

The Italian Labor Market in the midst of a new economic slowdown and yet another reform

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- ◆ *In the first half of 2019, employment grew in Italy despite GDP stagnation. Two factors have contributed to the observed higher-than-expected employment growth: i) the ongoing compositional shift towards a larger services sector, with the growth highly concentrated in some labor-intensive, low value-added activities; ii) recent changes in labor legislation (the so-called "Dignity Decree" of July 2018), introducing stricter rules on short-term contracts that are likely to have pushed some companies to anticipate stabilizations of fixed-term workers – a short-term effect, bound to fade.*
- ◆ *As a matter of fact, employment growth has already come to a halt in the summer. In the near future, it will be negatively affected by the economic performance in the industrial sector, where labor productivity is on free fall since early 2018 – a trend that cannot last.*
- ◆ *The results of a survey collecting the opinions of 4.000 firms (members of Confindustria) show that we can expect the Dignity Decree to cause a wide range of changes in employers' choices about hiring and retaining workers. For more than a fifth of firms, the use of fixed-term contracts would decrease in their organization, but not necessarily in favor of more open-ended contracts; 18.8 percent thought that turnover of fixed-term workers would increase.*
- ◆ *What do hard data tell us so far about the effects of the Dignity Decree? 1) Fixed-term employment has remained substantially stable since July 2018, in contrast to previous years, but this is partly due to the responsiveness of temporary employment to the cycle; 2) in the same period, permanent employees increased by almost 250K units, from 14,8 to over 15 million; flow data show that the increase is driven by the transformation of fixed-term contracts into open-ended ones; 3) in the second half of 2018, after the decree became law, transformations accelerated sharply, but in Q2-2019 the YoY change in transformations returned to Q2-2018 levels, suggesting that the effects of the new rules are already fading away; 4) fixed-term hiring flows, however, remain much lower than in the past, and a reduction in the number of short-term contracts activated will result tomorrow in a smaller pool of workers who can be potentially transformed from temporary to permanent contracts.*
- ◆ *Despite evidence of a compositional shift towards a higher share of permanent contracts, there could be a negative effect on the overall size of employment if the economy does not start growing again and drops in fixed-term hires are larger than the rise in open-ended activations.*

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1. Higher-than-expected employment growth so far in 2019: why and can it last?

In the first half of 2019, employment grew in Italy despite GDP stagnation. Why? Both economic factors (primarily the ongoing shift in the composition of growth towards a larger services sector) and recent changes in labor legislation have played a role in the observed higher-than-expected employment growth (Figure A).

Most of the 170 thousand additional headcount employment registered between Q4-2018 and Q2-2019 in Italy generated in the services sector – more than 80 percent of it in just a few branches, that are, those of entertainment, household care and repair, and personal care. These are activities:

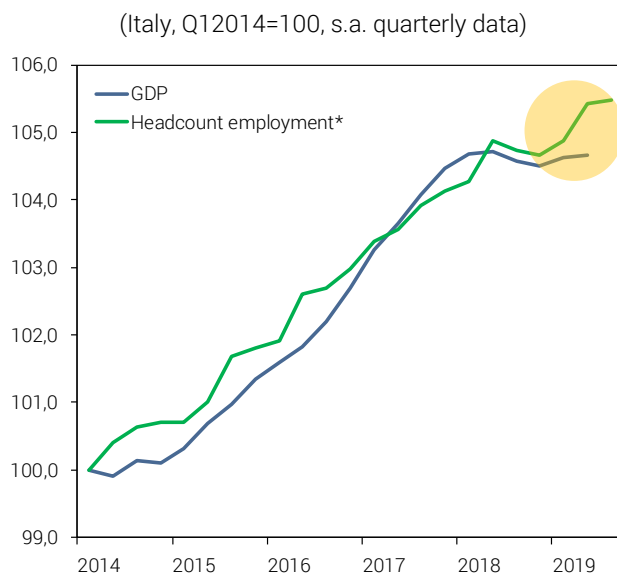
- I. on the one hand, very labor intensive and, therefore, low value added;
- II. on the other hand, characterized by work schedules that are often short and irregular.

These two aspects provide a mechanical explanation for both the observed weak dynamics of GDP and the composition of employment growth, which all derives

from the increase in part-time work. In the first half of 2019, indeed, the number of part-time workers grew by 144 thousand units compared to the second half of 2018, while full-time workers dropped by 104 thousand units; as a result, over the same period the share of part-time work over total employment rose from 18.4 to 19 percent.

Recent employment trends must also be read in light of the restrictions on short-term contracts introduced by the so-called “Dignity Decree” in July 2018. In particular, the maximum duration of fixed-term contracts has been lowered from 36 to 24 months; for durations of 12 or more months, employers need to provide a formal reason for the short-term and pay an additional social security contribution for each extension/renewal of the contract. These new rules are likely to have pushed some companies to anticipate stabilizations of fixed-term workers already in their workforce at the time of the passage of the new rules. In support of this explanation, the recent increase in total employment is observed to be driven by the growth of open-ended contracts, which in turn is mainly explained by the acceleration in the number of transformations of fixed-term contracts (see below). Part of these conversions would have

Figure A
Higher-than-expected employment growth in the first half of 2019



* Q32019: average of monthly data for July-August (Labour Force Survey).
Source: Centro Studi Confindustria calculations on ISTAT data.

likely taken place in any case as the highest ceiling set by the old legislation (36 months) approached, but were anticipated, perhaps even without the immediate need to expand the workforce, by those companies that did not want to lose human resources already in place. However, this is a short-term effect, which is bound to fade.

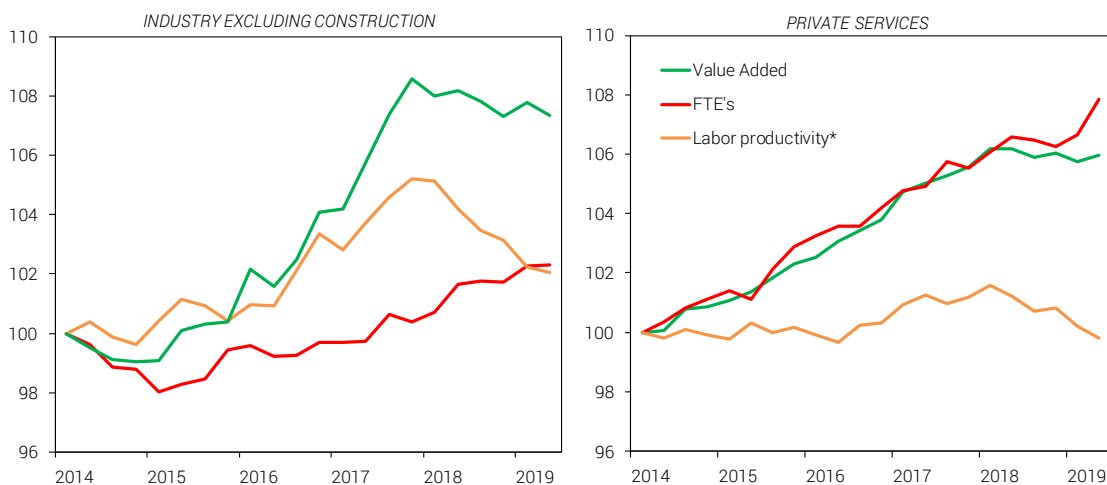
As a matter of fact, employment growth has already come to halt in the summer (headcount employment registered zero growth in the two-month period July-August). In light of these considerations, headcount employment is projected to grow by 0.7 percent in 2019 (+0.6 percent already carried-over from the first two quarters).

The slowdown in employment growth will be affected by the ongoing negative economic performance in the industrial sectors. Gross value added in industry, excluding construction, has been shrinking since the beginning of 2018. A decreasing value added, coupled with increasing employment, has caused labor productivity to contract sharply: in Q2-2019 it was almost 3 percentage points below the Q1-2018 level (Figure B). Productivity drops of this magnitude cannot last over time, and need to be at least partly reversed, in sectors that are exposed to foreign competition as much as the manufacturing ones.

Between the end of 2018 and mid-2019, we have observed a new rise in the Italian short-time work scheme, the Cassa Integrazione Guadagni (CIG), a sign of firms' difficulties. This scheme supplement wages for employees affected by temporary lay-offs (who are not considered unemployed), or under a forced reduction of working hours. It is estimated that full-time equivalents covered by CIG have grown by about 30,000 units since September 2018. The increase is driven by the Extraordinary CIG component, that is, the one activated in case of business crisis or restructuring. As such, the observed rise in the number of hours authorized under the CIG scheme could open the way in future months to a contraction in employment in the industrial sectors.

Figure B

What's behind the productivity plunge
(Italy, Q12014=100, s.a. quarterly data)



* Value added per Full-Time Equivalent.

Source: Centro Studi Confindustria calculations on ISTAT data (National Accounts).

2. The effects of stricter rules on short-term contracts: what do we know so far?

On July 14, 2018, the so-called "Decreto Dignità" (converted into Law 96/2018 in August 2018) has introduced regulatory changes in the Italian labor legislation, explicitly aimed at curbing the use of non-permanent contracts. In particular, the law has introduced the following set of new restrictions and disincentives to the use of fixed-term contracts:

- ◇ it reduces the maximum duration of fixed-term contracts (even if started through a work agency) from 36 to 24 months; the cap does not apply to a single contract, but to the sequence of subsequent contracts between the same worker and the same employer, even in the presence of interruptions but holding constant the worker's title/position;
- ◇ it requires employers to provide formal reasons for fixed-term contracts beyond 12 months. The reason must fall in one of the following two categories: 1) objective and temporary needs, unrelated to the ordinary business, or need to replace somebody else (e.g. on maternity or sick leave); 2) needs related to significant and unexpected demand increases or seasonal peaks;
- ◇ the maximum number of extensions of the same contract has been reduced from 5 to 4;
- ◇ for each renewal, the additional social security contribution due by the employer increases by 0.5 percent¹;
- ◇ the new rules also apply to temporary agency work, when a worker is employed by the agency with a fixed-term contract, and then hired out to perform his/her work at a user company².

As a result of these new rules, there are certain actions that firms are expected to take, some of them intended by the law-maker, others somewhat unintended, including:

- ◇ reduced attractiveness of hiring with fixed-term employment (even when provided by a work agency) in favor of hiring with other contracts (including, but not limited to, open-ended contracts) or expanding the labor input through longer working hours;
- ◇ acceleration of transformations from fixed-term to permanent contracts to avoid reaching the new maximum durations of 12 or 24 months, where the former is likely to be the most binding, because overcoming it entails both monetary costs and increased uncertainty surrounding the "formal reason" in case of labor litigations;
- ◇ preference for labor turnover on the same job rather than renewal of contracts to the same worker.

¹ An additional SSC, to finance unemployment benefits ("NASPI"), was introduced by the Law 92/2012 (the so-called "Fornero Law") and set equal to 1.4 percent, in addition to the ordinary contribution of 1.61 percent, but partly reimbursed to employers who transform fixed-term contracts into permanent contracts.

² Temporary workers are now counted in the quota of employees on short-term contracts per firm, but the threshold has been increased from 20 percent to 30 percent of total employees.

The employers' view In February-April 2019 we collected the opinions of around 4.000 firms about what changes would the Dignity Decree cause to some of their human resources management choices. The questions were included as part of a survey, conducted annually among the firms that are members of Confindustria, on topics related to employment, working hours, performance-related pay and welfare benefits. The main results, as concerned those firms that used fixed-term contracts in 2018, can be summarized as follow:

- ◇ More than a fifth of them (22.0 percent) stated that, everything else being equal, the use of fixed-term contracts would decrease in their organization as a result of the Dignity Decree; the share is higher among larger firms, with more than one third of industrial firms with 100 or more employees thinking so (35.4 percent).
- ◇ One fourth of firms, among those thinking that the use of fixed-term contracts would decrease, believed that there would be no compensation for this reduction (24.5 percent). If so, total employment would decrease. The majority of firms thought that there would be some form of spill-over to other ways of expanding the labor input: 29.2 percent envisaged they would use more open-ended contracts (in line with the law-maker objectives), but 33.6 percent expected a larger use of other types of contracts (including collaboration contracts and job-on-call) and 28.7 percent longer working hours. When comparing the answers provided by industrial versus service firms, it appears that the former were more prone to expand the use of open-ended contracts while the second to ask for longer hours of work.
- ◇ Almost one-fifth of firms (18.8 percent) stated that turnover of fixed term workers would increase as a result of the Dignity Decree, with the share sharply increasing with the firm size (38.8 percent among firms with 100 or more employees, 38.8 percent and 30.0 percent respectively in the industrial and service sectors).

Table A

The effects of the Dignity Decree in the employers' opinion

(% of firms providing a given answer*, among those with fixed-term employees as of 31/12/2018)

	Overall mean	Industrial sectors			Private services		
		1-15 employees	16-99 employees	100+ employees	1-15 employees	16-99 employees	100+ employees
As of December 31, 2018:							
% of firms with at least one fixed-term employee	46,6	28,7	61,9	84,9	26,8	67,9	87,1
Fixed-term employees as a % of total employees	5,6	5,1	6,6	3,9	6,3	9,7	6,0
Q1: Everything else being equal, as a result of the Dignity Decree, the use of fixed-term contracts in your firm will:							
increase	5,3	3,8	5,5	4,2	7,4	4,6	5,8
stay the same	72,7	78,8	67,5	60,4	84,3	77,2	70,4
decrease	22,0	17,4	27,0	35,4	8,3	18,2	23,8
Q2 (if "decrease" in Q1): The reduction in fixed-term contract will entail (multiple answers allowed):							
more open-ended contracts	29,2	34,7	31,8	31,0	11,3	22,9	26,3
more of other types of labor contracts	33,6	30,7	35,3	34,2	33,0	30,9	32,5
longer working hours	28,7	20,1	34,1	23,0	//	36,0	37,9
no compensation	24,5	19,8	23,5	24,8	46,9	20,8	24,5
Q3: In your view, as a result of the Dignity Decree, labor turnover of fixed-term workers in your firm will:							
stay the same	45,8	56,9	43,3	36,5	45,7	49,4	42,8
increase	18,8	6,5	20,5	38,8	7,4	17,4	30,0
decrease	5,2	3,5	6,8	6,4	3,4	4,6	5,1
don't know	30,2	33,1	29,4	18,3	43,5	28,6	22,1

* Figures are weighted based on the distribution by sector and firms size of the universe of firms associated to Confindustria.

Source: Centro Studi Confindustria calculations on data from "Indagine Confindustria sul lavoro nel 2019".

As highlighted by the results of this survey, we can expect the Dignity Decree to cause a wide range of changes in employers' choices about hiring and retaining workers. In what follows, we provide an overview in recent trends observed in the Italian labor market at the aggregate level, aimed at disentangling, if possible, the effects of the Dignity Decree from other factors, most notably the business cycle.

Stock data from the Labor Force survey Two main stylized facts emerge from the Labor Force Survey, which collects information on the occupational status of a representative sample of the population residing in Italy:

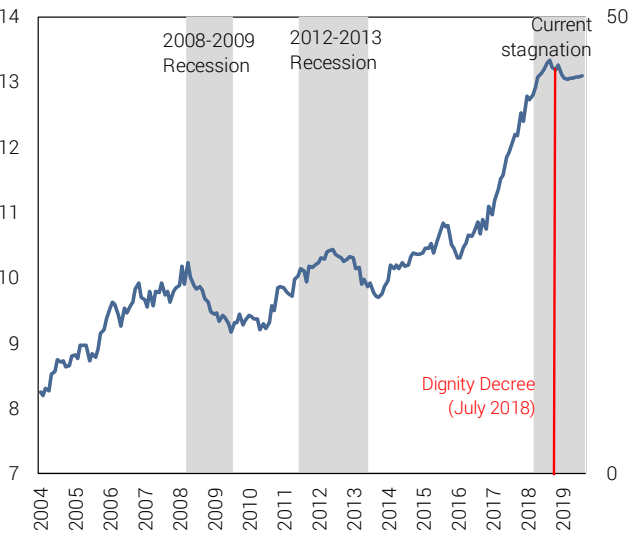
1 - Fixed-term employment has remained substantially stable since July 2018, both in absolute and relative terms: a year ago temporary employees were 3 million and 62 thousand and represented 13.2 percent of total employment; in August of this year they were 3 million and 63 thousand and weighed for 13.1 percent.

One would be tempted to find in this stylized fact evidence of an effect of the Dignity Decree: after all, without the new restrictions, fixed-term employment would have continued to grow, as it had done in previous years.

However, this reading does not take into account the strong responsiveness of temporary employment to the economic cycle. The incidence of fixed term employment has fallen in both the last two recessions and it is therefore likely that its recent slowdown is affected by the stagnation of GDP registered since Spring 2018 (Figure C).

2 - In the same period, the number of people on open ended contracts increased by almost 250 thousand units, from 14 million 800 thousand to over 15 million (Figure D). The growth of permanent workers has driven the increase in total employment, in contrast to the stagnation of economic activities.

Figure C
Temporary employment in slight fallback: economic cycle or policies?
 (Italy, Temporary employees as a % of total employment; s.a. monthly data)

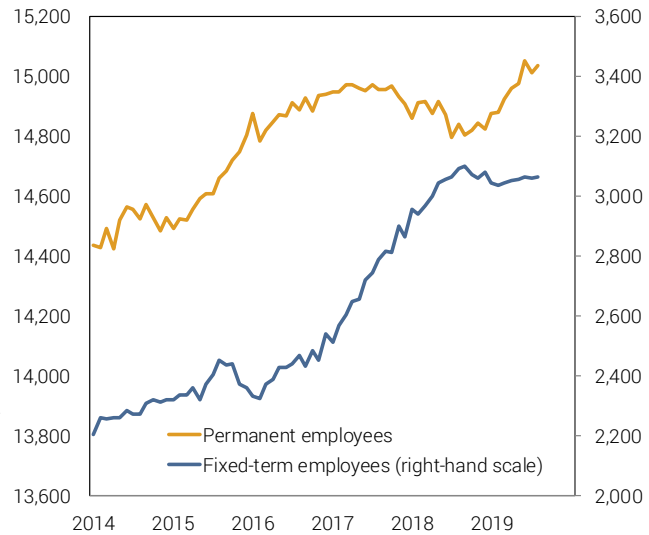


Source: Centro Studi Confindustria calculations on ISTAT data (Labor Force Survey).

As it will be evident from the analysis of labor market flows documented below, the increase in permanent work is driven by the transformation of fixed terms contracts.

But can this phenomenon last? Probably not, for at least two reasons. First, with fixed-term employment growing less than in the past, the pool of workers who can have their contract converted from temporary to permanent gets thinner; second, in the long run there can be no employment growth without economic growth, therefore employment (of any kind) will stop increasing if GDP does not start rising again.

Figure D
Permanent employment on the rise: can it last?
 (Italy, thousands of persons, s.a. monthly data)



Source: Centro Studi Confindustria calculations on ISTAT data (Labor Force Survey).

Administrative data on labor market flows Administrative data from INPS, the Italian Social Security Institute, which document labor market flows in the non-agricultural private sector, help us to better understand what is behind the changes in the stock of employment by type of contract documented so far. The following stylized facts emerge:

3 - In the second half of 2018 transformations of fixed-term contracts into open-ended ones accelerated sharply. The timing of the acceleration, right after the Dignity Decree entered into effect, is consistent with the tightening of the rules playing a role.

As shown in Figure E, already in the first months of 2018 transformations of fixed-term contracts into open-ended ones rose sharply compared to the same period in the previous year, as a result of at least two factors:

- I. New hiring incentives for permanent jobs, effective from January 1st, 2018: fiscal incentives for permanent jobs, provided as part of the Jobs Act, expired at the end of 2016, and this partly explains the rise in temporary contracts observed in 2017³. The 2018 Budget Law has introduced new tax incentives to support youth employment on permanent contracts: effective from January 1st 2018, private employers get a 50 percent reduction in social contributions (up to a cap of EUR 3.000 per year) on new hires below the age of 30 (below 35 until 2020) for the first three years of an open-ended contract.

³For 2017, some hiring incentives for permanent jobs were still in place, but targeted some groups of workers in the South.

The timing of the incentives clearly plays a role in explaining job flows by type of contract: as shown in Figure E, recruiting on permanent contracts jumped in January 2018 compared to one year earlier, as opposed to the sharp drop at the end of 2018, when it was probably delayed due to the expectation of the incentive renewal for certain permanent contracts in 2018.

The rise was particularly strong for transformations (+92.5 percent YoY in January 2018, relative to +24.2 percent for new hires) and more persistent (the number of transformations through the first half of 2018 remained at least 50 percent higher than in the same period in 2017, while new hires returned to the same level of the previous year by March). This difference provides support for the second factor below.

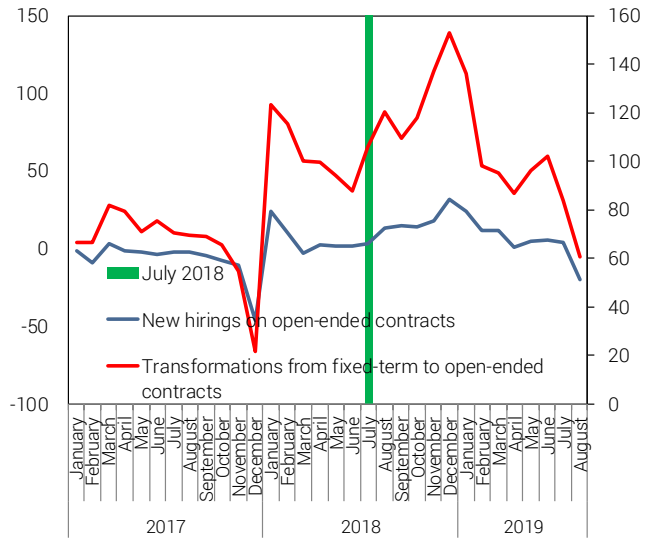
- II. A “scale effect”, given the substantial increase in fixed-term contracts registered through the beginning of 2018: even with the same “transformation rate”, an increase in fixed-term contracts in a certain period x mechanically determines an increase in transformations at a certain distance of time ($x*s$). Taking as a reference an average duration of the interval between recruitment and transformation around the year⁴, then this positive “scale effect” could persist throughout the whole year 2019.

In the context of the above factors that explain a rise in transformations already in the first part of 2018, we observe a further acceleration of transformations in the fourth quarter of the year, that is, after the Dignity Decree was converted into law. It was indeed foreseeable (and in line with the intentions of the lawmaker) that some companies, in view of the new maximum duration restrictions (from 36 to 24 months) and the higher costs of extending contracts beyond 12 months (that are, need to provide a formal reason and additional social contributions), would have stabilized some workers, probably anticipating conversions of contracts that would have occurred anyway, but later, if the old regulation had remained in

Figure E

Large but short-lived acceleration of transformations

(Italy, not seasonally adjusted monthly data, YoY % ch.)



Source: Centro Studi Confindustria calculations on INPS data (Osservatorio sul precariato).

⁴ Around 10 months in the Italian region of Veneto, as estimated in Veneto Lavoro (agosto 2019), Misura n.86, “Note sul primo adattamento delle imprese al decreto dignità”.

force. This "anticipation" effect, however, is only relevant in the short term, and is bound to fade over the medium to long term. In fact, already in the second quarter of 2019, the YoY change in transformations returned to the levels registered in the second quarter of 2018.

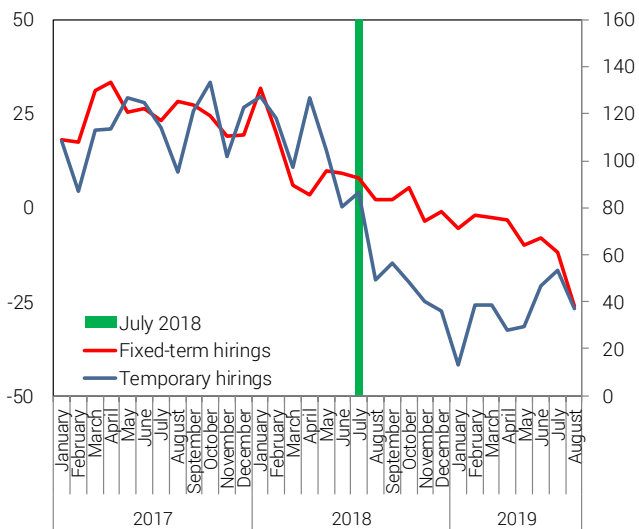
4 - In the second half of 2018, fixed-term hiring flows decreased, in particular for temporary contracts (Figure F). The timing of the decrease suggests, also in this case, an effect of the Dignity Decree, which is in line with expectations (and the legislator's intentions): the new restrictions on fixed-term contracts, extended to temporary work, would reduce their use.

This decrease in activations, however, highlights some potential undesired effects that could stem from the Dignity Decree in the medium-long term, that could be particularly likely to happen at a time of sluggish economic growth:

- ◊ A reduction today in the number of short-term contracts activated will result tomorrow in a smaller pool of workers who can be potentially transformed from temporary to permanent contracts. This negative "scale effect" could take a toll on permanent employment in the near future.
- ◊ Despite the desired compositional shifts towards a higher share of permanent contracts, there could be a negative effect on the overall size of employment if drops in fixed-term hires are larger than the induced rise in open-ended activations.

Figure F

Sharp drops in fixed-term and temporary hirings
(Italy, not seasonally adjusted monthly data, YoY % ch.)



Source: Centro Studi Confindustria calculations on INPS data (Osservatorio sul precariato).

3. Extended flat tax regime for self-employed professionals:

In Fall 2018 new tax incentives for self-employment were introduced. The 2019 Italian Budget Law has raised the income thresholds for the favourable tax regime already in place for entrepreneurs and self-employed professionals (so-called "Partite IVA"): taxpayers who in the previous fiscal year did not exceed the new income threshold of EUR 65.000 (up from 30.000) can opt to be subject to taxation at a 15 percent flat rate, with no deduction allowed. The flat tax substitutes for any Personal Income Tax (State, Regional and Communal tax). Statutory tax rates for the State Personal Income tax alone range from 23 percent to 43 percent. The new provisions were clearly aimed at reducing the number of self-employed not reporting their income, but at the same time they risk to disincentive dependent work in favor of pseudo-self-employment.

Consistent with this measure boosting reported self-employment, the data released by the "Osservatorio delle Partite IVA" of the Ministry of the Economy and Finance show a boom in the number of "partite IVA" opened by individuals: 170,582 in the first half of 2019 from 123,341 in the same period in 2018 (+38.3 percent).

It is difficult, however, to assess whether this increase has somehow displaced the activation of dependent employment contracts, given that, as documented above, the latter are clearly influenced both by the economic slowdown and by the effects of the Dignity Decree. For a more complete picture of the impact of the extension of the flat rate in terms of possible substitution between dependent and autonomous employment, it is therefore necessary to wait for more data, or for better estimates, which would reasonably identify and isolate the effects of the measure.