Entry and Exit Flexibility:
Asymmetries in the Italian Labour Market

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May 2008

Introduction

The main argument in this paper is that the recent reforms aimed at enhancing Italian labour market flexibility on the hiring side may have limited beneficial effects if the protection guaranteed to permanent employees remains extremely high.

There are well documented facts that characterize the Italian labour market:

- a very high rate of youth unemployment
- flexibility on the hiring side
- very restrictive firing regulations
- long term unemployment
- low job mobility
- large black market economy
- a productivity trap

All these point are interrelated and feed into each other. We propose here to deal with the first four points. We focus on the effects of stringent labour market regulation and the way in which it reinforces a dual labour market. Duality arises when the labour market is separated into a primary and a secondary sector. Workers with jobs in the primary sector (known in the economic literature as “insiders”) have higher pay, greater job security, better working

conditions and superior opportunities for promotion through the internal labour market which remains largely closed to “outsiders”. Workers in the secondary sector (the outsiders) have jobs with lower status, are poorly paid, have poor working conditions, little job security and very limited promotion or training opportunities. In Italy, duality manifests itself mostly acutely in a high level of youth unemployment.

1. Youth unemployment

The Italian unemployment rate has decreased to 5.7% in 2007 from 11,3% in 1997. It is among the lowest unemployment rates in the EU. At the same time, youth unemployment has reached 20%, among the highest rates in the EU and is even higher for females. Unemployment is therefore concentrated in the 16-25 age group. From the age of 25, it drops back to (and beyond) the national average.

The decline of unemployment with age is in part due to exits from the labour market - inactivity rates[1] increase by more than the increase in employment rates. The increase in employment is also due to the impact of immigrants (+9.4%) who tend to be older than 25. Very high youth unemployment is one of the major aspects of the persistent dualism in the Italian labour market.

2. Flexible hiring

A large amount of attention has recently been paid to the consequences of the increased flexibility on the hiring side, introduced since 1997 by the Treu Law and extended in 2003 by the Biagi Law[2] that permitted atypical contracts. Labour market flexibility came to Italy later

[1] Italy has a low rate of participation among the young, women and the elderly. In 2005, the rate of unemployment of people in the 20-29 age group with a university degree was 23.9% against an EU average of 9,3%. (Eurostat, 2006)

[2] **TREU**
Legge 24 giugno 1997, n. 196
"Norme in materia di promozione dell'occupazione."

BIAGI
Legge 14 febbraio 2003, n. 30
"Delega al Governo in materia di occupazione e mercato del lavoro"

than to most other European countries and was a means of coping with fierce international competition and demand uncertainty. The first wave of flexibility measures in Europe took place in the early 1980s. For instance in 1984, Spain introduced temporary contracts while Italy introduced training contracts (*contratti di formazione lavoro*) in 1986, a first timid attempt to cure the high youth unemployment (around 30%)[3] by lowering the cost of hiring. Firms made heavy use of these training contracts. However, in Italy flexible contracts were introduced only in the second wave of labour market reforms in the EU countries, that started from the late 1990s - France in 2000 and again in 2007, Britain, in 2002.[4]

The increased flexibility has had a positive effect on the unemployment rate in Italy which has fallen from 12% to 5.7% in a decade. Over this ten year period, Italian companies generated 3.5 millions new jobs. Atypical contracts have indeed increased job opportunities for the unemployed.

In the light of the strong restrictions imposed on the firing side, firms have resorted massively to temporary contracts. Further, despite the fast changes in the production processes over these years, the length of the trial period[5], based of the national contract, has not been revised since 1993, temporary contracts have also become a means of testing the abilities of new

[3] Eurostat, 2007.

[4] The Fixed-term Employees (Prevention of Less Favourable Treatment) Regulations 2002 came into force on 1 October 2002. The Regulations give fixed-term employees the right in principle not to be treated less favourably than permanent employees of the same employer doing similar work. The purpose of the Regulations and the EU Directive is to prevent the misuse of fixed-term contracts. Jobs which are intended to be permanent (i.e. more than one year) should be filled by permanent contract holders rather than by fixed-term contracts which are then renewed. Under these Regulations the three types of temporary contract that apply in the UK (fixed term, "specific task" and "future event") are now all known as fixed-term contracts. The Regulations also prevent employers from using a succession of fixed-term contracts by limiting such contracts to a maximum period of four years. The contract will be deemed to be permanent after four years unless it can be objectively justified. In Italy the maximum duration of fixed-term contracts is 36 months.

[5] A labour contract can include a trial period, during which both sides can interrupt without notice (*art. 2096, 3° comma, codice civile*).This period is intended to allow verification of the worker's characteristics and the employer to discontinue the contract without justification during this period (*Cassazione 25 marzo 1996, n. 2631, in Foro italiano, 1996,1633*). Recently, however there is a trend in legal decisions to acknowledge that premature termination of a the trial period can constitute unfair dismissal if the termination results from facts unconnected with the employment or a manifestly unfair reason (*Cassazione 12 marzo 1999, n. 2228, in Corriere giuridico 2000, 340*).

workers. This does not imply that firms do not hire permanent employees. Indeed, in 2007, 86.6% of all contracts were permanent, only marginally less than the 88.8% recorded in 1997. (Istat, 2006) Around half the temporary contracts were subsequently confirmed as permanent.[6] This demonstrates that very many firms are not using temporary workers as replacements for or alternatives to permanent employees. However, the turnover of temporary workers, who proceed from temporary employment to unemployment and back again, remains very high.

The share of temporary contracts in total employment has risen from 6% in 1993 to 13.4% in 2007, which nevertheless remains lower than the average in the EU equal to 14.7%. (Isfol Plus Report, 2006). Fixed-term contracts are most widespread among the young. In the 15-24 age group, 1 out of 3 is a non standard temporary employee, but the share of this type of contract in total employment is smaller[7] than the other EU countries - 56% in Germany, 48% in France and 60% in Spain. The percentage of temporary contracts in the age range 24-39 is about 10%, not higher than in the other EU members (Istat, 2006). [8]

Much of the political debate has focused on the effects of the increased flexibility in the labour market. The existence of a group of atypical workers, with low firing costs and only weak attachment to their job place, has introduced a new concept definition that has become an ideologically-loaded catch-phrase and which recurs throughout political discussions. The so called "*precarietà*", a term which defines the status of a typically, but not inevitably, young person who finds himself/herself in a long sequence of temporary contracts, and therefore the protection afforded to permanent employees, and who generally has a low wage. One consequence is that temporary workers find it more difficult to obtain loans for car purchase or residential mortgages. We need to ask whether *precarietà* is a uniquely Italian phenomenon, and if not, how it manifests itself in other European countries.

[6] We need to distinguish between industry, agriculture and services. Atypical contracts are used more intensively in services and agriculture than in manufacturing.
[7] Italian students have a high school that lasts one extra year than the EU average. Also university, lasts longer.
[8] One type of atypical contracts known as "*lavoro interinale*" accounts for 0.64 of total employment versus 5% of UK, 1% of Germany and 2.2 of EU average. About 35% of these contracts become permanent.

It is interesting to note that, in other countries where labour market flexibility has existed much longer than in Italy, people do not necessarily perceive themselves as "*precari*". It is, for example, difficult to find a young British person who would recognized this status. In many countries, it is quite normal for young people to change jobs very frequently, to voluntarily accept fixed-term contracts as not imposing long term obligations and to move throughout the country (and across countries) . This not only reflects employers' desires for flexibility but also supply side factors as when young workers wish to obtain a diversified skill and employment portfolio. Such workers regard atypical contracts as granting welcome opportunities rather than imposing social disadvantage. Why are there such different perceptions?

In Italy, young workers have become increasingly poorer over time (Boeri and Galasso 2007 and Rosolia and Torrini, 2007). Rosolia and Torrini document the earnings loss suffered by young workers who entered the labour market in the 1990s. The wage gap between old and young rose from 20% to 35% in the early 2000s. This is mainly due to falling real wages at the entry and to a U-shaped wage setting system that values seniority ahead of ability. Promotions to a permanent contract take place for one out of two highly qualified workers, one in three white collar workers and only one in five blue collar workers. (Isfol Plus Report, 2006).

In a system in which wages are rigidly linked to seniority and permanent jobs are strongly protected by law, adverse labour market shocks have a disproportionate impact on the oldest (incumbent) and youngest (job seeking) cohorts. When, in addition, strict job protection shelters incumbents from cyclical downturns, the system forces the burden of labour adjustment on young people and temporary workers. This is the Italian reality.

All this is well-known. Already in the early 1990s, Bentolila and Dolado (1994) showed that countries with the most stringent regulations, in particular with the most stringent limitations on the dismissal of permanent workers, are also those with the highest percentage of temporary employment. Their argument, made in the Spanish context of the 1980s, has clear application to contemporary Italy.

3. Inflexible firing

It is very difficult to reduce the massive resort to atypical contracts by firms if we are unwilling, at the same time, to face the problem of the constraints on the firing side. Recent debates have focused on a possible tightening of the current temporary job provisions in order to discourage the intensive use of fixed-term contracts. However, it is misguided to attempt to address the current situation by imposition of restrictions on temporary contracts. The difficulties currently faced by temporary workers can only be moderated if we are willing to modify the protection granted to core workers.

The process of firing an employee on a permanent contract will often lasts for three to four years[9], implying very high and uncertain costs for the employer. In this context, an employer will inevitably be very cautious before offering employment on a permanent contract. In practice, except for rare and extreme cases of clearly unsatisfactory behaviour in the work place, a dismissed employee will invariably initiate a claim for unfair dismissal. Judges have substantial discretion in determining whether the lay-off is justifiable, but a dismissed employee can normally hope for a positive payment. The slow course of Italian justice implies that any case is likely to continue for several years, largely because of the excessive number of appeals.[10] The net result is that there is almost always a financial incentive to initiate a claim as it will almost always deliver a significant compensation although after a long time. An efficient arbitration mechanism is one means of reducing the social cost of an inefficient justice system.

In the likely case of unfair dismissal the law discriminates between firms with less than 15 employees (*tutela obbligatoria*) and firms with more than 15 employees (*tutela reale*). Firms with more than 15 employees face more restrictive sanctions in that the dismissed worker may choose whether or not to be re-hired (*articolo 18*).

- If he/she chooses not to be re-hired, the firm must pay five months gross wages of penalty plus 15 months gross wages as a compensation plus all the wages between the

[9] Confartigianato, data from Ministry of Justice and Economy, November 2007.

[10] The long duration of court cases is generally not the result of thorough and detailed examination on the part of the judge but rather reflects an accumulated backlog. The backlog often has the effect of diminishing the depth of the judicial examination and may generate an incentive for judges, who have substantial discretion, to bring cases to a conclusion that can favour the dismissed employee as likely victim.

date of the firing and the date of the sentence. If the worker was working during the period, his/her income is deducted from the wage-bill to reflect employment over the period (usually years) in which the court case was taking place. This is known as "*aliunde perceptum*".

- If he/she chooses to be re-hired the firm has to pay five monthly gross wages plus all the wages between the first day of firing and the date of the sentence taking into account, as in the case above, of the *aliunde perceptum*, i.e. deducting all the income he/she earned between the date of firing and the date of the sentence.

There are exceptions for small companies. Firms of up to 15 employees can fire more freely than larger firms. They are subject to lighter sanctions, up to two to six months pay and they do not have the obligation to re-hire the worker.

Various fundamental asymmetries result from the current firing legislation:

- The court sentence has immediate execution even if the firm decides to appeal. Appeals imply a further long spell of time. In principle, if the firm is found not to be guilty the worker should return the payment made at the time of the initial sentence.
- In the case of re-hiring, the firm must pay all contributions for the period between the dismissal and the court sentence, since this implies that the job contract was not interrupted. However, given that the court case takes a few years, the employee ends up also paying a fine for the delayed payment of contributions. The employer is therefore fined for judicial inefficiency.
- In the case in which the employee loses the court case, the legal costs are split between the two parties.
- In the case in which the employer loses the court case he/she is obliged to pay the legal expenses for both parties.
- The choice of whether or not to be rehired rests on the employee. The firm has no discretion over this.

It is clear that this procedure works to unnecessarily increase uncertainty about the timing and the cost of firing a worker. Even if they have a shorter duration than other civil court cases, labour actions typically still last between three and four years, and much longer durations

routinely arise. What makes Italy almost unique case within the EU, and the indeed the OECD, is Article no. 18 of the Worker's Act (*Statuto dei lavoratori, articolo 18, legge 300, 1970)*. In most countries, such as Finland, Ireland, UK, Sweden, France, Germany, Spain, Belgium, Denmark, the Netherlands and even Portugal, re-hiring is only required in very special cases and it is not mandatory, except in Austria. It does not exist in Switzerland.

Article 18 has distortionary effects both on the employee and on the company. What should the dismissed worker do during the time the court case takes place? S/he clearly needs to find a new job. What proportion of dismissed employees opt for re-hiring? In practice, very few, since the worker needs to earn a wage over the period of the action and since it may be unattractive to return to a conflictual work environment. Nevertheless, dismissed workers have an incentive to take legal action in view of the high probability of winning under current legislation, in combination with the additional payments that they can subsequently extract through the ability to threaten return by virtue of Article 18.

4. Natural wastage, another constraint on company's choice

In the recent years Italy has made various attempts to reform the pension system. The reform of the pension system in 2004 aimed at raising the pension age introduced incentives for people to decide to postpone retirement. To continue working beyond the nominal retirement age, an employee only needs to communicate six months before retirement his/her intention to go on working. Firm do not have any alternative but to accept the decision. In 2008, a further reform has raised the retirement age. The age of retirement is due to increase gradually up to 60 by 2011.

Prolonging the pension age is clearly necessary to ensure the continued solvency of the Italian pension system. At the same time, the new legislation introduces an important constraint on the ability of firms to adjust their labour force. Given high firing costs, natural wastage is the major means Italian firms have at their disposal for adjusting employment. Retirement without replacement is non-conflictual and given firms at least one element of flexibility. From this point of view, delaying the retirement age introduces another obstacle to labour adjustment.

5. Long Term Unemployment

Increased flexibility on the hiring side was an attempt to overcome the problem of the obstacle to exits, resulting from the prohibitive level of firing costs and by the uncertainty introduced by the very long duration of court cases. However, during economic downturns or period of crisis, larger firms are able to release large numbers of workers through collective firing. This action needs to be approved by the unions. Dismissed workers join a system of wage subsidization known as *Cassa Integrazione* and *Mobilità* or, if eligible, proceed to early retirement. In the lucky situation in which the firm sheds labour only temporarily, some of these workers will be re-hired later (while in *Cassa Integrazione*, the firm cannot hire new people). Otherwise, they join special lists (*liste di mobilità*) that allow them to be hired by other firms that thereby benefit from a discount in payroll taxes.

Wage subsidization for workers with permanent contracts by this means provides a good replacement ratio with a long duration, but the scheme typically results in workers leaving the labour market for very long periods and, often in the case of older workers, indefinitely. The consequence is substantial and economically inefficient depreciation of human capital. Workers affected under this scheme have the incentive join the black market or accept low quality jobs through temporary contracts. Hence, although the introduction of flexible contracts may have been beneficial in reducing long-term unemployment it has also reinforced a dual aspects of the labour market.

Del Boca and Rota (1998) analyze the role of firing costs on firms behaviour during the cycle. They emphasize how firms in Italy may avoid unfair dismissal procedures by resorting to the legislation on redundancies that provides a relatively less expensive means of reorganizing their labour force. The implication is that firms may find it easier to dismiss workers collectively instead of individually. As noted above, workers fired collectively benefit from generous wage subsidization. This behaviour generates an adjustment process that is driven by fixed costs. Thus the legal constraints on employment reductions may provide an incentive for companies to vary employment by large amounts, since it is more profitable to incur the fixed costs of adjustment once and for all and to avoid the costs of individual dismissal. Rota (2004) finds clear evidence for fixed costs by estimating a structural model. She finds that fixed costs amount to around 15 months labour costs for the firm of median size.

6. Flexicurity

The Italian employment system has introduced the flexibility necessary to cope with the extreme rigidity on the firing side, but Italy has not adequately reformed the welfare system. The Italian labour market lacks efficient policies to help unemployment. A universal safety net for the unemployed and for the poor, an efficient system for workers and jobs reallocation (with the exception of only a few provinces such as Trento, Bolzano and Modena), a good scheme for training and for helping in the transition between school and work are still missing.

In Denmark, lay-offs are unregulated but unemployment subsidies are high and universal, and placement is efficient, fast and targeted. In Italy we experience exactly the opposite: lay-offs are extremely regulated and very expensive, but placement is inefficient, slow and idiosyncratic and unemployment subsidies are low and unequal. Reasonable wage subsidization schemes exist only for dismissed workers with a standard contract.

France provides a very useful guideline for possible labour reforms in Italy. France faces problems that are similar to those in Italy. As Saint Paul (2008) explains, French firms expect to pay large turnover costs and a substantial fraction of these costs is dissipated in litigation rather than being paid as a compensation for the worker. Firms have always complained about the huge uncertainties created by this system; they simply do not know how much it costs to get rid of a worker and for this reason do all they can to avoid offering permanent contracts, and rely heavily on temporary contracts when they hire people.

In France the recent agreement between employers and unions on labour market provides an attempt to reduce non-wage labour costs to firms – in particular, firing costs – while preserving the protection of the workers as they move between jobs. The reform is inspired to the Danish “flexicurity model”, which is based on protecting workers in the labour market through high benefits, which nevertheless decrease over time, and active labour market policies, as opposed to protecting them in their current jobs. The most innovative provision is that employers and employees can now separate by mutual agreement, which gives workers statutory severance payment as well as eligibility for unemployment benefits. In exchange, the conditions under which the worker can challenge the agreement in a court are made more

stringent, and a cap is put on the maximum compensation that the court can impose, as well as on the maximum time period within which the worker can resort to litigation. This takes power away from the courts and restores private contracting. The reform reduces the tax implied by the legal system on workers and firms jointly, while improving worker compensation. Workers benefit because they receive a fraction of previous litigation costs as severance payments. Lawyers suffer lost earnings but the judicial system is able to redistribute its activities towards more socially important cases.

7. Some proposals

Any good proposal of reform of the labour market should eliminate the distortions introduced by the very stringent limitations on the dismissal of permanent employees. This has always a forbidden question, a taboo that has generated serious social conflict in the past. In 2002, the timid attempt to limit the application of *articolo 18* was called to a halt by major union protest which forced the government to withdraw the proposal. The consequence is that these problems remain. Reform is a precondition for recovery in the very low Italian growth rate.

A first modest step would be elimination of the uncertainty implied by the judicial intervention and the possibility of rehiring the worker. Bergonzini, Del Boca and Rota (2007) suggest two possible ways that are compatible with the current system of industrial relations.

1) Introduce certainty into firing costs. The firing tariff could be directly proportional to the worker seniority. It is important that compensation is pre-defined in order to eliminate systematic resort to legal action. This proposal would not only cut down on the high procedural costs but it would also limit the discretionary power of the judges. It would cure the problem of courts overloaded with endless trials. It would not necessarily have any effect on the average level of compensation paid (except to the legal fraternity).[11]

2) Introduce binding arbitration by mutually acceptable arbitrators, leaving only extreme cases, such as discriminatory firing (racial, sexual or religious) or non-observance of

[11] It would also be possible to introduce a tax on separations in the spirit of the US experience rating system In order to restrain firms form resorting to firing too freely (Blanchard and Tirole, 2005).

fundamental worker rights, to the courts.[12] In order to make arbitration attractive one simply makes dismissed employees liable for the employers' legal costs in the event they decide not to follow the arbitration route and the case goes against them.

These proposals in no way detract from workers' current rights and protection. They will make employment compensation clearer, more efficient and more certain for all parties. The net effect of these changes will be that *articolo 18* will become less relevant and this may enable less politicized debate on employee rights to take place in the future.

Conclusions

Recent debates have focused on the tightening of the current temporary job provisions in order to discourage the intensive use of fixed-term contracts. We argue that the imposition of restrictions on temporary contracts is completely misconceived. Unless and until we reform the protection granted to core workers, we will fail to improve the conditions of flexible workers. We acknowledge that any increase in the flexibility of the contractual conditions of permanent employees will be politically difficult. This is the reason why, up to this point, Italy succeeded in introducing increased only at the margin and why unions insist on the establishment of conversion clauses by which workers on fixed term contract have to be either fired or made permanent employees after a certain period.

We have argued that increased productive efficiency will only arise the once rigidity affecting core workers is directly addressed. Italy case provides a good example of a distorting institution (high firing costs for permanent employees) which has not been reformed but has instead been modified by the introduction increased flexibility at the margin. This has reinforced existing dual labour market features of the economy with negative consequences for productivity growth, improvement of welfare and wage growth. We have suggested a

[12] The current system involves, as a first step, an arbitration stage at the local labour bureau (*Ufficio provinciale del lavoro*). However, this has only a bureaucratic function. The parties simply agree that there is no round for an agreement and they officially initiate the court case. Also the judge asks whether the parties are willing to reach an agreement. However, from the worker's standpoint it is worth starting the trial, given that an agreement may always be reached at any time before the sentence and given the typically benign attitude of the judge.

number of proposals which address these difficulties without detracting from current levels of employee protection.

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