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Dual labour markets and the tenure distribution: Reducing severance pay or introducing a single contract☆

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HIGHLIGHTS

- We evaluate the effects of the 2012 Spanish labour market reform.
- We concentrate on the changes introduced regarding employment protection.
- This reform reduces unemployment by 10.5% and job destruction by 7.5%.
- It smoothes the tenure distribution due to the decrease in the severance cost gap.
- We find that a single contract is cheaper and more effective to decrease duality.

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ABSTRACT

This paper evaluates Spain's 2012 labour market reform concerning the reduction in severance pay from 45 to 33 days of wages per year of seniority and the introduction of a new subsidised permanent contract. We also compare this policy with the introduction of a single open-ended labour contract with increasing severance payments for all new hires. We use an equilibrium search and matching model to generate the main properties of this segmented labour market. Our steady-state results show that this reform will reduce unemployment (by 10.5%) and job destruction (by 7.5%). However, in terms of wage subsidies, the cost of implementing this reform will be very high. A cheaper and more effective way to decrease the duality in the labour market could be to eliminate temporary contracts and introduce a single contract. Unemployment and job destruction in this case could be reduced by 31.5% and 35%, respectively. Most interestingly, tenure distribution could be even smoother than under the designed reform, as 22.5% more workers could have tenures of more than three years and there could be 38.5% fewer one-year contracts. The transition shows that both policy measures would benefit a majority of workers: only 7.4% would experience a decrease in tenure under the approved reform (5.5% in the transition to the single contract) due to the improvement in job stability.

1. Introduction

The "Great Recession" has once again revealed the poor performance of dual labour markets. The most striking case is that of the Spanish labour market. Up until recently, this was one of the most dynamic markets in the Euro area (EA). During the decade preceding the current crisis, and according to the European Labour Force Survey, almost one-third of the total job creation in the EA occurred in Spain. However, during the current crisis, Spain has recorded the highest rate of job destruction, particularly with regard to temporary jobs, thus leading to a huge increase in the unemployment rate from 8% in 2007 to 26% in

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2012.[1] According to Costain et al. (2010), Spain provides a high degree of external protection, but only for workers in permanent contracts (PCs), a factor that partially explains the enormous volatility in employment. In fact, the gap between the severance payments of workers with PCs (45 days of wages per year of seniority (p.y.o.s) for unfair dismissal) and temporary workers (8 days of wages p.y.o.s) accounts for almost 61% of total job destruction over the period 2008–2012, when temporary contracts (TCs) have been used as the basic adjustment mechanism (see Bentolila et al., 2012).

Apart from the huge employment volatility, the basic consequence of this dual character of the Spanish labour market is the existence of a bimodal distribution of tenure: there exist a significant number of workers with very short tenure on the job, basically those hired under a TC, whereas workers with a PC exhibit a totally different distribution, with a large percentage of them enjoying tenures of more than ten years in the firm (see Fig. 1).[2] Furthermore, there exists some clear evidence showing that permanent workers are more productive than temporary workers. For example, Berton and Garibaldi (2012) assume that workers employed in PCs are much more involved in professional training than workers employed in TCs based on the empirical evidence offered in Bassanini et al. (2007) and European Commission (2010). Dolado et al. (2012) provide the same kind of argument and show that a high turnover rate in TCs may decrease the probability of investing in specific human capital or receiving firm specific training while in a temporary position, which could lead to lower productivity among workers with TCs, and to overall lower aggregate productivity given the high degree of persistence of this labour market segmentation.[3] In fact, using Spanish data, Albert et al. (2005) found that workers with only TCs were less likely to receive firm-provided and/or financed training than those with PCs, and also OECD (2002) found that having a temporary job had a negative impact on the probability of participating in training.

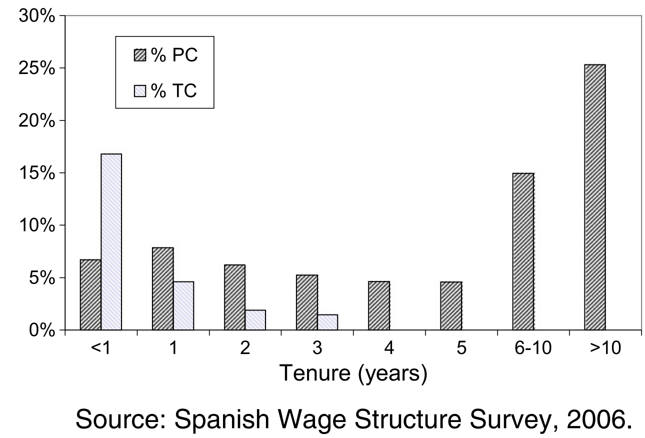

Fig. 1. Distribution of tenure by type of contract in Spain.

To reduce these perverse consequences of the dual labour market structure in Spain, different governments have launched several labour market reforms over the past twenty years (see Bentolila et al. (2008) for a summary). In 1997, permanent employment-promotion contracts (PECs) with lower severance costs were introduced for some worker categories. In addition, permanent job creation, either by directly hiring workers under PECs or by converting TCs into PCs, was heavily subsidised through substantial rebates in social security contributions. The 2006 reform extended these subsidies to more worker categories. In fact, Spain devotes more resources to this type of active labour market policy (0.3% of GDP, on average, over the past ten years) than most other European countries. However, García-Pérez and Rebollo (2009) have found that these measures have had negligible effects on both the temporary employment rate and the TC–PC conversion rate.

Given the huge increase in the unemployment rate and guided by the idea of "flexicurity" (see, for example, Boeri et al., 2012), the present Spanish government has launched a far-reaching labour market reform ("the 2012 Reform"), comparable in its importance only with the reform that liberalised TCs in 1984. This reform has introduced major changes in external and internal flexibility by bringing them closer to the modus operandi of the rest of Europe. Regarding internal flexibility, the reform allows for an internal devaluation by facilitating the adjustment of hours and wages to changes in a firm's economic conditions as an alternative to job destruction. Regarding the external aspect, there has been a considerable reduction in severance payments for unfair dismissals, from 45 to 33 days of wages p.y.o.s, bringing this indemnity closer to the mean OECD compensation, which is 21 days of wages p.y.o.s (See OECD, 2013).[4] Moreover, the new definition of dismissal due to economic reasons will allow firms with financial difficulties to use such reasons more easily. In addition, the reform introduces a new PC, which is referred to as the "entrepreneurs' permanent contract" (EPC), with a one-year probationary period, zero severance costs during such period and large wage subsidies for younger and older workers hired by small firms.

An alternative strategy to combat the dual character of the Spanish labour market is the introduction of a single open-ended labour contract (SC) for new hires, with severance payments increasing with seniority. In the document "Proposal to Restart the Spanish Labor Market" (see Andrés et al., 2009), a group of Spanish economists argue that severance pay should increase steadily to prevent massive redundancies before the deadline when a TC has to be converted into a PC (between the second and the third year in Spain, depending on the contract type). These economists propose replacing the existing system of TCs and PCs with an SC for new hires, where severance payments smoothly increase with seniority until reaching a value similar to the mean OECD indemnity.[5] Based on this notion, Bentolila and Jansen (2012) suggest replacing the recently introduced EPC's severance cost arrangement with an increasing indemnity that starts at a low level but reaches, after three years, the same amount that would have been awarded under the present structure. This amendment would not only reduce the burden of the fiscal externality generated by the intensive use of wage subsidies, but would also smooth the tenure distribution, which could have important consequences for firms' investments in human capital and aggregate productivity.

This paper evaluates all of these alternatives, focusing on the changes in the design of severance pay introduced in the Spanish 2012 labour market reform and comparing its expected effects with those that would prevail under an SC for new hires. Accordingly, we use an equilibrium model of job creation and destruction of the search and matching type that extends the one proposed in Mortensen and Pissarides (1994) by introducing certain elements to capture the specific features of the Spanish labour market: (i) the existence of a *segmented labour market* with two types of jobs (permanent and temporary) that differ in productivity, in the maximum length of the contract and in the associated severance costs; (ii) endogenous job conversion of TCs into PCs;

[1] The Spanish Labour Force Survey shows that during the first three years of the current crisis (2008–2010), more than two-thirds of the total number of dismissed workers had a temporary contract.

[2] According to the European Labour Force Survey, the share of temporary workers over total employment in the last decade has been 32.1% in Spain, whereas it is just 14.4% in the European Union.

[3] García-Pérez (2010) shows that, until the year 2008, five years of seniority and more than seven contracts were, on average, necessary to reach a PC. Furthermore, almost 40% of the workers who had a temporary job at age 20 still had one at age 40.

[4] The previous 2010 reform took steps to narrow the gap between the severance costs of PCs and TCs by extending the use of PECs for many worker categories and by progressively increasing the severance costs for TCs from 8 days of wages p.y.o.s. in 2011 to 12 days of wages p.y.o.s. in 2015.

[5] Similar proposals have been advocated by Blanchard and Tirole (2004) and Cahuc and Kramarz (2005) for France, and Boeri and Garibaldi (2008) for Italy.