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Highlights in this issue:

- Spain shows the highest share of fixed-term contracts in the EU.
- Temporary contracts have increased labour market flexibility.
- But their excessive use may imply negative externalities.

Fixed-term contracts in Spain: a mixed blessing?

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Introduction

According to economic literature (Doeringer and Piore, 1985; Amuedo-Dorantes, 2000), a segmented labour market is divided into primary and secondary sectors. The primary sector features better working conditions, employment stability and prospects for advancement. In turn, workers in the secondary sector often hold temporary contracts against their preferences and a significant part of them tends to be trapped in this sector.

Following reforms implemented in the mid-1980s, Spain has presented the characteristics of a formally segmented labour market. Specifically, permanent contracts offering a high degree of on-the-job protection have co-existed with temporary contracts with almost no restriction on hiring and firing. Temporary contracts have come to account for nearly one third of total employment, more than twice the EU average. Although fixed-term contracts have been instrumental in increasing employment in Spain by providing labour flexibility to deal with changing economic conditions, there are indications that the segmentation between permanent and temporary workers might imply negative spillovers on human capital investment and other elements of flexibility such as labour mobility.

The following sections aim at describing in a concise way the main distinctive characteristics of labour market segmentation in Spain and its evolution over the last twenty years.

Origin and evolution of the labour market segmentation in Spain

In the first half of the 1980s, high unemployment in Spain triggered the adoption of deregulating measures aimed at increasing labour market flexibility. Although these measures were seen as effective in reducing unemployment, their implementation raised concerns among unions in relation to working conditions and employment stability. As a result, the 1984 labour market reform introduced significant changes in the regulation of fixed-term contracts while keeping untouched the employment protection legislation for permanent workers, giving rise to the so-called "flexibility at the margin". Specifically, the prevailing "causality principle" for fixed-term contracts

In 1984 fixed-term contracts were deregulated...

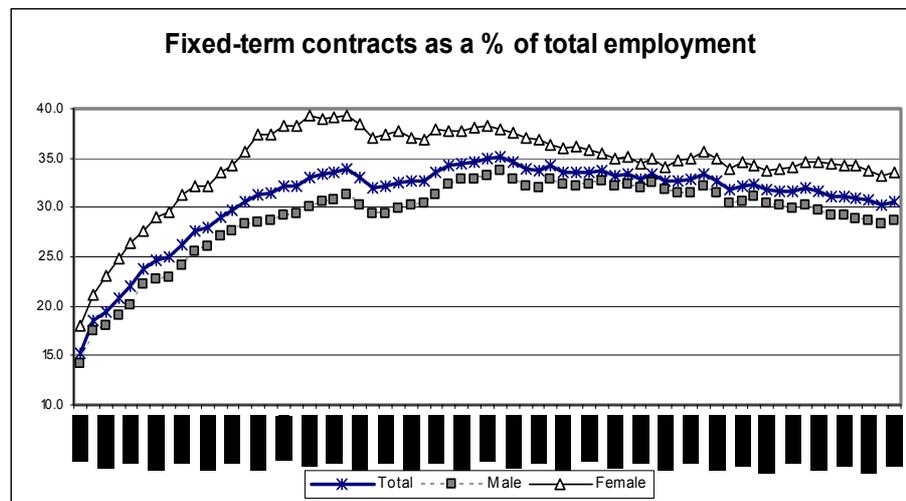
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(i.e. fixed-term contracts could only be used for temporary needs of the firms) was weakened and companies were allowed to hire non-permanent workers to carry out their permanent activities.

...as a result, the share of fixed-term contracts increased dramatically to around 30% at the end of the 1980's.

Although temporary contracts had always been permitted, their unconstrained availability represented a major innovation in the Spanish industrial relations. The most important new temporary contract brought about by the 1984 reform was the "employment promotion fixed term contract", which had to last at least for 6 months and could be renewed up to 3 years. After this maximum period, the firm had to offer a permanent contract; if this were not done, the vacancy could not be filled by another temporary worker. The result of this reform was a dramatic increase in the use of fixed-term contracts during the second half of the 1980s: from a share lower than 10% before the 1984 reform to near 30% in 1989 (see graph 1) and a first peak at around 34% in 1992. Despite the legal changes introduced since 1994 restricting the use of temporary contracts (see below), the proportion of fixed-term contracts has only decreased slightly since then and appears to have stabilised at around 30%.

Graph 1



Source: INE (EPA)

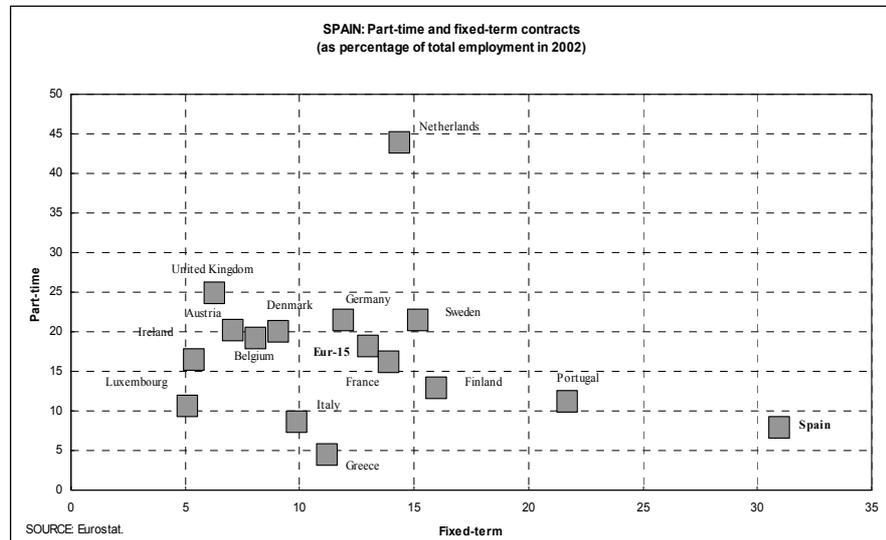
Construction shows the highest share: nearly 60% compared to 20% in the EU

All sectors of activity in Spain record a high share of fixed-term contracts compared to the EU average. Nevertheless, more than 50% of temporary jobs concentrate in six sectors: agriculture, construction, wholesale and retail trade, hotels and restaurants, domestic services and public administration. Construction shows by far the highest percentage of fixed-term contracts (nearly 60% compared to 20% for the EU) and it is also the sector which most contributed to maintaining the overall share of temporary jobs in recent years. By specific groups, nearly 50% of temporary workers are below 30 years old while females show a higher share of fixed-term contracts than males. As for educational level, workers with less schooling are the most likely to be employed on a temporary basis, although fixed-term contracts are also common for university graduates (the respective shares stand at around 42% and 24%).

Flexibility in the use of labour rather than wage differentiation seems to be behind the success of temporary contracts in Spain.

The success of fixed term contracts in Spain is still a matter of discussion among experts. Given the strict regulations on permanent employment, it is generally agreed that the flexible use of labour in face of changing economic conditions and the reduced costs of firing have played a prominent role in the success of fixed-term contracts while wage differentiation has only been a secondary element. In this latter respect, there are no recent and reliable data, but some researchers have estimated a wage differential in favour of permanent workers of around 10% (Jimeno and Toharia, 1993; Bentolila and Dolado, 1994). Likewise, it is broadly accepted that the scant use of part-time contracts in Spain is closely linked to the high share of fixed-term contracts: the flexibility provided by part-time contracts in other Member States appears to be achieved in Spain by a disproportionate use of temporary contracts (see graph 2).

Graph 2



Since the second half of the 1980s, the diffusion of fixed term-contacts gave rise to various concerns. On the one hand, the lack of employment stability has been criticised as detrimental to workers' welfare. On the other hand, such insider-outsider framework can produce negative effects on wage setting (i.e. when wage formation is controlled by insider employees protected by high firing costs, permanent workers may be able to negotiate higher wages given the presence of temporary workers or outsiders; see *Jimeno and Toharia (1993)*, *Bentolila and Dolado (1994)* and *Lindbeck and Snower (1989)*). At the same time, the 1992 downturn showed that the high share of temporary contracts did not prevent firms from dismissing permanent workers.

Different attempts to reduce segmentation in the 1990's.

This situation led the authorities to carry out several labour market reforms during the 1990s, which basically aimed at reintroducing some constraints on the use of fixed term contracts while easing employment protection legislation for permanent workers. In 1994, the "employment promotion fixed-term contract" was restricted to some specific groups (workers over 45 and long-term unemployed) whereas the "causality principle" was to apply to the "standard" fixed-term contracts. The 1997 reform entailed the complete elimination of the "employment promotion fixed term contract" and the approval of a new contract on permanent basis with lower dismissals costs. Finally, in 2001 dismissals costs for temporary contracts (8 days per year worked) were introduced.

Sticky share of fixed-term contracts and high turnover

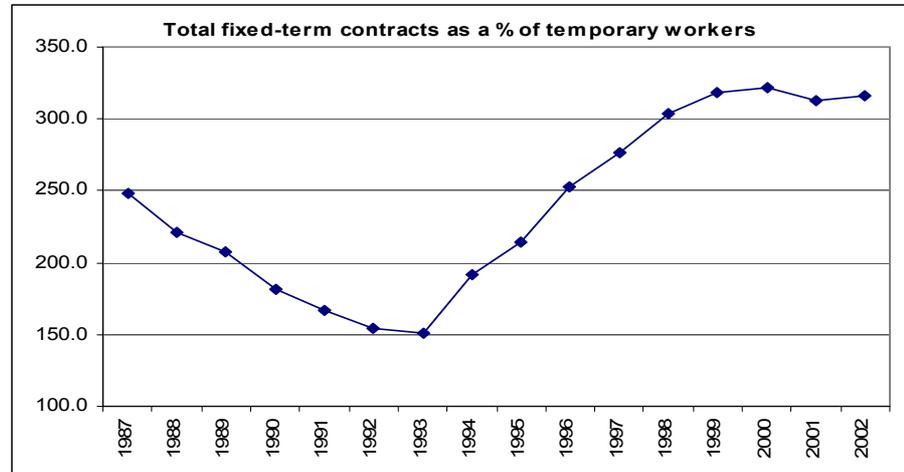
Measures implemented in the 1990s seem to have increased the turnover of fixed-term contracts.

As can be seen from Graph 1, the reforms implemented in the last ten years do not seem, at first sight, to have lowered significantly the share of temporary contracts. However, two aspects deserve further attention.

The development in the use of fixed-term contracts has been accompanied by a high and increasing contract turnover (see graph 3). In this respect, the lifting in 1994 of a minimum time-limit on the duration of fixed-term contracts seems to have induced employers to roll-over an increasingly large number of contracts for increasingly shorter periods of time. Thus, in 2002 there were approximately 13

million fixed-term contracts of which around 30% were to last less than one month and nearly 45% less than three months. By contrast, the restoration of the link with the temporary needs of the firm does not seem to have prevented employers from continuing to resort to “ordinary” fixed term contracts for covering permanent activities (i.e. breaching the causality principle). Although in the period 1995-2002 the share of temporary contracts in Spain decreased by 4 p.p., it continues to be more than twice the EU average.

Graph 3



Source: INE and INEM

Although the share of temporary contracts in the private sector has decreased partly due to the 1997 new permanent contract with lower dismissal costs.

However, it is worth noting that this evolution reflects a significant decline (from nearly 40% to 32%) of the share of temporary contracts in private sector employment and even a more significant rise (from 15% to around 22%) of the share in public employment. The reduction in the private sector is generally explained with the successful introduction of the new permanent contract in 1997. The lower dismissal costs and the social security contribution rebates offered by the new contract have worked as incentives to promote employment on a permanent basis. In contrast, the increase registered in the public sector was due to the budgetary restrictions imposed in the second half of the 90s on the replacement of civil service vacancies.



Transitional periods and the use of fixed-term contracts as a screening device

Fixed-term contracts can be used as a screening device.

A key element to assess properly the impact of temporary contracts in terms of social welfare is whether workers with fixed term arrangements are trapped in this situation for a long time or, on the contrary, can obtain a permanent job after a short period. In the latter case, temporary work arrangements would be used as screening device instruments, which allow employers to observe temporary workers' performance. Thus, successful workers obtain a permanent contract after a probation period holding a fixed-term contract (Guell-Rotllan and Petrongolo, 2000).

Although the transitional periods from a temporary to a permanent job seem to have increased since 1987.

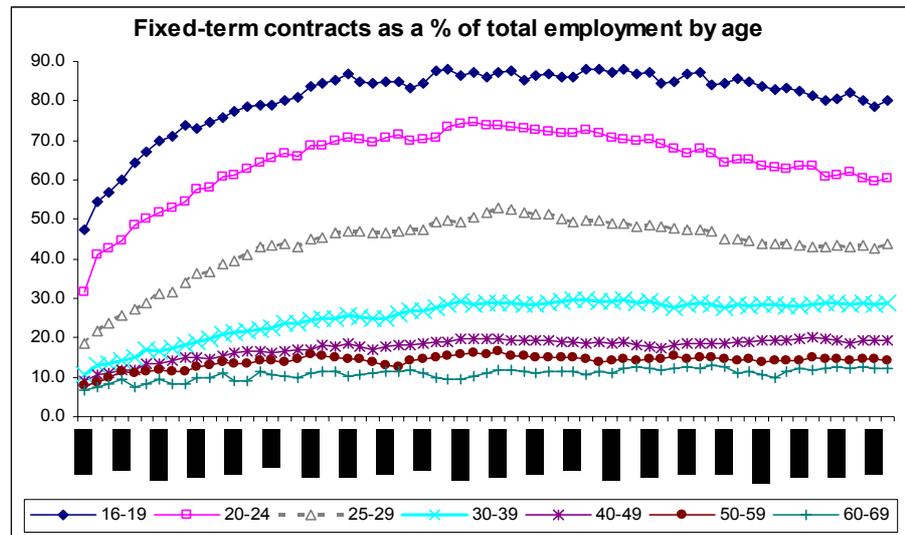
In the Spanish case, it must be pointed out that a non-negligible share of workers with fixed-term contracts remains in this situation one year later. This percentage has tended to increase during the period 1987-2001: from around 55% and 45% to nearly 70% and 65% for males and females, respectively. In addition, the share of workers with temporary contracts shifting to permanent jobs one year later has decreased in the same period: from approximately 20% to around 15%. These figures suggest that the transition from a temporary to a permanent post is in general rather slow and is longer at present than in previous years. This empirical insight seems to be confirmed by recent researches (Amuedo-Dorantes, 2000).

However some mobility across age cohorts is observed.

Nevertheless, some mobility among age cohorts can be observed, indicating that at least part of the share of fixed-term contracts might be used as a screening device. In 1995, 29% of those workers born between 1966 and 1970 had fixed-term

contracts while 25% had permanent posts. In 2000, for the same group, these percentages were 20% and 49% respectively. These results would be consistent with the distribution of fixed term contracts by age groups shown in graph 4.

Graph 4



Source: INE (EPA)

Fixed-term contracts play an overall positive role by easing labour market rigidities.

But their excessive use in the Spanish case may deter human capital while hampering other elements flexibility.

Further steps in line with the 1997 new permanent contract and a wider use of part-time arrangements seem advisable. Sectoral measures and a stricter control on fixed-term contracts would be desirable.

Conclusions

Overall, fixed-term contracts play a positive role by providing a buffer which allows firms to cope with economic fluctuations. In the presence of labour market rigidities and strong unions, liberalisation at the margin may represent the most feasible option from the political point of view. In addition, temporary arrangements can be used as screening devices and may be transformed into permanent jobs after a certain period of time. Finally, temporary jobs can sometimes facilitate a higher outflow from unemployment, which can benefit some specific groups of workers and is clearly a better option than remaining unemployed.

However, their generalised use coupled with a high turnover rate of temporary jobs gives little incentive either for employers or workers to invest in human capital (Dolado et al. (1999) estimate that the probability of receiving on-the-job training is significantly lower for workers with fixed-term contracts). In addition, since the share of temporary contracts is the highest among young workers who ought to be more mobile geographically (see graph 4), labour mobility might be also negatively affected. The slow transition periods from temporary to permanent posts described in the previous section imply that it takes more time for young people to find a stable employment and establish themselves as independent households, which in turn might help partially explain the low fertility rates registered in Spain in the recent past (L.Toharia and M.A.Malo, 2000).

As for policy recommendations, four kinds of actions can be identified in order to tackle segmentation in the Spanish labour market. Firstly, given the success in promoting employment on a permanent basis achieved by the new open-ended contract with lower firing costs introduced in 1997, further steps in this direction appear advisable. Secondly, despite the recent implementation of some legal mechanisms of control, fixed term contracts are often used beyond their legal purpose of covering temporary needs of firms. Therefore, a closer monitoring of the use of fixed-term contracts might be appropriate. Thirdly, measures targeted at promoting part-time contracts should help reduce the share of temporary contracts while promoting female participation. Finally, apart from these horizontal measures, the considerable concentration of fixed-term contracts in some particular sectors may call for specific policy measures addressed to these activity branches.



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