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Italy is different: Beyond labour market reforms

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The German debate about Southern European economies often suffers from premature conclusions on the basis of analogies to the German experience of the 1990s and early 2000s. However, the causes of Italy's weak growth differ from Germany's troubles in the post-unification era, and, in some respects, they differ from other peripheral economies' problems as well. The main break on faster eco-economic growth in Italy is the public sector.

Moreover, important and often underestimated factors in the Italian crisis are systemic effects stemming from membership in the Eurozone. In particular, Italy suffers from a credit crunch caused and magnified by adverse feedback loops in a currency union.

Is it the labour market?

Italy suffers from weak growth over the course of the last years, combined with high unemployment. What are the main causes? And what would be appropriate strategies for the new Italian government?

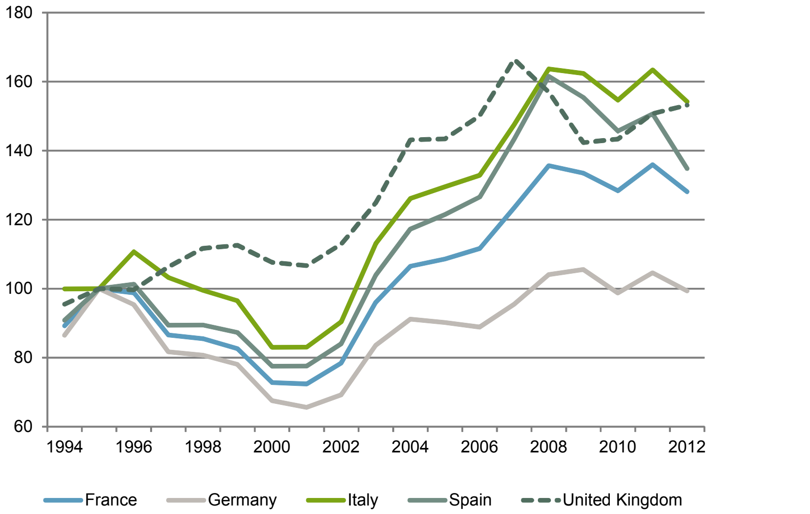
If you look at Italy through the lenses of German mainstream analysis, the answer is clear: One of the most important tools to overcome Italy's economic problems seem to be labour market reforms, in order to reduce labour cost and improve competitiveness. This view is, of course, an echo of Germany's own experience of the last one-and-a-half decades. Consequently, liberalisations in employment protection planned by the new Renzi government are greeted with much acclaim. A first look at the development of unit labour cost in different countries of the Eurozone – with Italy at the top – seems to corroborate that perception (cf. figure 1).

While labour market reforms do have their merits, the case for them in Italy is however weaker than elsewhere:

Labour market regulation comprises two distinct sets of regulations and institutions: Individual labour law comprises rules on unfair dismissal, termination indemnities, permissibility of short-term employment contracts. Collective labour law provides for the right to strike, collective labour agreements and the institutions negotiating them.

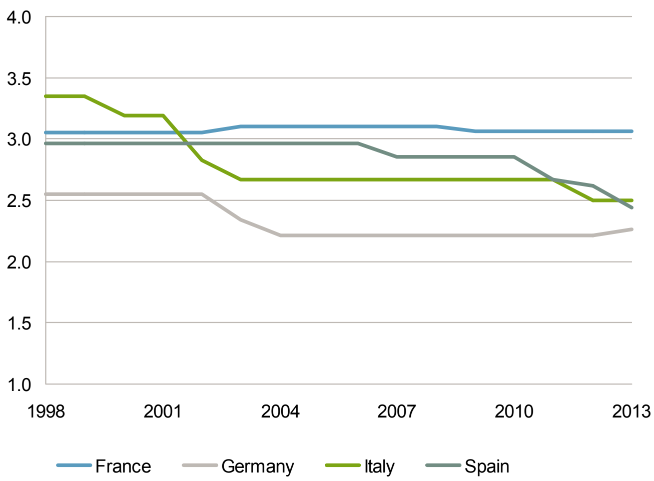
- Italy's individual labour law is not substantially stricter than that of other big

Figure 1: Evolution of Relative Unit Labour Cost, 1995–2012



Source: OECD.

Figure 2: Strictness of overall employment protection by OECD Indicator (the higher, the stricter)

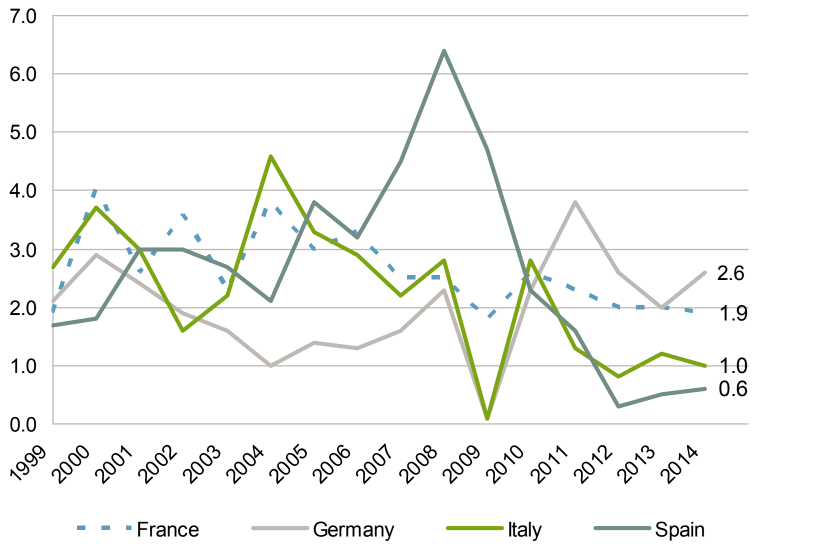


Source: OECD, own calculations. The Indicator shown is the weighted average of the three OECD indicators on individual dismissals (5/12), additional regulations for collective dismissals (2/12) and temporary employment (5/12).

Eurozone economies, regardless of their respective employment levels (cf. graph 2). Moreover, Germany manages to obtain high employment and competitiveness with a very similar degree and style of employment protection.[1] This observation is in line with empirical findings: The majority of empirical studies tend to find no significant effects of employment protection legislation on overall employment.[2] Of course, measures like the planned implementation of a "single labour contract"[3] in Italy will still be welcome, in particular in facilitating the transition of young people from the educational phase into employment.

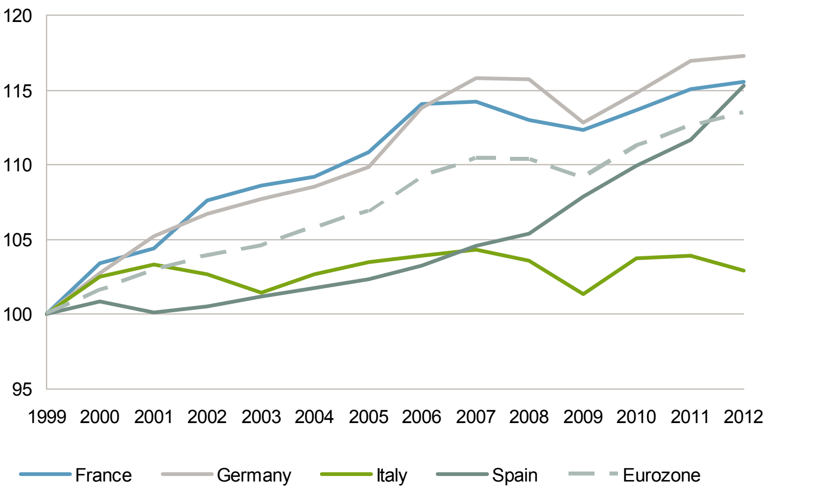
- Much of Germany's recent employment success is credited to its system of negotiating collective wage agreements.[4] The system combines regional framework contracts between union and employer representatives being negotiated for every industry with, in effect, a large degree of discretion for local firms to opt out from or amend the national contract, provided local employee representatives consent. In Italy, union wages are often negotiated at the national level and apply to all firms in the industry, with comparatively little involvement of local employer and employee representatives.[5] It is frequently argued that countries with more centralised wage-setting could benefit from flexibility as this would allow for easier adjustment of nominal wages in both upturns and downturns.[6] However, both theoretically and empirically wage-setting systems with a higher degree of compulsion don't fare that bad, as all participants adjust their negotiation and compliance behaviour to it. Empirically, "quite different institutional arrangements are capable of obtaining similar levels of macroeconomic job performance."[7] The Italian wage setting system has indeed adapted to the environment of the Eurozone. While, for the first years of the Eurozone, collective bargaining had produced wage increases well above most European peers, and in particular, above productivity growth, current nominal wage growth is very low, the competitiveness gap slowly closing. Even lower nominal wage growth is not desirable, due to the feedback of very low wage growth on capacity utilisation, and because of implied deflationary risk. Last but not least, under the June 2011 labour agreement between employers, government and the three biggest unions, collective bargaining has already changed to allow for more discretion on the local level. The government supports local negotiations by tax incentives. Given the importance in a currency union of replacing the possibility to depreciate by some form of internal flexibility, this is a major accomplishment.

Figure 3: Nominal Wage increases, y-o-y (Average annual income of dependent full time employee, y-o-y, total economy)



Source: OECD. Estimate 2013 / Forecast 2014: Own estimates based on OECD Economic Outlook forecast 2013 for compensation per fte.

Figure 4: Real labour productivity per hour worked, 1999=100



Source: Eurostat.

What is it then?

If it is not primarily the labour market institutions, what is it then? What explains the disappointingly slow adjustment in unit labour cost as shown in figure 1?

It is the slow productivity trend shown in figure 4. No other major economy seems to have such a hard time increasing productivity. While it is clear that the low productivity trend does not primarily stem from a lack of investment (Italian Gross Fixed Capital Formation is without pathological findings), the precise causes are controversial.

A breakdown of productivity by sectors shows that the low productivity trend can be explained to a large extent (albeit not entirely) by poor performance of the services sector.[8] This hints at causation by Italy's almost notoriously inefficient public sector. Not only is the public sector itself part of the services sector, through regulation or the education system it exerts greater influence on the service sector than on technical progress in manufacturing. With government outlays of more than 50 % of GDP (2013: 51.4 %), Italy's public sector is above OECD (41.7 %) and Eurozone (49.5 %) averages. While the size in itself does not have to be an impediment for productivity or growth (frequently proven by e. g. Scandinavian countries), deficiencies in the public sector are the more detrimental the bigger it is. The deficiencies of the Italian public sector affect productivity growth in a number of ways:

- The judicial system shows by far the lengthiest trials in the western world. With an average duration of 1,200 days, it takes more than twice as long as in an average OECD country to resolve a normal civil case.[9] This has a couple of consequences: Enforcing contracts is difficult, resolving insolvency is difficult and – because it takes banks on average seven years to resolve insolvencies –, getting credit is more difficult in Italy and involves more collateral, even under normal cyclical conditions.

- Because loans are the prime source of financing for SMEs, the inherent difficulty of getting credit is one of the reasons for small firm size and slow upgrowth of SMEs, adding to foregone economies of scale, and hence, foregone productivity growth.

- Among the main reasons cited by international investors for not investing in Italy, difficulties with the legal and judicial system rank extraordinarily high. In the World Bank's "Ease of doing business survey", from eight items where Italy is perceived to be below international average, four relate to the judicial system, and all seem to relate to public governance issues.[10] Low foreign direct investment, however, is seen as one of the drivers of low productivity growth, since FDI alleviates international permeation of technology, is associated with economies of scale and, by increasing domestic competition and driving down markups, forces domestic companies to invest into productivity increases.

- Another weakness of the public sector seems to be the administration of large infrastructure and construction projects. This adds to a lack of public infrastructure (in southern Italy). However, physical and technical infrastructure, regardless if owned privately or held by the state, is complimentary to other production factors and contributes to productivity growth.[11]

- The educational system, while producing highly qualified university graduates, is hallmarked by a high number of school dropouts (17.6 % as opposed to the EU average of 12.7). Furthermore, the share of university graduates in an age cohort seems low by international standards.

- Last but not least, utilities and professional services appear to be regulated in a suboptimal fashion in Italy, leading to high prices, high mark-ups and, accordingly, low domestic competition and low productivity increases. This is particularly true for the electricity sector, where the cost per kWh is almost 50 % above Eurozone average. Both the utilities and the professional service sector do indeed need government regulation, for economic (e. g. electricity and gas grids being natural monopolies) as well as normative reasons (lawyers need to be regulated in order to ensure the rule of law). However, regulators in Italy are perceived as weak, ineffective and "captured" by the lobbies they are to regulate.[12]

All in all, in line with the new Prime Minister, who called bureaucracy "the mother of all battles"[13], we perceive a reform of the public sector as being of higher priority than any other area of reform policy. This is plausible not only because of higher potential for growth-enhancing reforms in these areas but also because the social cost-benefit ratio would be more favourable.

It should be noted that the reform of the public sector is in progress. Italy has already implemented a couple of reforms with respect to the energy, professional and local public services sector. Additionally, the number of courts dealing with commercial and trade law cases has been increased. However, reform of the public sector and regulation is complex and requires both time and some fiscal space. Improvements of the judicial or educational system will almost certainly require additional funds being allocated to these sectors, even if some or indeed the better part of the problems may be solved by changes in structures, institutions and law alone. Economic reform requires at least moderate doses of fiscal space and macroeconomic support.

Euro crisis as an external shock – it's not only the supply side.

Speaking of macroeconomic support, one observation seems to be in order: Despite all the - alleged or real - weaknesses of the Italian economy, Italy managed to sail along very well as recently as in the 1990s. The table shows Italy's per-capita growth being above the Western European average, above Germany's and among the fairly successful countries in the 15 years preceding the Euro. None of the weaknesses have prevented Italy from growing decently through most of the 1990s. Trouble began with the onset of the Eurozone, in particular, with the euro crisis – an indication that, whatever the structural weaknesses, additionally strong macroe-

Table : Italy's average growth per capita, compared to its peers

G7 plus Western Europe, average real growth per capita	1985–1998	Rank	1999–2012	Rank
United Kingdom	2.9 %	1	1.2 %	4
Spain	2.8 %	2	1.0 %	5
Japan	2.5 %	3	0.8 %	8
USA*	2.2 %	4	1.3 %	2
Italy	**2.1 %**	**5**	**0.1 %**	**9**
OECD Western Europe**	2.0 %	6	0.9 %	6
Germany*	1.9 %	7	1.3 %	3
France	1.7 %	8	0.8 %	7
Canada	1.5 %	9	1.4 %	1

* 1999-2013
** OECD Western Europe = Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK.

Source: OECD, own calculations

conomic forces are at play.

The most important of these forces are negative feedback-loops that led to a severe credit crunch on the Italian banking market:

The Italian recession began at end-2011 with a sudden and drastic withdrawal of liquidity from the Italian banking system, which in turn aggravated the recession. This could not result in a depreciation of the currency to alleviate the recession. Hence, the recession was stronger than usual due to the lack of a European crisis management and liquidity support system.

Additionally, until the announcement of OMT, funding was expensive for Italy, forcing excessive austerity on the Italian state, transforming this recession into the longest recession in Italian post-war history.

This led to both a high share of non-performing loans (NPL) in the loan portfolio (more than tripling from 5.1 % at the end of 2008 to 16.0 % by September 2013) and a devaluation of collateral. Provisions for NPL, however, put a strain on Italian banks` capital and reserves, further hampering their capacity to supply loans in the recovery.[14]

While the 3-year LTROs and OMT have secured Italian banks' liquidity position, wholesale and long-term funding is still difficult, as proven by the heavy and ongoing reliance on Euro system funding (about a quarter of the entire Euro system amount outstanding) and high CDS spreads on Italian bank loans (the highest among the big Eurozone countries). Moreover the phasing-out of government guaranteed bonds in March 2015 will further limit the banks' willingness to extend long-term loans.

Figure 5 displays the consequences over the course of the last years: Both the initial tightening at the onset of the euro crisis as well as a recent tightening cycle since mid-2012 are visible, interrupted only by a brief recovery in early 2010. As a result, bank lending has been contracting now for 2 years, driven to a large extent by restrictions on the supply side.[15]

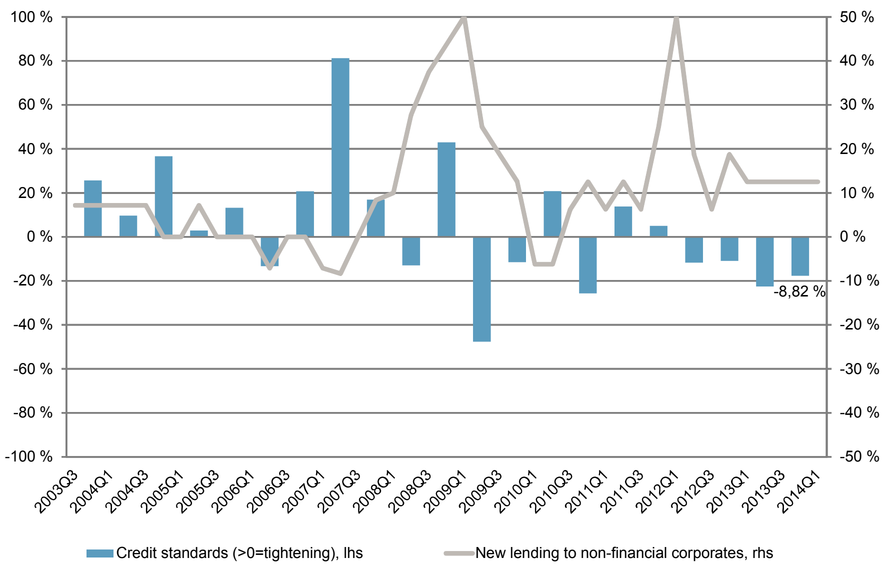
What should Italy do about it?

To cut in on that negative feedback loop and to allow private banks to take problem assets off their books, Italy should establish a bad loans vehicle. Since Italy has one of the lower ratios of revenue from wealth taxes among large economies, the country could, for example, raise its property tax and use the proceeds to support this. In order to gain sufficient traction, European financial support would be useful. Italy itself could further support the banking sector by establishing a market for distressed debt.

Alternatively, the recovery could be supported by granting Italy more fiscal space. A better cyclical environment would improve the quality of some of the distressed debt and allow banks to gradually write it down.

In conclusion, Italy's current problems differ from Germany's past ones in many respects. It would be wrong to simply transfer ready-made recipes. Beyond specific supply-side reforms with respect to the public sector, Italy would very much benefit from macroeconomic support. This could come in the form of banking sector support or the use of additional fiscal space. ■

Figure 5: Credit conditions and new lending to non-financial corporations



Source: Banca d'Italia.

[1] Even for the infamous "Article 18" a German equivalent exists: § 23 KSchG, the threshold is 10 employees.

[2] Cf. OECD Employment Outlook 2013, p.71

[3] "Single labour contract" relates to the level of employment protection increasing with seniority only

[4] Cf. Dustmann, C., Fitzenberger, B., Schönberg, U. and A. Spitz-Oener, *From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy*, Journal of Economic Perspectives, Volume 28 (2014), p. 167–188

[5] Cf. Dustmann et alii, loc. cit., p. 183

[6] Cf. Dustman et alii, loc. Cit., p.183f

[7] See OECD Employment Outlook 2004, p.130

[8] Cf. Fois, Fabio, *Italy: Searching for growth*, Barclays Economic Research, April 2012, p.2

[9] Cf. IMF Country Report 13/298 (September 2013), p. 17

[10] Cf. IMF Country Report 13/298 (September 2013), p. 15

[11] Cf. Sachverständigenrat zur Begutachtung der Gesamtwirtschaftlichen Entwicklung, *Staatsverschuldung wirksam begrenzen,* Sondergutachten *(2007)*, Kasten 4, p.50–52.

[12] Cf. IMF Country Report 13/298 (September 2013), p. 16

[13] Cf. http://www.agi.it/politica/notizie/201402231033-pol-rt10007-renzi_burocrazia_madre_tutte_battaglie

[14] Cf. IMF Country Report 13/298 (September 2013), p. 25

[15] Cf. European Commission Occasional Paper 182 (March 2014), *Macroeconomic Imbalances Italy 2014*, p. 16; IMF Country Report 13/298 (September 2013), p. 5