

*STUDIES ON GROWTH WITH EQUITY*

**SPAIN**

**QUALITY JOBS FOR A NEW ECONOMY**

EXECUTIVE SUMMARY AND POLICY RECOMMENDATIONS:  
PREPRINT EDITION

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# Executive Summary and Policy Recommendations

## *The exceptional increase in Spain's unemployment...*

In the aftermath of the global financial and economic crisis in 2008, the output performance of Spain was similar to that of other large advanced economies: in the second quarter of 2009 real GDP fell by 4.4 per cent compared with the previous year, which is less than the 5.1 per cent contraction in the EU-15. The impact of the global crisis on the labour market, however, has been much stronger than in most other EU countries. In the first quarter of 2011, the unemployment rate stood at 21.3 per cent, that is over 13 percentage points more than in 2008 – the most dramatic increase among advanced economies. Youth and workers with temporary contracts have been disproportionately affected by the increase. For instance, 45 per cent of labour market participants aged 15–24 were unemployed in the first quarter of 2011.

## *...reflects the simultaneity of the global crisis and the end of a period of unbalanced growth.*

One factor behind the exceptional increase in unemployment is the twin nature of the crisis in Spain. The country has had to cope simultaneously with the global crisis and the country-specific crisis associated with a growth model which relied excessively on construction and housing. In the decade leading up to 2006, when real GDP in Spain grew more than twice as fast as the EU-15 average, employment grew by more than 50 per cent and the unemployment rate fell from over 22 per cent in 1996 to 8.5 per cent in 2006. However, construction and real estate activities accounted for more than a third of total employment gains over this period. Similarly, residential

investment and non-housing-related construction accounted for more than two-thirds of total investment growth in the decade preceding the crisis.

But the domestic crisis had deeper roots. In particular, the unbalanced growth pattern was fuelled by a financial system in search of short-term returns. Many regional banks (the so-called *cajas*) took excessive positions in the housing sector. Also, many of the jobs created during the expansionary period were low skilled: despite significant improvements in educational attainment, close to 15 per cent of jobs in Spain were in low-skilled or elementary occupations, compared with less than 10 per cent in most of the neighbouring EU countries. Despite several reforms, the incidence of temporary employment rose to nearly 35 per cent prior to the crisis, the highest figure among advanced economies. These developments had important implications for overall productivity and competitiveness, which have deteriorated dramatically over the past decade. The model eventually became unsustainable.

***So the challenge is to make a structural transformation of the growth model, while addressing the deteriorated employment situation.***

The challenge for Spain is thus to make a structural transformation towards a new, more balanced economy, while at the same time reducing unemployment. It is indeed crucial not to replicate the same growth patterns which prevailed before the twin crises, which had moved the country away from its true source of comparative advantage.

A transformation of this nature will not be easy – it entails restructuring of firms and jobs associated with the previous growth model. Yet, if accompanied by well-designed macroeconomic, labour and social policies, it can lead to the creation of new dynamic firms and quality jobs commensurate with the prevailing skills levels, especially among qualified young graduates.

***There are early indications of a positive transformation taking place...***

Underlying the overall weak aggregate picture, there are a number of positive developments, which, if properly supported, could lay the foundations for a solid recovery and lower unemployment. GDP growth returned to positive

territory in the third quarter of 2010 and is expected to grow at an annual rate of 0.8 per cent in 2011 and 1.5 per cent in 2012. Since early 2010, exports have grown at an annual rate of over 15 per cent, driving the recovery. Already at the beginning of 2011, exports were 3 per cent above their pre-crisis levels, with exports of relatively high value-added products – e.g. chemicals, pharmaceuticals, metals and machinery – exhibiting particular dynamism. Likewise, investment in machinery and equipment is starting to pick up. Job gains in sectors where growth can take a firm hold have started to offset the continued job losses in other sectors, such as construction.

These patterns represent a marked departure from pre-crisis growth, which was driven by low-skill-intensive output and debt-led domestic demand – notably housing investment. External competitiveness has also improved somewhat. More generally, counter to prevailing wisdom, wage levels do not seem to be a constraint on the shift to a new growth model in Spain. Nor were wages at the root of declining competitiveness.

### ***...and this can be accelerated through a coherent policy strategy, including a number of recent measures...***

These positive recent developments will be insufficient for ensuring a successful transition. The Government and social partners have made strides over the past two years to facilitate the structural transformation of the Spanish economy:

- *Law on Sustainable Economy (Ley de economía sostenible)*: the law, which entered into force in March 2011, provides a strategy for a new growth model based on innovation, technology, internationalization of business, product market competition and enhanced efficiency of public administrations in order to enable economic, social and environmental sustainability.
- *Labour market reforms*: Over the course of 2010–11, a series of labour market reforms were undertaken with the aim of promoting job creation while facilitating transition to a new growth model. The reforms: (i) address overly high rates of temporary employment through adjustments in dismissal procedures as well as modifications in the rules governing temporary contracts; (ii) promote internal flexibility (adjustments in wages and working hours) instead of external flexibility (redundancies, especially of workers on temporary

contracts); (iii) increase financial subsidies for firms hiring young people, the less skilled, women and long-term unemployed; and (iv) support labour market intermediation and delivery of employment services.

- *Pension reform:* The pension reform of 2010–11 in Spain is particularly noteworthy in that it highlights the importance of collective bargaining and social dialogue with employers and unions. Furthermore, the new pension reform also requires a review of the parameters to be conducted every five years.
- *Internal flexibility and collective bargaining:* In June 2011, the Spanish Government adopted new labour legislation (Royal Decree Law 7/2011) which aims to reform the collective bargaining structure in Spain and improve internal flexibility. The main features of the legislation are: (i) a widening of the scope of opt-out clauses for firms facing financial and economic difficulty; (ii) provisions to encourage firm-level negotiations, particularly over hours and wages; (iii) possibility for firms to distribute 5 per cent of the total working time in a flexible manner; and (iv) a modification to the “ultra-activity” of collective agreements – where the old agreement remains applicable beyond its expiry if a new agreement cannot be reached. The new law introduces possibilities for arbitration in case of disagreement between social partners and stipulates that new agreements must be implemented within 8 months (for agreements with a scheduled duration of 2 years) or 14 months (for the rest) of the end of old agreements. However, the Government passed this legislation after the social partners were unable to reach an agreement following a lengthy period of negotiation.

### ***...and hopefully a series of new measures, first to facilitate the transition to a more productive economy...***

It is crucial to complement these recent measures with further efforts to support structural transformation. The recent measures represent an improvement over the initial policy response under the so-called *Plan E*, which was general in nature – more transfers to local authorities, spending on infrastructure, untargeted cash transfers— and did not address the underlying imbalances. There is now wider awareness of the depth and nature of the

crisis. But a more comprehensive strategy, building on recent measures, is now needed to boost recovery and create decent work opportunities.

There is significant scope for making product markets more productive and open to innovation, notably by:

- *Ensuring the financial sector serves the needs of the real economy:* The financial sector bears significant responsibility for the crisis. It facilitated the easy access to credit for households and firms that helped fuel the asset bubble. The Spanish Government has slowly taken some steps to reform the financial sector, notably by encouraging consolidation among savings banks or *cajas* and by raising capital requirements (Royal Decree Law 2/2010). However, many promising enterprises continue to face credit constraints, therefore hampering their job creation and growth opportunities. In the short term, the Official Institute for Credit (ICO) needs to work closely with credit-related institutions to examine ways – in addition to those announced earlier in the crisis – to ensure that firms are able to access financing and take advantage of new growth opportunities. Also, it is surprising that the EU recommendations to moderate remuneration practices in the financial sector have not yet been implemented in Spain – almost four years after the start of the crisis. Such a slow reaction not only delays adjustment in the financial sector, but also creates the impression that the burden of the crisis is unfairly shared.
- *Strengthening export base:* In Spain, exports account for less than 25 per cent of GDP, the second lowest share in the EU following France and well below the EU-27 average of close to 40 per cent. The potential to leverage further the recent growth in exports is significant and there is scope to build upon recent developments. Encouraging further the development of sectors that are more intensive in the use of technology would be an important step in the sustainable development of the export sector. Governmental measures aimed at facilitating the internationalization of firms – within the present multilateral context – would help. Non-EU destinations, where most of the trade growth is happening, currently account for less than a third of Spanish exports. Diversifying foreign trade relationships, especially with emerging and developing countries, could help leverage additional gains in export shares.

- *Reducing administrative burdens and barriers to business start-up:* Administrative burdens for business start-ups are still significant in Spain and substantially greater than in other advanced economies. Despite progress being made in simplifying and streamlining start-up requirements, Spanish entrepreneurs still have to overcome a large number of administrative burdens to activate a firm.
- *Targeting incentives to foster improved innovative capacity and increased productivity:* The Government has made important strides in this area of late, such as the asset redemption leeway for corporate tax payers. However, promoting investment in high value-added sectors will require better targeting in the form of conditional investment initiatives on activities with significant spillover effects, such as technological advances, renewable sources of energy and green growth initiatives. The recent example of the Republic of Korea's support for its electronics industry is an important case in point.

### ***...second to align education, skills and training policies to the new growth model...***

While improvements in the educational system have occurred, especially as regards tertiary attainment, the quality of outcomes leaves much to be desired. According to the Programme for International Student Assessment, Spanish students perform significantly below the OECD average in terms of reading, mathematics and science skills, ranking near the bottom in all three categories. Part of this trend might be explained by the fact that many of the jobs created in Spain prior to the crisis did not require higher level qualifications. However, as structural transformation takes place, increased efforts to improve educational outcomes will be called for.

Similarly, there is likely to be a rise in the rate of job transition, as workers move from one sector to another. Future gains in productivity, as well as the chance of re-employment, will depend on workers having the skills and training that match the needs of the new economy. However, although total spending on active labour market programmes (ALMPs) is high in relation to the OECD average, a disproportionate share is spent on hiring incentives rather than on skills development.



This calls for the alignment of education, skills and training initiatives with the need for effective and fair employment transitions, through:

- *Ensuring a responsive and quality education system:* Renewed efforts to improve outcomes will be essential as the economy moves towards a new growth path. Also, there is significant scope for strengthening the links between education institutions and labour markets (see below for more details on possible avenues for achieving this).
- *Improving access to high-skilled occupations:* Qualification-related entry barriers are high in Spain relative to other EU countries, and a large number of exclusive rights continue to be granted to professionals in areas such as legal services and accounting.
- *Emphasizing training initiatives in ALMPs:* Less than a quarter of ALMP spending in Spain is on training, considerably less than in other countries. Yet, employment outcomes of training initiatives are relatively high, in some cases closed to two-thirds. Reallocation of resources from existing hiring incentives towards training would be a welcome initiative. Engaging local employers through greater use of public – private partnerships should also improve outcomes. Indeed, positive returns to training results often occur over the longer term and can be quite strong if well designed.

### ***...third, to promote active policies while supporting jobseekers adequately...***

During the current period of structural transformation, the benefits system will continue to play an important complementary role to activation strategies by providing income support to unemployed workers. In this regard, the public employment service (PES) will be central to facilitating the movement of workers from unemployment into employment. Yet, despite efforts to recruit more staff, the client-to-staff ratio is nearly 450 in the Spanish PES – among the highest in the EU countries with available information. Urgent improvements are thus needed in the design and delivery of benefit support, notably:

- *Reinforcing PES:* Additional resources to the PES are needed to improve staff-to-client ratios and ensure that staff are qualified to provide personal attention to jobseekers, and the partnerships

between public and private employment agencies must be made to work better than they have in the past. Currently, spending on the PES as a share of ALMPs is less than 18 per cent, while countries such as Germany spend more than 35 per cent. Meanwhile, the Government has made significant strides in the use of computer-based technology to administer unemployment benefits and subsidies. Going forward, this should free up resources for reinforcing the PES in Spain and activation measures more generally.

- *Improving activation strategies:* Regular interviews between jobseekers and PES officers and opportunities to participate in programmes after a set period of unsuccessful job search are key – consistent with additional resources for PES staff, as per above. Recent efforts to ensure that benefit levels for the long-term unemployed are adequate – especially important in view of the stagnant employment levels at the macroeconomic level – and to ensure that recipients do not reject suitable job offers or training opportunities are positive first steps.
- *Improving targeting of hiring subsidies:* The existing suite of hiring subsidies is too broad in nature. The effectiveness of targeted measures of this nature is greater when they are aimed at addressing a particular disadvantage, e.g. low-skilled or disadvantaged jobseekers, rather than an entire group.
- *Continuing to improve coordination efforts:* There is a lack of coordination between different regions and no coherent national strategy for providing effective public employment services. The role of the National Council, which has been given the task of coordinating activation policies across regions, needs to be reinforced. Consideration could be given to linking financial transfers to PES offices with their placement performance, as has been done in other advanced economies, such as New Zealand and Switzerland.

### ***...fourth, a comprehensive strategy to ensure that no youth is left behind...***

The onset of the crisis has only exacerbated a number of challenges already confronting Spanish youth. There is an urgent need for a comprehensive and inclusive strategy that centres around: (i) reducing drop-out rates; (ii) keeping

youth in contact with the labour market; and (iii) tailoring support to the needs of youth. Ensuring that Spanish youth play a central role in the transition towards a new growth model will have important social and economic implications. To address these challenges, the Government should consider the following:

- *Ensuring that no youth is left behind:* Each young person who is not in school should be offered some form of “activation guarantee”, i.e. the opportunity to work, train or engage in some form of activation measure. The situation regarding youth in Spain represents a major challenge for social cohesion. It requires a comprehensive strategy to ensure that all young jobseekers are offered one of the following opportunities, depending on the specific situation of each young person – continued schooling, job-search support, a reinsertion chance, training, a subsidized job, business start-up opportunities, or even possibilities to acquire work experience in other countries.
- *Improving school retention rates:* The share of youth (aged 18–24) with at most lower secondary education and not in further education or training – at more than 28 per cent – is more than twice the EU-27 average. Efforts are urgently needed to reduce high-school drop-out rates by encouraging young people to stay in school. Another possibility would be to make the preparation of education and training plans compulsory for youth. In Denmark, 15–17 year olds are required to make such plans in collaboration with their parents, school and guidance centre, and the plan needs to cover such areas as further education, training, employment, internship and volunteer work.
- *Enhancing labour market attachment of youth via effective PES:* Since many youth are not eligible for unemployment benefits or subsidies, registration with PES is often low. To help young unemployed workers remain attached to the labour market the Government could consider ways to provide financial incentives for youth to engage and register with PES. This could be complemented by mandating a lower PES client-to-staff ratio and more frequent interviews for disadvantaged youth, as is the case in Germany.
- *Ensuring youth have access to training:* In comparison with other EU countries, fewer youth in Spain have access to training. Yet, labour

market integration of training initiatives is highest in Spain among youth. The Government needs to give preferential access to training for low-skilled youth. Existing programmes such as *Escuelas Taller* and *Casas de Oficios* could also be reinforced.

***...and fifth, by continued efforts to reduce labour market duality while promoting more and better jobs.***

It will be critical to ensure that the right set of labour market institutions is in place to facilitate adjustment and promote job creation. Yet, keeping in mind the lessons of the past, policies must also consider the quality of the jobs being created. In this regard, the reforms of 2010–11 are significant achievements in their own right. However, as a number of parameters are yet to be defined, it will be important to bear in mind the importance of job quality when moving forward. Although the cost of dismissal is reduced at the time of job separation, the monthly labour cost is now higher due to all employers having to make monthly contributions – which could amount to around 3 per cent. Careful consideration must therefore be given to the manner in which the new system is implemented:

- *Extending access to the Workers' Capital Fund to temporary workers:* If the Fund is applied in isolation to open-ended contracts – which is currently the case – it could encourage firms to hire individuals on a temporary contract given the relative increase in hiring costs. Extending access to the Workers' Capital Fund to temporary workers – as is the case in Austria – would equalize the hiring incentives and have the added benefit of promoting mobility and training among temporary workers. This could be achieved by allowing temporary workers to carry forward in the fund the same proportion of total severance pay as workers with open-ended contracts.
- *Monitoring the effects of the Fund on employment and job quality:* It will be important to ensure that the Fund does not increase further the cost of hiring, especially for open-ended contracts. This is particularly relevant at a time when the economy needs to bolster competitiveness and create more and better jobs. The system could be evaluated in a year's time to that effect.

- *Improve financial sustainability of the Fund:* As the case of Austria has demonstrated, the conditions under which workers can receive the lump sum payment of 8 days per year of service will have an important impact on how the funds are used. Indeed, Spain should consider introducing a number of incentives should it wish to encourage workers to carry forward the payment for retirement. Finally, the Workers Capital Fund needs to adhere to stringent investment safeguards to protect the fund from excessive fluctuations while ensuring a stable return.

The combination of the introduction of the Workers' Capital Fund, a clearer definition of "economic grounds" for fair dismissals and the gradual closing of the gap in severance pay between temporary and open-ended contracts should help reduce labour market duality in Spain. However, a number of issues require further consideration:

- *Improving rules governing court proceedings for fair dismissals:* Making dismissal procedures and court proceedings as predictable as possible is crucial for effective reduction of duality and to facilitate job creation. The Netherlands provides an important case in point.
- *Strengthening social protection for temporary workers:* Overall, social protection for temporary workers needs to be strengthened. This is especially important as regards pension rights, including for young people who work as trainees during their studies and part-timers – often women who wish to reconcile work with family life. Countries such as Austria and Denmark show that it is possible to provide social protection to temporary workers without institutionalizing temporary work (both countries have relatively low labour market duality).
- *Re-orienting the current incentive structure governing part-time employment:* The recent introduction of hiring subsidies to promote part-time employment among vulnerable groups, especially youth, is well intended. Policy-makers recognise the potential benefits of being able to adjust hours cyclically, as opposed to adjusting employment. Moreover, part-time employment remains low in Spain (11.8 per cent in 2009) compared with other advanced economies (OECD average of 16.2 per cent in 2009) and can, if combined with adequate social protection measures, offer a much need boost to worker and firm

flexibility. In this respect, efforts to promote part-time employment should focus on closing the benefits gap between full-time and part-time workers, as other countries in the EU have successfully done (e.g. the Netherlands), rather than providing untargeted financial incentives for hiring on part-time contracts.

### ***Effective social dialogue is crucial for unlocking the economic potential of Spain and avoiding social unrest***

Spain has slowly begun to emerge from a deep crisis – one that has highlighted the inadequacies of the previous growth model. Moving forward, success will depend on developing a vision supported by a clear strategy. Such a strategy needs to be inclusive and consistent with fiscal goals – now is not the time for ill-conceived austerity measures. To this end, as highlighted by recent agreements, reforms achieved through social dialogue can be both fair and comprehensive – increasing the coherence between economic and social objectives. An approach of this nature will be central to developing quality jobs for a new economy and addressing remaining challenges:

- *Factors other than wages were lowering competitiveness:* Real wages grew very little in the period prior to the crisis and at a pace slower than its Euro-zone counterparts. It is price increases that drove nominal wage growth, eroding competitiveness. In addition, the decline in competitiveness was due more to the nature of the job growth and investment patterns, i.e. in low-productive sectors such as constructions and real-estate. Keys to improving competitiveness therefore lies not in wage cuts – which would perpetuate the unbalanced growth patterns-- but in improving the quality of employment and investment through a more comprehensive strategy of aligning economic and labour market policies. Euro-area coordination on wage policies is also crucial to avoid a “race to the bottom”.
- *More balanced wage determination process notably through the set up of a body to monitor income developments:* Social dialogue is the natural remit of the determination of wages and working conditions. Recent reforms have widened the scope of enterprise-level bargaining while amending other important aspects of the collective bargaining process, such as “ultra-activity”. It is unfortunate that consensus on the measures was

not possible. However it will now be important to assess their impact in terms of supporting structural transformation – which will require more internal flexibility and job creation in new sectors – while avoiding a spiral of wage cuts. This assessment could be made through the creation of a small monitoring body including experts from government, employers and workers. Similar experiences exist in other countries undergoing structural change. Indeed, discussions on wage-price trends – crucial as they are in view of the need to support structural transformation – have tended to be blurred owing to different perceptions on the trends.

- *Recognition that labour market policies are consistent with fiscal goals is urgently needed:* In some instances, re-orienting policies along the lines discussed will mean shifting priorities in terms of financial resources. It may also mean additional spending in some areas. In this respect, there needs to be a consensus that labour market policies can be highly cost effective and can have important positive spillover effects on future growth and government resources. Cutting active and passive labour spending for the sake of austerity would only derail the current recovery process and prolong the labour market recession. Reaching consensus of this nature will rely heavily on effective social dialogue.

Spain can make a successful transformation to a new economy but it will require placing labour market and social policies at the heart of the recovery. Social dialogue is more important than ever if the vision of a new growth model is to be successfully carried out. It is also vital for averting social unrest.

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