

The Portuguese labor market legislation: a technological shock

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Abstract

The recovery of the Portuguese labor market is tenuous. Employment is 5.2 percent below the pre-crisis level; in Spain, it is only 1.3 percent below and, in Ireland, it already exceeds pre-crisis by 3.6 percent. The population loss, at levels similar to the 1960s, reduced the productive potential of the Portuguese economy. The lower oil prices and the devaluation of the euro alleviated the problem, but they are not structural growth factors. In this context, it is necessary to design a labor market regulation closer to the technological frontier. Standardize employment contracts and proper incentives in the unemployment insurance are two steps needed to promote steady growth. Growth based on the investment in the quality of labor matches. (JEL: J08, J41, J65)

Introduction

Among the intervened countries, Greece, Ireland and (partly the banking sector in) Spain, the recovery of the Portuguese labor market is far from a success. If we take as reference the beginning of the economic and financial assistance program, total employment in Portugal is still 5.2 percent lower, while in Spain is lower 1.3 percent and, in the Irish case, it already exceeds in 3.6 percent the 2009 value. Among such countries, only Portugal and Greece observe a reduction in their populations. Because labor is one of the production factors, some argue the most important, this decrease in active population has negative consequences for potential output.

Under these circumstances, it is important to consider a range of structural measures to boost the potential output of the Portuguese economy. We cannot take for granted as driving factors the lower oil prices and the devaluation of euro. Without forgetting our specific context (Section 2), we consider the “best practices” in the organization of a labor market (Section 3), to put forward a set of measures to change the structure of the Portuguese labor market.

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The proposed measures depart from the idea of income protection, rather than the current vision of employment protection. This will be achieved by reducing employment and non-employment segmentation (Section 4). It will be based on a standardization of labor contracts, which limits the use of fixed-term contracts, and on an overhaul of the unemployment insurance system. The latter with two components. For firms, it induces the internalization of unemployment costs by creating a *bonus/malus* system. For workers, individual accounts reduce the moral hazard, promoting a more rational use of unemployment insurance, which we want universal for all workers.

Although the labor market is the most important of markets, there are other areas whose malfunction is detrimental to the efficiency of the Portuguese economy. Taxation, justice and the product market, although not the object of this reflection, should not be forgotten.

Labor market: characterization

Nicholas Kristof, the *New York Times* of 09/19/2015, notes that a “ briefing posted on the White House website Explained why Saudi Arabia would be a good partner in battling ISIS: ‘Saudi Arabia has an extensive border with Syria’, ” concluding that we should be skeptical whenever a war is justified with a country that we do not know where it is.¹

If we are serious about this sensible advice, characterizing the labor market participants – workers and firms – is a necessary condition to formulate successful proposals.

Over the years, we were fed myths about the functioning of the Portuguese labor market, particularly by creating a false sense of lack of flexibility. The concepts of flexibility and efficiency were misunderstood.

The first myth made us believe that the Portuguese quarterly worker flows – hires and separations – were extremely low. The myth was fed, for example, by Blanchard and Portugal (2001), who placed worker flows at 21 to 28 percent of those observed for the United States. But Centeno *et al.* (2007, 2008) and Centeno and Novo (2012) show that the quarterly worker flows in the Portuguese economy reach at least 2/3 of the American’s, or 200 percent above those previously reported. The evidence shows that the rotation in the Portuguese labor market is among the highest in Europe. There is contractual flexibility in Portugal. Unfortunately, inefficient. There is a substantial part of workers who rotate between jobs – foremost fixed-term contracts – feeding an inefficient flexibility.

The second myth burst after the crisis. In 2013, the International Monetary Fund published in its report on the Portuguese economy a histogram showing

1. The Syrian and Saudi borders never coincide, they are apart at least 100 kilometers.

that there were no nominal wage cuts (IMF 2013). As if the labor market was a spot market, the fact that wages of Portuguese workers did not fall justified the rise in unemployment (excess supply). But since Galileo Galilei, we know that the truth is not the daughter of authority, but of time. In the pseudo-histogram, over 15 percent of registered labor contracts in the Portuguese Social Security were missing. The omitted observations corresponded to nominal wage cuts. This paved the path to end one more myth.

All official data show that there is a substantial number of workers with wage cuts in the same job from one year to the next. In 2010 and 2011, *Quadros de Pessoal* report wage cuts affecting, on average, 29.7 percent of workers. In expansionary periods, from 1994 to 2008, the average was 18.7 percent (in 2004, year of recession in Portugal, it reached 28.1 percent). Meanwhile, there are also frozen wages (with zero annual variation); for the recent period, 14.6 percent and, for the period 1994-2008, 7.4 percent.

Here too, the numbers do not differ from other labor markets. Elsby *et al.* (2013), with the data from the *New Earnings Survey* from the UK, show that there are more wage freezes than in Portugal, 18.7 and 8.6 percent, respectively for those periods. In the 1994 to 2008 period, wage cuts are similar to the Portuguese, 20.2 percent, and most recently 23.4 percent.

This regularity is confirmed in the *Survey of Income and Living Conditions (SILC, Eurostat)*, for the period 2003 to 2009. On average in Austria, Belgium, Germany, Denmark, Spain, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Sweden and the UK, 30.3 and 6.2 percent of workers reported wage cuts and freezes, respectively. In Portugal, the same data result in 34 and 5 percent, respectively above and below the average of other European countries. There is no idiosyncrasy in the Portuguese economy; the labor market is governed by the same economic principles and, therefore, it reacts similarly.

With the myths extinct, we now characterize the Portuguese economy in the most recent period. With the international financial crisis of 2008, performance of the Portuguese economy, already weak, has become dramatic, with profound impact in the labor market. The unemployment rate almost doubled between 2007 and 2013, from 8.5 to 16.4 percent, corresponding to an increase of 430,000 unemployed workers. At the same time, Portugal has lost 680,000 jobs. The structural nature of some of the losses, e.g. construction and older and less qualified workers, raises questions of reintegration and long-term unemployment.

Common sense would have us think that the problems of declining employment and rising unemployment result from labor redundancies and company closures. However, what moves the employment cycle are hires, not worker separations. Before the crisis, on average, Social Security recorded 250,000 new quarterly hires and just under 250,000 separations. After 2009, quarterly hires do not exceed 140,000. The fall extended to separations, which are now around 190,000 per quarter. The problem is the absence of hires,

not the excess of separations. Hence the emphasis on structural reforms and short-term policies has to be placed on hires. Full employment, which today is legally synonymous with preventing separations, can only be achieved with job creation.

Employment and non-employment segmentation is the structural problem of the Portuguese labor market.

Employment is segmented between those with permanent contracts and those with fixed-term contracts. Fixed-term contracts were introduced in 1976, but since have gained importance in the management of human resources. In first quarter of 2015, among salaried workers, 21.2 percent had a fixed-term contract or other temporary form of employment. This trend remains because, on a quarterly average, 90 percent of new jobs for unemployed and inactive workers are in the form of temporary contracts. The use of more flexible contractual forms has been gaining importance in Europe, but more in some countries. In 2014, Portugal and Spain used these types of contracts 50 percent more than the average European Union country (14 percent).

Income protection is segmented between those with and without access to unemployment insurance. As a result of short-lived contracts and worker rotation, a significant portion cannot accumulate contribution periods to access unemployment insurance. In 2007, of the 441,000 unemployed, only 245,000 (56 percent) received insurance unemployment. In 2013, this share fell 14 percentage points to 42 percent (293,000 to 713,000). In connection with employment flows, segmentation extends to the periods of non-employment.

Labor market structure

Against the backdrop of the Portuguese labor market, it is necessary to rethink its structure. But we should not do it without recognizing which are the structuring elements of a modern labor market.

Supply, demand and institutions: productivity and wages.

Wages and employment are determined in the labor market as the result of the interaction between supply, demand and institutions.

The demand for labor is derived from the needs of firms to acquire the labor services. The labor supply is made by workers, who are willing to transact working hours in exchange for a wage. But the functioning of the labor market also depends on institutions, defined as all existing regulation.

However, there is a characteristic that distinguishes the labor market from other markets, the traded service has free will. Unlike in the market for apples, in the labor market is important to know the demand and supply actors. We cannot think about the functioning of the labor market only in terms of excess supply or demand because unemployment existing simultaneously with job vacancies and an ongoing effort to search for the better matches.

The success of the economy depends on the quality of this effort. There are two principles that underpin these differences.

First, the structural element of the labor market are the worker-firm matches. The formation of these matches takes place in a setting with imperfect and asymmetric information. In these circumstances, the wage has an increased function in the allocation of workers' qualifications to the needs of companies.

As the traded service has free will, the employee plays a decisive role. This difference is crucial: the paid wage influences productivity. Wages do not have to be equal to the marginal productivity of labor (the notion of efficiency wage). The wage is also an incentive, the labor market is no longer a "spot market"; searching for better matches results in volunteer unemployment.

If institutions penalize long-term labor relations, they reduce the possibilities for firms and workers to invest in these relationships, affecting job stability and, therefore, for production. Precarious jobs induced by bad regulation have consequences far beyond that established between the company and the worker.

Second, the functioning of the labor market is not conceivable without regulation. The occurrence of market failures (information differentials, market power and risk aversion) is the main reason for the existence regulation. The labor contract is the main regulatory mechanism.

Labor contract.

The labor contract has as main objectives: regulate the risk of the labor relation; lessen the effects of asymmetric information between employer and employee; and regulate the hold-up problem in the (mutual) investments of employers and workers in the relationship. In performing these functions, the contract limits the negative consequences of information and bargaining power differentials between the two parties. As in other economic areas, the contract limits the future behavior, making it as predictable as possible.

The contract serves to prolong the duration of labor relations, not to make it harder to terminate them. It does so because it encourages productive investment by protecting the return of each party.

Despite the efforts of each party, labor relations sometimes end prematurely. These situations are all the more destructive, the greater the investment made by each party. If a worker leaves the company after receiving training, the company does not enjoy the return on the investment it made. The same uncertainty arises to the worker whenever (s)he makes specific investments to the employment relationship. The existence of a contract, by providing rights and obligations for the parties, limits the uncertainty induced by the hold-up problem, reducing the uncertainty of the production function.

Through the protection it confers, the contract serves as an insurance that companies provide to their workers. These are more risk averse, requiring

greater protection in the face of fluctuations in demand. The company offers this insurance (severance payment) in compensation for lower wages. The discussion of the impact on employment of different aspects of job protection legislation has important contributions in Lazear (1990); Blanchard and Tirole (2008) and Boeri (2010).

Non-employment protection.

Unemployment protection takes preferably the form of an universal insurance for all workers, while mitigating moral hazard on the behavior of workers and firms. For workers, the moral hazard is associated with the fact that insurance works as leisure subsidy. On the side of firms, unemployment insurance can generate greater rotation of workers. The income protection provided by the current mutual unemployment insurance system leads Portuguese firms and workers to ignore costs imposed on society by their private behavior.

A labor market for the 21st century

The definition of labor market regulation is not a simple task. It should be carefully designed because it interferes in the formation of worker-firm matches, but it also affects social dimensions (e.g. family decisions). This is an atomized relationship, but it should be adjusted due to the asymmetry of information and the bargaining power. The legislator must create regulation that approximates the private and social costs of ending an employment relationship.

While trying to stay true to this principle, the following proposals intend to transform the employment protection in income protection. It requires an efficient adjustment to labor contracts to protect investments in the labor relationship. But it also establishes a tripartite agreement between the worker, the firm and society to share the costs and benefits of such protection.

To reduce segmentation, the new system uses consistently two instruments: the standardization of the labor contract and the protection system in non-employment.

A new labor contract

The new labor law must change the inefficient way it promotes employment protection, which leaves unprotected an increasing fraction of the population.

The biggest difference between contracts lies in the judicial uncertainty at the end of contract. It is inexistent in fixed-term contracts and high in permanent contracts. It is necessary to reduce these differences and thus return contracts to their economic reason. For this, one must standardize the

labor contracts, ending the separation that the legislation promotes between fixed-term and permanent contracts.

The contract is not a productive feature of the job, but it interferes with the incentives to investment in the match. The new contract must be implemented starting from the current permanent contracts, but adjusting its features. In particular, it must balance the procedural components that protect the two parties' rights. This is achieved by paying more generous compensations, with longer periods of dismissal notice balanced with longer trial periods and by establishing a limited set of non-economic dismissal reasons.

The main proximity to existing permanent contracts is the open-ended nature of the new contract. The redundancies will only be permissible for cause, but they always give rise to a monetary compensation for the employee's investment in the match. By paying a compensation, the firm is also internalizing the social costs it imposes on society; the private cost of dismissals for the firm is always lower than the social cost.

Fixed-term contracts should be abolished, except in well-defined situations (e.g. replacement of absent workers on maternity/paternity leave, illness or temporary disability).

The intervention of the judiciary would be limited to discrimination issues (e.g. gender, age or union). Thus, it would reduce the need to involve the system judicial in the economic analysis of redundancy procedures.

Internalizing firing costs

In Portugal, the unemployment insurance system is partially financed by companies through a fixed contribution to Social Security. However, more than half of the Portuguese companies does not have ex-workers with unemployment insurance processes and those that have use it to rather different extensions. There is a cross-subsidization of the "good" (little use) companies to the "bad" (intensive use). The costs of the redundancies are not fully internalized.

The introduction of a *bonus/malus* mechanism, as used in the insurance industry, penalizes companies that induce a higher usage of unemployment insurance. To promote the internalization of social costs by firms, contribution rates must be directly associated with the spending on unemployment insurance and worker rotation of each firm. As a numerical reference, we can use the usage ratios of all companies over the past three years to infer what is "normal" rotation and usage of unemployment insurance. Then, businesses will pay increasing contribution rates at, say, three levels: low, normal and high.

The proper incentive that this system generates in companies would lead to a reduction in the rotation of workers and in the financing needs of the Social Security.

Individual accounts: unemployment insurance

The optimal design of unemployment insurance should balance the liquidity and the substitution effects. The former is virtuous because it allows workers to smooth consumption between periods of employment and unemployment, providing a more effective job search. On the contrary, the latter creates an incentive to reduce labor supply, acting as a leisure subsidy. Unemployment insurance should be designed to promote the liquidity effect. That's what the individual accounts do.

Individual accounts act as an insurance for periods of unemployment. The social contributions – which do not need to be different from the current ones – accumulate a balance in an individual account, which the worker can use when unemployed involuntarily. In order to cover accounts with insufficient funds, a fraction of the contribution feeds a solidarity component. This component, with a level deemed socially desirable, guarantees that all workers receive some income when they lose employment involuntarily. At the end of the working life, the worker receives the remaining balance. The operation of these accounts gives the correct incentive to workers – it is their money –, reducing the moral hazard associated with the substitution effect.

The unemployment system should also consider automatic stabilizers associated with the economic cycle. The entitlement periods can be automatically extended in recessions. Similarly, the minimum number of contributions needed to access the system may also vary with the economic cycle.

Individual accounts are not an esoteric proposal. There are successful experiences in countries such as Austria, Chile, Colombia and Estonia.

Conclusions

Reform creates winners and losers. Rather, it creates new winners and new losers. We must not forget the current thousands of unemployed, those who left the country and the workers with precarious contracts; these did not win with the current status quo. But change is justified if the welfare of the country increases. To avoid social capital destruction and to ease the transition and adoption of the reform, it is necessary to find mechanisms that compensate those who may stand to lose.

In the presence of a high protection, job holders do not invest in more training and applicants – young students – in the face of the few opportunities available to them (and future protection) also lower education investment. The tax system is an obstacle and the distorted access to justice perpetuates inequality.

The proposed reforms aim to create a more efficient labor market and a fairer society. With less segmentation of the labor market and more equitable

access to better job opportunities. Together, they promote productivity and, therefore, growth in Portugal. The market regulation should always facilitate these transition processes, without perverting incentives to induce the correct investment of workers and firms.

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