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