Monti and Rajoy cross the labour market Rubicon

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Summary

- The governments of Mariano Rajoy in Spain and Mario Monti in Italy have both announced significant programmes of labour market reform as part of their economic reform agendas. Monti has this week announced he will seek change without the support of Italy's largest union.

- Both Monti and Rajoy have chosen totemic targets: Italy's Article 18 statute on worker dismissal and Spain's national and sectoral collective bargaining rules. These are arguably the most significant reforms in either labour market for a generation.

- Monti in particular, with no clear political base, faces a tough parliamentary fight with Italy's largest union to secure the reforms. He may find himself squaring up to a conservative electorate and even the Catholic church.

- Despite their political potency, for international investors, neither set of reforms will dramatically transform the inward investment conditions in Spain or Italy when set against wider competiveness issues around labour costs, skills and productivity.

Last week saw an important moment in the Italian debate on labour market reform, as Prime Minister Mario Monti's cabinet approved a set of proposed changes to Italy's 'Article 18' worker protection statute. Monti will now take them to the Italian parliament, where debate and resistance are expected to be fierce. For the first time in living memory an Italian leader has taken a substantial package of labour market reforms to parliament without the backing of Italy's largest union, the Confederazione Generale Italiana del Lavoro (CGIL). Monti has nevertheless explicitly staked his prime ministership on passing them.

Mariano Rajoy in Spain has also made labour market reform a central plank of his economic reform strategy and an important demonstration of his credibility to his Eurozone partners and financial markets. Justifying his decision to trim Spain's deficit-cutting target for 2012 in early March, Rajoy pointed to his labour market reform package as evidence of his commitment to the deficit reduction programme. With Spanish unemployment now pushing 24% and youth unemployment twice that (Chart 1), Spain's government passed a package of reforms a month ago to address some of the same structural rigidities in labour markets that Monti has pledged to address in Italy.

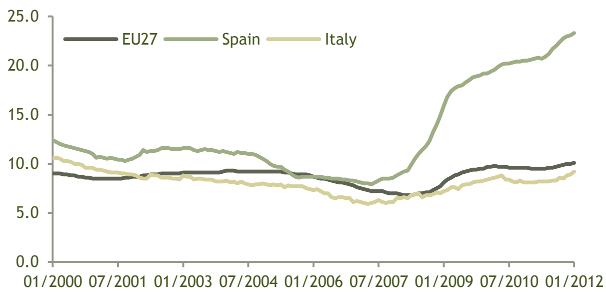

Chart 1: Unemployment rates 2000-2012

Source: Eurostat 2012

Monti and Rajoy have chosen slightly different targets, but both have aimed for totemic parts of their countries' labour market settlement. Monti wants to change Italy's Article 18 protections for dismissed workers. Rajoy sees a core problem in Spain's system of collective wage bargaining. In both cases these issues have defined the ambition of labour market reformers since the 1980s. Both the prime ministers also face concerted opposition from organized labour. This Global Counsel Insight note looks at the scale of Monti and Rajoy's ambition, the obstacles that remain in their way, and the implications for inward investors to Italy and Spain.

Never let me go

Monti's approach in Italy has been to target Article 18's previously taboo legal protections for dismissed workers in firms that employ more than 15 staff. In particular, he is targeting the powers it gives workers to appeal sackings even for economic or commercial reasons, and for courts to force businesses to reinstate workers and pay lost earnings. In Italy's grinding bureaucracy this process can easily take years and the perception among businesses is that judges have a marked leaning towards reinstatement. The disincentive to either hire or fire permanent staff in Italy has long been regarded a key problem for Italy's labour market.

Monti's proposed compromise is to extend the severance payments for employees made redundant for economic reasons but to remove the ability of courts to require reinstatement, except in cases of discrimination. Monti told an Italian television audience earlier this year that there would no longer be jobs for life in Italy. The comment was regarded by many in Italy as the first real public false step by the technocrat Prime Minister, not least for the indignation it provoked from some of Italy's exceptionally well-remunerated and pensioned politicians. It did however put down a marker.

Monti certainly faces an uphill struggle politically. Stable and protected employment is regarded as a key social good by many in Italy. It reinforces the insider culture practiced by the civil service, family-run businesses and, historically, by artisanal guilds. It is also a guarantor of financial security for large families. It is significant that Monti has faced criticism not just from the six million-strong CGIL union, but from Catholic media invoking the Church's support for employment protection since the industrial revolution.

Monti's focus is not just on eroding the privileged and protected status of permanent employment but in smoothing the stark divide between the shrinking group of protected workers covered by Article 18 and the growing army of largely young and female workers on temporary contracts that are not covered by it. Monti wants to create incentives to employ permanent workers or apprentices rather than temporary ones, and intends to require that temporary workers be made permanent after three years (Table 2).

Perhaps surprisingly, polling in Italy on the proposed reforms suggests that even the proposed beneficiaries of the reforms – young workers on temporary contracts - are unenthused. The belief in the value of highly stable protected employment – not least for securing mortgage or consumer credit – appears to have made Italians, including those disadvantaged by the system, defensive of a labour market that privileges insiders over outsiders. Monti's approval ratings have fallen by a third to just above 40% since he proposed his labour market reforms in early March.

Weakening the hold of collective bargaining

In Spain Mariano Rajoy's government has focussed its political energy on reducing the hold of collective bargaining agreements on national and regional wage levels and working conditions. These agreements are the defining feature of the Spanish labour market, and considerably stronger in Spain than elsewhere in Europe. The Rajoy administration argues that collective bargaining has contributed to a tendency for the Spanish labour market to adjust through layoffs rather than revisions in hours or wages. It has picked up loosening these arrangements where the previous socialist PSOE government left off in 2010.

The legislation, passed by decree in February 2012 and now awaiting parliamentary ratification, extends to all permanent employees redundancy pay caps first proposed for limited groups in 1997. It will reduce redundancy pay for all workers to 33 days per year worked from the current 45 days per year worked, and cap it at 24 months. It creates tax breaks for the employment of workers under 30, raises the progressive cost of terminating temporary contracts and reduces the threshold requirement for the conversion of temporary to permanent employment from three years to two.

It also creates three year tax credits for employers who permanently employ those between 16 and 30, or those over 45 who have been employed over twelve months in the previous year and a half. Unemployed workers will be able to continue claiming 25% of their unemployment benefit for one year after employment.

Most controversially for its union opponents, Rajoy's government intends to strengthen further the ability of individual companies to opt out of collective bargaining on both the national and regional levels by giving precedence to company labour agreements. It will extend the ability of employers unilaterally to reduce salaries, working hours or employment terms for reasons of competitiveness and productivity, as well as giving employers scope to change working hours and labour terms unilaterally.

Implications for inward investors

Mario Monti had been aiming to head for China next week with a package of reforms under his belt, the better to sell Italy as a destination for Chinese inward investment. Rajoy will doubtless have a similar story for international investors. So how significant are these packages for labour market competitiveness in Spain and Italy?

Ranking of 142 markets internationally	Spain	Italy	UK
Cooperation in labour-employee relations	111	118	25
Flexibility of wage determination	128	134	17
Rigidity of employment	123	94	19
Hiring and firing practices	137	126	36
Link between pay and productivity	126	125	21

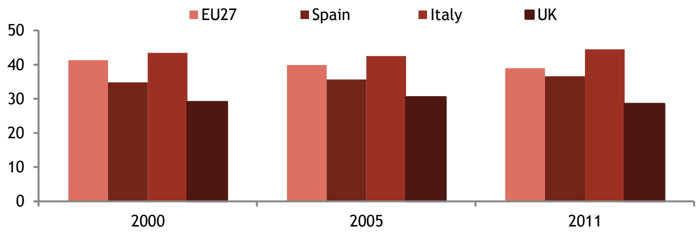

Table 1: WEF Global Competitiveness Report 2011-2012, labour market flexibility criteria (ranking of 142 markets); Chart 2: Tax wedge as a share of gross employment costs, Spain, Italy, EU27, UK

Source: WEF 2011, Eurostat 2012

The reality is probably modest, at least in the short term. The chilling effect on job creation created by Article 18 in Italy and collective bargaining in Spain will be partly thawed by these reforms, and combined with further reform of the Spanish and Italian social welfare systems to provide a better safety net and adjustment assistance for dismissed workers, they will certainly help. But Article 18's right of reinstatement is only actually taken up by a tiny fraction of those suing employers, and it remains expensive to make redundant long-term workers in both economies. Much more importantly, employment costs for employers remain high in both countries and productivity in relation to pay remains low (Chart 2, Table 1).

The perceptions of Italian bureaucracy in particular are negative, persistent and justified. So too are perceptions that much of corporate Italy still remains instinctively suspicious of cross-border investment, as last year's serious political tussle over the French firm Lactalis' bid for Italian dairy giant Parmalat demonstrated. Perceptions of labour relations and management attitudes in both countries are probably excessively negative, but they will not be helped by the imminent wave of public union resistance to change. These wider perspectives will rightly remain key for inward investors. The labour reforms are big changes, but part of even bigger problems.

Italy	Spain
Reform of Article 18 to remove requirement to reinstate workers made redundant on judicial order, except in cases of discrimination.	Much greater scope for opting out of collective sector or country-wide wage agreements through company-level agreements
Increase in severance pay obligations to up to 27 months wages for long term employees.	Capping redundancy payments at 33 days per year worked, and at a total of 24 months, for all Spanish employees.
Requirement to convert temporary to permanent contracts at three years.	Tax deductibility of 50% of costs of employees under 30 in first year.
	Right to 20 hours of workplace training annually, part-funded by the state.
	Progressive increases in the costs of termination in temporary contracts. Requirement to convert temporary to permanent contracts at two years.

Table 2: Key proposed 2012 labour market reforms in Spain and Italy

Assuming that Monti's package is adopted in parliament without significant weakening, the impact of these measures is more likely to be symbolic and psychological. But this should not be underestimated. For twenty years or more, the repeal of Article 18 has been a totem for Italian reformers and a taboo for Italian organized labour. The unions saw off the Berlusconi government in 2002 and the CGIL at least will fight this change hard. But union resistance is not unanimous, and there is a growing recognition in both countries of the scale of their economic problems.

Nevertheless, Monti has already come close to alienating his key ally Pier Luigi Bersani, the leader of the Democratic Party, which is closely linked to the CIGL union. Given the multi-year framework of Italian reform plans and Monti's expressed intention not to run in next year's Italian elections, many international investors are likely to defer judgment on the scale of the commitment in Italy to further reform.

The collective bargaining system has the same emotive force for organized labour in Spain as Article 18 does for many of their Italian counterparts. It is probably fair to see its dismantling as the most significant step in Spanish labour relations since the end of the Franco period. Although the previous Socialist government in Spain began to tackle national collective bargaining power, Rajoy's government has taken a further serious step towards genuine decentralisation. With a clear parliamentary majority and a much smaller unionised workforce than Italy (15.9% to Italy's 34.7%), Rajoy arguably has the easier job, although Thursday's national general strike showed that he still faces considerable resistance.

The impact of decentralised wage bargaining will not be felt overnight. Skill levels are still a persistent problem in a Spanish workforce in which a third of workers are on temporary short-term contracts and much of Spain's employment growth in the last decade has been semi-skilled work in the highly cyclical construction sector. This is why the Rajoy government has included in-work training incentives in its labour market package.

For investors in Spain and Italy, the Rajoy and Monti governments have certainly ushered in a new level of commitment to reform, and new signs of concrete change in both product and labour markets. The crisis has created a political opportunity that both feel they have a mandate to use. Neither will want actively to alienate organised labour, but they may find that their programmes, and their willingness to act without union backing, mark the end of decades in which reluctance or inability to take on union resistance has constrained labour market reform to incremental change.

However, it is also the case that both leaders face electorates for whom labour market flexibility is a highly ambiguous idea, and concern for personal economic stability against a worsening European outlook and sharp cuts in public spending can easily trump abstract arguments for business flexibility. Although these national deals dominate the headlines, investors thinking about asset stakes in both Italy and Spain would be well advised to pay due attention to labour relations in each individual asset. Rajoy was careful to tell the Spanish parliament that his labour market reform package was just the start and not a quick fix. He is surely right.

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