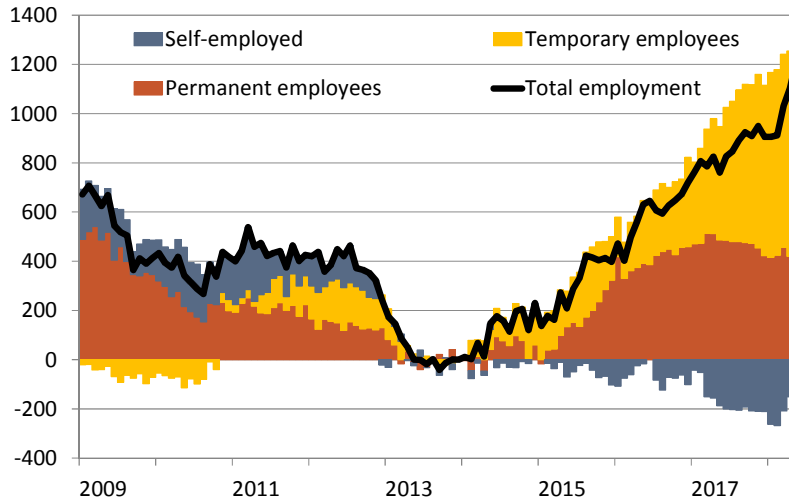


18 July 2018

## The big Italian risk: labour reform reversals

The progress at risk: Italy's 2014-2015 labour reforms have worked to some extent



Cumulative change in employment since December 2013, in thousand persons. Source: ISTAT

- It's the labour market, stupid:** Countries with persistently high unemployment, sub-par trend growth and chronic fiscal problems resulting from such supply-side malaise need to make their labour markets more flexible. Margaret Thatcher did that the UK in the 1980s, Gerhard Schröder followed suit in Germany around 2004. In both cases, the reformers turned their struggling countries into new growth engines after a while. Reforms work. In the same vein, reversing labour reforms can push a country back into misery. Italy now faces that risk.
- Renzi tried – with some success:** In Italy, then Prime Minister Matteo Renzi made major progress with his Jobs Act of 2014-2015 and some further reforms. Although he did not tackle Italy's other big problem, the sheer inertia of its often arcane bureaucracy and judiciary, forcefully enough, his overhaul of the labour market did yield results. The total rise in employment in 2016 and 2017 outpaced that of any other two-year period since 2001.
- Stages of change:** Renzi reduced the judicial risks of layoffs for companies and introduced a unified labour contract for new hires. He also offered temporary subsidies for permanent jobs. The chart shows the result: in the first wave of new hiring in 2015, companies mostly used open-ended contracts. When these subsidies were phased out from 2016 onwards, jobs growth shifted to the temporary jobs that are often a precursor of a lasting labour market upturn. To some extent, temporary jobs have replaced some even more precarious kinds of "self employment".
- Temporary jobs: part of the problem – or part of the solution?** Most workers prefer the security and protection that comes with a permanent job. However, in uncertain times, companies often resort to precarious jobs first before they feel confident enough to offer standard permanent job contracts. After the German reforms, precarious forms of employment surged until, some years later, the boom in the more sought-after permanent jobs set in.
- A bad start for Italy's radical government:** As its first major initiative, Italy's radical government passed a decree in early July that restricts temporary jobs in a number of ways: temporary contracts can now be extended only for a maximum length of two rather than three years. Any extension is penalised by a 0.5ppt increase in payroll taxes. Even worse, temporary contracts can only be used for specific reasons, making these contracts vulnerable to expensive legal challenges. In addition, the "dignity" decree raises the maximum compensation for "unfair" dismissals from 24 to 26 months' salary and threatens companies with heavy penalties if they relocate production abroad within five years of receiving a subsidy in Italy. Italy's parliament will likely endorse the decree in late July, with some chance that Lega leader Matteo Salvini may still water down slightly the decree championed by 5Stars.
- Less flexibility today is a recipe for a crisis later:** As the weakest of all big Eurozone members, Italy cannot afford even a partial reform reversal. If companies find it more difficult to fire and to resort to temporary work contracts, they will employ less labour. Reduced flexibility impairs a country's long-term growth potential. An even slower pace of trend growth would make Italy highly vulnerable to a debt crisis. By implementing its expensive tax cut and spending promises *only in stages*, Italy can – probably – *avoid such a crisis* for now as long as it does not get into a noisy fight with the EU that could spook investors. But once the next recession, due perhaps in 2021 on current US cyclical dynamics, lays bare the impaired state of Italy's supply side, Italy may be heading for serious trouble.

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