
3.3. What did the reform of severance pay bring?

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1. Motivation

The labour market reforms implemented in Portugal between 2011 and 2014 were unquestionably comprehensive and in-depth. These reforms were carried out as part of the overall Economic and Financial Assistance Programme agreed between Portugal and the Troika in May 2011. The Portuguese package of labour market reforms also ranks as one of the most comprehensive among the European Union countries in recent years. Even though a number of the initial reforms and measures have already been reversed, there is a general understanding that the Portuguese labour market is now considerably more flexible than it was prior to 2011.

Before the reforms, Portugal was an outlier among the OECD countries in terms of stringency of employment protection legislation for individual workers on open-ended contracts. This reflected *inter alia* the high level of severance pay and a very stringent definition of fair dismissal that made particularly difficult for employers to dismiss workers on open-ended contracts. In addition, the Portuguese labour market was also characterised by a large regulatory breach between open-ended and fixed-term contracts, contributing to the high degree of segmentation in the labour market. For workers, this segmentation reduces the incentive to invest in firm-specific skills and has a negative impact on motivation; from firms' standpoint, it increases worker turnover and recruitment costs and hampers productivity.

Employment protection legislation (EPL) concerns the set of legislation that governs the hiring and firing of workers. Typically, it tries to balance between, on the one hand, the need for flexibility that allows firms to adjust the level and composition of the workforce to changing technology and demand conditions and, on the other hand, the need to protect against the costs that are frequently associated to job displacement. These costs are both for workers (earning losses and the possible obsolescence of job-specific skills and experience) and for the society as a whole (unemployment benefits, costs on job-search assistance or on active labour market programmes). EPL

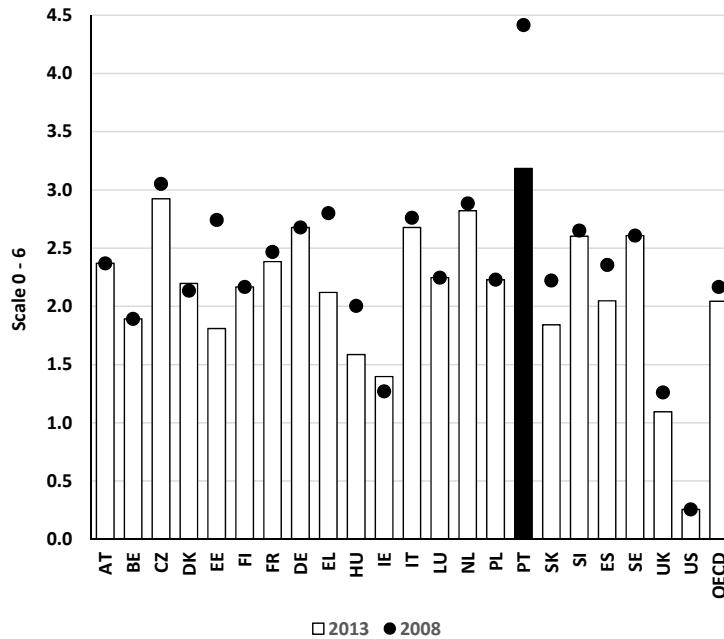


Figure 29: OECD EPL index for the strictness of employment protection to individual and collective dismissals

provides a mechanism that ensures that firms internalise at least part of these costs while avoiding excessive and inefficient worker turnover. However, EPL can be harmful for productivity by imposing excessive constraints on labour market flows with negative impact on the effectiveness of labour allocation to the most productive jobs.

2. Reforming EPL in Portugal

The reforms carried out in Portugal have taken employment protection on open-ended contracts to levels close to the OECD average. Between 2008 and 2013, Portugal observed the largest fall in the OECD's EPL index measuring the strictness of employment protection for individual and collective dismissals (Figure 29). Crucial among the changes in the Portuguese legislation was the reduction in severance payments, the introduction of a new reason for dismissal (inadaptability without change in the nature of the job post), and the new performance-related criteria for dismissing workers in the case of extinction of a work position, moving away from the seniority-based criteria. These reforms helped to reduce the protection of workers on open-ended contracts in Portugal and narrowed the regulatory gap with workers on fixed-term contracts.

Interestingly, the most emblematic and resilient reforms were taken in the domain of firing costs. Survey evidence shows that these are precisely the measures that firms' perceived as having the largest positive impact in the economy but also those where additional changes are considered urgent. In addition, preliminary indications suggest that the recent EPL reforms are encouraging on-the-job search – a lead indicator of job-to-job flows (Orsini and Núñez, 2014) – and having positive impact on firms' hiring rates. The impact on separations has been mitigated by the existence of grandfathering clauses.

Even though the number of changes in the Portuguese Labour Code was relatively extensive, the large cut in severance pay, in particular on open-ended contracts, is expected to have the largest impact at least in the short-run. From firms' perspective, lower severance pay is likely to contribute to increase hiring and firing rates; for workers, it is expected to lead to greater on-the-job search and to job-to-job flows. This Section discusses the possible implications of this particular reform and shares some preliminary evidence of its impact on the Portuguese labour market.

3. The reform of severance pay in Portugal

At the beginning of this decade, Portugal had one of the highest levels of severance pay for open-ended contracts among the OECD countries. Upon dismissal, every worker, irrespective of tenure, was entitled to receive a minimum of three months' severance pay with no upper limit. Severance pay was lower for fixed-term contracts than for open-ended contracts. This system acted as a disincentive for firms to hire workers on open-ended contracts and contributed to impair the efficient allocation of labour resources not only because of the large firing costs for firms but also because the right to receive high severance payments in case of dismissal acted as disincentive for workers to look for new jobs even if they involved better matches.

In this respect, it is interesting to see that, according to the results obtained from a firm-level survey conducted in 2014 by Banco de Portugal in the context of its participation in the Wage Dynamics Network (WDN),¹⁹ the size of firing costs was reported as the second most important reason for Portuguese firms to be reluctant to hire

¹⁹ The Eurosystem Wage Dynamics Network (WDN) was a research network created in 2006 and reactivated in 2013 with the main purpose of assessing labour market adjustments. In the third wave of the WDN the 25 participating national central banks launched a 'wage-setting survey' as an update to the two previous surveys carried out in 2007 and 2009. The motivation for the new survey was to understand how firms responded to the crisis, to what extent these responses depended on what happened between 2007 and 2009, and how the structural labour market reforms

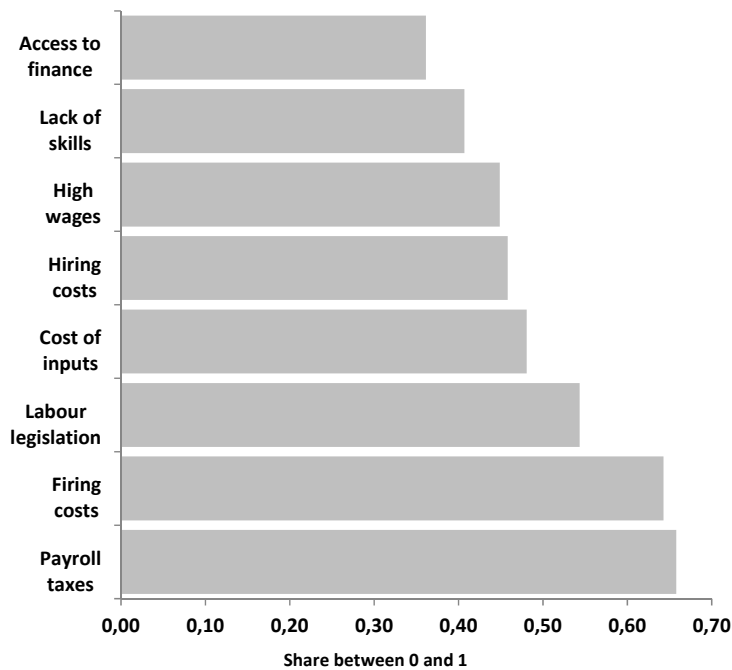


Figure 30: Main obstacles for hiring workers on open-ended contracts (share of firms considering each option as relevant or very relevant)

workers on open-ended contracts (Figure 30). The answers took the period 2010-2013 as a reference.

Between 2011 and 2013, severance payments for open-ended contracts were reduced from 30 days of base wage plus tenure-based pay to 12 days for every year of tenure. In addition, the minimum of three months' pay was removed and it was introduced a ceiling on the maximum amount to be paid out.²⁰ Severance payments on fixed-term contracts were also reduced, though to a smaller extent.²¹ Nevertheless, severance payments on fixed-term contracts are still lower than on open-ended contracts.

One important characteristic of the new severance pay rules is that they are only valid for new contracts. This has an impact on the short-run as the rights for contracts signed before 2011 were

affected firm behaviour. The main results for Portugal as well as details on the survey can be found in Martins (2015).

²⁰ An upper limit of 20 times the national monthly minimum wage was set for the reference wage used to calculate the entitlement (base wage plus tenure-based increments) whereas it was also laid down that the total amount of severance pay could not exceed 12 times the reference wage – i.e. 240 times the national monthly minimum wage.

²¹ They were cut from three days per month of tenure on contracts lasting six months or less and two days per month of tenure for contracts lasting more than six months, to 18 days per year of tenure incremented by 12 days per year of tenure for contracts lasting more than three years.

kept virtually unchanged. There is evidence in the literature (see for instance von Below and Thoursie (2010)) that changes in employment protection can lead to a short-run contraction of employment as their immediate impact tends to be more concentrated on separations than on hirings. One way to avoid excessive job losses in the short-run is to impose grandfathering clauses. The drawback is that the potential positive effects of reforms take longer to become visible. Obviously, this only applies to open-ended contracts because in the case of fixed-term contracts, given their shorter tenure and higher turnover, the new rules are now entirely in place.

4. Some preliminary evidence on the impact of severance pay cuts

Evaluating the impact of each of the labour market reforms is far from being an easy task. Firstly, they were introduced over a 4-year period, which makes it difficult to identify a date that clearly draws the line between the period before and after the reforms. Secondly, they were combined with other reforms, which might have also affected the labour market. Thirdly, since not much time has elapsed since reforms were implemented, it may be too soon to make a conclusive assessment. Finally, the period after 2013 has been characterised by a gradual recovery of economic activity in Portugal and, most remarkably, by a considerable improvement in both employment and unemployment rates – even better than expected given the pace of recovery. Therefore, we should be cautious in establishing any type of causality between the reforms and the performance of the labour market, in particular because it is not straightforward to disentangle the impact of reforms from the effect of the economic cycle.

To get early indications on firms' perceptions about the impact of labour market reforms, the WDN survey asked Portuguese firms to report whether they considered being easier or more difficult to perform a set of actions in 2014 than before 2011. More specifically, firms were asked whether it was easier or more difficult to: i) dismiss employees, collectively, individually, temporarily or for disciplinary reasons; ii) adjust working hours; iii) recruit new employees; or iv) move employees to other positions or locations. Except for the case of geographical mobility and dismissal for disciplinary reasons, a non-negligible fraction responded that their ability to perform these actions had become easier or much easier (Figure 31). In particular, 32% of firms perceived individual dismissals as being easier or much easier than before the reforms. It is true that the figures are not overwhelming but in any case they are in most cases higher than those reported in other Southern European countries that also implemented wide-ranging labour market reforms (Izquierdo *et al.* (2017)).

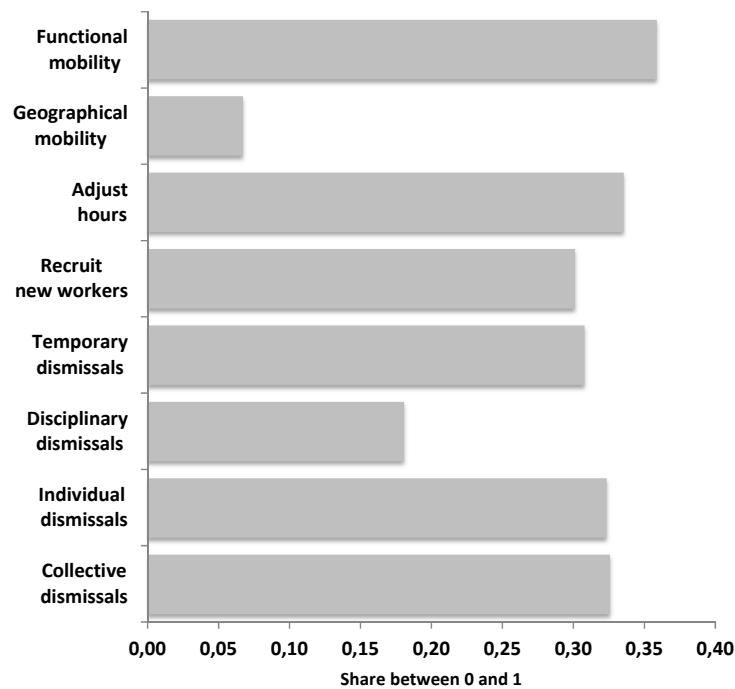


Figure 31: Share of firms perceiving each action as easier or much easier in 2014 than in 2010

These results are broadly consistent with those obtained from a similar survey conducted by the IMF in 2015 (IMF (2016)). The survey covered not only the labour market but also the other three areas that were subject to reforms between 2011 and 2014 (product markets, public sector and financial sector). Respondents were asked to indicate their perception about the impact of a long list of reforms on their competitiveness and growth prospects as well as the perceived importance of additional measures in each reform area. In the case of labour market reforms, the list included increases in work time, increases in work-time flexibility, collective bargaining, hiring and firing costs, active labour market policies and effectiveness of employment agencies. In general, labour market reforms scored better than other reform areas, though the results in many cases were not significant. Nonetheless, the reforms that were perceived as having the largest positive impact on firms were the increase in work-time flexibility and changes in hiring and firing costs, which included the new rules for individual dismissals and cuts in severance pay. These were particularly important for exporting firms and SMEs.

However, the IMF and the WDN surveys do not disentangle the impact of cuts in severance pay from other changes in firing costs. In a tentative exercise, the OECD (OECD (2017)) estimates the impact of severance pay cuts on the probability of workers' on-the-job search

as well as on firms' probability of hiring and firing. The analysis is based on the information taken from the Labour Force Survey and the Portuguese *Quadros de Pessoal* (QP), a matched employer-employee administrative dataset. The (OECD (2017) results suggest that severance pay cuts increased on-the-job search and firms' hiring rates. In particular, based on quarterly data from the LFS the exercise estimates that reducing severance pay by 1 percentage point (p.p.) has increased on-the-job search by 0.075 p.p. and the hiring rate by 0.13 p.p.²² These impacts are estimated using individual-level regression models where the dependent variable - a dummy variable indicating if an individual is engaged in on-the-job search or firms' outcome (hirings or separations) - is regressed on the average percentage difference in severance pay between pre- and post-reform systems and a number of other worker and firm characteristics.

Results based on annual data from QP also reveal a positive impact from severance pay cuts on the separation rate, though considerably lower than the impact on the hiring rate. In particular, reducing severance pay by 1 pp has increased the separation rate by 0.04 pp and the hiring rate by 0.29 pp.²³ Even though these are relatively small coefficients, it is important to mention that the estimated difference between the old and the actual severance pay is 5.6%, while the difference between the old and the new severance pay (if the rules were applied fully, i.e. without grandfathering) would amount to 25.6%.

5. Final remarks

Despite the considerable progress in recent years, Portugal remains the OECD country with the most stringent regulations for individual dismissals of workers on open-ended contracts. While the reforms have narrowed the regulatory gap between open-ended and fixed-term contracts, the duality remains important and labour market segmentation is likely to continue a distinctive characteristic of the Portuguese labour market. This is because a number of incentives to keep hiring on fixed-term contracts were left untouched. Firing a worker on an open-ended contract involves more than just paying a compensation as it involves considerable procedural costs. According to Centeno and Álvaro Novo (2012), these costs represent the main difference *vis-à-vis* fixed-term contracts. These procedures can extend

²² The average share of workers engaged in on-the-job search per quarter is 6.6% whereas the average hiring rate per quarter is 3.8%.

²³ According to the information obtained from QP, on average 14.2% of workers separate from their employer every year whereas each year 16.2% of workers are new hires.

the dismissal process substantially, thus in many occasions firms are likely to keep their preference to hire workers on (lower-cost and more flexible) fixed-term contracts. In this respect, it is illustrative that despite the remarkable performance of the Portuguese labour market in recent years, the share of fixed-term contracts in total employment remains quite stable around 18%.

Further progress in lowering EPL on open-ended contracts in Portugal would probably require changes in labour market legislation. Clarifying the meaning of "just cause" would be very important, in particular the conditions under which firms can dismiss workers for economic reasons. France in 2017, under the so-called "Macron reform", and Spain in 2012 (OECD (2013)) have made important progresses in this domain.

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