

Labour market institutions and the recent crisis.

Where we come from and where we are going.

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PROVISIONAL DRAFT

NOT TO BE QUOTED

Comments welcome

1. When talking about labour market institutions it is necessary to get rid of a fundamental misunderstanding. That is to think that there are countries, or better economic systems, which relay on markets as opposite to countries which relay on institutions. In fact, markets themselves are sets of institutions, and labour markets in particular (let's mention Solow's essay "The labour market as a social institution") always operate with agents' decisions and interactions shaped by rules. Even the jungle has its "rules" and competitive markets need often special rules in order to protect their own existence. We may distinguish between formal and informal rules¹ and their relative weight, and we may make judgments about "good" or "bad" institutions, but we cannot imagine (nor define) an "institution less" system. Nor we can assume that institutions are "per se" detrimental to the working of market forces: think of antitrust regulations or of the definition of property rights; they are institutions on which the working of efficient markets is based.

This consideration is important because allows us to establish that is not the presence of labour market institutions which reduces "economic freedom", but rather their quality that may be against or in favour of economic freedom. Otherwise we could easily place Zambia, or Uganda (due to their lack of "formal" institutions) at the top of the rank of economic freedom and, say, Germany or Sweden at the bottom², and

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¹ Although this distinction is less sharp than it may seem, see Fadda (2010)

² And this has actually been made, see the Fraser Institute index of economic freedom

jump to a conclusion that a negative relation exists between labour market freedom and the level of GDP per capita.

Having said that, the scheme of this paper will be as following:

- To see “where we come from” I’ll try to trace the evolution of the attitude towards labour market institutions starting from the OECD Jobs Study of 1994.
- Then I’ll consider the burst of the recent financial crisis, trying to see if its origins reveal a link with the institutional set up of the labour market;
- At this point, a look at the effects of the crisis on the labour market would allow to establish whether these may have been affected by differences in labour market institutions and whether a process of institutional change has been stimulated by the crisis;
- finally, the study will turn to consider whether the impact and the success of the measures to overcome the crisis may be influenced by the labor market institutional set up and in which directions this should evolve in order to enhance the chances of success of the stimuli in overcoming the crisis.

2. The bulk of “structural reforms” that the Oecd suggested in its well known “jobs study” of 1994 (Oecd,1994) in order to improve the performance of labour markets and employment all over the world did actually boil down to a set of measures directed at obtaining changes in the labour market institutions along the following lines: increase labour “flexibility”; reduce unemployment benefits; reduce employment protection and security provisions, increase the responsiveness of wages to market pressure, improve labour market active policies. The soundness of these suggestions should be considered in the first place through their links with the theoretical framework and in the second place against the empirical evidence.

- Of all the dimensions of the so called flexibility (functional flexibility, freedom to change tasks and working time within the firm, and freedom to fire and hire) the last is the most significant and the one to which the best consequences in term of labour market performance are generally attributed. It has been suggested (Schivardi, 1999), though, that under certain conditions, removing restrictions to firing and hiring is neutral with regard to levels of employment, while it may affect the efficiency of the system through a better resource allocation. It’s more interesting for the purposes of

this paper to consider the increase in flexibility under the perspective of the reduction of the adjustment costs that it implies, and particularly to consider the effect of this reduction on the labour share in GDP. As P. Vermeulen (2007) puts it, “firing costs cause firms to fire less in recessions and hire less in booms, causing wage costs to fluctuate less cyclically than output, thus inducing variability and counter-cyclicalities in the labour share”. Redundancy or severance payments, legal restrictions to workers’ dismissal and also the cost of mobility would therefore act contrary to the Kaldorian stylized growth fact that the labour share is constant in the long run. Obviously, one thing is the long run and another thing is the cyclical movement; nevertheless, without specifying how long is the long run, we can observe deviations from this constancy for significant lengths of time. Of course it is of paramount importance, as we shall see, to establish whether movements in labour share can be explained through changes in institutional factors such as firing and hiring costs.

- Reducing unemployment provisions was a second pillar of the advocated structural reforms. The bulk of the argument against unemployment benefits does not lie in public budget considerations, but rather in their effect on the supply of labour (Burtless, 1990). As non-wage income they would have a wealth effect reducing labour supply for any given wage level and would raise the reservation wage; the decrease in the cost of search would cause an increase in the duration of voluntary search-unemployment. It should be noticed, though, that, as for the labour supply, the traditional microeconomics refers to hours worked and the effect is not directly transferable in the decision as to whether to participate at all in the labour force (intensive and extensive elasticities are different); and that, as for the job search intensity, the longer time devoted to job search could result in an improvement of the quality of job matches. Besides, differences in unemployment benefits duration, conditionality, eligibility, coverage and replacement rate may, after all, significantly affect the behaviour of labour supply (Schmieder, 2010).

- The reduction of employment protection legislation and security provisions is supposed to work in the same way as the increase in flexibility. In fact, the employment protection legislation can take several forms. It is possible to impose compulsory negotiations with worker representatives prior to dismissals, or administrative authorizations as necessary condition to proceed with dismissals, or to inhibit “unfair dismissals”, or to impose severance payments, and so on; but all of these can be actually converted in terms of adjustment costs and therefore they have an impact on the labour market in the same way as the degrees of flexibility. The important point to make in this regard is related to the presence of “legislation”,

which might not be reflected in the actual behaviour of agents (and these patterns of behaviour, rather than the rules, should really be considered as “institutions”) (Fadda 2006), owing to the gap between formal rules and actual practice. Obviously, this aspect, although relevant under a theoretical profile, is most decisive in the field of empirical investigation. Under a theoretical point of view it is worth considering the employment protection legislation as a case of property rights definition. According to the Coase theorem, with freedom of bargaining and no transaction costs the distribution of property rights should be irrelevant with respect to efficient allocation. When this is applied to labour market, If the worker is attributed the right not to be fired, the firm will pay for the decisions according to the established restrictions; if the firm is attributed the right to fire, the firm itself will detain the profit from the decision. In this line it has been suggested (Freeman 2007), therefore, that any property rights distribution set by the employment protection legislation would possibly affect the income distribution, but not the efficiency of production³.

- A third suggestion by the mentioned Jobs Study is in favour of making wages more responsive to market pressures. Actually, the rationale and the meaning of this statement are far from clear. Are “market pressures” supposed to lead to an aggregate full employment equilibrium wage level? Do these pressures guarantee a perfectly competitive market so that same market and same occupation correspond to same wage? Should marginal productivity of labour be the parameter for wage setting? Aren’t “efficiency wages” themselves a result of free market pressures? Are variables such as “power” part of the “market pressures” which influence wage bargaining? What actually this recommendation comes to seems to be a substantial reduction of the role of trade unions and collective agreements in wage setting, on the assumption that this would push wages above the “market” level. But on this point many questions can be raised. First, the role and weight of trade unions in wage setting is a vector of several variables which includes trade unions density, coverage of collective agreements, various degrees of centralization or decentralization, coordination devices, different parameters for wage setting. Second, the impact of such vector on labour market and economic performance is difficult to establish on theoretical terms, not to say on empirical grounds, due to different influences and

³ “The analysis suggests that institutionally determined rules, such as employment protection legislation, which some blame for European high unemployment by making firms leery of hiring workers they cannot readily lay off in the future in fact have no effect on employment. ...What EPL does is alter the division of the profits from the efficient choice. With EPL the firm pays some of the profit from a layoff to the worker to induce the worker to leave. Absent EPL the firm gets all of the profit from the decision. In this model, institutions alter the distribution of income but not the efficiency of production” (ib. page 15).

different weights of each component. It could be argued that “work councils”, good industrial relations at firm level, with more knowledge diffusion and workers’ participation, would favor wage moderation, but also the opposite: that centralized bargaining and social dialogue would make workers more aware of the constraints coming from balance of payments and prices stability.

Finally, the Jobs Study includes among the advocated structural reforms the improvement of active labour market policies. Obviously, this does not affect the aggregate demand for labour, but, mainly through job search assistance, counseling and training, it may reduce frictional and structural unemployment. If measures for direct job creation or subsidies for self employment are adopted an impact on the overall labour demand may also be considered.

When from the level of theory we move to the level of empirical evidence unfortunately we don’t get much help in detecting the impact of the institutional variables mentioned above on the performance of the labour market and the economy in general. The results of empirical investigations are not univocal and even when significant relations are found, they are generally accompanied by warnings, caveats and particular assumptions. As it is easily understandable, the main reason lies in the difficulty to find countries which are similar in all the relevant economic variables except for that particular institution to which the difference in economic performance is to be attributed. Even within the set of institutions it is not possible to test the influence of one particular feature without taking into account the overall institutional set up. A study made in 2002 for the Center for European Studies (Baker, Glyn, Howell, Schmitt, 2005) deals in great detail with the main empirical cross country investigations and also multivariate analyses trying to establish a relationship between labour market institutions and economic and employment performance. The study puts under examination “the evidence for the widespread belief that labor market rigidities are largely responsible for high unemployment and that labour market deregulation is therefore the best route to raising employment rates”. The study concludes that none of the links between the above mentioned elements of the so called “structural reform” suggested by the Oecd and the labour market outcomes is empirically proved. In particular, the results of the examination “suggest a yawning gap between the confidence with which the case for labor market deregulation has been asserted and the evidence that the regulating institutions are the culprits. It is even less evident that further weakening of social and collective protections for workers will have significant positive impacts on employment prospects. The effects of various kinds of deregulation on unemployment are very hard to determine and may be quite negligible. Moreover such effects as there are may influence labor force participation rather than employment (e.g., lower wages

and greater employment insecurity may lead workers to opt out of the labor force altogether, which could contribute to lowering the unemployment rate)”.

Nevertheless, in spite of this lack of empirical evidence, the traditional consensus has maintained its strength. Advices and recommendations have kept pouring in this direction, and several countries, particularly those more dependent on World Bank and IMF conditionalities, have taken measures to weaken “institutional rigidities”.

3. The recent financial crisis: are some of the roots deepened in the labour market? While governments of different countries were busy to implement to a various degree the “structural reform” among these lines, the great financial crisis occurred. As it is well known, it started creeping in the US financial sector, then exploded in a violent bust and spread its effects in the real sector near all over the world.

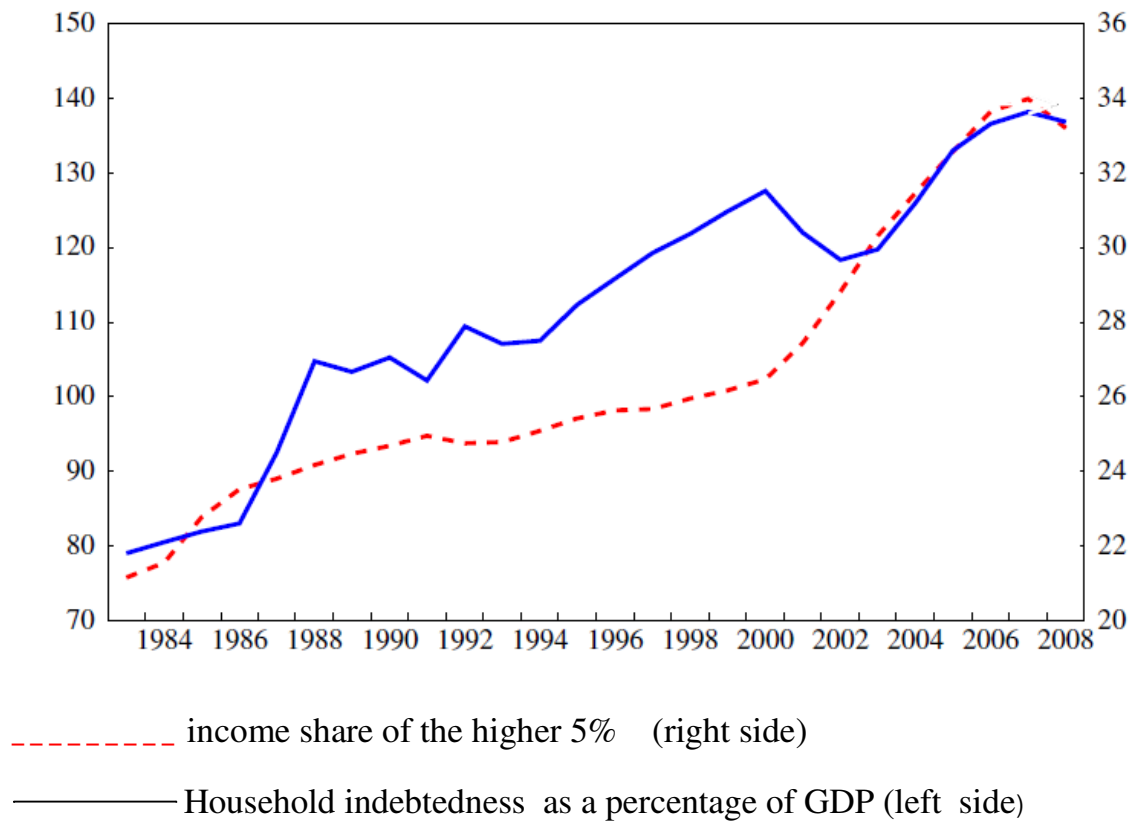
Although on the “mechanics” of the sequence that led to the explosion of the crisis there is a common agreement, more open questions remain as for the root causes of it. Surely two facts have converged to determine the crisis: one is the financial disorder which has accompanied the financialization of the economy allowing for an unlimited buy of financial assets on credit (excessive leverage and spread of the risk in a variety of derivatives); the second is the expansionary monetary policy of the Federal Reserve, with low interest rates and easy credit which led to financial “euphoria”. If this were the complete explanation of the crisis, the countermeasures should be sought at the financial level and they would be enough to avoid a similar crisis happening again. But a deeper insight shows that the root causes of the crisis lie in a structural aspect of the real sector, and precisely in the fall of the purchasing power of households, which would have implied a deficiency of aggregate demand had not households been able to keep a high level of consumption demand through an increase in their indebtedness. It is this enormous increase, extended more and more to people unable to repay the debt mainly in the housing sector, accompanied by a wild deregulation of financial markets, that triggered the spiral of the financial boom which led to the bust once the de-leveraging process started to work. The aggregate demand required to sustain the growth of the economy was therefore financed out of private debt⁴ rather than out of income (Cynamon and Fazzari 2008, Kumhof and Ranciere 2010), but this process could not last forever, and in fact it didn’t. It is worth considering that once the aggregate purchasing power had fallen, either it had to be compensated by an increase in borrowing or it would have led straight to a recession in the real economy through a fall in the level of economic activity.

⁴ For the difference with the financing through public debt, see Barba, Pivetti 2009

The question to be asked now regards what has caused the decrease in the purchasing power. There is wide agreement in the literature that the cause is to be attributed to the increase in income inequality, which has produced first a fall of the saving rate of households and secondly an increase in their indebtedness. No general awareness existed before the crisis about the risk that increasing income inequality and decreasing of the labour share in GDP could have led to such disastrous results, although the phenomenon was well known (Glyn 2006, 2007); and this is quite striking. Among the rare warnings that were made before the crisis one should mention the paper by Barba and Pivetti (2006), which pointed out the long term macroeconomic implications of the rise of households debt, underlining the great difference between private and public debt. Now the role played by the growth of income inequality seems to be widely recognized (Fitoussi and Saraceno, 2010), although the measures taken all over the world to overcome the crisis do not show coherence with this view.

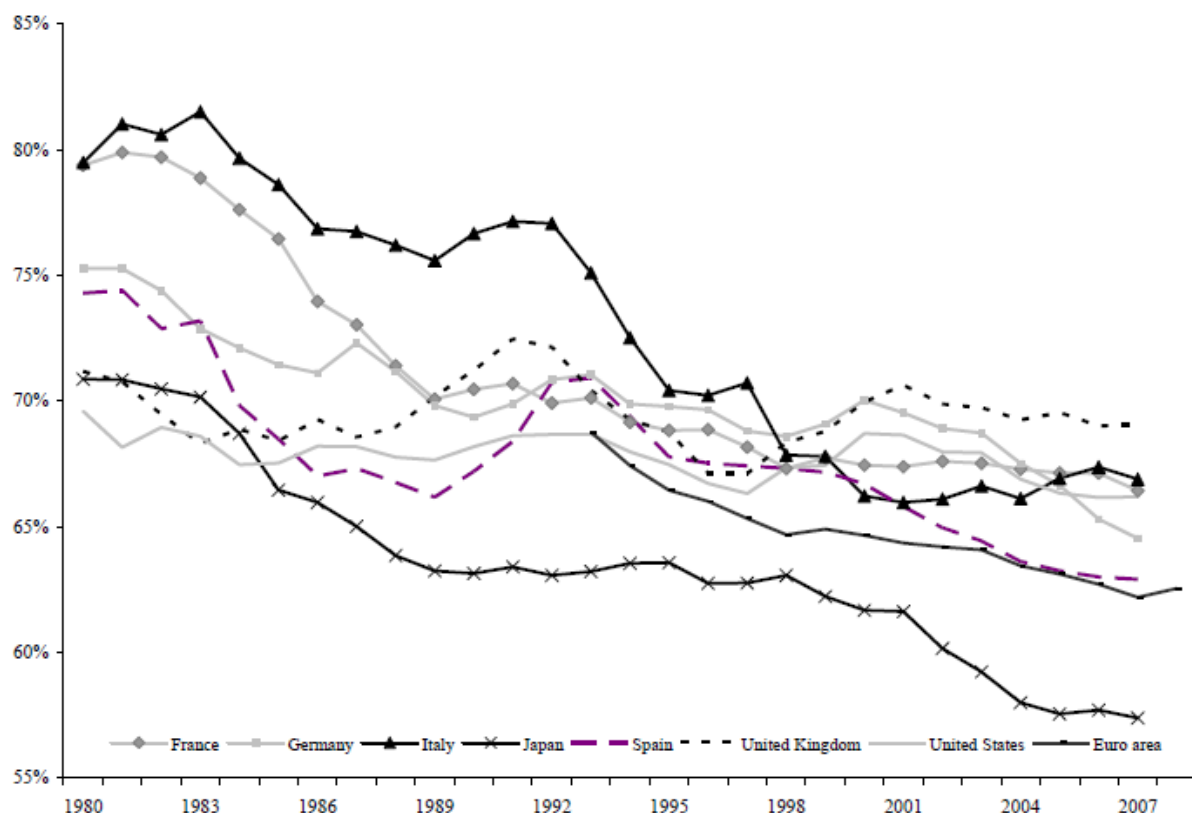
But to see where we come from we must now ask if any role has been played by labour market institutions in determining the trend in income inequality. Three facts are empirically evident: first, the trend in income inequality has been growing nearly everywhere in the industrialized countries in the last decades; second, the US show the greatest increase and the highest absolute level of inequality; third, the increase in income inequality is parallel to the decrease in the labour income share in GDP.

Income inequality and household indebtedness in the US



Source, IMF 2010

The fall in labour share



Source OECD (from Fitoussi 2010)

Against these facts we can observe the evolution of some features of the labour market institutional set up.

The first feature is the level of employment protection legislation, with all the caveats regarding the oecd index we can notice that while inequality was growing and labour share falling in the States, epl was kept there constantly and significantly under other countries level, while in other countries the fall of labour share was accompanied by a fall in epl, though remaining much higher than in the U.S. It's difficult to imagine a causal relationship going from the first to the latter.

EPL index, selected years

	1985	1995	2008		1985	1995	2008
Austria	2.21	2.21	1.93	Italy	3.57	3.57	1.89
Belgium	3.15	3.15	2.18	Netherlands	2.73	2.73	1.95
Denmark	2.4	1.5	1.5	Portugal	4.19	3.85	3.15
Finland	2.33	2.16	1.96	Spain	3.82	3.01	2.98
France	2.79	2.98	3.05	Sweden	3.49	2.47	1.87
Germany	3.17	3.09	2.12	UK	0.6	0.6	0.75
Greece	3.56	3.5	2.73	US	0.21	0.21	0.21
Ireland	0.93	0.93	1.11				

Source: OECD

A second relevant feature is the decrease of trade unions power as expressed by Union density data. The Oecd data show not only a decreasing trend of workers trade union participation but also a significant difference between the United States (11.9% in 2008) and main European countries in the same year (Sweden: 68%; Belgium: 51.9%; Italy: 33.4%; Germany: 19.1%).

Trade Union Density in %				
	1970	1980	1990	2000
Australia	44	48	40	25
Austria	63	57	47	37
Belgium	41	54	54	56
Canada	32	35	33	28
Denmark	60	79	75	74
Finland	51	69	72	76
France	22	18	10	10
Germany	32	35	31	25
Greece		39	32	27
Iceland		75	88	84
Ireland	53	57	51	38
Italy	37	50	39	35
Japan	35	31	25	22
Luxembourg	47	52	50	34
Netherlands	37	35	25	23
New Zealand	56	69	51	23
Norway	57	58	59	54
Portugal		61	32	24
Spain		7	11	15
Sweden	68	80	80	79
Switzerland	29	31	24	18
UK	45	51	39	31
United States	27	22	15	13

Source. Oecd employment outlook, 2004

A third feature is the degree of collective agreements coverage

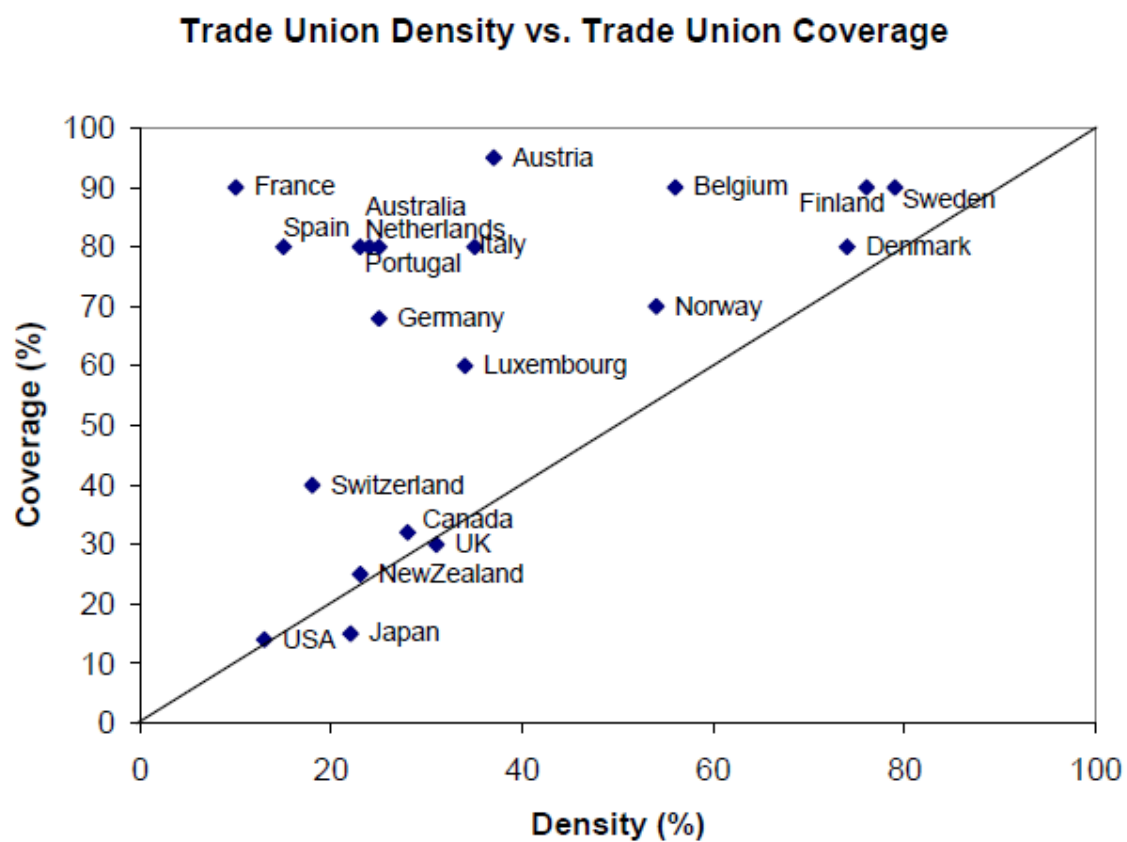
Collective Bargaining Coverage in % - selected countries

	1980	1990	2000
Austria	95	95	95
Belgium	90	90	90
Denmark	70	70	90
Finland	90	90	80
France	80	90	90
Germany	80	80	90

Italy	80	80	80
Sweden	80	80	90
United Kingdom	70	40	30
United States	26	18	14

Source: Oecd Employment outlook, various years

Taking the data about Union density and collective bargaining coverage it is possible to see the relative position of the United States:



Source: Oecd

A fourth element is the degree of collective bargaining centralization, which is largely supposed to negatively affect wages inequality⁵. Even on this ground the United States show a lower degree of centralization compared with European countries.

Centralization of bargaining index

	1970-74	1975-79	1980-84	1985-89	1990-94	95-2000
Australia	4	4	4	4	2	2
Austria	3	3	3	3	3	3
Belgium	4	3.5	3	3	3	3
Canada	1	1	1	1	1	1
Denmark	5	5	3	3	3	2
Finland	5	5	4	5	5	5
France	2	2	2	2	2	2
Germany	3	3	3	3	3	3
Greece						
Iceland						
Ireland	4	4	1	2.5	4	4
Italy	2	2	3.5	2	2	2
Japan	1	1	1	1	1	1
Luxembourg						
Netherlands	3	3	3	3	3	3
New Zealand	3	3	3	3	1	1
Norway	4.5	4.5	3.5	4.5	4.5	4.5
Portugal	5	4	3	3	4	4
Spain	5	4	4	3.5	3	3
Sweden	5	5	4.5	3	3	3
Switzerland	3	3	3	3	2	2
United Kingdom	2	2	1	1	1	1
United States	1	1	1	1	1	1

Source: OECD

Source: Oecd

⁵ The strong conclusions in this sense drawn by Wallerstein (1999) have been questioned by Golden and Londregan (2005), who stress the importance of other factors, like changes in the supply and demand for skills, or the impact of tax policies

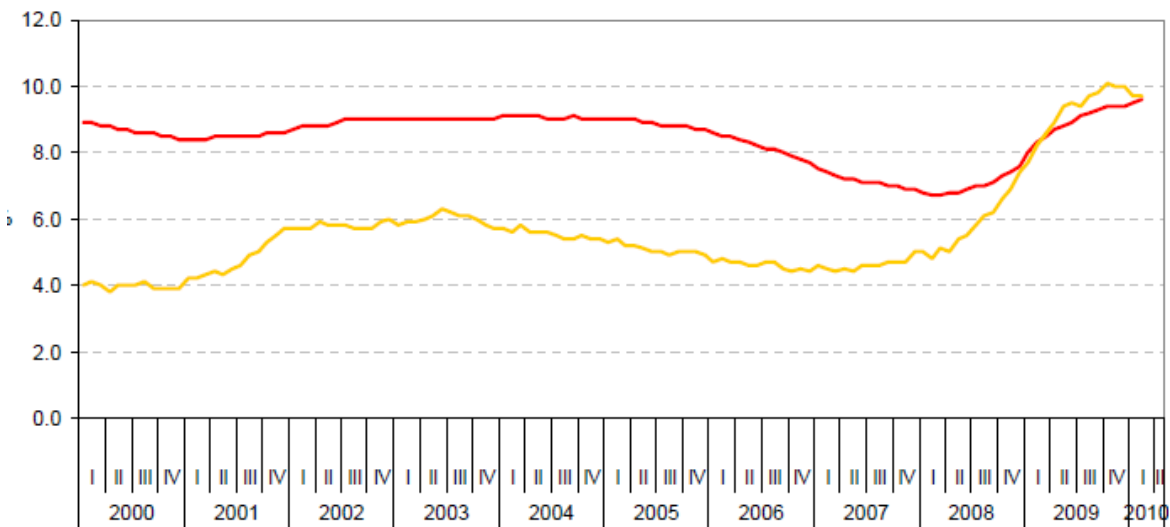
The trend in wages and the wage share on gdp may also be seen against the growing of the so called non standard work contracts.

It is clear at this point where we come from. We come from a labour market institutional set up which has depressed the share of labour in the economy and has created that “great moderation” of which even Bernanke declared in a famous speech to be proud. Undoubtedly this institutional evolution has taken place under the pressure of globalization, which on one side has granted the employers an increase in bargaining power in front of the employees due to the possibility and the threat of transferring abroad part of the production and on the other side has pushed the government to favour this process with the aim of resisting the strong competition from emerging countries. But the story has proved that such attempts to respond to low labour standard and even social dumping in competitor countries through lowering labour standards in turn, far from succeeding in reaching the target has created the structural basis for the slow building of the crisis which later exploded as a financial crisis.

4. The effects of the crisis on the labor market have been widely analyzed in the literature. According to ILO’s global employment trends, the global unemployment rate rose between 2007 and 2009 from 5.6 to 6.3. But it’s important to compare the performance of the labour market between the US and the European countries. As shown by Eurostat (Statistics in focus, 20/2010), in the European Union, despite the stronger downturn of economic growth, the unemployment rate has risen sharply as a result of the economic crisis, but the increase has been much smaller than in the United States.

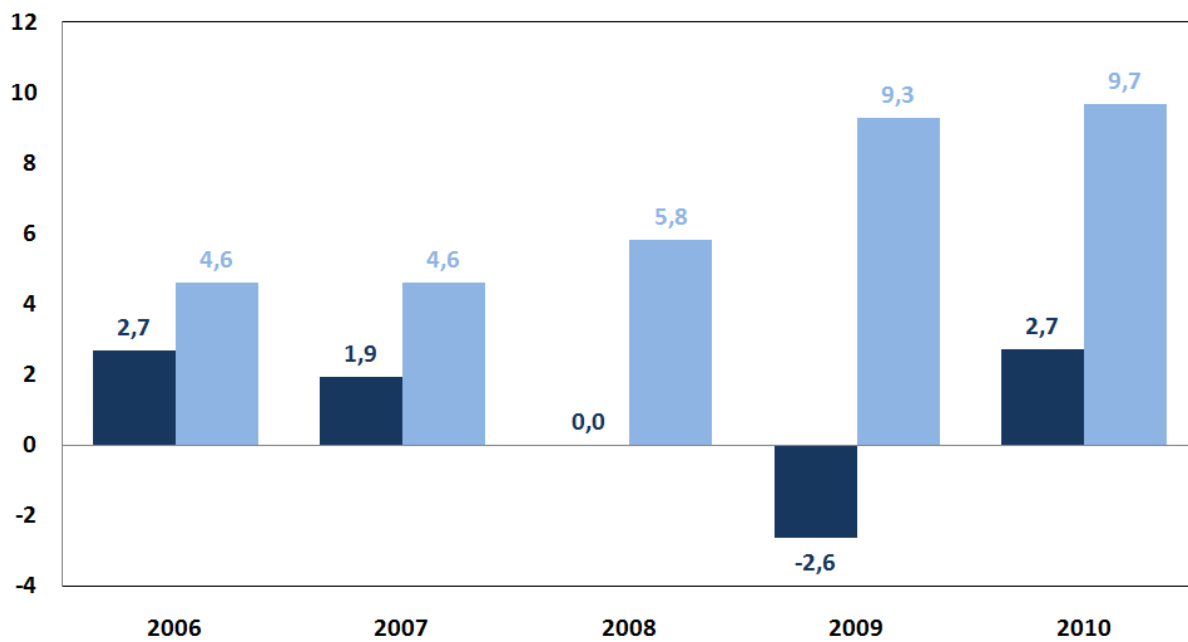
The following graph shows the trend of unemployment in the EU and in the US (lower line) since 2000. In spite of being much lower at the start of the crisis the US rate has overtaken the EU rate at its peak. The two subsequent graphs are a description of the relationship between the growth of GDP and the rate of unemployment respectively in the US and in the EU. What can be seen is that compared with the United States the crisis has had in Europe a greater impact on GDP but a smaller impact on unemployment.

Unemployment rates in EU 27 (upper line))and US, seasonally adjusted



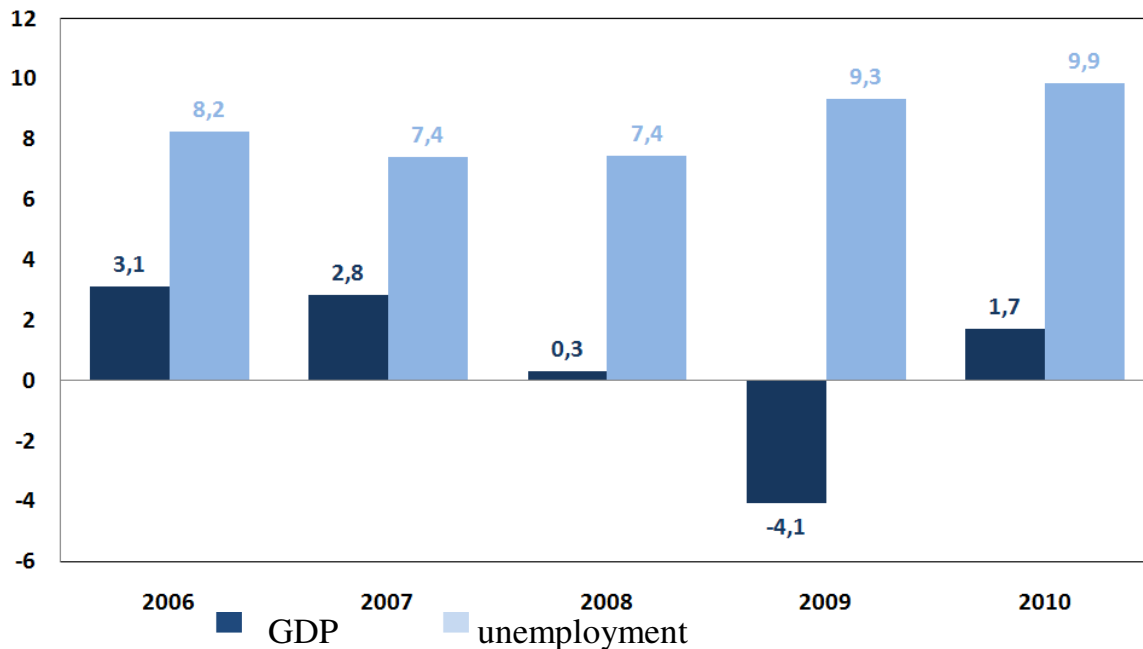
Source, Eurostat, Statistics in focus, 20/2010

GDP growth and Unemployment rates in US before and after the crisis



Source: Oecd data

GDP growth and Unemployment rates in EU before and after the crisis



Source: Oecd data

The question which requires an answer is whether these different elasticities of unemployment with respect to cyclical fluctuations of GDP are connected to different labour market institutions.

Subsequently it could be asked whether the crisis has influenced the evolution of labour market institutions themselves.

As for the first point, it seems possible to explain the different impact on unemployment in Europe on the basis of its more rigid labour market institutions. It goes without saying that it is necessary to pay attention to all the difficulties that we mentioned relatively to cross country comparisons of the relationship between economic performance and labour market institutions, since many variables other than institutions do influence the performance of the economy. But this difficulties are largely relieved in this point because the question is not to observe the influence of institutions on economic performance but rather the impact of the economic

slowdown, let's say recession, on the labour market. We simply have to consider the reaction of unemployment to the fall of Gdp growth rate in different countries. Clearly, structural effects influence this elasticity: the different sectors affected by the fall in the level of economic activity will create different effects on aggregate unemployment simply because of their different labour coefficients and of their different proportions in the composition of GDP. But, once these aspects are accounted for (for instance, the role of the financial sector in the case of UK and Ireland, or the role of the housing sector in Spain) the role played by labour market institutions could be detected. Nevertheless, the problem at this point is given by the complexity of the vector of labour market institutions: it is difficult to disentangle the effect of any single institutional feature, which actually operates together with all the other components of the institutional set up that may compensate or accentuate what its influence would be if considered alone. In fact the labour market institutional set up is an extraordinary combination of a great variety of aspects (some of them have been mentioned in chapter 2 of this paper) which makes it difficult to classify and clusterize the different countries. Furthermore, the gap between formal legislation and actual practice plus the presence of informal employment are other sources of difficulty. The well known IZA grid is only a simplified approximation which can be used, though, to give an idea of the position of different countries as far as labour market institutions are concerned..

Flexibility models

		Employment protection (core)	
		Strong	Weak
Labour market policies	Big	1 (Continental countries, e.g. Germany)	3 ("Flexicurity" countries, e.g. Denmark)
	Small	2 (Mediterranean/ Roman/Latin countries, e.g. Spain)	4 (Anglo-Saxon countries, e.g. United Kingdom)

Source: IZA

In general terms the higher elasticity of US unemployment with respect to variations in GDP due to the crisis can be explained with less labour market rigidities, as expressed by the variables considered in the above chapter 2. “Countries with relatively few labour rigidities respond to negative shocks with higher unemployment” (Fitoussy, 2010, Signorelli, 2010), as the cases of U.S., U.K., Canada, Ireland and Netherlands seem to show⁶. Nevertheless, coming to more details and considering the European evidence, some studies seem to deny this correlation. For instance Eichhorst (2010) after a detailed analysis concludes that “when analyzing the issue of EPL for regular workers and its role in shaping the outcome of the crisis more generally – i.e. output and employment – a rather ambiguous relationship arises. Indeed the impact of the crisis in terms of GDP and employment appears to have little to do with the level stringency of employment protection”. But this statement needs two qualifications: first, it refers only to the role of ELP and not to the whole set of labour market institutions, whose role can still be thought as relevant; and, secondly, it does not distinguish the impact of the crisis on unemployment via changes in GDP from the impact of given changes in GDP on unemployment. Surely, “growth in formal sector jobs is correlated with high economic growth, irrespective of the type of labour markets regulations being applied” (ILO, 1995), but this is not to say that they do not influence the reaction of unemployment to GDP fluctuations. As Blanchard (Blanchard and Wolfers 2000) says, labour market institutions although potentially able to explain cross country differences today, can hardly be considered as able to explain the general evolution of employment over time, but they may significantly influence the ability of economies to respond to adverse shocks.

In fact, as for the impact of GDP fall on unemployment, this has been lower in countries where the institutional set up as a whole (apart from specific EPL) has provided: a) a greater “internal” flexibility, that is working hours, wage and task adjustments; b) a higher level of labor market active policies, that is counseling, training and job search assistance; c) more generous passive labour market policies, in terms of more coverage and higher levels of unemployment benefits, social security and tax relieves (Eichhorst, 2010). The last measures, though, impact more

⁶ A caveat must be made here, due to the fact that changes in unemployment rate may be influenced by changes in activity rates induced by changes in the rates of unemployment themselves (discouraged worker effect). But, given the differences in activity rates of various countries, we may assume that their changes respond in similar ways to changes in unemployment.

on the level of economic activity through their automatic stabilizing mechanism (ILO, 1995), rather than directly on the elasticity of unemployment to GDP.

Beyond considering the elasticity of unemployment, of paramount importance is to consider the effect of the crisis on labour market structure. In this regard, the ILO (2010) points out the growth of what it calls “vulnerable employment”. This notion groups all the kind of jobs which do not meet the qualifications of a “decent work”. They range from fixed term workers to economically dependent autonomous workers, to workers with informal arrangements, usually without social protection, without rights recognized by collective agreements, with bad working conditions, low pay, low skills and low productivity. The growth of this component can be considered as a main structural effect of the crisis on the labour market. To a large extent this effect is due to a change in labour market institutions, sometimes achieved through structural reforms of labour market regulations, sometimes through actual practices based either on breaking the laws or on their abuse. Clearly the increased international competition associated with the downturn of the world economy has stimulated this kind of evolution on the belief that this might help the countries to become more competitive. Entrepreneurs, on the other side, try in this way to survive their market and financial difficulties. But surely the decision to introduce greater flexibility of the kind which allows an increasing use of low paid, unskilled and precarious work as a way out of the crisis is a short sighted one.

Unfortunately, all this kind of so called “flexibility” has impacted on labour productivity. Labour hoarding, the reduction of working hours and the growth of this precarious work are all factors which have contributed to the lowering of productivity per worker.

The proportion in the combination of these three factors is both firm and country specific. It’s specific to firms in that it is up to them, when they experience a fall in market demand as temporary, to decide whether to adjust correspondently the labour force or to hoard. The Okun’s law implies the decision to hoard. This decision may be influenced by firing and hiring costs which, it has to be noticed, are not dependent entirely on institutional factors but also on turnover costs associated with the level of technology, the pace of innovation and the general conditions of the industrial organization and of the supply of human capital. It’s also specific to firms in that they can negotiate with the workers working hours reductions instead of employment reductions. Finally, it is firm specific in that it is up to the firm to decide. under the

pressure of competition, whether or not to use a quota of “precarious work” if that is less costly.

But that proportion is also country specific, because labour market institutions are to a large extent determinant of turnover costs and of the possibility of internal numerical flexibility (up to a “zero –hours” reduction in working hours in the case of Italy!). It is particularly on the possibility of using “precarious work”, its cost and its conditions, that the institutional set up of each particular country is decisive. If the labour cost (per worker) of precarious work is significantly lower compared to standard work the firm will be ready (with a short term view) to give up higher per worker productivity in exchange with lower unskilled labour cost.

When this combination of factors happens, per worker productivity either slows down or falls; this in turn will reduce both wage share⁷ and competitiveness, triggering a spiral effect which will delay, or rather prevent altogether, the recovery because of insufficient domestic and foreign aggregate demand. Obviously, governments can partially counteract these effects by more spending in passive labour market policies, but a wiser policy should be oriented towards institutional measures aimed at discouraging this perverse combination and at fostering productivity growth, which in the long run would contribute to expand both GDP growth and employment.

The empirical evidence about the relationship between employment and productivity after the crisis shows that countries where internal flexibility (as defined above) have helped in smoothing the impact of the crisis on unemployment had to pay this with a productivity slowdown (Marelli, Signorelli, Tyrovicz, 2010). Countries with “flexicurity” model (high external flexibility combined with strong and effective active and passive labour market policies) had both reduction in employment and increase in productivity. Accordingly, the best choice should be to combine both external flexibility (of the kind necessary to reduce adjustment costs) and internal flexibility with effective active and passive labour market policies.

5. In the way of conclusion. Where we are going and where we should go.

⁷ Tronti has suggested to me the view that when productivity falls, the labour share raises, due to downward wage rigidity. But we are considering here a fall in productivity due exactly to intensive hiring of low wage labour.

As we have seen, the empirical evidence and the theoretical views on the role that labour market institutions play in the crises and should play for the recovery are far from univocal. From what we have been considering in the paper, the following chain of “stylized” facts can be summarized.

Labour market institutional factors have contributed to increase income inequality and to reduce the labour share in GDP. Out of this evolution a great increase in private indebtedness has come out.

Growing private indebtedness and financial disorder have nourished the crisis which has eventually exploded through a financial bust. The impact of the crisis on the labour market happens through the impact on GDP and through the employment elasticity to GDP variation.

The containment of unemployment effect is due generally to the presence of higher labor market rigidities. But a deeper analysis shows that what has smoothed the impact of unemployment is not so much the presence of EPL but rather the increase in internal and functional flexibility plus wage moderation, plus the effective active and passive labour market policy⁸.

An important structural effect on the labour market has been the growing of “vulnerable work”, that is low paid, low skilled and precarious work. This fact, together with the containment of unemployment because of labour hoarding or working time reduction, has generally caused a slow down or a fall in per worker productivity. Labour market formal and informal institutions play a key role in this dynamics.

That’s about where we are now, with the addition of a set of fiscal stimuli that have been delivered in several countries in order to speed up the recovery. These fiscal stimuli are different in magnitude according to different countries, going from Germany at the top to Italy at the bottom.

⁸ The case of Germany is particularly significant in this regard. Its well known missing decline in unemployment during the recession is mainly explained by two peculiar facts: the missing employment increase in the previous boom and the particular incentive to working hours reduction obtained through the “working time accounts” agreed in labour union contracts (Burda M, Hunt J. 2011); practically a kind of “implicit contract” exchanging overtime work in expansionary phases for working time reduction during recessions.

	Tax cuts & fiscal expenditures		Extra credit & similar measures	
	€ bn	% of GDP	€ bn	% of GDP
Belgium	1.2	0.4%	2.1	0.6%
Denmark	0	0.0%	0	0.0%
Germany	39.3	1.5%	70.3	2.8%
Ireland	0	0.0%	0	0.0%
Greece	0	0.0%	23	0.9%
Spain	12.3	1.1%	54.3	4.9%
France	16.9	0.9%	41.5	2.1%
Italy	-0.3	0.0%	0	0.0%
Netherlands	6.1	1.0%	0.3	0.1%
Austria	3.9	1.4%	2.5	0.9%
Poland	1.6	0.5%	5.0	1.6%
Sweden	1.1	0.4%	8.8	3.0%
United Kingdom	22.6	1.4%	23.3	1.4%
13 largest EU countries	104.8	0.91%	231.1	2.0%
Imputed EU-27 total	117.3	0.91%	258.5	2.0%
European Commission	9.3	0.07%	15.5	0.1%
Imputed grand total	126.6	0.99%	274.0	2.1%

Table from Bruegel Policy Contribution (2009)

While fiscal and monetary policy should accompany new financial regulations and converge in stimulating the recovery, great attention should be paid in avoiding the real economy to fall again into those traps which have been the root cause of the recent crises.

In order to do this we suggest that labour market institutions be properly used. Therefore it may be useful to look at the contribution that each particular element of the labour market institutional frame can give to the achievement of five tasks that appear to be necessary to set the recovery on a right and not dangerous path.

The five tasks are:

- 1.to stimulate aggregate demand through more equal income distribution rather than through private indebtedness;
2. to reduce labour adjustment costs in order to meet the requirements of fluctuations in demand and of restructuring the productive system;
3. to improve skills and human capital accumulation in order to increase productivity;
4. to improve the activity rate and the quality of jobs
5. to support social dialogue, worker participation and cooperative behaviour among unions, entrepreneurs and government.

Taking a taxonomy of labour market institutions it's possible to construct a grid which allows to see their contribution to each of these five targets.

	1	2	3	4	5
Functional flexibility		+			
Working time flexibility		+			
Numerical external flexibility	–	+			
Possibility of precarious work	–		–		–
Unemployment benefits duration	+			–	
Unemployment benefits coverage	+	+			
Unemployment benefits replacement rate	+				
Union density					+
Coverage of collective agreements					+
Coordination of wage barg. & income policy	+				+
Minimum wages	+				
Job search assistance		+		+	
Counseling			+	+	

Training			+		
Hiring incentives				+	
Help for new start-ups				+	

Of course every element in the rows needs specifications and is in turn decomposable into different sub elements and characteristics. The grid is only a suggested tool for figuring out the set of labour market institutions more appropriate to the needs of a sustainable recovery.

With regard to this, two qualifications must be added. First, all the institutional elements have to be considered in terms of complementarity with each other. It doesn't make any sense to consider them separately, because they interact with each other, and the interaction may be such as to turn into positive the effects that separately would be negative, or the other way round. This is also evident when the signs in a same row are positive in some columns and negative in others. The net effect clearly depends on the balance with the other elements, in addition to the specific characteristics of the single institution itself. Secondly, in addition to the need of general tax and fiscal policy harmonization among different countries, also for labour standards (concerning, for instance, working time, wage setting, union agreements, precarious work, and so on) a higher degree of international coordination and harmonization is needed in order to avoid a kind of "social-labour dumping" among countries, which would be damaging for all.

To conclude this section it must be added that the program and recommendations of Europe 2020 are in line with these directions. Differently from the previous Lisbon strategy, guideline 7 for the employment policies of the Member States explicitly states: "Member States should step up *social dialogue* and tackle labour market segmentation with measures addressing *temporary and precarious employment, underemployment and undeclared work*. Professional mobility should be rewarded. The quality of jobs and employment conditions should be addressed by fighting *low-wages* and by ensuring adequate *social security* also for those on fixed contracts and the self-employed. *Employment services* should be strengthened and open to all, including young people and those threatened by unemployment with personalised services targeting those furthest away from the labour market". (*italics mine*)

This is all good, but unfortunately the so called “open method of coordination” doesn’t make these recommendations binding for Member States, and it is up to each country to decide whether or not to follow them.

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