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Wage Formation and
Unemployment in Italy**

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INSIDE THE BLACK BOX: LABOUR MARKET INSTITUTIONS, WAGE FORMATION AND UNEMPLOYMENT IN ITALY*

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1. Introduction

In the post-war period Italy has undergone significant changes in the functioning of both product and labour markets. Although the sustained growth experienced in recent decades has led Italy among the main industrialised countries, this process has not been without contradictions. In the last two decades Italy passed from being one among the highest-inflation economies at the edge of the second 'Oil-shock', in 1979, to an inflation rate fully comparable with that prevailing elsewhere among other EU partners, in 1999. The large public sector debt inherited from deficit spending of the 1980s, after years of tight fiscal policy shows now a budget surplus (net of interests). Also real interest rates have been rapidly converging, in recent years, to the European average. On the other hand, the "Italian model" has often been indicated to be an example of diffused inefficiencies ranging from significant labour market rigidity, reduced product market competition, pervasiveness of public sector intervention and, last but not least, political instability.

A further aspect that characterises the Italian economy is the high unemployment rate that, in 1999, was around 12 percent of the labour force. While, this rate is not significantly different from that of most continental European economies -- being only lower than that of Belgium and Spain --, it is significantly higher than the rate of joblessness currently observed in other industrialised countries, such as the US (4.6) and Japan (3.4).

In the light of the above features, it has been argued that Italy's recent participation to the European Monetary Union (EMU) -- and the need to comply to Maastricht criteria -- will reduce the ability to implement both domestic short-run stabilisation policies and policies to deal with regional unbalances, giving greater weight to those aspects that hinder the adjustment process face to exogenous shocks. Hence, whilst the good performance of the Italian economy over the post-war period remains a puzzle for most of the observers, still an assessment of those features that "inside the black box" contributed to shape the evolution of the modern economy may prove a useful exercise. This is particularly so now that, after the completion of EMU, the growth rate of the Italian economy -- but also that of the whole Europe -- has shown signs of a slowdown. What seems clear from this overview is that the performance of the Italian economy has to be evaluated against the rise in unemployment and its persistently high level.

The purpose of this study is, first, to document the evolution of the Italian economy in the European context focussing particularly on the functioning of the labour market at an aggregate level. A broad picture describing the dynamics of wages and (un)employment will be presented, also considering the role played by rigidities originating mainly in the labour market.

In this context, the paper looks at the evolution of labour market institutions with particular reference to the set of constraints and economic incentives facing workers and firms operating on the market. Examples are the system of wage indexation (the so-called *Scala mobile*) which operated throughout most of the 1970s and 1980s, and the labour legislation (the *Statuto dei lavoratori*) regulating, among others, hiring and firing rules. The role of 'social partners', along with the tripartite consultations at national level, also has played a central role in the political dialogue being a key element in the formulation and implementation of macroeconomic policy. Among the latter, incomes policies knew renewed interest when the policy of concertation in labour cost formation led to the 1993 agreement to curb inflation (the so-called *Accordo sul costo del lavoro*) (Fabiani, et al., 1998).

Aggregate figures, however, conceal several structural phenomena that, in Italy, play such an important role in determining economic outcomes, namely the existence of both significant imbalances across regions as well as marked disparities across groups of individuals competing on the labour market. These structural features of the Italian labour market are addressed in the third section. Regional imbalances in terms of participation rates, diffusion of self-employment, wage differentials, unemployment rates and not to be forgotten the relative size of the irregular economy represent the most salient features of the phenomenon. Other types of imbalances concern the rising share of low-wage employment and the high rates of unemployment as well as its duration among selected groups of individuals.

In the fourth section, we evaluate the role of labour market policies which have characterised the first wave of reforms or are currently being introduced, to cope with the rising trend in unemployment and the share of long term unemployed. Whilst, several active labour market programs have been put in place together with various incentives measures directed to promote part-time work, work-sharing and geographical mobility, yet very little is known on the effects that such measures are expected to play on both employment and unemployment.

2. Employment, Unemployment and Wages: an Aggregate Perspective

A standard way of assessing the level of prosperity and the performance of an economy is to look at a number of macroeconomic indicators which are intended to capture the efficiency in 'using' as well as 'allocating' the available (scarce) resources. Although the identification of the appropriate indicators and their measurement poses enormous problems -- both statistical and conceptual --, still they can provide a rough guidance to evaluate a country's relative economic efficiency. In this context, it might be argued that is certainly important to assess what is the level of GDP per capita and track its evolution over time, but it is also equally relevant to evaluate what proportion of the working age population is employed and how intensively the factors of production are utilised. Looking at the above indicators for the Italian economy and contrasting them with most OECD countries, one can notice significant differences in both the way economic outcomes are generated and the level of factor utilisation chosen. In particular, as shown in table 1, if we consider various measures of productivity levels (GDP per unit of labour or per hours worked) Italy ranks above the EU15 average among the most performing countries in the industrialised world. This outcome does not seem to depend on differences in the number of hours worked (per employee) or upon purely demographic factors, the main feature lies in the employment-population rate (51 per cent) which is one of the lowest among OECD countries (with Spain, 46.4 per cent). The latter is also the main characteristic that differentiate European countries from US and Japan: the employment rate is 12 and 16 per cent higher, respectively, in the latter two with respect to Europe.

Table 1 - Economic Prosperity and Labour Utilisation^(*)

	country						
	France	Germany	Spain	Italy	E15 ^(**)	US	Japan
GDP/POP [°]	17.92	18.33	12.67	17.66	16.74	23.77	19.73
GDP/HRW [°]	27.06	25.61	21.88	28.37	24.50	29.61	19.44
HRW/EMP (p.a.)	1739	1666	1807	1752	1721	1737	1905
EMP/ POP ₁₅₋₆₄ (%)	60.5	63.7	46.4	51.2	60.2	72.1	76.4
POP ₁₅₋₆₄ /TPOP (%)	63.3	67.5	65.8	68.9	66.0	65.9	69.7
UNEMPL rate (%)	11.7	8.2	22.9	11.9	10.8	5.8	3.2
(i) males	9.8	7.1	18.2	9.2	9.4	3.1	1.9
(ii) females	14.0	9.6	30.5	16.4	12.5	4.	8.4

Note: °GDP per head measured in terms of purchasing parity standards (PPS).

(*) The following decomposition has been used:

$$\text{GDP/POP} = [(\text{GDP/HRW})(\text{HRW/EMP})(\text{EMP/POP})(\text{POP/TPOP})]$$

(**) including the new German Länder

Sources: National Accounts, DGII, 1995; Community Labour Force Survey, 1995; OECD, 1994.

In other words, the proportion of employed people over working age population suggests that in Italy for every person in work there are several others who potentially belong to the active labour force but are in various non-employment status (inactive, unemployed, retired, etc.) and need to be supported. With the exception of the unemployment status, which clearly indicates a malfunctioning of the economy, in principle there is obviously nothing wrong if one country is characterised by a division of labour such that some segments of the population exhibit a higher preference for leisure while there is an implicit redistribution of income between ‘work’ and ‘non-work’.

However, as we shall argue in the remainder of the paper, the high level of unemployment and the low participation rates which characterise both females and older cohorts make the implicit redistribution between work and non-work difficult to be sustained in the long run. Hence, with concern to these features, the 'Italian model' appears very efficient in the 'utilisation' of labour inputs but somewhat inefficient in the 'allocation' of them. Hence it seems worth investigating further, what incentive structure and which set of constraints may have contributed to produce these patterns in both participation and (un)employment rates.

2.1. Employment and participation patterns

The observed differences in employment-population ratios between the US and Europe, and Italy within Europe, can be better evaluated by looking at figure 1. The employment performance of Italy, as compared to the US and Europe, shows in the last 10 years a continuous decline in the employment-population rate, and a sharp rise in unemployment (fig.3). Whilst the evolution over-time mirrors closely that of Europe (E15), in terms of the level the employment rate in Italy exhibits a worse trade-off. Conversely, both the pattern and the evolution are entirely different in the US, where employment-population has increased significantly (and unemployment has declined).

[Figure 1 – around here]

Despite the suggestions that figure 1 might provoke, the relationship between the employment-population ratio and non-employment should be interpreted with some care. As previously discussed, the proportion of the working age population who is in employment should not be used as a direct measure of the inability of European economies to create jobs, for only part of the employment-population gap can be explained by differences in unemployment rates. The patterns in labour market participation and demographic trends may account for the rest¹. While the latter does not vary very much across countries, activity rates do differ significantly both across countries and within countries across group of individuals (Table 2).

The factor that mainly contributes to the observed difference in employment and participation rates between Italy, as well as other European countries, and the US is due to the far lower proportion of younger (below 25) and older cohorts (over 55) who are at the time employed or actively participating to the labour market, whilst almost no difference exists among male adults. Whereas in the US and Japan over 70 percent of workers aged 15-24 have a job, in Italy the proportion is around 30 percent (European average is 50 percent). Similarly, among older cohorts (people aged over 55) around 25 percent are in employment in Italy as opposed to almost 60 percent in the US and Japan. The above patterns show a significantly different picture of working and non-working segments of the population. These differences, as far as young cohorts are concerned, reflect in part the higher participation of young people in education and training in Italy and Europe *vis-à-vis* the US, but also the smaller number of those who combine education with job spells (Krueger, 1999). The latter might be particularly relevant for Italy, still, due to the lack of a large supply of jobs with flexible work

¹ The employment rate has fallen in Italy, as in most OECD countries. Looking at participation rates, it can be noted that participation of women in the labour market -- still much lower in Italy as compared to the European average -- has continued to rise, counterbalanced by a progressive fall in male participation.

arrangements or fixed term contracts, as well as to the existence of a large informal sector which attracts mostly young, unskilled flexible labour. With concern to older cohorts, the differences in employment and participation rates across countries reflect both the existence of more generous retirement scheme which might have distorted the structure of incentives to work over the life-cycle -- for example allowing a significant portion of workers, still below the official retirement age, to withdraw from work --, as well as some forms of discouragement and hidden unemployment.

Table 2 - Labour Force Participation and Employment rates by Age groups and Gender

	Country						
	France	Germany	Spain	Italy	E15 ^(*)	US	Japan
LF part (%)	68.4	69.5	60.2	58.1	67.6	74.8	76.5
<i>males</i>	75.7	78.4	75.1	73.5	78.2	84.2	88.6
<i>females</i>	61.3	60.3	45.6	43.0	57.1	68.3	61.3
<i>young (15-24)</i>	48.4	60.0	60.0	44.3	58.3	68.6	44.1
<i>old (over 55)</i>	53.7	44.0	48.1	23.3	48.1	56.3	62.9
<i>School leaving age</i>	16	18	16	14^o	16	15-16	17
<i>retirement age (M/F)</i>	60/65	60	60	60/65	63.2	<i>n.a.</i>	<i>n.a.</i>
EMPL rate	60.5	63.7	46.4	51.2	60.2	72.1	76.4
<i>males</i>	67.1	70.6	59.5	66.2	64.1	75.1	78.4
<i>females</i>	52.1	55.3	31.2	35.6	40.0	70.5	62.1
<i>young (15-24)</i>	41.8	57.6	48.8	32.5	51.1	71.3	69.7
<i>adult (25-54)</i>	76.5	73.4	58.8	63.2	65.0	74.6	75.4
<i>old (over 55)</i>	51.3	41.5	46.2	22.7	38.4	55.9	62.2

Note: ^o set to 15 in 1998.

(*) including the new German Länder

Sources: OECD, Labour Force Statistics, 1996. Eurostat, 1995; Community Labour Force Survey, 1995.

Finally, a further dimension of the difference in participation and employment rates, between Italy and the other countries considered here, lies in the different attachment of females to the labour market. In table 2, Italy exhibits -- despite the long-run increasing trend -- one of the lowest participation rates for females (43 percent) both within Europe (57 percent) and compared to the US (68 percent). This evidence could be taken as an indication for the existence of discouragement effects and forms of discrimination (women are more likely to be relegated in the family), as well as differences in social and cultural attitudes towards the organisation of the household and the lack of child-care facilities (Prasad and Utili, 1998).

In the light of the above evidence, the Italian labour market appears to be characterised by a "dual" structure, with high employment rates for adult males and both low participation and low employment rates for other groups of individuals, such as: young, old and females.

The economic implications of the patterns described are difficult to assess. It seems hard to tell what type of preferences, or constraints, might have generated such a partition in the potential labour supply between 'work' and 'non-work'. A simple way to rationalise the evidence -- and its stability over time -- is to note that the different working and non-working groups are often member of the same family and that a sort of gender-generational pact guides a redistribution of resources within the household. Moreover, it should be considered that people 'not in work' are often engaged in the production of services which are not exchanged in the market (child care, elderly care, house

maintainance, etc.) and hence not recorded in national accounts². This phenomenon -- which is well known at least in its statistical form -- it is certainly not an exclusive feature of the "Italian model", though for a number reasons (which we shall discuss later) it appears to be more relevant there than elsewhere (Cigno, 1991). Other institutional factors besides the organisation of the household economy may have an influence on labour supply, these include the role of the welfare state, the organisation of the education and training systems, the organisation of the labour market and working time arrangements, as well as the ease of leaving and re-entering the labour market.

Finally, there seems to be no direct relation between a higher labour force participation and unemployment rates, countries that are characterised by higher participation than Italy have no more unemployment. Moreover, countries which have tried to reduce their labour supply did not succeed in reducing unemployment. Indeed, if a relationship between overall labour force participation and unemployment is to be found, as shown in figure 2, the pattern appears to be negative rather than positive as commonly held.

[figure 2 around here]

In many respect, using aggregate data to draw such inferences on the complex relations that exist between labour supply decisions, (un)employment and different institutional arrangements is not entirely correct as it can hide important trade-offs between the different labour market states. Nevertheless, the evidence behind the stylised facts presented and the implications that they seem to suggest appears rather powerful to warrant further investigations on the nature of the phenomena and the role of the Welfare state and labour market institutions.

2.2. Unemployment structure and labour market dynamics

The broad picture describing the distinctive patterns between work and non-work which characterise EU countries and, in particular, the Italian labour market deserves more attention. In particular, it appears interesting to investigate further both the structure of employment and non-employment status, as well as the flows between them. Among the different non-employment status, unemployment is commonly used as the main indicator for poor labour market performance. As shown in figure 3, focussing on the evolution of the overall rate of unemployment it appears that following the "oil shock" European countries have faced a progressive deterioration of labour market conditions characterised by a continuous growth in joblessness and an increasing trend in overall unemployment.

[figure 3 around here]

Moreover, although high unemployment rates have been recorded in most European countries, in Italy the problem is exacerbated by the relatively high proportion of unemployed people who have been out of work and searching for a relatively long period of time (i.e. more than 12 months). As shown in table 3, Italy exhibits one of the highest share of long-term unemployed over total unemployment, and an average duration of unemployment spells which is significantly longer than the European or the US average.

² In almost all countries there are some forms of (statistically) hidden contributions to the national product, see Tanzi, 1993 for a thorough discussion.

Table 3 - Long Term Unemployment and Unemployment duration (*)

	country						
	France	Germany	Spain	Italy	E15 ^(**)	US	Japan
Long-Term Unemployment	45.6	48.3	56.5	62.9	35.4	8.7	6.5
Unemployment duration	7.7	12.4	14.9	26.1	6.7	1.1	1.8
<i>Unemployment in-flows</i> <i>InU=(EU+NU)</i>	3.88	3.01	1.61	1.88	2.00	23.88	<i>n.a.</i>
<i>Unemployment out-flows</i> <i>OutU=(UE+UN)</i>	69.62	93.33	16.8	20.30	45.0	545.47	<i>n.a.</i>
<i>Total turnover</i> <i>Tot=InU+OutU</i>	73.5	96.34	18.41	22.18	47.0	569,35	<i>n.a.</i>

Note: long term unemployment is computed as a percentage of total unemployment. Unemployment duration is measured in months.

(*)Unemployment flows computed as percentage to the stock of unemployed (outflows) and as percentage to the working age population (15-64) less the unemployed (inflows)

Sources: OECD, 1994; Eurostat, 1995, Machin and Manning, 1999.

(**)including the new German Länder

In particular, the proportion of people who have been out of work for more than 12 months is over 60 percent in Italy, around 35 percent in the EU and less than 9 percent in the US. Similarly the average duration of an unemployment spell is over 26 months in Italy, while is 7 months in Europe and less than 2 months in the US and Japan. The existence and persistence of such differences underlines a fundamental difference across countries in labour market dynamics (Davies and Haltinwanger, 1996). Namely, whilst average flows out of unemployment and into unemployment (either to (from) non-labour force UN (NU) and employment UE (EU)) are relatively high in the US, they are generally rather modest in the EU and very small in Italy (see table 3).

The above patterns can be characterised by saying that, on average, it is easier to become unemployed in the US as opposed to Italy (and Europe), however once in unemployment it is equally easy to exit it while the reverse is true generally for Italy (and Europe). The last row in table 3, clearly shows that labour turnover across different employment states is nearly ten times larger in the US with respect to Europe.

A large share of long-term unemployment is often associated to high unemployment rates. Figure 4, reports the evolution of the overall rate of unemployment and the incidence of long term unemployment for different countries over the 1983-1995 period. Two features of this relationship appear interesting: the cross-country correlations and the - within country - time profile. Cross-country correlations show that there is a clear positive correlation between the two: Italy, being characterised by high levels of both, while the US showing a more favourable trade-off.

[figure 4 around here]

However, in the light of the above evidence it is still unclear whether it is the persistence of unemployment which determines high rates of unemployment or rather it is the growing rate that forces individuals into long spells of joblessness. In other words, the direction of the causation between overall unemployment and the incidence of its long-term component is not yet clear. In this context, as shown in figure 5, inspecting the different types of dynamics it appears that EU countries and Italy exhibit a anticlockwise spiral in the time profile whilst hardly any cycle is observed in the US.

Without drawing any major implications from the above trends, it can be observed that long-term unemployment seems to be following with some lags the unemployment rate. In particular, in Europe a negative shock on unemployment seems to be followed, in the short run, by a reduction in the incidence of long-term unemployment as marginal segments of the labour force reduce search intensity and/or withdrawn from the labour market; whilst, in the longer run as unemployment persists and more stable part of the labour force are hit, the incidence of long-term unemployment shows a progressive increase. Conversely, in the US, long-term unemployment seems little affected by changes in the overall rate of unemployment as the share of long-term joblessness appears rather modest and constant over time (Machin and Manning, 1999).

[figure 5 around here]

The rise in unemployment and its persistently high level have been blamed, both in Italy and in other European countries, on imperfections and rigidities originating mainly in the labour market. The crucial difference across countries appears to lie in the exit rate from the unemployment pool which characterises European countries. That is, any explanation of the rise in unemployment must also be an explanation of the fall in the average outflow rate (i.e. as an hiring problem). The standard explanations put forward in the literature have generally focussed their attention on the role played by several factors, such as: generous welfare benefits and taxes on labour, trade unions and wage determination, minimum wages and employment protection provisions (Bean, 1994, Emelshov, et al., 1998, Scarpetta, 1998).

However, some observers have argued that labour market institutions in most European countries (perhaps with the only exception of the UK) have not changed enough in recent decades to explain the rise in unemployment. Thus the observed deterioration in the allocation of the labour factor must lie in a combinations of features that, face to a "common" shock, have generated a significantly different performance across countries. In the remainder of the paper we shall review the main institutional features of European labour markets, with particular concern to the specific features of Italy, and discuss their implication for employment performance.

3. Labour Market Institutions and Unemployment: the Italian Puzzle

All countries have their own set of labour market institutions, regulating hiring and firing decisions, setting industrial disputes and providing some welfare protection to the unemployed and to those out of work. Wage determination is also heavily influenced by the presence of powerful trade unions and collective bargaining institutions. Differences in these institutions can be important determinants of a range of labour market outcomes and contribute to explain differences in (un)employment rates, wage levels and earnings inequality (Nickell and Layard, 1999). Among the factors that are more frequently advanced as potential explanations for an inefficient labour market performance: employment protection, union power in wage determination, welfare generosity and taxation always feature at the top of the ranking (Bean, 1994). In the following sections we shall investigate their main implications for the functioning of the labour market and on economic performance.

3.1. Job Protection and Wage Compression

When looking at the set of labour market institutions that are present in most industrialised economies, a remarkable feature is that employment and wage rigidities are often associated with each other across countries: in labour markets where employed workers are protected from dismissal by job security provisions also various wage constraints prevent competition from outsiders' wage offers. In Figure 6 we rank countries according to their degree of employment protection -- a higher index

denotes higher protection -- and report an overall index of earnings inequality -- measured by the decile ratio, D9/D1 -- (OECD, 1994; 1996a)³.

[figure 6 around here]

Quite interestingly Italy and the US lie at the opposite end of the employment-protection index -- while France and Germany are somewhat in between -- and earnings inequality exhibit a reverse ordering with the highest wage compression observed in Italy, Sweden and the Netherlands. In other words, wage inequality appears to be lower in the same countries where employment protection is stricter. The Italian recent experience on this point can be quite instructive. Among the main features that have characterised the Italian institutional setting in recent decades both the strong employment protection regulation and the rigid system of wage determination appear to have played a major role. The "Charter of Workers' Rights" (*Statuto dei lavoratori*), mentioned before, established various employment restrictions (in firms with more than 15 employees) on individual hiring and firing procedures -- such as workers' right to claim against unfair dismissal --, as well as on temporary labour contracts⁴. Complementary to this, on the wage side, a form of 'real' wage protection was granted by an indexation mechanism based on an cost-of-living adjustment clause (*scala mobile*). Given its structure across levels it implicitly set a minimum (fixed in absolute terms) for low-paid workers granting higher protection and proportionally larger increases in wages at the bottom of the wage distribution. Over the years in which wage formation was regulated by the *scala mobile*, a huge compression of wage differentials was observed in Italy.

This evidence should not come as a surprise since, as shown in some recent contributions to the literature, most often institutional arrangements originate from different types of market failures -- such as incomplete markets and informational asymmetries -- and are intended to protect individual workers against "unfair" adverse outcomes, for example unemployment or low wages⁵ (Bertola and Rogerson, 1997; Bertola, 1999b; Saint Paul, 1996). Also, they might reflect specific objectives pursued by organised labour to insulate workers from external market pressures to prevent underbidding by the unemployed and maintain high-wage/low-employment equilibria on the labour market⁶. Henceforth, restriction on employment adjustment and wage rigidity tend to reinforce their mutual effects strengthening the power of "insiders" at the expense of "outsiders". Other side effects that the above setting is likely to produce are high wage growth and persistent unemployment. Note, however, that job security provisions "per se" can only explain aggregate employment dynamics -- i.e. in the form of lower employment variability -- while they cannot explain poor employment performance (Boeri, 1996; Garibaldi, 1997; Bertola, 1999a; Bertola and Ichino, 1995a,b). It is the combination of institutional wage compression and job security provisions that can be a powerful source of "insider" power : high and increasing wages and low-employment can be expected to result from the protection afforded to currently employed "insiders" *via* the effects played by institutional wage compression and job protection schemes⁷.

³ The index of 'job protection' reported accounts for rigour of dismissal procedures, requirements on severance pay and notice periods, as well as the regulation of fixed-term and temporary work contracts.

⁴ Workers have the right to be re-integrated in the same job in the event of unfair dismissal.

⁵ It is fair to note that employment and wage rigidities would make little sense in the presence of efficient contingent contracts when markets are complete. In this case, enforceable private contracts could circumvent any inefficient regulation (Lazear, 1990).

⁶ Another reason why wage compression is likely to be more stringent in the same countries where job protection is higher might be explained by the observation that firing constraints would not be binding if wages were totally flexible and firms could lower them either to induce quits or to make any given level of employment profitable.

⁷ Also note that the composition of unemployment is rather different in Italy *vis-à-vis* the US. In Italy a substantial portion of the unemployed exhibit long spells of joblessness, and the unemployed are mainly young workers entering the labour market while fewer are the real job losers.

3.2. Collective Bargaining and Union Power

As far as wage determination is concerned, the main difference between the unregulated US economy and the highly regulated European countries is the degree of centralisation of wage bargaining and the existence of higher wage floor -- either set through statutory minimum wages or by collective bargaining --. In most European countries wages are determined by collective bargaining between large trade unions and employer confederations (Booth, 1995). Although the main level at which negotiations take place (i.e. plant, firm, industry or national) does vary within European countries (often with more than one level involved), in several cases when contracts are signed their effects become legally binding for all workers belonging to the firm/industry concerned⁸. The effects this forms of mandatory extension have significant implications for wage determination and more generally the functioning of labour markets (OECD, 1998). In particular such provisions have the power of significantly reinforcing the power of trade unions over and above their actual membership. A rough indicator of the "extra" union power granted by mandatory (or *de facto*) extension provisions can be computed by subtracting from a measure of union coverage their actual membership -- that is the proportion of workers covered by a collective agreement minus the proportion of workers who are effectively member of a union -- (Buti et al., 1998; Lucifora, 2000). When we plot this index of "extra" union power against the (average, 1989-95) employment rate, as we do in figure 7, a negative relationship emerges. In other words, countries characterised by both high coverage and low membership -- mostly continental European countries -- seem to be characterised by lower employment rates as compared to countries where coverage and membership are much closer -- mainly countries characterised by either decentralised or centralised bargaining --.

[insert fig 7 around here]

Hence the "extra" union bargaining power granted by a more favourable institutional setting seems to have pushed (continental) European countries -- and Italy -- higher up along the labour demand schedule towards an equilibrium characterised by higher wages and lower employment. This evidence is also reinforced by the evidence that whilst the dynamics of employment and real wages is markedly different between US and Europe, the evolution of the total wage-bill is strikingly similar across countries (OECD, 1994; Bertola, 1999b).

Also in this case, a substantially different employment performance can be reconciled with both the "insider" power that some institutional settings -- more than others -- grant to economic agents operating on the labour market, coupled with a weak perception of the negative externalities that are being produced. In a decentralised bargaining situation, unions take employment opportunities in other sectors as given, but uncoordinated wage demands, by sector-level unions endowed with "extra" bargaining power, generally lead to inefficiently low levels of employment in the economy as a whole. Conversely, when trade unions play the political role of "social partners", by internalising the (expected) negative employment outcomes they effectively take into account the effects of wage settlements on all workers rather than only those of the sector-level union. Hence centralised bargaining processes, by taking into account the welfare of all workers rather than only that of the "insiders", should result in better employment performance (Calmfors and Driffil, 1988).

While it is intuitive to understand why insiders may want to keep wages rigid in the face of negative labour demand shocks preventing the resulting unemployed from being re-hired, what might be still unclear is what prevents the outsiders from bidding for employment. In this context, insider-outsider models propose a view where labour market institutions may isolate currently employed workers (insiders) from underbidding by the unemployed (outsiders/entrants). The main implication of

⁸ The Italian bargaining structure is structured around a two-tier system, with first a national sectoral bargaining level which sets contractual wage levels for all employed workers ('de-facto' extension of the terms of contracts operate) and a second level bargaining which takes place at the local level. Whilst there has always been some overlap between the issues bargained over at the different levels, the 1993 reform introduced a sharp distinction between them.

the insider-outsider hypothesis is that insider power should be associated to persistent unemployment and wage processes (Lindbeck and Snower, 1988).

Furthermore, when the source of restricted competition on labour and product markets derives from the existence of specific regulations or, more generally, market institutions which are shaped to favour "incumbents", both firms and workers, as opposed to "outsiders" (or entrants) also additional types of "segmentation" and diffused X-inefficiencies may result.

The empirical evidence also suggests that European countries, as opposed to the US, are characterised both by a higher share of long-term unemployment as well as a larger percentage of highly stable jobs (Glyn and Salverda, 2000). In figure 8, we report the relationship between the share of workers who have held their jobs for more than 10 years and the share of long-term unemployment. The observed cross-country variation -- hinting to a positive relationship -- appears consistent with labour market institutions shaped to protect primary wage earners from labour market risk and a marginal fringe of workers who are alternatively highly flexible or persistently unemployed.

[figure 8 around here]

These findings can be interpreted as supportive of a "dual" characterisation of the functioning of the labour market with a "rigid" primary labour market, in which a core group of insider held jobs that are very stable, whilst instability falls disproportionately on a residual "flexible" secondary labour market, where jobs are unstable and unemployment spells can last long (Saint-Paul, 1996; Boeri and Tedeschi, 1998).

Along these lines the Italian experience can prove an interesting example. Table 4 provides some basic statistics on the share of stable jobs in the primary sector and the share of unstable and less protected jobs in the secondary sector (excluding agriculture). It can be noted that the dimensions along which the 'core' of insiders has been identified are mainly public sector jobs and jobs in firms with more than 15 employees (according to the application of the *Statuto dei lavoratori*). These workers face almost no risk in term of both employment and income stability, and they account for approximately 40 percent of the total labour force.

Table 4 - Stable and Unstable Jobs in the Italian labour Market

Job characteristics	as percentage of total labour force
primary sector: protected jobs	
- jobs in firms with more than 15 employees	15.3
- public sector jobs	24.6
<i>Total protected jobs</i>	<i>39.8</i>
secondary sector: unprotected jobs	
- jobs in firms with less than 15 employees	13.6
- irregular jobs (temporary, fix-term, black-econ., etc)	11.4
- self-employed	24.2
<i>Total unprotected jobs</i>	<i>49.2</i>
residual sector:	
- unemployed	11.0
Total labour force:	100.0

Source: P. Ichino, 1996

The remainder is composed by workers -- i.e. approximately 50 percent of total labour force -- who have little or no protection at all, as far as employment and income stability are concerned (in most cases not even social insurance), and who have high probability of experiencing long and repeated

spells of unemployment. In this context, while it is often argued that one of the Italian comparative advantages lies in the dynamism of both its entrepreneurship and the network of small firms⁹, it should be noticed that this may be the result of a marginalisation of a large number of workers looking for jobs in the (protected) primary sector while alternating precarious jobs to unemployment spells (sometime both at the time). Thus institutional features designed to protect workers from labour market risks may end up segmenting the labour force, increasing job instability and paradoxically increasing the duration of unemployment.

A further aspect that has been extensively investigated in the literature is related to the effects that secondary labour force and long term unemployment exert on wage determination. The empirical evidence has shown that a large and increasing share of both precarious jobs and long-term unemployed exert little no downward pressure on wage setting thus increasing the power of 'insiders' when bargaining wage levels (Layard, et al. 1991; Nickell and Wadhvani, 1990).

3.3. Social Welfare and Taxation

In Europe, on average, only 6 individuals out of 10 in working age have a job, while a large share of the rest are not even looking for work. In Italy this picture is even more worrisome as for every person in work there is another one who is either inactive, unemployed or retired and, as such, need to be supported. Long-term unemployment and non-participation are a clear waste of resources, on the one side, and an additional burden on social welfare, on the other. If in some countries (mainly in Northern Europe) the incentive structure offered by the welfare system may be thought as encouraging inactivity and exclusion; in others countries the reasons for lengthy joblessness and non-participation is often due to regional imbalances and different forms of transfers provided to non-employed individuals of working age. In Italy, in particular, unemployment and non-participation have a clear regional dimension and tend to be concentrated in specific age groups. The prevalent form of transfer to non-employed individuals is either in the form of pensions (many of which for 'inability to work' reasons) or generous pre-retirement schemes for laid-off workers, hence covering older age groups. Conversely youngsters receive state support indirectly via their families -- while continuing education (in a rather inefficient educational system) --¹⁰. The fact that the family is the main source of support and acts as an insurance device for labour market risks also explain why face to such a large regional imbalances there are almost no flows of individuals from the high unemployment regions (South) to the high employment regions (North). The investigation of the regional imbalances is returned to the following section.

We address the issue of welfare expenditure using the standard classification between "passive" and "active" measures: the first being essentially directed to provide income support, the second aimed at directly improving the functioning of the labour market.

Passive measures

Social welfare in Italy has been traditionally intended to protect (male) adults as heads of the household. In case of collective redundancies, temporary lay-off schemes granting generous treatment and high replacement ratios are in place. In most cases, a large proportion of inflows into (temporary) unemployment end with the worker returning to its former employer, in other cases early retirement (and other 'soft landing') schemes are provided. Alternatively, retirement schemes based on "seniority" entitlements -- granted to relatively young cohorts and particularly to civil servants -- allow an early exit

⁹ Note that almost 50 percent of employment is in small firms with less than 15 employees, in which the rigid employment protection rules set by the *Statuto dei lavoratori* do not apply.

¹⁰ Youngsters in Italy stay with their family for long time: the age group of first entry into the labour market to get a job is between 25-30.

from the labour market with full pension¹¹. In table 5, we sketch a rough picture of the structure of benefits which currently exist in Italy. A comprehensive system of unemployment benefits has never been in place and only selected groups of workers (i.e. manufacturing firms and large units in some industries of service sector) have been covered by specific schemes. The ordinary unemployment benefit scheme -- available only to previously employed workers with a minimum period of contribution -- offers a rather low replacement rate (30 percent), and lasts for 6 months. Since 60 percent of unemployed have been out of work for more than a year and, on average, the level of social support is well below the European average (equal to 50-60 percent), this scheme cannot be considered the main cause of long-term unemployment in Italy.

Table 5 - The Italian Unemployment Benefit System

	Unemployment Benefit	CIG-Ord. (<i>Cassa Integrazione Guadagni</i>)	CIG-Straord. Special Regime	Mobility List
Workers involved	Lay-off workers (permanently)	Temporary Lay-off	Temporary Lay-off (in firms facing economic crisis, +15 employees)	Collective and individual lay-off (if already in CIG)
Replacement Ratio (in percentage)	30	80 (with a max)	80 (with a max)	80 (1 st year) 64 (afterwards)
Eligibility	2 years contribution	No conditions	3 months of tenure in the firm	12 months of tenure in the firm
Maximum duration (in months)	6	12	no limit	12-48 (* "long mobility" up to retirement)

Source: Boeri, Layard and Nickell, 1999 (tab. 4, pag.15)

Other temporary lay-off schemes (*CIG Ordinaria*) are designed to subsidise employers to keep on workers in times when they would have otherwise been laid off (the entitlement can last from 6 to 12 months). However, since the *CIG Ordinaria* can then be replaced by *CIG Straordinaria* -- for firms in structural crisis -- at essentially the same replacement ratio, the difference is largely formal and benefit entitlement has in practice unlimited duration¹². Recently the *CIG Straordinaria* has been replaced by the *Mobilità* scheme whereby firms receive a subsidy to hire workers listed in the scheme. Note that according to the original design of the scheme, these workers are generally not classed as unemployed in official statistics. These features -- apart from official statistics -- may instead contribute to lengthen jobless spells and induce duration dependence (Atkinson and Micklewright, 1991)¹³. As previously mentioned, also invalidity benefits and early retirement schemes should be considered, for there is evidence that they often work as substitutes for unemployment compensation (i.e. reforms in individual schemes have often resulted in unemployed being shifted onto other schemes, thereby masking the problem of benefit dependency).

¹¹ Minimum years of service for civil servants was set at 20 for men and 15 for married women.

¹² See Boeri, Layard and Nickell (2000) for an extensive treatment of social welfare in Italy and the UK.

¹³ The issue of duration dependence is very important since, as shown in the literature, it is crucial to distinguish to what extent duration dependence reflects differences in the characteristics of workers or indicates a 'pure' dependence effect. Empirical evidence based on raw data suggest the existence of negative duration dependence for most countries; conversely, econometric studies show that once (observed and unobserved) heterogeneity has been taken into account there is little evidence of 'pure' duration dependence. The policy relevance is clear since, in one case, policies should be designed to prevent people from becoming unemployed, whilst in the other case, policies should be targeted to selected group of workers irrespective of the length of the unemployment spell.

While the traditional argument for opposing generous social benefits is that public assistance raises reservation wages and --, by lowering the return to job acceptance -- prolong unemployment duration, the evidence for Italy seems to suggest that benefit generosity cannot be considered as the main cause of unemployment. Once again, however, the picture that emerges is one of high protection from labour market risks for a restricted group of 'insiders'.

Active measures

An alternative approach to prevent people from becoming long-term unemployed is to adopt active labour market policies to ensure that individual searching for employment receive proper job offers and that -- when a mismatch between supply and demand makes employability difficult -- appropriate re-training schemes are operated. Early measures introduced in Italy in the attempt to tackle unemployment more directly have been directed at improving the employability of the unemployed, particularly the young and the long-term unemployed, through job training schemes (*Contratti di formazione lavoro*). Other active measures have taken the form of direct employment subsidies to foster job creation by means of tax and social charges rebates and start-up loans offered to young unemployed individuals (mainly in Southern regions). Also direct job creation schemes (the so-called *Lavori socialmente utili*) have been designed to offer temporary job opportunities to long-term unemployed.

While expenditure on these programmes in Italy still remains at one of the lowest levels in Europe (about 0.35 of GDP), their efficacy in creating additional jobs remains doubtful: crowding-out, substitution effects and large dead-weight losses in the implementation of the schemes are indicated as the main factors for the poor performance. In most of the cases, the schemes have simply achieved to compensate for differences in labour costs due to the large differences existing in labour productivity levels, between Northern and Southern regions, and the limited wage differentials allowed by collective bargaining.

Labour taxes

One of the main implications of both the low employment rate and the corresponding high proportion of individuals who need to be supported (in one way or another), is to be found in the high social welfare expenditure. As already discussed, in the case of Italy, the latter concern not so much measures to support the unemployed, but mainly transfer to older age groups and various categories of pensioners (the old-age dependency ratio is high and increasing compared to European standards). A feature shared by most European countries -- and Italy in particular -- is that a significant part of the tax burden falls on labour. Although in a perfectly competitive world with no transaction cost it should not matter on which factor of production taxes are mainly levied; in practice, if markets are incomplete and different institutions regulate the functioning of the labour market the incidence on labour can make a difference. High taxes on labour, in general, mean higher labour costs, but the effects are not likely to be the same everywhere. Labour market institutions, such as unions or minimum wages, can effectively shift the burden on higher labour cost thus reducing employment and rising capital-labour ratio. In the last 30 years, in continental Europe, overall taxes on labour income -- the so-called tax-wedge -- rose approximately 20 percent with the implied effect on both unemployment and capital-labour ratio (Daveri and Tabellini, 2000)¹⁴. In figure 9, we report the evolution of the tax-wedge (on

¹⁴ Daveri and Tabellini (2000) report that -- between the 1960s and the 1990s -- average unemployment in continental Europe rose from 2.1 percent to 10.5 percent, while capital-labour ratio more than doubled. Conversely, in spite of similar growth rates, US and Canada did not show any trend in unemployment and capital-labour ratio only increased by 30 percent. They also estimate that the rise in the tax-wedge can explain half of the increase in the unemployment rate and both the growth slow down and the fall in the investment share. For an alternative view see, Layard and Nickell (1999); Blanchard and Wolfers (1999).

labour) versus the employment ratio, comparing the US with three continental European countries (Germany, France and Italy). The difference in the tax-employment patterns across countries are clear. On the one side, the US show a low-tax/high-employment equilibrium (top-left corner in fig.9) with a significant decrease in the tax-wedge mirrored by a huge rise in the employment-ratio over the last 15 years (after an increase in the '70s and early '80s); on the other side, Italy exhibits a high-tax/low-employment equilibrium (bottom-right corner in fig.9) as well as an increase in the tax-wedge followed by a progressive deterioration of the employment-ratio (i.e. a similar pattern can be detected in Germany and France).

[figure 9 around here]

The interaction of several institutional factors with the tax system seem to have produced a worse outcome in Italy than in any other country, the most worrying feature, however, is the perception of a vicious circle which tends to perpetrate a highly inefficient economic performance. In particular, the strength of "insider" effects on the labour market appears to be amplified by the role of taxation which, on the one hand, tends to further reduce employment displacing workers out of the "primary" sector into the irregular economy and the less protected segments of the labour force (where no social contributions are levied) and, on the other hand, imposes higher (tax) rates on a smaller (labour) tax base in order to finance social welfare expenditure. The main concern here is not so much related to the short-run inefficiencies associated to high taxation and (un)employment, but to the more permanent effects that make the implicit redistribution between work and non-work (in all its different features) difficult to be sustained in the long run¹⁵.

3.4. The North-South Divide

Regional differences in economic conditions and in factor prices are common phenomena to most industrialised countries. Italy in particular, in the last two decades, has experienced a progressive polarisation of local labour market conditions in different areas of the country (mainly the north-south divide). As shown in figure 10, the difference in average unemployment between Northern and Southern regions has progressively increased: in the mid-nineties unemployment rate was close 30 percent in the South, while less than 6 percent in the North. At the same time both a reduction in relative wage differentials between northern and southern regions and a decreasing trend in (internal) migration flows - from the South to the North of Italy – occurred (Faini, 1998; Faini et al., 1997).

[figure 10 around here]

An additional feature, particularly relevant in the Italian case, is related to the presence of a large share of the labour force employed in the underground economy. Whilst the effective size of this non-regular form of employment is not known, its effect on the functioning of local labour markets might be relevant¹⁶. Indeed, it has been argued that the reduction in relative wage differentials, coupled with substantial governmental subsidies to both firms and households in the south and the diffusion of jobs in the irregular economy -- by reducing the incentive of individuals to move -- have exacerbated the regional mismatch (Brunello, et al., 1998; Lupi and Ordine, 2000). When the rule of law is poorly enforced and the size of the informal sector is relevant also the environment in which firms have to operate tends to deteriorate. Public employment, in the last 20 years, also increased significantly in the

¹⁵ Another anomalous effect of the structure of the welfare system in Italy is that, being targeted mainly to financing non-employment through income maintenance and towards the aged *vis-à-vis* the non-aged, it encourages low fertility rates and as such determines more pronounced ageing. The vicious circle by raising old-age dependency ratio further increases social expenditures in pensions and related income maintenance schemes for the elderly thereby worsening the effects of welfare state and taxation on employment.

¹⁶ According to some recent estimates, the irregular economy can account for as much as 30 percent of employment in the South.

south (see table 6, rows 1-5). Originally this was intended to compensate for the poor employment opportunities of the private sector, though over time public jobs have become a critical source of disposable income to sustain standard of living in the south thus increasing further the imbalance with respect to private sector job opportunities and job creation. An oversized public sector represents a form of hidden transfer to high unemployment regions and, since (low-skilled) entry wages tend to be higher in the state sector as opposed to comparable private sector jobs, individuals prefer -- while unemployed -- to queue and "wait" for public sector jobs to become available (Alesina, Danninger and Rostagno, 1999)¹⁷.

A number of additional dimensions of "segmentation" along the north-south divide can have important implication for the functioning of the labour market. According to various indicators which might be thought as indirectly related to the efficiency of the economic system, in terms of the (subjective) "quality" of public services and crime control the south generally shows a much lower performance (table 6, rows 6-9).

Table 6 - Regional Mismatch and other North-South Imbalances

Characteristics	north	south
1 - Public employees per 100 employed	12.4	22.1
2 - Public employees per unit of regional product (1)	124.0	275.1
3 - Police officers per 1,000 crimes denounced (2)	72.9	108.3
4 - Tax inspectors per unit of regional tax yield (3)	11.6	59.9
5 - Postal workers per 100,000 units of correspondence (4)	179.3	1,782.7
6 - Quality of public transport (5)	6.1	4.5
7 - Quality of health services (5)	6.0	4.0
8 - Quality of University functioning (5)	6.3	4.7
9 - Safety, crime control (5)	5.9	4.0

Notes: due to the concentration of public sector employees in one central region (Lazio), the Centre has been excluded.

(1) regional product in (x100) billion of Lira.

(2) police officers in 1996 per 1,000 crimes denounced by the police in 1995.

(3)Regional Tax Yield in 1996 (VAT, Direct and Corporate taxation, ILOR and Customs duties)

(4)N. of post office employees per 100,000 letters and parcels sent in 1977.

(5) Subjective evaluation 1=worst; 10=best.

Source: Alesina, Danninger and Rostagno, 1999 (tab. 3, pag.27)

Further to what discussed thus far, persistent regional disparities in unemployment and in the distribution of public employment can also be relevant for wage determination. First, since a 'de facto' extension exists to collective wage agreements, the only way to compensate for lower productivity -- now that transfers to firms operating in the South are being reduced in accordance to EU prescriptions -- is to operate in the informal sector. Second, considering that public sector wages are essentially isolated by general labour market conditions, that collective bargaining is mainly driven by the national level which tends to be dominated by employed 'insiders' and, finally that wage competition by (immobile) southern unemployed workers is rather limited, then the expected outcome is that poor economic conditions and high unemployment in the south (no matter how high) are likely to have no moderating effects on average wages (Lucifora and Origo, 1999). Henceforth, high unemployment in

¹⁷ Alesina, Danninger and Rostagno (1999) argue that about half of the wage bill of the south can be considered as redistribution from North to South (and in excess to any structural features). This is the combination of two effects: a 'scale' and a 'price' effects. The former is due to the high proportion of public sector employment, the latter to the fact that (nominal) wages are similar across areas while prices are not. It should be noted, however, that the latter is not an exclusive feature of Italy, as a matter of fact in most European countries wages in the Public sector are centrally determined and do not vary much across regions (Dell'Aringa and Lanfranchi, 1999)

the South and labour shortages in the North could coexist generating inflationary pressures in local labour markets.

4. Institutional change and the recent wave of reforms

Our evaluation of the institutional changes that have characterised the Italian labour market will begin with the first period of reforms which concerned the *Scala mobile*. The second period of reforms, more recently, introduced with the *Accordo sul costo del lavoro* a new wave of incomes policies and some changes in the modes of collective bargaining. We shall also consider measures centred on wider connotations of labour market flexibility: employment protection, wage regulation, social welfare support and more direct labour market policies.

The reform of the *Scala mobile* started in 1983 with the reform of the indexation clause which reduced progressively inflation coverage and led to its definitive abolition in 1992. In principle, the end of the *Scala mobile* mechanism can provide a natural experiment for examining the impact of the removal of a wage floor on employment determination. However, since its abolition job creation has been rather poor. In particular, as far as low wages are concerned, the empirical evidence does not provide support for the fact that mainly wage minima were preventing workers to find a job "pricing themselves out of jobs" (Freeman, 1997; Lucifora and Salverda, 1998)¹⁸. Other measures such as the so-called 'solidarity contracts' introduced (starting in the early 1980s) some additional wage flexibility by allowing employers to pay wage levels below the nationally bargained levels (particularly in some disadvantaged regions of the South of Italy). Also a substantial flow of transfers and subsidies (mainly in the form of cuts in social security contributions, *Fiscalizzazione degli oneri sociali*) was directed towards firms operating in Southern regions. As already mentioned, these schemes have at most attained to compensate for differences in unit labour costs between Northern and Southern regions without creating any (net) employment gains.

On the job protection side mild reforms of procedures for employment reductions and collective (temporary) layoffs for economic reasons took place. The new legislation reformed the CIG scheme both fixing the maximum length of the subsidy and then introducing the *Liste di mobilità* scheme, as previously described, to favour the placement of workers after the elapse of wage supplementation. Evidence on their effects is not always encouraging and the employment subsidies concerned do not seem to have significantly increased outflows from unemployment.

The 1993 *Accordo sul costo del lavoro* marked a new wave of labour market reforms which eventually led Italy in the EMU. A predetermined inflation rate was to be used in both private and public sector collective bargaining as a reference for wage determination. Some further decentralisation in wage setting has taken place, both with the introduction of performance-related pay schemes negotiated at the local level and by the so-called *Patti territoriali* and *Contratti d'area* which allowed various types of incentives and exemptions to selected disadvantaged areas. Whilst both income policies and the more co-operative industrial relations climate are considered a major success for the sharp reduction in the inflation rate, the effects on job creation and reduction of unemployment seem rather modest (Dell'Aringa, 1999).

In more recent years, several additional reforms concerned different aspects of the employment relationship which -- though not yet completely enforced -- introduced more flexibility in employment contracts. The so-called *Pacchetto Treu* increased the possibility of firms to use fixed term contracts, it introduced agencies of job intermediation (sub-contracted jobs by 'private' placement Agencies) and extended the diffusion of part-time employment. Fixed-term plus training contracts for young entrants (*Contratti di formazione lavoro*) seem to have been the main area of job creation in recent years. In 1999, almost 85 percent of the new post created have been accounted by these types of 'atypical contracts'.

¹⁸ Extensive evidence from empirical studies suggests that the elasticity of labour demand at the bottom of the distribution (with few notable exceptions) is, in general, very low and that the employment gains (if any) are very modest (Dolado et al., 1996; Card and Krueger, 1995).

Available evidence, however, suggests that these have mainly acted as a cyclical buffer without affecting structural unemployment, and that the majority of those who held a 'temporary job' are still looking for a permanent position.

The search for increased flexibility has been directed also to a large range of labour and product market institutions, as well as administrative rules. Some examples are legislative changes introduced in industrial action procedures (i.e. regulating the ability of unions to strike in the services of public utilities), in union internal organisation (i.e. union leaders must be elected by a secret ballot) and, finally, in union methods of financing (i.e. the usual 'check-off system' whereby employers deduct union dues directly from payroll can no longer be used, whilst now individual authorisation is required). Although these measures were introduced with the main purpose of increasing flexibility, transparency and democracy at the shop-floor, they also had the unintended effect of rising the costs of organising membership and collecting membership subscriptions. Additional measures concerned administrative simplification in the public sector (i.e. the so-called '*Bassanini Law*') both in terms of recruitment procedures as well as in public work rules (Buti et al. 1998).

In sum, institutional changes to the functioning of the labour market brought about by the mild programme of deregulation and labour market reforms have been pervasive though the process is still far from complete. The major shortcoming to the functioning of the labour market discussed above show only modest improvements without any significant effect on the performance of the Italian economy. An agenda of the reforms which would be necessary for rising participation and employment opportunities and reducing long-term unemployment is discussed hereafter.

4.1 The Policy Agenda

The participation of Italy to the EMU and the constraints imposed by the 'stability pact' in accordance to the Maastricht treaty, as discussed in the Introduction, are putting additional pressure on the inefficiencies of the labour market. The reduced ability to implement (domestic) policies to deal with cyclical fluctuations and regional unbalances, suggests that more flexibility both in terms of wage-bill as well as labour adjustment will be necessary to accommodate idiosyncratic shocks. The poor performance of the labour market, as discussed in the paper, is not a recent phenomenon and cannot be attributed to Maastricht criteria or to the participation of Italy to the EMU.

In the new economic setting, however, some institutions which have regulated the functioning of the Italian labour market protecting workers from various market failures and uninsurable risks (i.e. the risk of unemployment or low pay), are likely to involve much higher adjustment costs. Employment protection legislation, compressed wage differentials and specific social welfare benefits while reducing the individual cost of a negative shock, end up strengthening the power of "insiders" -- those employed in the 'primary' sector -- and imposing high social costs on the "outsiders" -- those without work and those employed in informal sector --. In this view, reforms are needed mainly to reduce insider power and eliminate the various forms of discrimination that currently exist, between different groups of workers, in job and labour income protection (OECD, 1997a,c).

As the previous overview of the pattern of reforms has shown, institutional changes directed to eliminate rigidities -- particularly in labour market practices and regulations -- have encountered strong resistance. This resistance derives from different sources. First, it should be considered that in the decision process about desirable changes the preferences of median voters matter, since the latter are likely to be employed their choice may be more oriented towards higher wages and employment stability rather than lower unemployment and productive efficiency. Second, there are reservations about the desirability of a more 'flexible' labour market. Some labour market 'rigidities' such as the social protection system, collective bargaining and minimum wages are perceived as factors contributing to the improvement of economic and social welfare. In particular, the experience of the

US and UK raises concern that increased flexibility might induce higher inequality and more job instability. Third, as previously shown, in labour market settings where household-head job and labour income are strongly protected, a "dual" structure in which non-employment is mainly concentrated among youngsters and women emerges. Whilst these patterns may simply reflect social attitudes and family structures prevailing in Italy, it should be observed that, since 'gainers' and 'losers' are member of the same family, the apparent low social conflict and its persistence over time could be rationalised in terms of the existence of an (implicit) internal redistribution of (net) benefits.

All the arguments reported above are legitimate and deserve proper attention.

(i) Unions and Collective Bargaining

The presence of strong unions and collective bargaining practices should not be considered as an impediment to labour market efficiency and better economic performance. Large representative unions which cover the interests of the various groups of individuals belonging to the labour force (the so-called encompassing-union), as opposed to many conflicting corporative unions attempting to protect the "insider" power of different groups, have an important role to play in the process of reforming the labour market. In the presence of imperfectly competitive markets and imperfect information, unions may improve upon factor price distortion and dead-weight losses by limiting firms product market power and monopsonistic behaviour (Boal, 1997). Through the "collective voice" unions may reduce firm's turnover costs -- allowing a better matching and lowering inefficient separations --, improve information dissemination and the (re)allocation of workers to jobs. Finally, the shift from monopolistic behaviour to incomes policies and concertation practices can -- by internalising the employment costs of high (real) wage dynamics -- contribute to wage moderation and employment creation, as well as reinforcing the credibility of the welfare system reform and fiscal adjustment for the reduction of public sector debt. Finally, as far as the optimal level of bargaining is concerned the costs and benefits of centralised co-ordination versus more decentralised wage setting should be clearly evaluated. In the lack of effective co-ordination a decentralised system does not necessarily guarantee neither wage moderation nor higher flexibility. A two-tier wage determination system might be achieved either with a collectively bargained wage minima or a statutory minimum wage, at the central level, while granting additional flexibility at the decentralised to allow: a more efficient allocative function of local labour markets and both profit sharing as well as pay for performance schemes.

(ii) Labour market flexibility and social security reform

In order to avoid that a change in hiring and firing procedures and in overall labour market flexibility will be associated to an excessive widening of wage differentials, creating higher income inequality, greater poverty and social exclusion; a reform of the structure of benefit schemes should be envisaged both extending their insurance role and targeting them to 'active' measures (i.e. such as work-incentives and active placement agencies) rather than simply passive schemes.

Although it is often argued that low-paid employees are not, on the whole, part of low-income households, this snapshot perspective ignores the issues of income distribution within households and masks the dynamics of social exclusion over the lifetime (Freeman, 1995). In the new retirement system (the so-called *Amato-Dini* reform), the adequacy of income after retirement is based on labour market income over the whole working life, in this context low earners may face poverty in later life due to inadequate pensions. Low pay also disadvantages certain sections of the population more than others, such as women and minority ethnic groups, thus the problem is central to equal opportunities policies.

The reduction in extensive regulation and excessive protection against labour market risks can -- by reducing "insiders" power -- improve the efficiency of the matching process but it should not be seen as the main solution to the problem of long-term unemployment. The shortening of the length of the spells of unemployment must be put at the forefront of the agenda for policy actions in Italy, although

a balance must be found between policies aimed at increasing flexibility and those preventing low pay and social exclusion. The most effective policy mix will have to consider both employment opportunities as well as the effects of low pay on the individual alone and as part of the household. Higher employment can redistribute income within households (from "insiders" to women and young "outsiders") while leaving household income unchanged or even higher. The evaluation of these policy trade-offs, in terms of both efficiency and equity, should consider the possibility of devoting more resources for compensating the losers of the reform process.

(iii) Labour taxation and employment subsidies

Finally, payroll taxes should be reduced in order to favour employment opportunities. Given the imperfection and the role played by institution in the functioning of the labour market a shift of part of the tax base from labour to other factors might be beneficial, since, as previously discussed, the distortionary effects of high taxation on labour may create a significant misallocation of resources and dead-weight losses.

Fiscal incentives may be directed to all workers or just to selected groups of individuals, however larger scope exists in using tax reductions to encourage transition from non-employment into employment of more disadvantaged groups in the labour market: mainly the low-skilled and those with short work experience. Regional imbalances are of course another dimension towards which tax and social security reductions could be targeted to compensate for lower productivity. Other forms, of incentives such as in-work benefits or income tax-credits may provide additional support for low-paid individuals.

In conclusion, the tax reform should complement other institutional changes directed to the reduction of "insider" power on the labour market so as to eliminate the vicious cycle that, on the one hand, tends to displace workers out of the "primary" sector into the irregular economy (where no social contributions are levied) and, on the other hand, imposes even higher (tax) rates on the remainder (labour) tax base in order to sustain social welfare expenditure.

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List of abbreviations

EMU - European Monetary Union
EU - European Union
E15 - Community (15 countries)
GDP - Gross Domestic Product
OECD - Organisation for Economic Cooperation and Development
CIG - Cassa Integrazione Guadagni (Wage Supplementation Fund)





