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EUROZONE CRISIS AND SOCIAL MODELS:  
WHAT WE CAN LEARN FROM  
ITALY AND SPAIN

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**ABSTRACT**

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This paper considers the role of social model features in the economic performance of Italy and Spain during the run-up to the Eurozone crisis, as well as the consequences of that crisis, in turn, for the two countries social models. It takes issue with the prevailing view - what I refer to as the “competitiveness thesis” - which attributes the debtor status of the two countries to a lack of competitive capacity rooted in social model features. This competitiveness thesis has been key in justifying the “liberalization plus austerity” measures that European institutions have demanded in return for financial support for Italy and Spain at critical points during the crisis. The paper challenges this prevailing wisdom. First, it reviews the characteristics of the Italian and Spanish social models and their evolution in the period prior to the crisis, revealing a far more complex, dynamic and differentiated picture than is given in the political economy literature. Second, the paper considers various ways in which social model characteristics are said to have contributed to the Eurozone crisis, finding such explanations wanting. Italy and Spain’s debtor status was primarily the result of much broader dynamics in the Eurozone, including capital flows from richer to poorer countries that affected economic demand, with social model features playing, at most, an ancillary role. More aggressive reforms responding to EU demands in Spain may have increased the long term social and economic costs of the crisis, whereas the political stalemate that slowed such reforms in Italy may have paradoxically mitigated these costs. The comparison of the two countries thus suggests that, in the absence of broader macro-institutional reform of the Eurozone, compliance with EU dictates may have had perverse effects.

Keywords:

Eurozone, Eurozone crisis, social models, Spain, Italy, labor market, welfare state, internal devaluation.



## EUROZONE CRISIS AND SOCIAL MODELS: WHAT WE CAN LEARN FROM ITALY AND SPAIN

Explanations of the ongoing crisis of the Eurozone tend to fall into two –not necessarily mutually exclusive – categories: 1) those that emphasize the shortfalls of the currency union’s macro-institutional architecture (monetary union without fiscal or banking union), and 2) those that emphasize structural characteristics of the Eurozone’s debtor countries as the source of the intra-Eurozone financial imbalances that became the focus of bond markets during the sovereign debt crisis. It is the latter view – what Fitoussi and Saraceno (2013) have referred to as the “Berlin -Washington consensus” and has later come to be known as the “Brussels-Frankfurt” consensus - that carried the day in the Eurozone and lies behind the “pro-cyclical austerity cum structural reforms” formula that has been imposed on debtor countries by their European institutions (the Commission and, for a time, the ECB) and other Eurozone governments (the Eurogroup). Chief among the demands of the EU - carried out by way of both formal and informal modalities of conditionality attached to critical financial support during the debt crisis - were budgetary cuts that have fallen heavily on social protection programs along with changes in labor market regulation intended to facilitate internal devaluation via downward adjustments in labor costs. Even when the perverse effects for growth of this approach of labor market liberalization coupled with pro-cyclical fiscal measures have been recognized by important actors (the IMF and, less openly, the Commission, [see Bontout and Lokajickova 2013; European Commission 2012b]) warnings against any slow down in fiscal consolidation and calls for further structural reforms in debtor countries have remained the order of the day in intergovernmental negotiations within the Eurogroup. Meanwhile, changes to the macro-institutional architecture of the Eurozone that could

limit the damage inflicted on debtor states (such as, for instance, the issuance of mutualized debt instruments to end the risk of sovereign defaults and redenomination) have remained blocked by intergovernmental impasse or put on timelines that preclude real relief in the foreseeable future (as is the case with key elements of banking union). All this reflects the conviction (central to the Brussels-Frankfurt consensus) that the situation in which the debtor countries find themselves is in some way or other to blame on excesses in their “social models” (Dølvik and Martin, forthcoming), that is to say their systems of labor market regulation and social protection.

The experiences of Italy and Spain are of particular relevance to this debate surrounding the sources of the Eurozone crisis and the repercussions of the austerity centered approach adopted by the EU. With the third and fourth largest economies in the currency area, the two countries are widely seen as determinant for the future of the Eurozone at large. At the same time, Italy and Spain have traditionally been identified in the welfare state and Varieties of Capitalism (VOC) literatures as representing a “Southern European” model of capitalism characterized by social policy and labor market features that have pernicious effects: low levels of labor market participation (in particular by women), dualism between long time labor market insiders and outsiders and collective bargaining institutions that undermine competitiveness. From this characterization it is an easy step to the conclusion that social model characteristics must have been behind the situation the two countries found themselves in from 2010 onwards when the Eurozone sovereign debt crisis spread beyond the smaller peripheral states in the currency area. Indeed, the characterization of these countries in much of the VOC literature appears to vindicate the Brussels-Frankfurt consensus on the roots of the Eurozone crisis.

A closer look at the evolution of welfare state and labor market institutions in the two countries both prior to and following the sovereign debt crisis, however, sheds a far more complex picture:

one that reveals important differences in their socio-economic and political dynamics as well as the extent to which social model change and its economic effects in each country have depended on wider macro-economic developments in the Eurozone.

This paper takes up the question of whether Italy and Spain's fate in the Eurozone crisis can be attributed to the social model features that have been the focus of current reforms. It argues that there are multiple ways in which the two countries' experiences challenge the underlying assumptions and adequacy of the course that they have been encouraged, when not forced, to follow by their Euro partners via both formal and informal conditionality. In the sections that follow, I first describe the evolution of the Italian and Spanish social models in the period prior to the crisis, pointing to different reform patterns that were strongly affected by the different political and macro-economic constraints that governments faced at various points. Prior to the crisis, the domestic politics of institutional reform had moved the Spanish social model considerably closer to that of its Northern EU neighbors than was the case for Italy. This, however, did little to prevent the economic boom and bust that Spain experienced following monetary union. While Italy experienced less social model change and made less headway on such critical measures as labor force activation in the pre-crisis period, this can be attributed, to a significant extent, to the radically different macro-economic conditions with which it joined the Eurozone. Governments of the Left in Italy failed repeatedly in their attempts to shift the balance of social spending in a more activation friendly direction largely because of these macro-economic conditions. The lack of attention paid to the relationship between macro-economic constraint and the politics of social model reform is one of the striking short-comings of the analysis that lies behind the Brussels-Frankfurt consensus, which has served to justify the *de facto* imposition of reforms in areas well beyond the remit of EU institutions, contributing to economic hardship and raising fundamental questions of democratic accountability in both countries.

The second section of the paper focuses on the contrasting economic performances of Italy and Spain in the run-up to the Eurozone crisis. It considers various arguments that have been offered for how social model features may have contributed to the two countries' situation at the time of the crisis. While social model features and developments can explain some of the contrast in the labor market performance of the two countries during this period, there is little to suggest that they played a determinant role in producing the much touted loss of competitiveness the two countries suffered during the first eight years of monetary union or their vulnerability to contagion as the sovereign debt crisis developed. Developments within the Eurozone at large involving a rise in household savings in some of the richer countries (Germany in particular) and the intensification of financial flows within the currency zone from richer to poorer countries over the pre-crisis period (Lane and Pels 2012; Pettis 2012) appear to have played a more fundamental role, along with other country characteristics that do not form part of what we can call their social models.

The third and last section of the paper reviews the responses of the Italian and Spanish governments to the Eurozone crisis and the impact this has had on the two countries' social models. While only Spain was forced to sign a memorandum of understanding with the troika in order to obtain a credit line for the rescue of its banking sector in 2011, reforms in both countries were heavily determined by what Sacchi et al. (2010) have referred to as "informal but strong conditionality" imposed by the Eurogroup in coordination with the ECB starting in 2010. With an already more market-oriented social protection system and the advent of a center-right government with an absolute majority in 2011, Spain moved considerably faster and further in the direction of labor market deregulation advanced by the troika than Italy, where electoral results forced a slower pace of reform and a different trade-off between productivity growth and employment. Indeed, Italian governments and social

actors up to 2012 were able to limit the degree of job destruction by building on existing non-market mechanisms of employment-sharing without incurring any substantially higher bond market penalty than Spain, even though Spain's internal devaluation and competitiveness measures improved considerably and Italy's continued to deteriorate. These facts - due largely to the negative feedback effect of employment and household income insecurity on domestic demand and lending in Spain - present a real challenge for the assumptions underpinning the Brussels-Frankfurt consensus. They raise the possibility that Spain's faster and more decisive embrace of the troika's prescriptions in the midst of an economic downturn and in the absence of substantial macro-institutional reform of the Eurozone may in the end bear little advantage. Indeed, they illustrate the danger that liberalizing labor market reform imposed in the context of pro-cyclical spending cuts and without decisive change in the Eurozone's institutions may only lead countries to fall into a "bad" economic equilibrium (de Grauwe 2012; Grauwe and Ji 2012; Wyplosz 2012; 2013) and impair growth in the long term by disregarding the relationship between present and future output (Fitoussi and Saraceno 2013).

### **I. The Spanish and Italian Social Models: evolution in the pre-crisis period**

The social models of the countries of Southern Europe have often defied easy categorization. Nonetheless, following the work of Leibfried (1992) and Ferrera (1996), who emphasized the limited development of social policy, the male breadwinner bias in social spending and labor market regulation and the central role of the family as a safety net, Italy and Spain have commonly been described in the Varieties of Capitalism (VOC) literature as sharing a distinct "South-European," or "familial" model of welfare capitalism (see Rhodes 1996; Bonoli 1997; Trifiletti 1999; Crouch 1999; Naldini 2003; Amable 2004). This view of the two countries, however, was based fundamentally on snap-shots taken in the late 1980s and early 1990s when their welfare state and

centrated in old age pensions and little if any income support going to people who did not have extensive contribution records (younger population cohorts, working age families, and women in general). Neither country had an adequate system of minimum income support for those of working age and this was reflected in high levels of dependence upon the family as a safety net, low female labor force participation rates and fertility, and higher than average rates of poverty risk. Most importantly, the logic of this familial model of welfare provision was seen to be self-reinforcing as high levels of employment protection and old age pensions served to compensate the mostly male breadwinners of earlier decades - ensconced as union insiders - for the lack of other forms of income support and security for themselves and their families. According to some authors, this combination of welfare state features was also believed to undergird a tendency toward low-wage production strategies and/or regional divisions and a firm structure skewed towards overly small firms, thereby locking these countries into a self-perpetuating "Southern syndrome" of low employment rates and productivity growth (Amable 2005; Rhodes 1996; Hancke and Herrmann 2007).

The perception that the two countries represented a distinct variety of capitalism with its particular logic and set of deleterious consequences was also reinforced by work on their industrial relations systems, characterized by the coexistence of competing labor confederations, a complicated combination of sometimes overlapping levels of wage bargaining (in particular in Italy) (Regini 1979, 1997) or a national employer confederations that, although highly encompassing, did not have adequate leadership capacity vis à vis its affiliates (the case of Spain) (Perez 2000; Regini 1979; 1997; Ebbinghaus and Visser 2000). An intermediately centralized bargaining structure combined with high levels of employment protection and divided labor organizations were believed to undermine efforts to deliver coordinated wage moderation (Regini 1984; Crouch 1985). And although both countries shared

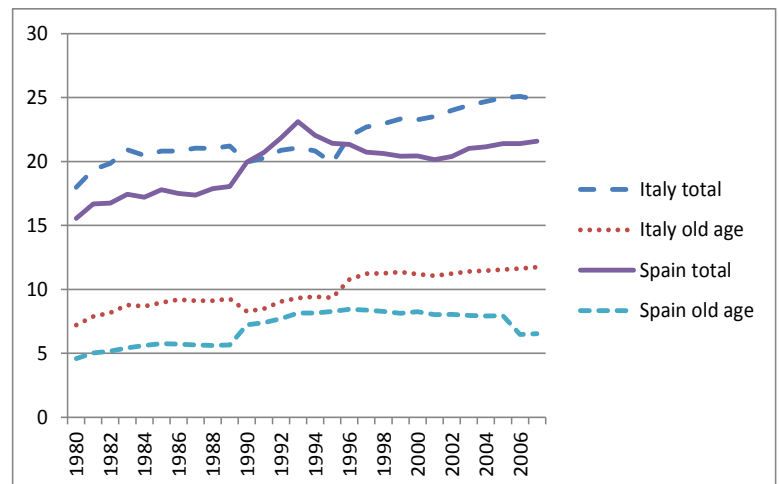
a substantial history of nationally negotiated incomes policy - or “concertation” – pacts designed to deliver wage restraint, by the late 1980s these efforts appeared to have broken down indefinitely in Italy and be on the verge of collapse in Spain (Negrelli ; Perez 2000).

This in a nutshell, was the scenario at the start of the 1990s when efforts to characterize the two economies in relation to the VOC literature’s juxtaposition of liberal and coordinated market economies took place. The subsequent two decades saw significant changes in the two countries. Nonetheless, the view that the Southern economies were subject to a distinct historical logic socially rooted in their welfare and labor market institutions has proven influential. And even after pointing out a much wider set of institutional factors on which the two countries often differ, Amable (2005, p. 242) would go as far as to write that the high-skill-level job-security route seems mostly out of reach for Mediterranean capitalism,<sup>102</sup> and a competitive model based on flexibility is much more in order. Implementing this model potentially means meeting some considerable opposition from insiders. Leaders of these countries would therefore welcome any political support at the supra-national level. It would be easier to overcome domestic opposition if the labour flexibility measures appeared to come from a European initiative...

As is evident, such VOC interpretations of Italy and Spain’s social models encourage precisely the type of interventions and prescriptions that lie at the heart of the Berlin-Washington consensus and have guided the “informal but strong” (Sacchi 2013) conditionality that both countries have faced in the course of the Eurozone crisis. A review of developments in the two decades prior to the crisis, however, suggests that the conclusions that might be drawn from these rather static efforts at classification fail to take into account the dynamics of social model change in the two countries.

By the mid 2000s some of the postulated similarities between the two cases had waned and what was once thought to be a common set of self-perpetuating and path-dependent socio-economic dynamics appeared more a matter of temporary coincidence. First, while from the standpoint of the early 1990s, the social protection system of the two countries might not have appeared different, this had changed considerably. On one hand, between 1996 and 2007 Italy’s total social expenditures rose (from 20 percent to 26.7 percent of GDP) right up to the EU15 average, while Spain’s (at only 21 percent of GDP in 2007) continued to place that country at the very low end of the Eurozone (and closer to the highest spenders among the new EU member states from the CEE). But on the other hand, the distribution of spending in Italy remained very skewed towards old age pensions (see Figure 1 below), consistently around 51-52 per cent of all social spending (compared with an EU15 average of 37-39 per cent), while in Spain the overall weight of old age pensions in social spending had dropped from 41 percent in 1996 to 38 percent in 2007. This was the result of a far more successful process of pension bargains with unions (which had lowered pension spending to 9% in 2007, well below the EU15 average) and a fairly consistent effort by Spanish governments to shift spending to benefits supporting those of working age workers through family, labour market, health care and sickness policies.

Figure 1. Social expenditures as a percentage of GDP



Source: OECD.StatExtract iLibrary (downloaded May 4, 2012)



Thus, while overall social spending in Spain remained particularly low, the structure of that spending had moved much closer into line with that of the rest of the EU 15 (see also Moreno; Guillen 2011 for discussion).

From 1996 to 2007, Spanish governments increased their spending on sickness and healthcare from 29 to 31 per cent, social exclusion from 0.8 to 1.3 per cent (compared to Italy's minimal move from 0.1-0.2 per cent), and benefits for families and children from 2.3 per in 1996 (then just a quarter of the EU15 average) to 6 per cent in 2007, while Italy increased its spending in this area from just 3.5 to 4.7 per cent. Between 2004 and 2008 Spain also spent twice as much as Italy on labour market policy, increasing that expenditure as a proportion of GDP from 2.1 per cent in 2004 to 2.5 percent in 2008, while Italy's fell from 1.3 to 1.2 per cent of GDP over the same period. By 2007-2008 Spain was spending as much of its GDP on labour market policies as the EU's leaders in this area (the Netherlands and Denmark). Nonetheless, the greater part of that spending went to income maintenance benefits rather than active labour market policy. Indeed, most of the difference between Italy and Spain's labor market expenditure was due to Spain's more developed non-contributory minimum pension and unemployment benefit system which protected all categories of workers, including workers on fixed-term contracts. Although overall coverage in 2008 was still on the low side (47 per cent, compared with 80-90 per cent in Denmark and Austria), this compared well with Italy's 17 per cent. Moreover, the gross earnings replacement rate during the first year of unemployment (though not thereafter) and the overall duration of benefits in Spain were relatively high by EU standards.

The difference in the evolution of the Italian and Spanish social model was not just one of quantities. In what has been called the "Northern turn" of the Spanish model, social model developments in Spain also included qualitative changes introduced by governments of both the Left and the Right (Moreno and Sarasa 2008; Guillen 2010; Guillen and Leon 2011):

minimum non-contributory pensions for those without significant work histories, income maintenance of last resort for those of working age (above the extremely rudimentary levels of local social assistance that existed at the end of the 1980s), universal free childcare for children from the age of 3 introduced in 1990 (and a plan to extend this to children from age 0 introduced in 2007 that later had to be cancelled as a result of austerity measures), the extension of unemployment insurance to workers on temporary contracts (a feature that clearly distinguished Spain from Italy) and to the self-employed in 2007, the introduction of an "emancipation" subsidy to facilitate the ability of young people between 22-30 years of age to afford rental housing, and the so-called "dependency" law of 2006 that requires regions to allocate part of their social spending budgets to provide non-means tested, in-home care for the elderly and the disabled. This offers a striking contrast to Italy's repeated failure to establish even the most rudimentary piece of a more developed welfare state - a national income of last resort scheme - and, until the Fornero reform of 2012, to expand the availability of unemployment insurance beyond those on indefinite work contracts with long contribution periods. In spite of an increasingly apparent public awareness of the biases of the Italian welfare state and its consequences, little progress had been made by the end of the 2000s in these areas, or in others such as family policy and active labor force activation policies.

Alongside the Spanish shift in the structure of social spending, the other key point of departure between the two countries involved the regulation of employment. Spain initiated a far earlier and radical liberalization of employment through the legalization of fixed-term contracts as early as 1984. While Italy would follow course in stepwise fashion in the late 1990s and early 2000s (see below), the Spanish dualization of its labor market went well beyond that of any other EU15 state, with temporary employment contracts accounting for over 30 percent of total from the early 1990s on. At the same time, however, Spain also gradually expanded its unemployment protection



system from the early 1990s, turning it into a universal system covering all types of workers. By contrast, in Italy – where unemployment protection required particularly long contribution periods – it remained restricted to workers with indefinite contracts and extensive work histories, and drops in labor demand were also addressed through insurance and work-time sharing schemes (Jessoula 2011; Sacchi 2013), creating a stronger bias in favor of old timers than in Spain. In this regard, the regulation of the Spanish labor market moved several degrees closer to that of its Northern European neighbors in providing a measure of flexicurity that did not emerge in Italy.

The large share of fixed-term employment became an enduring and contentious feature of Spain's political economy from the late 1990s on. It has been cast as the cause of Spain's high structural unemployment and a potential source of poor labor productivity growth (Jimeno and Toharia 1993; Bentolila and Dolado 1994) and is blamed on a particularly intense defense by labor market insiders (represented by the unions) in the form of high dismissal costs for those on indefinite contracts at the expense of outsiders (Bentolila, Jimeno and Dolado 2012). What is less often emphasized is the extent to which this liberalization of the Spanish labor market at the margins through the liberalization of temporary contracts imbued the Spanish economy with a type of hyper-flexibility (albeit a segmented one) that has few counterparts in the EU15. The effects of this particular mode of labour market flexibility on total employment remain ambiguous. We do know, however, that it allowed for intense bouts of rapid employment creation and employment shedding in response to macro-economic stimuli following monetary union. Although Italy's labour market was also marked by growing segmentation in employment protection combined with an utter absence of any universal income of last support mechanisms (what Berton et al. (2009) have referred to as a regime of flex-insecurity), the existence of non-market mechanisms for employment sharing among labor market insiders (at least until the Fornero labor market re-

form of 2012) appear to have helped stave off the degree of employment fluctuation we observe in Spain.

Lastly, in the area of labour relations, the role of collective bargaining was significantly strengthened during the run up to EMU both through social pacts and unilateral government action. In Italy, the abolition of automatic wage indexation (*scala mobile*) agreed to by the main labor confederations in 1992 helped the country overcome the economic and political debacle of that year, when the existing party system collapsed and the lira was forced out of the European Exchange Rate Mechanism (ERM) (della Sala 2004; Culpepper 2008). In Spain, the main catalyst for change was a 1994 government imposed abolition of the system of labor ordinances dating back to the Franco era (Perez 2000b). Though the intention of that reform had been to liberalize the regulation of work conditions, its effect was that of raising the profile of collective bargaining as it forced unions and employers to bargain on a wider range of issues than wage setting. Both countries also saw efforts to create a more articulated bargaining structure in which national sectoral bargains took precedence in setting wage minima, while productivity premiums and other matters were left to lower bargaining levels (Regini and Regalia 1997; Perez 2000; 2010). This effort, turned out to be more decisive in Italy than in Spain where the national employer confederation could not bring along its local affiliates to accept national sectoral bargains in many sectors. Coordination in wage bargaining to maintain competitiveness, of which there is evidence from 1994 on, was thus carried out principally by the labor confederations until formal overarching wage pacts with employers were renewed in 2001. On the other hand, in Italy the concertation process re-initiated in 1992 began to collapse in 2001 (just as Spain's was being re-formalized) under pressure from the second Berlusconi government (Negrelli 2011). Indeed, social pact making and concertation in Spain lasted much longer (well into the economic crisis) than in Italy, leading some observers to speak of a virtual institutionalization of the process in that country prior to the crisis (Natali and Pochet 2010).

The following section explores the combination of political, institutional and economic conditions that made for disparate paths of social model change in the two countries, before we turn to their role in the economic crisis.

## **II. The Evolution of the Spanish and Italian Social Models up to the Eurozone crisis**

Welfare state and Varieties of Capitalism scholars in the past have posited that Italy and Spain are subject to self-reinforcing historical dynamics between welfare state, labor regulation and production regime features (Amable 2003 ; Molina and Rhodes 2007; Hancke and Herrmann 2007). These analyses provide potentially important insights into the sources of observed continuities in the two countries. Nonetheless, the notion that the social models of Italy and Spain reflect a similar long-range dynamic neglects crucial differences in the political contexts that shaped social and employment policies. These differences are important in understanding the divergent ways in which social protection and labor market regulation evolved in the period leading up to the crisis.

The social model that developed in postwar Italy was the result of a process of conflict and accommodation between center-right governments dominated by the Christian Democratic party, the political Left (in particular the Communist Party of Italy) and the main labor confederations (the Communist dominated CGIL, the Christian Unionist CISL, and the secular but anti-Communist UIL) in the course of the Hot Autumn of 1969 and its aftermath. This accommodation included the provision of relatively generous old age pension benefits, the empowerment of the national confederal unions at the firm level, the participation of the confederations in the control of contributory pensions, and the establishment of a mechanism of automatic wage indexation (the *scala mobile*). By the time of the crisis of the so called “First Republic” due to the tangenti scandals in the period 1991/92, this social

model had produced very significant wage compression across regions with quite different characteristics (North and South) and a large public debt burden derived from the old age pension system.

In Spain, by contrast, both the structure of wage bargaining and the introduction of a PAYG system, as well as some aspects of employment protection, were all shaped in the context of the authoritarian right-wing dictatorship of General Franco. The transition to a liberal parliamentary regime occurred in the context of an acute economic crisis that went some way towards containing demands for redistribution by the political Left. The process of building a “democratic” social model was thus barely into its second decade at the start of the 1990s and this is also the way in which it was viewed by domestic actors. In addition, the late transition to democracy also meant that Spain enjoyed some of the advantages of a late-comer to democratic welfare capitalism. When pension reform, for instance, was undertaken in the mid 1990s under the leadership of the first post-transition conservative government, Spanish unions had fewer incentives to block that reform than Italian unions did in the 1990s because they were not as heavily dominated by older pensioners as was the case in Italy.

Constitutional and political developments also took the two countries in different directions during the 1990s. In Spain the role of parliament was strengthened (Pérez Díaz 1999) while in Italy the collapse of the postwar party system in 1990-1992 produced a shift from consensus oriented politics to a more majoritarian democracy, the emergence of a new, bi-polar party-system and a strengthening of the executive. Up until its great crisis, the post-war Italian Republic had allowed for far greater proportionality than Spain’s post-Franco electoral law. The Spanish electoral system, although a party list system, involves a strong bias in favor of the two largest parties in any given electoral circumscription, favoring the two major national parties (the Social-democratic PSOE (Partido Socialista Obrero Español), and Center-right catch-all PP (Partido Popular)), and the

mainstream regional nationalist parties where these played a central role (Catalonia, the Basque Country, Galicia and the Canary Islands). However, in 1993 the Italian electoral system was changed to a predominantly SMDP system, producing the coalescence of the country's multiple political parties into left and right-wing 'blocs'. While Spain mostly had minority governments by one of the national parties supported by the mainstream regionalist parties (which espoused positions ranging from Christian Democratic to market-liberalism) in the 1990s and 2000s, Italy saw a steady alternation between the Right-wing coalition headed by Silvio Berlusconi and the re-combined center-Left. Spain thus arguably had a political scenario more propitious to consensus oriented social reforms than did Italy in the post 1994 period.

In addition to these very different political contexts, there were also key differences in the social model institutions of Italy and Spain that have tended to be overlooked by comparative VOC and welfare state scholars and that, when taken together, gave Spanish social actors and governments a greater capacity to produce policy coalitions in favor of social model reform than their Italian counterparts during the 1990s and 2000s. These differences included 1) the cohesiveness of union versus employer organizations, 2) the administrative role of unions in critical areas of the welfare state, 3) the legal framework of collective bargaining, which gave unions in Spain far more influence than implied by membership rates, and 4) the extent to which the wage bargaining system caused cross-regional wage compression.

The organization of employers, and in particular the degree of "encompassingness" of employer associations, has by now been widely recognized as a fundamental point of difference in the political economies of European states (Soskice 1990; Hall and Soskice 2001; Martin and Swank 2011). The Spanish labor confederation (CEOE) has a particularly high membership rate at 72 per cent, and the Italian employers association (Confindustria) a respectable 51 per cent. However, because

of its internal statutes, the CEOE exercises very little authority over its affiliates, making it a particularly weak organization in comparison to other national employer associations with lower membership rates (Costas and Nonell 1996; Nonell et al. 2006). While Italy's Confindustria was affected by important tensions between its small and large enterprise factions, the ultimate dominance of the latter has generally given it greater capacity of action.

On the labor side, the Italian confederations enjoyed a (still relatively high) 34 per cent union density rate in 2007 (down from 38 per cent in 1990), and this membership was based largely in manufacturing industry, providing the national confederations a great deal of leverage both at the firm and national policy levels. Yet while the Spanish labor confederations had a low membership rate (16 percent), they drew their strength far more from workplace elections (in which about 80 per cent of workers take part) and from the legal framework, which provides that agreements signed above the firm level by any union meeting the criteria of "most representativeness" (based on work place elections) automatically applies to all workers at the sectoral/territorial level at which it is reached and that agreements remained in effect until renewed (the principle of ultra-activity), at least until the 2012 labor market reform. Thus, while unions did not have strong representation within firms (with the exception of very large firms and the public sector), their representativeness (as measured by workplace elections) and their negotiating capacity far outstripped their formal membership levels. This rendered them capable social partners. On the other hand, while Spanish unions did not have the role, played by their Italian counterparts in co-managing the main public pillar pensions system, as well as the more recently created 'closed' second-pillar voluntary occupational pension funds, reforms in the early 1990s did strengthened their role in managing the public employment service, the continuing vocational training system and health and safety at work (Guillen 2010).

Lastly, while both countries had what are commonly labeled “intermediately” centralized and coordinated wage bargaining systems, the Italian system produced a far greater degree of wage compression across sectors, regions, and categories of workers first as a result of the *scala mobile*, which from 1977 on increased compensation across sectors by a common denominator for inflation (Locke and Baccaro 1999), and later by the important role of national sectoral bargains. The Spanish bargaining system, in which more workers are covered by bargains at the provincial-sectoral level than at the national-sectoral level and in which “inflation revision clauses” are dependent on collective bargains, always allowed more wage dispersion across regions, sectors, and categories of workers. Coordination in wage bargaining, on the other hand, was principally achieved in both countries through peak-level incomes policy guidelines that covered Italian wage setting since the early 1990s and wage bargains in Spain from 1977 to 1988 and again after 2001.

The different sources of power and incentives faced by Italian and Spanish employers, unions, and governments are likely to have had an important impact on the course of social model reform in the two countries. One way in which this can be observed is in the relative success of social pacts aimed at producing social model change in the period prior to the crisis. As the following sections describe, that process appeared far more successful in Spain than in Italy (where it repeatedly collapsed during periods of conservative government in 1998 and again after 2001), undergirding many of the changes in the Spanish social protection regime described above. The persistence of social bargaining in Spain prior to the crisis bespeaks differences in the reform dynamics of the two countries which suggest that the degree of similarity attributed to the two cases in the 1990s may have been more the effect of a particular historical vantage point than of persisting historical dynamics.

## 2.1 Italy: From grand pacts to reform stalemate

The run up to monetary union began in Italy with a major political crisis, the result of a series of political trials for corruption and abuse of power that affected a wide gamut of the Italian political class. The crisis climate was reinforced when the Italian lira was forced out of the European Exchange Rate Mechanism a few months after the 1992 general election. This prompted a period of social reform focused on wage moderation and pension cost containment, with some, albeit limited, attention to labour market issues (contractual flexibility and ‘social shock absorbers’, i.e. income maintenance for the unemployed) forged through social pacts between the major labor confederations and the technocratic governments that oversaw the transition to a new electoral law in 1993. The process of negotiated social reform continued up to the end of the 1990s (Locke and Baccaro 1999; Regini and Regalia 1997; della Sala 2004), but it broke down once Italy’s participation in EMU was secured. Starting in the early 2000s, Italian governments unilaterally introduced labor market reforms that increased the segmentation between labor ‘insiders’ and several categories of ‘outsiders’, with varying levels of entitlement to social protection or none at all (see Breton et al. 2009; Sacchi 2013).

The dual economic and political crisis of Italy in the early 1990s created a context in which the national union confederations emerged as key strategic partners to the technocratic governments of the period seeking to reestablish Italy’s credibility (Regini and Regalia 1997; Negrelli 2011). The collapse of the dominant Christian Democratic Party due to the “*tangentopoli*” scandals, the crisis of the Italian Communist Party, and the prospect that EMU membership might elude Italy following the ERM crisis all created a perception of emergency among unions and employers. This facilitated two important tripartite agreements: the first in 1992 abolishing the *scala mobile* system of automatic



wage indexation; the second in 1993 creating a new and stable architecture for incomes policies and collective bargaining (Regini 1996: 726; Perez 2000; 2002). The negotiation of the pacts also cemented a new period of inter-confederal union cooperation, which had been a critical feature of the earlier period of political exchange from 1970 to 1984.

The abolition of the *scala mobile* represented a critical change in the Italian system of wage setting. Since the late 1970s, the mechanism had become a driver of both inflation and of wage compression across sectors and regions in Italy. Because the wage adjustments dictated by the *scala* were so significant, they had come to dominate wage setting in the prior decade and therefore had rendered collective wage bargaining largely meaningless (Baccaro and Locke 1996). The subsequent 1993 agreement created a new, two-level architecture for wage setting -- with national sectoral bargains (guided by overarching cross-sectoral incomes policy guidelines) setting minima and so called “proximity agreements” at either the company or local level (depending on the sector) setting productivity-linked upgrades. This new, more orderly bargaining structure allowed both greater wage coordination and a rise in wage differentials. Wage dispersion, however, continued to be limited by the fact that minimum wages continued to be negotiated at the national central level by employers and unions (Hancke and Hermann 2007; Molina and Rhodes 2009; Birindelli and d’Aloia 2008: 29-34).

Following the transformative pacts on wage bargaining of 1992/93, the technocratic and Center-Left governments of what came to be known as the Second Italian Republic sought to turn what had been, initially, a mechanism of emergency governance into a routine mode of policy-making based on concertation with the unions. This model proved successful in allowing Italy to gain inclusion in EMU, but it repeatedly broke down in the context of subsequent Right-wing governments. The first major pension reform (following the first Berlusconi government unsuccessfully attempt to impose a unilateral reform)

was passed by the government of Lamberto Dini in 1995 and was largely based on the advice of union and Ministry of Labor experts. Although its impact on costs and liabilities was modest, it did bring about a shift from an earnings-based to a more contribution-related PAYG system, standardized contributions across categories of employees (private, public and self-employed) and incentives for the use of fully-funded supplementary pension schemes. Tripartite negotiations also produced a number of labor reform measures that sought to address the unprecedentedly high level of unemployment observed in the South (at 26 percent in ) and among youth (at 30 percent throughout the 1990s) during the 1993-1995 recession. These included the 1996 *Patto per il lavoro* and the 1997 reform of the labor market (Law 196/1997) also known as the *pacchetto Treu*. The *pacchetto Treu* represented the first major departure from an Italian tradition of labor law heavily focused on limiting contract flexibility, as it allowed new forms of internal labor market flexibility (in particular working time adjustments to address cyclical fluctuations) as well as external flexibility, by expanding the scope for atypical (temporary and fixed-term contracts). It was subsequently reinforced by the 2003 Biagi Reform - the first to extend the use of temporary contracts throughout the private and public sectors.

The 1990s and 2000 also saw two attempts to create a minimum income of last resort scheme to address the problem of the working poor, a measure that might have shifted the traditional bias in social spending in Italy. Means-tested minimum income schemes (*reddito minimo di inserimento*) were implemented in an experimental way from 1998 through 2003 and again, for a subset of municipalities across Italy, between 2007 and 2009, in both instances under governments of the Left (Boeri and Perrotti, 2002; Sacchi and Bastagli 2005; Colombino 2012) Yet the Right repeatedly set back the clock on these effort when it returned to power in 2001 and again in 2008. The last iteration of these repeated attempts to extend social protection to cover labor market outsiders prior to the Eurozone crisis occurred when the center Left government in the region of

Lazio tried to extend the minimum income program at the regional level without central government support in 2009, but the effort was abandoned again after the Right won the regional elections in 2010.

The electoral defeats of the Left by the Berlusconi coalition (in 2001 and, again, in 2008) also paved the way for the breakdown of the social concertation process. The last major tripartite pact on collective bargaining of the 1990s reached under the D'Alema government, the so-called 'Christmas Pact' of 1998, maintained the principle of wage concertation based on the two-level bargaining structure agreed in 1993 (Negrelli and Pulignano 2007). But the second Berlusconi government rejected the policy principle of "concertation" replacing it with a less binding notion of "social dialogue." Though in the first tripartite pact reached under its tenure - the 2002 'Pact for Italy' - the government backtracked from its position by acknowledging the role that concertation had played in allowing Italy to participate in EMU, it subsequently failed to deliver on the policy objectives agreed to with the unions - which included new income support measures for the poor and unemployed in return for more monitoring of work searches and increased public investment in the Mezzogiorno - in subsequent budget laws. The new social policy provisions of the 2007 'Pact for Welfare' signed between the unions under the Centre-left Prodi government in 2007 - which included flexibilization of eligibility criteria for pensions so as to cover more outsiders (Colombo and Regini 2011) - were also rescinded after the center-right coalition came back to power in April 2008.

## **2.2 Spain: Social model reform in the context of a highly segmented Labor Market**

In the two decades leading up to the financial crisis, Spain's social model underwent a number of important changes, many of which were agreed as part of bipartite and tripartite social pacts. Social pacts had played a critical role during the democratic transition of the late 1970s and early 1980s. A founding pact among political parties (*Pactos de*

*la Moncloa*) served to contain the wage price spiral that took hold during the last stages of the Franco regime and set the base for a series of subsequent tripartite wage pacts. The effectiveness of this negotiated incomes policy was enhanced by the provision in the 1980 Labour Statute that extended the application of any bargain signed by any union meeting representativeness criteria in works council elections to all firms and workers in the sector or territorial level at which it was signed. One of these pacts, the 1983 *Acuerdo Económico y Social (AES)* - signed between the Socialist government of Felipe Gonzalez, the CEOE and the UGT (but not the CC.OO.) and covering wages for 1984-1986 - proved particularly important. In it, the government and the CEOE agreed to increase the coverage of Spain's underdeveloped unemployment benefits system and to raise minimum wages for youth in return for the UGT's acceptance of the legalization of temporary work contracts (a concession that would lead to the profound dualization of the Spanish labour market thereafter) (Guillen 2010). The PSOE government's refusal - following its second electoral victory in 1986 - to compensate the Socialist confederation for these concession with further social policy measures led negotiations on incomes policy to unravel in 1988 (Perez, 2000). During the following years, the UGT - which had delivered wage moderation to support the PSOE's adjustment policies only to see unemployment rise above 20 percent and had suffer significant losses in works council elections - would join the CC.OO. in a far more militant wage bargaining stance to recoup its credibility. The social pact process that had underpinned the political transition would not recover until the PSOE's electoral defeat by the right-wing Popular Party (PP) in 1996.

Several factors conspired to allow for a re-launch of the negotiated reforms process following the 1996 elections. First, the two major labor confederations suffered a crisis of legitimacy as a result of the even more dramatic rise in unemployment that followed the ERM crisis of 1992 (Polavieja 1998). Both confederations came under new leadership that

recognized the negative fall-out of the militant bargaining positions taken in the 1989-1994 period and were willing to take a more compromising stance. Secondly, the new government of Jose Maria Aznar needed to strike a centrist tone (it was the first time the Right had come to power since the transition to democracy and it did not have an absolute majority) and embraced social pacts as a way to legitimize itself. Third, as the 1993/1995 recession came to an end and the Bank of Spain began to lower interest rates to converge with those of other EMU countries, Spain experienced a rapid economic recovery and a dramatic improvement in the government's fiscal position, allowing the PP government to reap the benefits of the orthodox policies pursued by its predecessor and to back union concessions with policy rewards in a manner that the PSOE government had failed to do. In 1996 it thus signed a landmark agreement (the Pacto de Toledo) with the unions that set in motion the gradual revision of the old age pension system, allowing Spain to achieve a far more sustainable pensions balance than most of its eventual Eurozone partners had at the time.

In April 1997, it took further measures to support a pact between employers and the unions committing both sides to seek national sectoral pacts in sectors not yet covered at that level and to establish procedures for the horizontal extension of collective bargains (across sectors within a territory). This effort to seek greater coordination in wage bargaining through its centralization had limited success, as the peak associations (in particular the CEOE) were unable to bring along lower level affiliates to consolidate bargaining at the national level in most sectors. But from 2001 on –in what may be seen as an effort to compensate the failure of bargaining reorganization at the national-sectoral level – the unions agreed to return to national bi-annual wage negotiations with employers and to set global wage guidelines (Acuerdos Interconfederales sobre Negociación Colectiva (ANCs)) under which lower level negotiators were invited (though not bound) to increase wages in line with inflation and productivity (Herrmann 2005).

By contrast to Italy, where both pension reform and labor market reform (in particular following the 2003 Biagi reform extending the use of temporary contracts) remained mired in conflict, in Spain contention between governments and the unions centered more squarely on the latter, and specifically on the issue of employment protection for those on indefinite work contracts. Seeking to rectify the extensive use of fixed-term contracts, both the conservative Aznar government and the subsequent Socialist government of Rodriguez Zapatero that came to power in 2004 sought to reduce the resort to temporary contracts. Their strategy was to create new categories of indefinite labor contracts carrying lower dismissal costs and offering tax subsidies as incentives for employers to use such contracts. Reductions in labor taxes were also agreed (first as part of the 1997 social pact and again in 2002). None of these reforms, however, managed to put a significant dent in the predilection of employers (not just private but also public administrations at various levels of government) for temporary work contracts. The extraordinarily high proportion of employment on such contracts (illustrated in Figure 4, section 3 below) would only show a significant decline from 2009 on, when non-renewal of workers on temporary contracts was used as the first line of employment shedding.

### **2.3 Explaining the Contrasting Reform Dynamics**

The political dynamics of social model reform in Italy and Spain produced some convergence in the area of labor market regulation with the extension of temporary work contracts in Italy during the 1990s and 2000s. But the political process did not allow for significant change in the structure of social spending in Italy, while it did do so in Spain. As noted, pension reform coupled with increased spending on programs benefiting the working age population allowed Spain to move its welfare state closer into line with the distribution of expenditure in other EU15 countries. And Spain had developed a far more encompassing unemployment benefit system which

protected all categories of workers and provided a minimum benefits to workers on fixed-term contracts.

A number of factors help explain the contrasting pattern of social model reforms in Spain in the decades prior to the crisis. Many of the changes improvements in social protection introduced in Spain were part of the social pact making process, which, as noted, broke down repeatedly in Italy. This in itself can be linked to other factors. We have already pointed out the opposite political contexts: the predominance of minority governments in Spain versus the majoritarian turn in Italian politics following the 1993 electoral reform. Three further differences were also important. The first is the sharply different fiscal position of the state, which allowed Spanish governments to support agreements between employers and hamstrung Italian governments, in particular those of the Left, in their efforts to reform the Italian social model. After the economic adjustment effort that the last Gonzalez governments imposed to keep the peseta in the ERM, Spanish governments were able to support pacts between employers and unions with fiscal resources, a significant contrast with continuous pressure to bring expenditures under control on Italian governments in their efforts to scale back Italy's persistently high public debt. Thus, while Spanish social pacts focused (as elsewhere in Europe) on regulatory trade-offs, there were also significant examples of distributive bargains - including public investment, tax relief, renegotiation of the minimum wage (by more than 30 per cent in 2004), as well as pension reform concessions to the unions (in 2001 and 2007), in return for their support for a stronger contributory element in the PAYG pensions system and for private complementary pensions. Such *quid pro quos* helped Spanish governments secure ongoing union commitment to wage moderation and facilitated agreement on changes in labor market reform (Rodríguez Cabrero 2002; Molina and Rhodes 2007).

Although the divergence in social model reforms in Italy and Spain can be dated back to the early 1990s (or even the 1980s, with the revamping

of the unemployment insurance system), the leeway Spanish governments had to support distributive bargains relative to their Italian counterparts was vastly augmented following monetary union. The two countries joined the Euro with very different macro-economic fundamentals and, given the Eurozone economic constitution which emphasized public debt and deficits without creating mechanisms to compensate asymmetric growth and financial flows in the Eurozone, this set off very different dynamics in the two countries. Spain entered the union with a particularly low public debt burden and a regulatory framework that allowed for a very high level of labor market dualism and, implicitly, flexibility of employment creation. It thus experienced a decline in interest rates without any demand for compensatory fiscal restraint coming from the Eurozone (given that its public debt position was far better than that of core Eurozone countries prior to the crisis). This spurred a rapid expansion of credit by Spanish financial institutions and investment concentrated in non-tradable sectors (notably construction) that was financed indirectly by large private savings flows from the Eurozone's core economies via the Eurozone's interbank lending market and purchases of Spanish loan backed bank securities by other Eurozone banks.

The result was a real estate bubble that eventually proved disastrous for the Spanish economy. Yet while it lasted, the boom in domestic demand encouraged a very strong pace of labor force activation (in particular of women) and spectacular employment growth. This facilitated the pattern of social policy change which moved Spain away from the traditional familial male-breadwinner model with which it was associated in the VOC literature and considerably closer to the social policy regimes of more employment friendly Northern EU economies. By contrast, in Italy, which joined the Euro with a particularly high public debt burden, governments struggled to meet the Eurozone Growth and Stability Pact objectives after entry. Although EM lowered the risk premium on Italian public debt and allowed some employment growth (as well as



price rises in non-tradables sectors), the ongoing need to reduce public debt in compliance with the GSP underpinned a period of limited government investment and extended low growth through the first decade of the currency union. This general context undercut repeated efforts by governments of the center-Left to shift the balance of welfare spending in ways that might have encouraged further labor force activation and more significant pension reform.

Secondly, while Spanish unions managed to converge on a strategy of moderation and accommodation after the mid-1990s and to maintain their unity in action, the main Italian labor confederations saw deepening divisions in the 2000s. This can partly be attributed to the fact that the pay-offs to unity in the form of government *quid pro quos* were so meager in Italy and to the fact that Spanish governments became more committed to social pacts after the early 1990s when attempts by the PSOE government to go it alone proved to be counter-productive. But unity between the labor confederations and their commitment to a strategy of accommodation in Spain also fit the unions' need to broaden their constituency to the growing and very large number of workers on temporary contracts, which constituted the majority of workers in some sectors, such as construction and in the public sector. This altered the nature of 'insider-outsider' dynamics in Spain more than it did Italy, allowing employment regulation to become a topic for social pact bargaining. Meanwhile, in Italy, the return to power of the Berlusconi coalition in 2001 against the background of majoritarian electoral reform and party-system transformation brought with it a more confrontational style by governments of the Right and this increased tension among the labor confederations.

Lastly, to some extent the far-reaching reform of the wage bargaining system in Italy in the early-to-mid 1990s and the subsequent institutional embedding of wage moderation took care of one of the most critical reforms for both unions and

employers (the former gained greater control of the system, while the latter secured the end of inflationary wage claims, even if they wanted further reforms to enhance wage flexibility). Thus, a major bone of contention and the most compelling issue for social bargaining by Italian governments and employers was removed. In Spain, as noted, the collective bargaining centralization foreseen in the 1997 Pacts remained incomplete. This, in addition to other factors (including the unions' goal of preventing a further decentralization to the firm level where their presence, at best, was very weak) helped produce the annual bipartite ANCs (*Acuerdos para la Negociación Colectiva*) which set national cross-sectoral pay parameters from 2001 on. This bipartite overarching wage setting framework helped to sustain the broader process of social bargaining well past the onset of the economic crisis in 2008.

### **3. Social Models and Economic Performance under EMU**

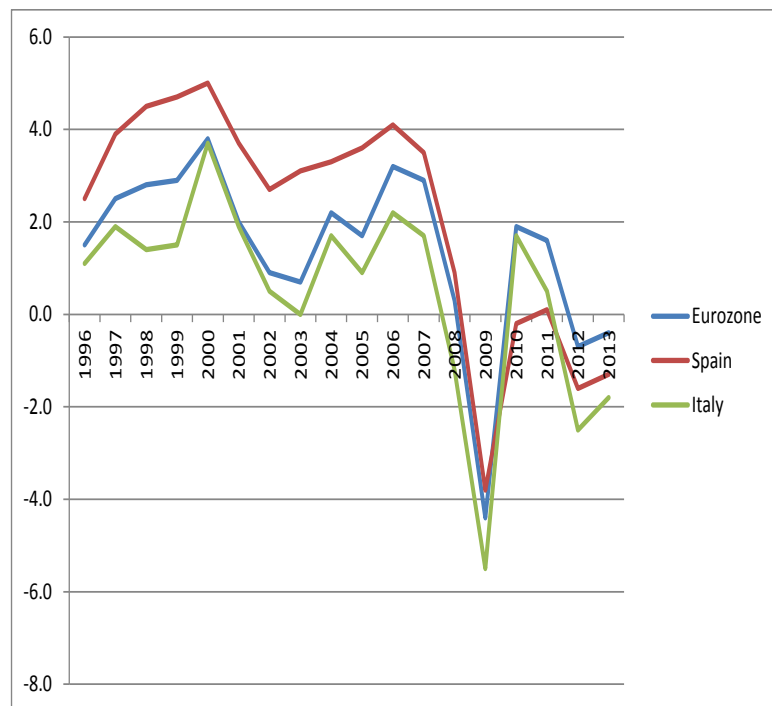
The austerity cum labor market liberalization centered approach pushed on Spain and Italy by their Euro partners have been premised on the assumptions that social model characteristics played a major role in landing both countries in the external financial positions that rendered them susceptible to contagion during the sovereign debt crisis. Even when, as in the case of the IMF (2013) and more indirectly the EU Commission (Bontout and Lokajickova 2013), there have been acknowledgements that the pace of budgetary restriction may be undercutting the utility of liberalizing labor market reforms and contributing to the very outcomes they are meant to address (economic and labor market stagnation, public deficits and financial sector vulnerability), these same institutions (and in the case of the EU, the Eurogroup) have insisted that the pace of labor market and spending reform be kept up or even taken further as a way to facilitate the internal devaluation that is offered as the only way out of the crisis.

What role social model features (i.e. social protection and labor market regulation patterns)

played in contributing to the situation of the two creditor countries, however, remains very unclear. The argument (when it is spelled out) usually refers to excessive borrowing and loss of competitiveness as measured by the evolution of unit labor costs in relation those of Germany, linking these phenomena to the deteriorating current account positions the two countries in the run up to the crisis but without much analysis of the sources of this deterioration. Labor market failures such as the phenomenally high level of unemployment in Spain since the outbreak of the crisis and that of youth unemployment in Italy are typically attributed to persisting rigidities that keep those markets from clearing. Although concessions have been made that there are other market failures at play (most notably the faulty transmission of monetary policy in the Eurozone to creditor countries as reflected in the much higher cost of credit faced by firms in the latter) the fundamental demand that the pace of labor market liberalization and spending reform be altered so as to allow adjustment via internal devaluation has been maintained in inter-governmental negotiations within the Eurogroup.

This section takes up the question of the role of social model features in the economic performance of the two countries following the launch of the Euro and in the course of the crisis. I first review various performance indicators before turning to the question of the likely contribution of social model features in light of other factors impacting the economic performance of the two countries. Looking first at growth rates, Figure 2 illustrates the dramatically different experience of the two countries in the decade leading up to the financial and sovereign debt crises. While Italy, with the brief interlude of 2000-2001, experience consistently low growth in the decade leading up to the crisis (averaging 1.6% from 1999 to 2007 compared to the Eurozone's 2.3 average), Spain joined the Eurozone at a time when it was beginning to experience an economic take-off and grew consistently well above the Eurozone at an average annual rate of 3.7% over the same period. After 2008, Spain experienced a considerable contraction

Figure 2: GDP Growth rates (Source: Eurostat)



(adding up to 5.6% of its GDP from 2008 through 2012). Italy experienced a short acute recession from 2008 to 2010, falling back into recession in 2011 and a cumulative contraction of 6.9% from 2007-2012

Turning first to the most common indicator of labor market performance – the unemployment rate – the contrast between the two countries could not be starker. Spain's has been marked by extreme fluctuation over the last two decades, from a first high of 24 per cent in 1994 down to 8 (right around the Eurozone average) just prior to the crisis, and up again to a record 27 percent at its height in 2013, before easing back to 26 per cent. This rise, as some have suggested, appears quite disproportionate to the actual contraction in Spanish GDP over the period. Italy's unemployment rate also varied considerably but far less so than Spain's, from 12.3 percent in 1998 down to 6.8 percent in 2008 and up to 12 percent by the end of 2013. On the other hand, a common feature of both countries is their persistently high youth unemployment rates (age group of 15-24), which has been well above the EU15 average throughout the period.

Nevertheless, it is noteworthy that in the case of Spain youth unemployment has conformed to the general rule in the EU (with the notable exception of Germany) in that it tends to double the overall unemployment rate and, thus, appears to be a function of that overall rate. In Italy, by contrast, youth unemployment has tended to exceed general unemployment by a higher multiple (a more than 3 to 1 ratio in 2012).

However, because both Italy and Spain also experienced very significant demographic change during the decade prior to the Eurozone crisis - through 1) immigration (of around 2 million into Italy and 5 million into Spain according to official figures) and 2) change in female labor force participation -- unemployment rates are not in fact a very good measure of labor market performance. It is far more informative to focus on employment rates which show the number of job holders relative to the working age population.

As illustrated in Figure 3, both Italy and Spain experienced very considerable employment growth during the first decade of EMU right up to the economic crisis. That employment growth, nonetheless, was particularly pronounced in Spain where jobs increased by almost 6.5 million from 1999 to 2007 (compared to 2.5 million in Italy). Indeed, employment growth in Spain was so strong up until the crisis that it accounted for more than 40 percent of all jobs created in the Eurozone to 2007. The rise in overall employment rates also reflected significant increases in the employment rates of women in both countries (Figure 4). Again, this phenomenon was much more marked in Spain, which saw a rise in the employment rate of working age women from 41 percent in 1999 to 56 percent in 2008 (compared to a rise from 40 percent to 47 percent for Italy over the same period). The dispersion of regional employment rates (especially for women) also declined in Spain considerably more than in Italy during this period, leading some sociologists to argue that Spain had undergone a definitive turn from the family/kinship to the dual-earner family model (Naldini and Jurado 2013).

Figure 3: Employment to Population Ratio (OECD Labour Force Statistics iLibrary, May 2013)

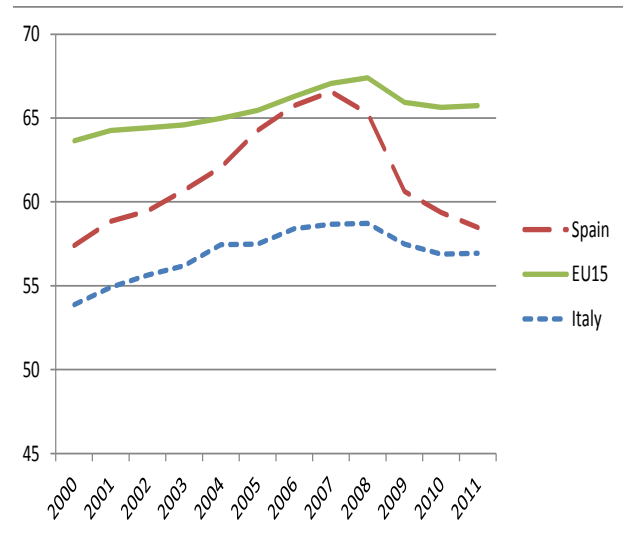
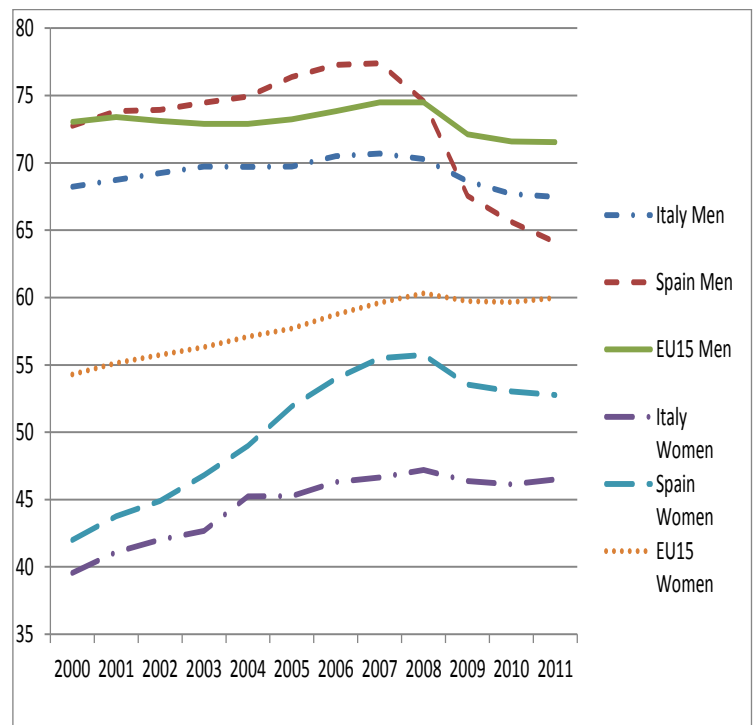


Figure 4: Employment rates by Gender (OECD iLibrary, May 2013)

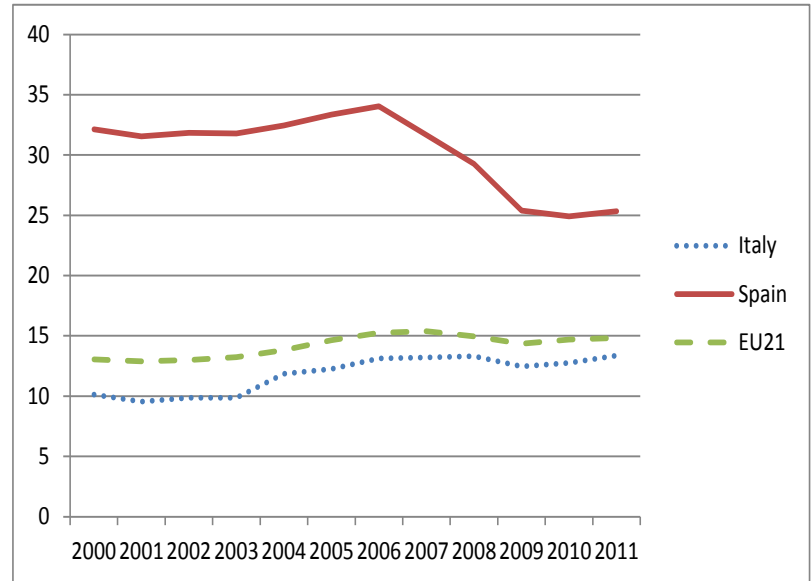
Figure 4: Employment rates by Gender (OECD iLibrary, May 2013)



Employment trends in the two countries following the onset of Europe's financial crisis proved equally disparate, with the drop in employment of Spanish men being, by far, the most dramatic (down from 76 percent in 2007 to 60 percent in 2012 (compared to a drop from 58 to 54 per cent for women). Indeed, the number of women employed in Spain continued to rise until 2009, when the Zapatero government began to implement austerity measures. In Italy the decline in the employment rate was less than 1 percent for both men and women up to 2009, limited to 3% by 2012 for men and negligible for women. Nevertheless, at the end of 2011, the Spanish economy still employed over four million more people than it had in 1990, and virtually all of that difference was accounted for by the rise in female employment. However, two years later, after two labor market reforms to ease dismissal conditions in 2011 and 2012 (see next section), it had seen the loss of a further million and a half jobs (figure for third quarter 2013).

Lastly, Figure 5 illustrates the dualism in both labor markets, including the exceptionally high levels of temporary employment in Spain, already in place at the end of the 1980s. In spite of a series of regulatory changes to encourage a reduction in the use of such contracts by firms, only the end of the housing boom in 2007 and the sharp downturn of the economy following the Global Financial crisis would truly result in such a reduction as temporary jobs were first to be shed. The Italian figures show a significant rise over the period but without reaching the EU average. Nevertheless, it is noteworthy that in the period since the start of the crisis, a full 58% of new jobs created in Italy have been in the form of temporary or other atypical contracts.

Figure 5: Share of temporary employment in total employment



Source: Eurostat

Turning to distributional outcomes, statistics on inequality paint a complex picture. Both countries started the EMU period with relatively high inequality measured in terms of the 80/20 income quintile share ratio (4.9 in Italy and 5.7 in Spain), although Italy had the very lowest income dispersion level in the Eurozone when measured in terms of the 9th to 1st decile share ratio (2.2). Italy's 80/20 quintile share ratio increased modestly but steadily through the 2000s, reaching a ratio of 5.2 in 2010, while Spain's declined during the construction boom, but deteriorated sharply thereafter. By 2010, with a quintile share ratio of 6.9 and a Gini coefficient of .34, Spain displayed the greatest rise in inequality within the Eurozone for the crisis period. The dramatically high level of unemployment was clearly the prime factor behind this particularly acute rise in inequality. But wage dispersion, as noted, has also been consistently higher in Spain than in Italy and increased significantly as the economic crisis dragged on (OECD Employment Outlook 2012; Banco de España November 2012). On the other hand, while neither country can be said to have done well in protecting vulnerable income groups, the reallocation of social spending did allow Spain to have a still modest but significantly larger impact



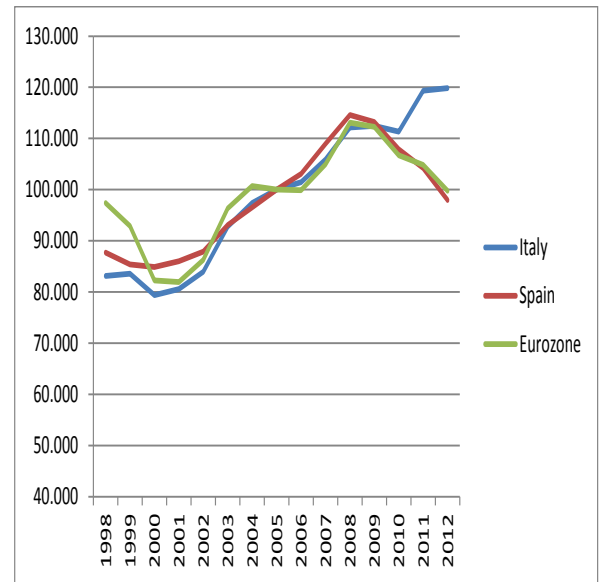
in poverty reduction than the Italian welfare state. Thus, while the at-risk-of-poverty rates after transfers in Italy was, at almost 20 percent in 2012, only 4 percent lower than the pre-transfer proportion, in Spain it was, at 22 percent, 7 percent lower than the pre-transfer proportion that year (not very different from the level in Germany for instance) (Eurostat).

Lastly, there is the performance of the two economies in terms of competitiveness measures. Much attention has been paid to the relative rise of unit labor costs of the Eurozone periphery countries in the period leading up to the sovereign debt crisis and in the role this played in the rise of these countries' current account deficits during the period (see for instance Dadush 2012; Sinn 2013). Both phenomena, and the connection between the two, are central to the view that the fundamental problem of adjustment in the Eurozone is one of competitiveness and that social model changes are critical to rectify this problem. This view also serves as an implicit justification for the position that internal devaluation by way of regulatory reforms intended to reduce labor costs was the only way to resolve the crisis and that such adjustment via internal devaluation had to be achieved as a precondition for macro-institutional changes in the Eurozone.

Figure 6 illustrates the evolution of the Real Effective Exchange Rate (a measure that takes into account developments in each country's main trading partners) of Italy and Spain based on their unit labor costs. It shows that, but for a brief period of depreciation up to 2001, the Eurozone as a whole experienced a significant appreciation of its REER, with Spain and Italy mostly trailing the Eurozone's overall development until 2005 and then experiencing somewhat higher ULC growth in Spain, followed by a considerable depreciation (internal devaluation) in Spain following the start of the crisis that was clearly not matched in Italy. Indeed, that internal devaluation of ULC is likely to have been much greater than the graph indicates, as aggregate compensation figures in Spain were artificially inflated after 2007

by the fact the share of low wage jobs declined far more dramatically than that of higher wage jobs. The actual reduction in wages behind the figures is thus estimated to have been approximately twice as much as the such aggregate compensation figures indicate (Bank of Spain, Economic Bulletin, February, 2014).

Figure 6: Index of Real Effective Exchange Rate, ULC based (2005 = 100), IMF International Financial Statistics



The role that social model features played in this growth, competitiveness and labor market performance picture, however, is far from clear. The matter is complicated by the fact that monetary union implied a major macro-economic shock for both countries because it altered the course of monetary policy by bringing interest rates down to those of core countries and, at the same time, encouraged a significant intensification of financial integration in the Eurozone area (Obstfeld 2013). At the same time, other factors affecting domestic demand, such as the leeway for public investment or for growth of private credit differed greatly between the two countries given their very different public debt positions and the Growth and Stability Pact's exclusive focus on public debt.

The run-up to monetary union involved large fiscal adjustment efforts in both Italy and Spain. Yet the “fundamentals” emphasized by the Growth and Stability Pact with which the two countries joined the Euro were far apart, in particular their public debt positions. One reason for this had to do with the 1992/93 ERM crisis. In the case of Spain, which had relatively low public debt even at its height in the 1990s, the central bank and the Socialist government of the time chose to pursue all necessary measures to keep the Spanish peseta in the ERM and avoid the fate of the Italian lira and the British pound, which were forced out of the mechanism. One consequence of this was the first dramatic surge in unemployment referred to above, to almost 25 percent in 1994. In the case of Italy, which faced the ERM crisis with a far worse public debt position, the employment consequences of that crisis were more limited because the lira’s exit and large devaluation afforded relief for the corporate sector. The orthodox course of the Socialist government in Spain – coupled with a series of controlled devaluations of the peseta within the system and the much lower accumulated public debt burden - allowed for a very successful fiscal turnaround. The primary deficit was cut to 2 percent as early as 1997 and would continue a steady decline from there on, leaving Spain in primary budget surplus territory for much of the 2000s. Italian governments imposed large budget cuts from 1996 to 1999, lowering the government’s annual deficits from 6 percent to a low of 0.8 percent in the year of EMU entry. But their failure to bring the large public debt –most of it accumulated in the pre-1993 “First Republic” period - into line with the Stability and Growth pact meant that fiscal policy remained continuously constrained following monetary union, a fact that only exacerbated the standoff over social model reform in the 2000s.

The different public debt positions with which Italy and Spain joined the Eurozone meant that the effect of the move to a single monetary policy on domestic demand was of a different order. Though EMU brought a reduction in interest rates for both

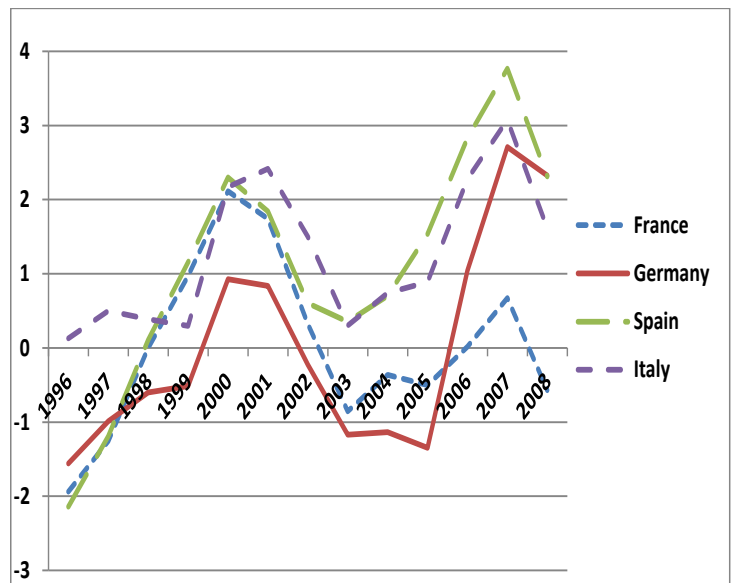
economies starting as early as 1998 (when their central banks began to lower their prime rates to converge with the Eurozone average), the need for continued fiscal consolidation to address the public debt in Italy meant that the effect of the monetary policy change was much larger for Spain because it fed into a process of economic recovery that was already underway. As lower interest rates in Spain coincided with a continuing decline in public debt (and hence created greater room for private borrowing), they set off a prolonged demand-driven growth cycle centered in the construction and real estate sectors. With employment rising, more people were able to move into the labor market and therefore also into the housing market. Women, long punished by decades of high unemployment (due, in part, to Spain’s earlier orthodox fiscal and monetary policies) had acquired high levels of educational qualifications and were particularly well primed to enter the labor force in large numbers (ergo the 20 percentage point rise in their labour force participation rate in just a decade). Spain’s rapidly expanding labor market also attracted large numbers of immigrants (many of whom found work in the construction sector) producing a demographic boom. Demographic growth, low interest rates and rising employment drove housing prices and, by way of the wealth effect, further fed private borrowing. In Italy, by contrast, lower interest rates appear to have made some contribution to domestic demand in the immediate period after 1998. But this effect was quickly muted by the continued need to reign in public sector debt following an initial, short post EMU boom.

The main difference in the demand profiles of the two countries was on the side of investment (rather than consumption), specifically in commercial and residential housing investment and in capital formation. Housing investment in Spain rose at a very fast rate – so much so that housing starts topped those of the three largest economies in the Eurozone (Germany, France and Italy) taken together in the last years of the boom (Estrada et al., 2009: p.35 ). Investment in ‘other construction’ was also considerably higher (by over two percent) than

in these three other economies. The boom in Spain also had a self-reinforcing character in that it both drove and was fed by the large scale demographic impact of immigration - itself driven by job growth. It may have been further facilitated by a liberalization of land zoning laws carried out by the first Aznar government, by tax incentives encouraging home ownership, and by the failure of the Bank of Spain to reign in the lending of regional savings banks to the real estate sector. However, in evaluating the role of these other factors it is important to keep in mind that without the lower interest rates and the rise in loanable funds coming through the Eurozone's interbank market following monetary union, the Spanish real estate bubble could never have developed as far as it did. Indeed, it would not have been possible without two much larger developments in the Eurozone: 1) the mismatch between ECB policy (set largely to match the different output-gap scenarios of core Eurozone countries, notably Germany and France) and domestic demand conditions in Spain (or, for that matter, in Ireland, which experienced very similar consequences), and 2) the financial imbalance created by the rise in the German national savings rate from 2002 onwards, which played a key role in financing the Spanish bubble through the interbank Eurozone market (on this point see Pettis 2012).

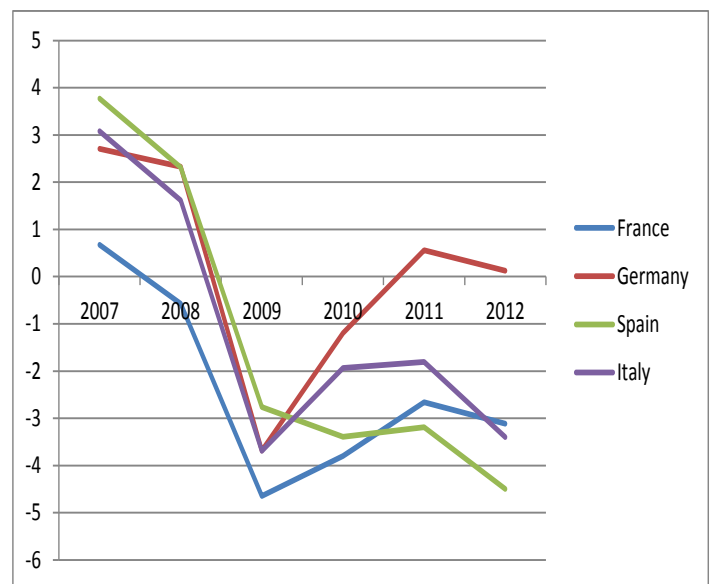
Figures 7a and 7b show the evolution of output gaps for Spain and Italy in comparison to their two largest Eurozone trading partners (Germany and France) before and after the crisis. As 5a illustrates, Spain and Italy joined the Euro with different output gap positions (quite negative in Spain, positive in Italy), largely because Spain had suffered a much stronger recession after 1992. Between 1999 and 2001, all Eurozone countries experienced a short boom bust cycle, and France and Germany entered negative output gap territory in 2002 lasting to 2006.

Figure 7a: Output Gaps up to crisis (percentage of GDP).....



Source: IMF, Word Economic Outlook Database, May 2013

Figure 7b: ....and from 2007 on



Source: IMF, Word Economic Outlook Database, May 2013

During this period the ECB refinance rate became very accommodating (see Figure 8), in particular as most Eurozone economies (including Germany, France, and Italy) were unable to meet the Stability and Growth Pact deficit objective. While this scenario persisted, Eurozone banks in slower growing economies (principally Germany and France) directed excess savings towards other Eurozone countries (much of it through interbank lending and purchases by German and French banks of Spanish bank issued covered bonds). Although other factors restrained investment in Italy, the output-gap figures suggest that ECB policy was also quite accommodating for the Italian economy, which also saw considerable financial inflows, although these were directed largely to Italian public debt. Then, as Germany and France re-entered positive output gap territory in 2006, the ECB raised rates (Figure 8) and kept them up until 2009 coinciding precisely with the Global Financial Crisis. This step precipitated the very fast collapse of the Spanish real estate market (which was based on variable rate loans linked to the Euribor) and the crisis of the Spanish savings banks with the heaviest exposure to that market. In Italy, the dynamic was different as easy money had flowed mostly into government bonds prior to the crisis, lowering the public debt burden but without producing the private investment boom observed in Spain. Nonetheless, up until the crisis inflows of funds from surplus countries helped ease the financial burden of the still large public debt that

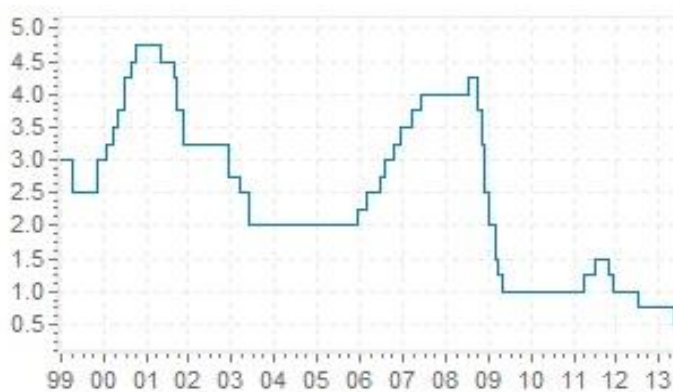
would prove Italy's Achilles heel during the sovereign debt crisis.

It is critical to keep in mind this macro-economic backdrop in considering what role social model features may have played in the economic performance of Italy and Spain – and in particular that of their labor markets - before and after the crisis. The different demand scenarios not just between Italy and Spain, but between Spain and most of the rest of the Eurozone up to 2007 is particularly important in understanding the economic boom and out of the ordinary employment growth in Spain. By 2007, the construction sector accounted for almost twice the share of GDP (11 %) as in the rest of the OECD (5.6%), and a much larger share of employment (13%) than the rest of the Eurozone (7.7%). By contrast in Italy, the size of the construction sector closely reflected the Eurozone averages, accounting for 5.4% of GDP and 7.7% of employment.

With this macro-economic backdrop in mind, we can consider arguments that are commonly offered for how social model features may have contributed to the economic outcomes Spain and Italy experienced following monetary union and to the vulnerable position they found themselves in during the sovereign debt crisis. Chief among these outcomes are 1) the much larger labor activation and employment growth experienced in Spain prior to the crisis, in particular by women, 2) the far more dramatic employment destruction in Spain in the course of the crisis compared to relative employment stability in Italy, 3) the growth in ULC both countries experienced up to the crisis, and 4) the much faster internal devaluation in Spain compared to Italy and 5) the failure of this devaluation to stem the fall in employment.

Focusing first on the different employment and growth performance in the years leading up to the crisis, we have already noted the key difference in macroeconomic fundamentals with which the two countries joined the Euro and the extraordinary demand boom to which the single monetary policy contributed in Spain. Employment growth was also sup-

Figure 8. ECB Refinance Rates



Source: ECB



ported in Spain by the fact that, as we shall see below, labor compensation growth remained quite modest considering the high GDP growth rates, though this was also true in Italy. These factors are likely to account for the bulk of the difference between the two countries. Nonetheless, one difference in the two countries social model features – the ease with which employers could expand temporary employment in Spain – could also have played an ancillary role.

First, it is clear that the Spanish employment regime allowed for very fast employment creation as soon as monetary policy took a less orthodox turn. The fact that the proportion of temporary employment to overall employment nonetheless did not rise very much suggests that, at least during the economic growth period, temporary employment did effectively work as a stepping stone towards indefinite employment. The years (2003-2007) in which the ratio did increase as a result of the particularly intense expansion of the construction sector were ones in which the “wealth effect” of rising housing prices had already taken hold (so that people invested in real estate for its expected appreciation) and during which the mismatch between ECB interest rate policy and conditions in Spain was particularly acute (as suggested by the output gap data). We can therefore venture the conclusion that the flexibility afforded by temporary contracts in Spain is likely to have interacted with the very particular macro-economic context so as to feed, rather than restrain, the impact of those macroeconomic conditions on employment growth and on the allocation of resources to the construction and real estate sectors during this period.

As regards the particularly strong pace of female labor force activation during this period in Spain compared to Italy, it is again probable that overall macro-conditions, in this case coupled with the considerable investment in advanced education by women during the prior decade of high unemployment, played an important role. A quickly expanding labor market with inbuilt mechanism for the integration of newcomers in the form of fixed-term

contracts following a period in which women had invested more heavily in higher education than men provided fertile ground for a large rise female labor force participation. However, as we have seen, social policy in Spain also had shifted in a more activation friendly direction during the previous decade. The introduction of non-contributory pensions and social assistance benefit, the expansion of unemployment insurance to temporary workers, universal free childcare from age 3, the 2006 Dependency Law, and the expansion of educational opportunities were all factors that facilitated female independence from family networks and entry into the labor market. Both factors, the change in social protection and a labor regulation regime that was particularly permissive of fixed-term employment, were missing in Italy at least until in 2003. But so, of course, was the fast pace of economic growth and employment expansion that Spain experienced prior to the crisis. Moreover, many of the new social protection policies preceded the sharp rise in women’s labour force participation. Thus, both the social model changes and the fast economic growth thus seem to have been needed to bring the social transformation to fruition.

However, if the combination of macroeconomic conditions and social model change in Spain lent themselves to a particularly strong rate of labor force activation (in particular by women) during the economic boom, it also facilitated the very dramatic employment shedding the country experienced once the ECB began to raise interest rates from 2006 to 2009 and the Global Financial Crisis hit. The total decline in employment (18% over the 2008-2012 period) was far out of line with the degree of economic contraction in GDP (5.6% over the same period). As the decline in the proportion of temporary workers in Figure 4 above illustrates, fixed-term employees bore the brunt of the burden of that adjustment as they could be cycled out of the labor force at virtually no cost at the end of their short contracts. To be sure, a very large proportion of these workers were concentrated in the construction sector, which saw a total contraction of employment of 50% in the first

few years of the crisis. But the same phenomenon occurred in other sectors as the Spanish economy entered a generalized recession in 2008 that it would not recover from for the following five years. Between the second quarter of 2008 (when total employment peaked) and the last quarter of 2013 employment declined almost continuously. Of the 3.7 million jobs lost in the period, approximately 58% was accounted for by the net loss of temporary jobs early on, with the decline in indefinite contracts starting later and following a much steadier path.

By contrast to Spain, the employment contraction in Italy and concomitant rise in unemployment was far more limited (1.15 million) even though Italy experienced a higher cumulative contraction of GDP over the period (6.7%). Again, one important reason is macroeconomic. Italy did not have the type of overgrown construction sector that accounted for such a large share of the employment contraction in Spain. Two other features, both related to social model characteristics, however, must also have been important. First, with a less dualized labor market, Italy simply did not have the same bulk of temporary workers that could be cycled out of employment at low cost at the end of their contracts. Secondly, as the next section will discuss, the absence of a conventional universal system of unemployment benefits led Italian governments and social actors to expand on existing non-market based institutions that provided for effective work-time sharing. One consequence of this different response is that Italy, at least up until the Fornero labor market reform of 2012, managed to protect employment at the expense of the type of internal devaluation effected in Spain through employment contraction and increases in productivity per hour worked (Figure 8).

This brings us to the question of the role that social models may have played in contributing to the much touted loss of competitiveness of the two countries vis à vis core Eurozone economies (principally Germany) either through their effect on labor costs or through their effect on productivity growth.

Here it is useful to start with the usual caveat that competitiveness as applied to countries (rather than firms) is a rather ill-defined concept and that there is no agreement on how it is best measured. Relative costs as reflected in real effective exchange rates based on unit labor cost (ULC) data (Figure 6) are the most frequent measure. But a country's share in world trade in relation to its GDP is sometimes seen as the more fundamental measure. The two are not as closely correlated as might be thought because trade share is influenced by many factors other than ULC. It is, in any case, well understood that trade share (or exports) depend on external developments at least as much (when not more) than on country attributes subject to regulatory manipulation (Krugman 2001).

Nevertheless, much attention has been paid to the rise in the unit labor costs of Eurozone periphery countries relative to Germany in the period leading up to the sovereign debt crisis and in the role this played in the rise of these countries' current account deficits during the period (Giavazzi and Spaventa (2010); Lane and Milesi-Ferretti 2011). Both phenomena, and the connection between the two, are central to the view that the fundamental problem of adjustment in the Eurozone is one of competitiveness and that social model (labor market and pension system) features are at the core (or at least crucial sources) of this problem (see for instance, Sinn 2013; Boltho and Carlin 2013; European Commission 2012, pp. 17-22).

Arguments postulating that social model features contributed to the rise in relative unit labor costs that Italy and Spain experienced following monetary union can be divided into two categories: those that suggest these features result in excessive growth in worker compensation and those that suggest they may contribute to inadequate productivity growth. Foremost among the first category is the view that labor market dualism allowed labor market insiders to set wages in light of their strong employment protection because they could assume externalities to be born by temporary workers (Bentolila and Dolado 1994). A different argument focuses on the degree of

coordination in wage bargaining across sectors and suggests that countries lacking strong export-sector leadership or cross-sectoral coordination were bound to loose competitiveness in the Eurozone once unions in sheltered sectors no longer felt that their national central banks would raise interest rates if they obtained excessive wage increases (Johnston, Hancke and Plans 2013). Both types of arguments directly and indirectly (in the latter case) justify the heavy emphasis among the troika's demands for reforms on reducing employment protection for permanent workers and on weakening the position of unions in the collective bargaining process by decentralizing bargaining to the firm level (see the next section).

Arguments linking social model features to low productivity growth, on the other hand, tend to focus on the ways in which such features may impede skill formation or productivity enhancing investment by employers. On the one hand, high employment protection may act as a disincentive for labor market insiders to engage in continuing training. On the other hand, as has been posited by political economists drawing on the distinction elaborated by Becker (1963), employment security (either in the form of high social spending or employment regulation) is a critical requirement to encourage people to invest in the kind of firm specific skill investment that is seen in high productivity growth countries (Estevez-Abe et al. 2001; Iversen and Soskice 2001). It also creates strong incentives for employers to make productivity enhancing investments either through training or through capital and technology investments (Acemoglu and Pischke 1999; Pischke 2004).

Some scholars have called attention to an absence of strong vocational training or continuing education system either at the firm level or above in Spain and Italy (Rhodes and Van Apeldoorn 1998; Amable 2003; Molina and Rhodes, 2007). It is very difficult to obtain good comparative data on the skill intensity of countries that actually measure training outcomes. However, the best available data on training systems for the two countries does not support the view that

this is a clear distinguishing feature of the Spanish and Italian economies. The fact that both countries managed considerable improvements in some of their human capital measures over time also suggests that skill formation is not particularly dependent on social model features such as employment protection or labor market dualism. Indeed, if we consider that both dismissal costs for indefinite workers and social protection in Spain were higher than in Italy, but Spain managed to improve its human capital measures more than Italy, these results do not support the view that high employment protection for indefinite workers or a dualized labour market in itself reduced investment in skill formation. If anything, they would lead us to the opposite conclusion as we would, in fact, expect from the political economy literature.

However, a different way in which social model features – and specifically the regulatory leeway allowed for temporary employment in Spain and increasing in Italy – may have affected productivity is by contributing to the pattern of sectoral investment in the two economies. It is possible that a regulatory regime offering a particularly high level of flexibility at the margins coupled with high dismissal costs for individuals on indefinite contracts might skew investment towards sectors that are not intensive in sector specific skills or in high skills.

Of course, as we have seen, Spain saw particularly high growth and employment in the relatively low wage/low productivity construction sector following monetary union. It is possible that the low regulatory barriers to temporary employment coupled with high dismissal costs associated with permanent contracts fed into the decision by large investors to allocate resources to the construction sector as they made investment in sectors requiring relatively little investment in training and development of human capital (compared to sectors requiring more development of sector specific skills) more attractive relative to sectors requiring more training. The fact that employment growth in Italy in the period following the Biagi reforms also became more concen-

trated in low skill sectors (construction; real estate renting and business activities; employment in private households, tourism and retail trade) does suggest that the liberalization of temporary work might create such a bias in sectoral growth patterns. Still, such a bias would have pre-dated the Spanish housing and real estate booms by almost two decades. There is thus little doubt that the boom and the associated shift in the sectoral composition of the Spanish economy (far more accentuated than the one in Italy) was produced in a first order by the combination of low public borrowing (which allowed more room for private borrowing) and the macroeconomic shock of monetary union, with the dualism in employment regulation playing perhaps and auxiliary role.

There are other reasons to be doubtful that social model features played a central role in Italy and Spain's loss of competitiveness during the first decade of monetary union. It will do to start with a few observations on labor costs. Figures 9a and 9b show annual growth in compensation per employee for industry and for the economies as a whole. It suggests that there was no clear contrast between the evolution of compensation in the two countries versus the Eurozone at large, except in the period immediately surrounding the world financial crisis when compensation growth in Italy and Spain shot up temporarily above the Eurozone average and then quickly corrected. Compensation growth for the economy as a whole remained below the Eurozone average for Spain prior to the crisis, and somewhat above for Italy only for some years. Other labor cost data also do not support the view that labor costs were a distinguishing feature. Annual real wage growth for the period 2000-2007 show growth of 0.1 percent for Spain and 0.8 percent for Italy compared to 0.9 percent for Germany and an average of 1.1 percent for the EU15. For the period 2007-2010, the average annual growth was of 1.9 percent for Spain, 0.3 percent for Italy, 0.2 percent for Germany and 0.9 percent for the EU15 (OECD Employment Outlook 2012, p. 242).

As for the uptick in compensation immediately following the world financial crisis, an analysis of the Spanish data by the Bank of Spain (2014) shows that it was due to a composition effect, reflecting the rapid contraction in lower wage temporary jobs in low wage sectors, which shows up as a rise in per employee compensation in the aggregate figures. Net of this composition effect, real wages declined in the period from 2007 to 2009. The same is likely to be true of the Italian data, given that employees on lower wage atypical work contracts bore the brunt of job losses. Indeed, in the Spanish case the compositional effect on wage statistics was so strong that the Bank of Spain

Figure 9a Percentage annual growth in Compensation per employee in Industry (OECD)

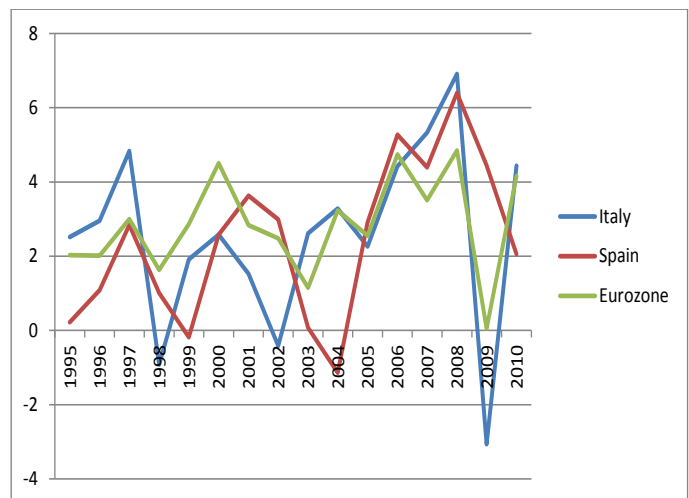
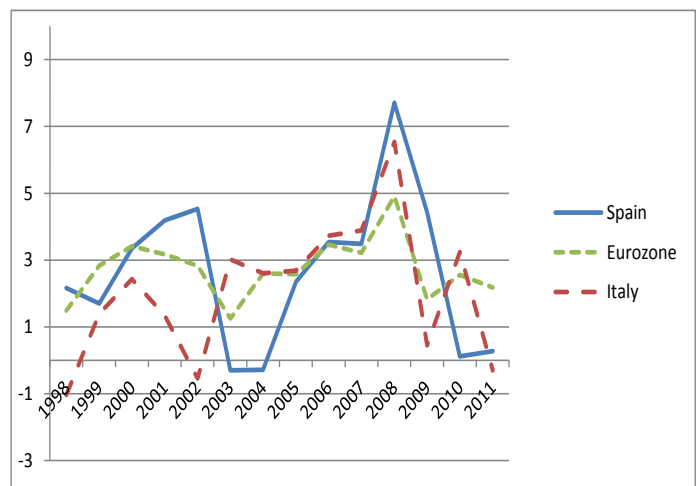


Figure 9b Percentage Annual Growth Rate in Compensation per employee Total Economy (OECD)





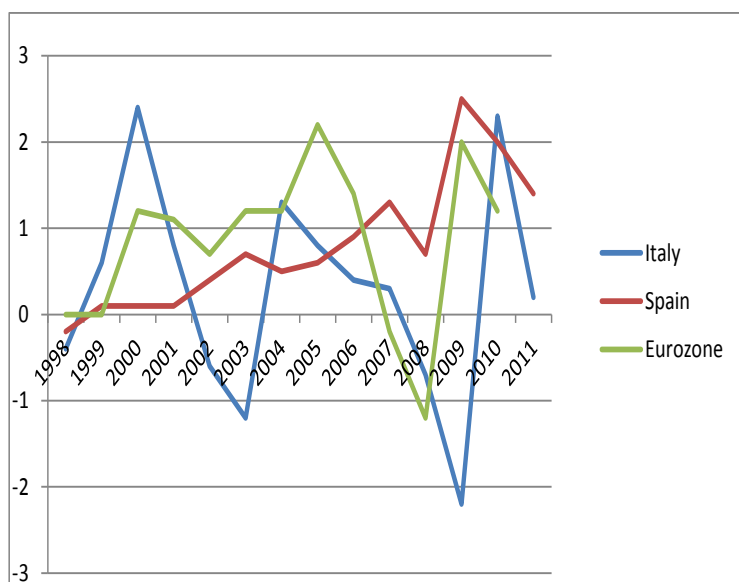
stipulated in early 2014 that the actual fall in compensation between 2008 and 2012 was likely twice that indicated by the aggregate figures shown below (Bank of Spain, Economic Bulletin, February 2014).

It is difficult to conclude from this data that there was any particularly strong role played by wage setting institutions in the deterioration of relative unit labor costs during the run-up to the crisis. Cumulative wage growth in neither country outstripped that of Germany prior to the crisis and far less that of the Eurozone as a whole. The data also reveals two other things. First, the sharp decline in employee compensation growth rates starting in 2001 in Spain coincides with the re-initiation of global wage pacts, suggesting that Spanish unions did have a very considerable capacity for wage coordination even in the midst of a great economic boom (see also Nonell et al. 2006). Secondly, the rise in labor compensation observed in Italy from 2004 on occurred during a period in which concertation had largely broken down. On the other hand, Spain's overall lower growth in employee compensation compared to Italy in spite of much higher GDP growth may be due to the higher share of temporary employment in that country. Yet neither this element of labor market flexibility (and of dualism, of course) nor Spain's higher productivity growth or lower labor cost growth (prior to 2007) relative to Italy prevented the unbalanced growth dynamic that resulted in the employment boom and bust. Indeed, if anything it facilitated that boom and bust.

If not wage dynamics, can the pace of productivity growth be attributed to social model features in the two countries? As Figure 10 reflects, aggregate labor productivity per hour worked grew at a lower rate than the Eurozone average in both Italy and Spain in the period prior to the crisis. Indeed, it is this relatively low rate of productivity growth, rather than developments in compensation, that accounts for the low higher growth in aggregate ULC in Italy and Spain compared to the Eurozone average. However, there is good evidence that these aggregate figures reflect changes in the sectoral com-

position of growth, specifically the disproportionate growth of employment in lower productivity sectors. It is well recognized that in the case of Spain the drop in aggregate labor productivity was largely due to the disproportionate growth of employment in such low productivity sectors as construction, real estate and business services (Estrada et al. 2009). This composition effect also becomes apparent with the sudden rise in aggregate labor productivity in Spain once employment in these sectors sector collapsed. It is noteworthy that in Italy, despite the absence of a housing price bubble, employment growth following the Treu and Biagi reforms (which increased the room for temporary, lower cost training contracts) was also concentrated in these very same sectors, so that the lower aggregate productivity measure may also reflect changing sectoral composition of employment in the economy. Again, as already noted, if social model features contributed to these sectoral growth patterns, it was primarily by allowing room for the creation of lower cost temporary or atypical jobs rather than by the high cost associated with indefinite employment, which should, if anything have worked as a productivity whip. The presumption that the causes of relatively low productivity growth were inherent to the social models of the two countries, is, in any event, also challenged by firm-level data which reveals that productivity growth in both countries was highly dependent on firm size, with larger firms in Spain, in particular, showing productivity growth that not only matched but outperformed that of other Eurozone firms in their sectors and size categories (Rodriguez et al. 2012; BBVA 2012; Amatori et al. 2011; Pagano and Schivardi 2003). If we are to look for supply side factors to explain aggregate productivity trends, it would thus make more sense to look at the determinants of firm size in the two countries.

Figure 10: Labour productivity annual growth (OECD)



The most important reason to doubt the conventional competitiveness story linking current account developments to social model features in Southern European countries (including Italy and Spain), however, comes from analyses that disaggregate the evolution of aggregate Unit Labour Costs in the two countries both by sectors and by their price versus cost components. As Gaulier and Vicard (2012) show, ULC developments in the two countries (as well as other Eurozone debtor countries) did not, in fact, reflect the kind of negative trade performance one would expect if the competitiveness thesis were right. Nor were the cost and price performance of the Italian and Spanish tradables sectors a direct cause of the two countries' deteriorating current account positions (or rising current account deficits). Looking at bilateral export developments for Eurozone countries in the period leading up to the crisis, disaggregated by product categories, their analysis shows that once geographical and sectoral specialization effects are accounted for, the export performance of Southern Eurozone countries was in fact quite good compared to the rest of the Eurozone in the 1999-2007 period. The "export push" (export performance not attributable to developments in export pull factors) of Italy (as well as Greece and Portugal) was "similar to that of Germany, with export market share losses below 1

percent yearly." Spain's was actually better, "partly offsetting a negative geographical and sectoral specialization." This also helps explain the paradox that Spain was the Eurozone country that suffered the second smallest loss in its world export share (second only to the Netherlands and with Germany in third place) from 1999 to 2011 (Cardoso et al., 2012).

The link between aggregate ULC and the rising current account deficits of Spain and Italy (as well as the other peripheral countries) during the period was not driven by labor costs or productivity growth in the tradables sector. But neither was it driven by wages in non-tradables, as the alternative thesis advanced by Johnston, Hancke and Plans would have. Gaulier and Vicard (2012) use EU-KL-EMS data to disaggregate ULC growth rates not just by sectors but also to distinguish the "between" and "within" components of ULC growth for both wage share and price deflator in each sector. The exercise shows that it was the dynamic of prices in non-tradables feeding through the debtor country economies that accounts for the bulk of the deterioration in aggregate ULC. This combination of rising aggregate ULC due to price developments in non-tradables on one hand, and a good (cost and price based) export performance by Eurozone creditor countries on the other relative to creditor countries is, as the authors put it, the "signature" of a demand shock rather than a "competitiveness" shock. And this demand shock from EMU can be explained by the increase of financial flows into Southern Eurozone countries following EMU given the combination of lower interest rates and increased confidence (Lane and Pels 2012; Lane and McQuade 2013). German banks played a particularly important role in this regard through their purchases of Spanish and Italian bonds (in particular mortgage backed bonds issued by Spanish banks (see WSJ June 27, September 24, 2012; European Commission 2012b, pp.47-53).

Gaulier and Vicard's analysis thus points to much larger dynamics within the Eurozone involving demand shifts between countries that created

powerful incentives for financial flows into non-tradable sectors in the poorer Eurozone countries. Taken together, these observations raise serious doubts about the prevailing view that Italy and Spain's problems in the Eurozone can be attributed to their social model features, with the possible exception of a reinforcing effect coming from the ease of temporary employment in Spain and the growing room for atypical work in Italy. The widespread acceptance of the competitiveness thesis – and its attribution to social model features – nevertheless has served to justify important changes in labor market regulation and social expenditures in both countries. As the next section describes, these changes have been more radical in Spain than in Italy given different institutional starting points and domestic political scenarios.

#### **4. Consequences of the Eurozone crisis**

While neither Spain nor Italy featured prominently in the onset of the Eurozone sovereign debt crisis that began with the dramatic loss of confidence in Greek public finances in the fall of 2009, by the summer of 2010, both countries came under heavy pressure to adjust their responses to the crisis and their regulatory models in line with guidelines from EU actors. The announcement of the details of the Eurozone's EFSF bailout fund in May 2010 proved an important trigger in this regard. It confirmed that the German government opposed fundamental institutional changes such as any mutualization of public debt through mutually guaranteed Eurobonds or, for that matter, the transformation of the ECB into a real lender of last resort for banks and governments. As the EFSF was authorized to raise only 250 billion euros beyond those needed for the already announced Irish and Portuguese bailouts – far too little to address a likely banking bailout in Spain or speculative attack on Italian debt – talk of a potential break-up of the Eurozone and of currency re-conversion risk began to be taken seriously by markets.

Both countries became subject to sovereign debt crisis contagion following the May 2010 summit because they were deemed to be too large to be bailed out under the terms of the new fund and because it seemed, at this time, that they had no lender of last resort. Bond spreads on Italian and Spanish public debt experienced their first serious spikes immediately after the announcement EFSF package and rose significantly over the following year, peaking repeatedly in the second half of 2011 above the level deemed the limit of viability (although never rising to the point of the Greek, Irish, or Portuguese levels).

Given the lack of support from Brussels, and more importantly, the ECB at the time, this forced governments in both countries to accept austerity measures in 2010 and 2011, as demanded by Brussels, in order to assuage bond markets. By the end of that second year, incumbents had fallen in both countries as a result of their perceived inability to tackle the economic crisis, but not before instituting emergency fiscal and labour market measures that were applied under pressure from the Eurogroup and the ECB. In Italy, the parliamentary coalition backing the Berlusconi government broke down principally due to Berlusconi's inability to persuade the Northern League to impose the type of pension reform that had been demanded in an August 2011 letter from the ECB - co-signed by then Bank of Italy head Mario Draghi - and reinforced by the Commissioner Olli Rehn (Sacchi 2013). In Spain, the Zapatero government capitulated in the face of growing public pressure after having imposed austerity measures and a first labour market reform in line with demands spelled out in a similar letter from the ECB (again, co-signed by the head of the national central bank) sent at the same time as the letter to the Italian government. The prime minister called early elections for November 2011 in which the PSOE was thoroughly defeated by the conservative PP, principally because it lost much of its vote share to third parties (including, prominently, the United Left). Spain would eventually sign a memorandum of understanding with the Commission that involved

further pension and labour market reforms in order to obtain a credit line to recapitalize its banking sector in July 2012, whereas Italy was able to avoid any formal agreements. Nonetheless, economic policy in both countries from 2010 on was carried out under the pressure of “stringent and pervasive” conditionality from the ECB, the Eurogroup, and the Commission, even if this conditionality was informal.

One striking feature of the ECB and Eurogroup demands in the cases of Italy and Spain is just how similar the measures pushed on the two governments were given that Italy’s weakness lay principally in its record of slow growth and inability to curb its public debt while the Spanish one derived principally from the high level of private debt (both households and corporate) which, in the face of collapsed domestic demand, threatened the situation of the banking sector. In both cases, European institutions demanded a liberalization of the labor market via a reduction in employment protection for workers with indefinite contracts and a faster pace of old age pension reform than had been agreed among domestic actors. As we shall see later, in spite of the similarity in the measures pushed by external actors, Spain was far more susceptible to that external pressure than Italy given different institutional and domestic political scenarios. Spanish governments thus advanced along the path dictated by the Eurogroup much faster and further than did Italy. However, before looking at the pattern of regulatory responses in each country and at how these matched up with external demands, it is important first to understand the ways in which the Global financial crisis and subsequent the Eurozone sovereign debt crisis affected each economy.

Reflecting the divergence in their economic dynamics over the previous decade, the sources of the two countries’ vulnerability to the credit crunch that followed from the GFC and to contagion during the Eurozone sovereign debt crisis were quite different. In Spain, that vulnerability derived principally from the consequences of the sudden collapse in domestic demand and rise in unemployment for Spanish banks most exposed to the real estate market. The expan-

sion of credit to the real estate sector by these banks had been financed largely through interbank flows of savings in the core Eurozone countries (both via the interbank wholesale market and through purchases of debt issues by Spanish banks by foreign – primarily German and French – banks). The international credit crunch of 2008 stopped that flow of funds through the Eurozone’s banking systems to Spanish financial institutions. The end of the construction boom produced massive job shedding in the construction and real estate services sectors, real estate credit defaults and ultimately the socialization of banking sector losses in 2011-2012. Although Spain obtained an EFS credit line to support its banking sector bailout, once concern over so-called “re-denomination” risk spread in 2010 (following the Germany’s refusal to contemplate a move to joint liability for government debt (Eurobonds) at a May EcoFin summit that year), Spain was left as vulnerable as Italy to sovereign debt market contagion in spite of its still good public debt position at the time. This vulnerability would persist following the banking sector bailout loan Spain obtained in 2012 because of Germany’s refusal to allow direct recapitalization of banks via the EFSF, meaning that the debt incurred to recapitalize the banks had to be added to the Spanish public debt (which in turn hurt the credit rating of Spanish banks that held much of this debt on their balance sheets).

The sharp drop in domestic demand in 2008 led unemployment to skyrocket in just two years from 8 percent (where it stood at the end of the boom in 2007) to 19% percent at the end of 2009, 22.9 percent at the end of 2011 (just prior to a major labor market reform), and a phenomenal 27% in early 2013 (following a second labor market reform). That contraction in the job market meant a rapid rise in credit delinquencies in particular for the regional savings banks that were most exposed to the real estate sector. The flow of interbank credit to these banks from the rest of the Eurozone came to a virtually complete halt. Coming at the very same time as a major drop in tax income (from the collapse of the real estate market) and rise in unemployment outlays (given the



fairly developed nature of the Spanish unemployment protection system), the contraction of private credit had to be matched by an increase in the public deficit and rise in the public debt. Although that public debt had fallen to just 36 per cent of GDP prior to the crisis and remained low compared to almost all other Eurozone countries well through the end of the decade, the speed of its rise after 2008 and the expectation that the public sector would have to bail out the banking sector constituted the principal weakness in the eyes of international debt markets. This expectation increased as austerity measures applied from 2010 on failed to produce a rapid turnaround but rather fed the vicious circle between rising unemployment, unemployment outlays, credit defaults, banking sector vulnerability, growth in the public debt, rise in interest rate spreads, and lack of external sources of private credit. That cycle was mitigated only by the eventual actions of the ECB (its 2012 announcement that it would take action to support the Euro and announcement of the OMT program).

By contrast to Spain's boom/bust scenario, the Italian economy experienced a much smaller contraction in employment during the post-2008 economic crisis, even though the contraction in its GDP would be greater than that of the Spanish economy. The unemployment rate in Italy rose by a mere 1 per cent during 2009 to 7.8 percent and still stood at 8.9 percent two years later in December 2011, then rising to 12.5% in 2013. This, combined with far lower levels of household debt, meant that the Italian economy did not become as caught up in the kind of private sector centered doom loop we observe in Spain. The vulnerability of the Italian economy derived rather from the still very high level of public debt, much of it held in the balance sheets of Italian banks. The sheer size of that debt in spite of steady decline up until the Eurozone crisis (it remained above 100% of GDP in 2008), meant that it rose significantly (beyond 120 percent of GDP by 2012) once spreads to the German bund began to rise and in spite of early austerity measures. Combined with the perceived inability on the part of the Berlusconi coalition to reign

in that debt, this landed Italy squarely in contagion territory following the May 2010 EcoFin summit.

One contrast between the two countries that nonetheless requires explanation is that in their labor market performances. Considering the relative size of their GDP contractions over the period 2007 to 2013 (a cumulative 6.9% for Italy compared to less than 4.7% for Spain), the size of job losses in Spain appears hugely disproportionate. Three things need to be kept in mind in understanding this paradox. First, the rise in the Spanish unemployment rate must be seen in light of the big rise in the labour force that took place during the growth years (given the large rise in female labor force participation (which continued into the crisis) and the 11 percent demographic growth produced through immigration over the prior decade). Italy's labour force also grew, but not as dramatically given its considerably lower participation rate (62 percent compared to Spain's 74 percent for those of working age at the end of 2012). Secondly, unemployment in Spain had a very strong sectoral component, being heavily concentrated in the construction sector, at least until 2011, while Italy did not experience the same kind of sectoral employment boom and bust that Spain did in the real estate sector. Third, although temporary and "atypical" jobs accounted for the bulk of the job losses in both countries (90 per cent of net job losses in the 12 months to June 2009 in Spain, and 47 per cent in Italy), such contracts accounted for a much greater proportion of employment in Spain. It is clear that the prevalence of temporary work contracts allowed employers to reduce their work forces at very high speed in Spain and that there simply was not the same bulk of such contracts in Italy to allow a similar response. Indeed, the high proportion of employees on temporary contracts made personnel cuts an immediate and rather low cost response to recession in Spain (OECD Economic Outlook 2009).

Differences in government responses, however, also played an important role, as Italy's unemployment rate would have been substantially higher

without that country's wage compensation scheme (Cassa Integrazione de Guadagni or CIG), which preserved the employment relationship between firms and workers made redundant, and which became one of the pillars of the Berlusconi governments response to the crisis. When taken together with the contrast in the evolution of relative unit labor costs - with Spain showing a fast recovery in labor productivity per hour worked as unemployment rose while Italy's unit labour costs continued to rise, it becomes clear that Spain increased productivity at the cost of job shedding, while Italy was more successful at protecting employment in the midst of severe recession while avoiding the internal devaluation prescribed as the way out of the crisis. This difference can largely be attributed to contrasting regulatory responses to the crisis described in the next section.

#### **4.1 Government responses to the Crisis in a context of external conditionality**

In both countries, governments initially attempted countercyclical measures to maintain employment. The specific policy mix in the two countries, however, differed as governments built on different existing institutions. The Socialist government of Rodriguez Zapatero raised spending on public infrastructure and financed a series of employment initiatives by regional governments. In line with its more developed unemployment insurance and social assistance record, it also introduced a new monthly euro 420 payment for those who had exhausted their unemployment benefit. At the same time it pushed employers and labor unions to agree to labor market reforms intended to reduce the dualism in the labor market. In Italy, the Berlusconi government passed a one-time special social assistance bonus to families with children and low-income pensioners for 2009. Far more significantly, however, was the expansion of Italy's long standing wage guarantee fund – the Cassa Integrazione Guadagni, CIG – which ensured continuity of income and employment of temporarily laid-off workers. The number of those covered by the scheme increased by

311 per cent from 2008 to 2009 (thereby also reducing the number of unemployed workers considerably). However, as in the past, it remained limited to those on indefinite contracts who also enjoyed more generous unemployment benefits in the form of the so-called “mobility allowance” (Rhodes 2011).

These efforts at countercyclical stimulus policy, however, were soon undercut by the course of austerity taken by Germany and the stance of the ECB, which, while cutting its prime rate, remained far more conservative than the US Federal Reserve. In the case of Spain, the large fall in tax revenues caused by the end of the construction boom coupled with rising unemployment outlays drove the public deficit for 2009 above 10 percent and produced a significant rise in the interest rate spread on Spanish public debt following the May 2010 announcement of the EFSF package. Although Spain's public debt, at 60 percent of GDP in 2009, remained low compared to that of Germany and other Eurozone states, the sharp rise in the deficit, coupled with the high level of private debt and rising defaults soon raised questions about the stability of Spain's banking sector. Speculation that Spain might be in line for default on its public debt if the banking sector – lacking a lender of last resort - had to be rescued by the government became the prime concern. In the case of Italy, the problem pushing the country into center stage of the Eurozone crisis in early 2010 was the persistence of low growth and the increasing attention paid by international bond buyers to internal conflict in the Berlusconi government over efforts to cut public spending, in particular pensions. The still very high public debt, which was also concentrated in Italian banks' balance sheets, and questions regarding its sustainability became the center of attention. Both scenarios – that of a looming banking sector collapse in Spain and that of the Italian government's failure to cut its public debt – played out in the context of growing speculation about the Eurozone's underlying structure (and the apparent unwillingness to provide more extensive fiscal backing manifested in the German government's rejection of proposals for the issuance of Eurobonds).

By the spring of 2010, both governments were thus forced to change course and abandon their stimulus efforts in favor of austerity and structural reforms. In Spain, the Zapatero government was forced to agree to important austerity measures at the Extraordinary Summit of the EcoFin in May. That same month it announced a 5 percent cut in public employee pay, a freeze on pensions and public sector pay through 2011, and 15 billion euros in spending cuts to be applied in 2010 (NYT May 12, 2010). In June it announced a labor market reform that 1) extended the use of “permanent employment promotion contracts” (indefinite contracts carrying dismissal costs of 33 days wages per year rather than the standard 45 days in the case of unjustified dismissals), 2) made it vastly easier for firms to carry out “objective” dismissals (which carried only 20 days pay for dismissal costs) that could be justified before a judge based on technical or production related reasons, and 3) introduced a mechanism whereby dismissal costs could be subsidized up to 50% through a public fund previously used only to pay severance costs for firms undergoing bankruptcy. To seek to balance this reduction in employment protection for permanent workers, it also limited the use of consecutive temporary contracts for the same employee to 24 month and limited contracts “for a specific job or services” to a maximum of 3 years (a restriction it nonetheless suspended a year later as employment situation continued to worsened). In late 2010, the government also initiated an extensive reform of the pensions system, announcing the gradual deferment of the ordinary retirement age from 65 to 67 years in late 2010.

And in May 2011, it began to impose sharp austerity measures in public spending. These included the freezing of pensions (previously adjusted for inflation), higher deductibles on prescription coverage by the National Health Service, the abolition of a Euro 2,500 tax deduction for the birth or adoption of a child. The government also imposed an across the board increase in income taxes and a 5% increase in VAT.

The 2010 labor market reform and cuts to social spending - which prompted a general strikes by the unions in September 2010 - were designed in close consultation with the EU Commission and intended to fulfill a commitment made to its Eurozone partners to cut the deficit to 3 percent of GDP by 2013. The same was the case with a subsequent reform in July 2011, implemented by decree, which altered the collective bargaining framework so that firm level bargains could abrogate minimum salary, work hours, occupational categories and work hour distribution conditions established in higher level bargaining (provincial-sectoral, regional, or national-sectoral). The main purpose of this reform was to calm international markets, given that negotiation between employers and unions on the matter had not produced an agreement. Rising unemployment and unemployment outlays, however, made this a difficult course to chart. While productivity per hour worked rose dramatically following the contraction of the construction sector (in contrast to all other Eurozone countries where productivity growth declined), unemployment went on to top 22 percent in 2011. The dismal situation forced Zapatero to call early election while at the same time continuing to tighten austerity measures, setting the stage for the PSOE’s electoral defeat by the Popular Party that year in November 2011.

In Italy, the Berlusconi government similarly launched a decree to ‘create financial stability and promote economic competitiveness’ following the May 2010 EcoFin summit, imposing cuts of 24.9 billion euros over 2010-2012 in an effort to reduce the public deficit from 5 to 2.7 per cent of GDP. It suspended all renewals of collective agreements in the public sector for 2010–2012, imposed a freeze on public sector salaries until 2013, and placed a 3.2 per cent ceiling on wage agreements in the private sector for 2008–2009 that applied retroactively to agreements signed before the decree. In addition, all government department budgets for fixed-term employees (except in research and education) were cut to 50 per cent of their 2009 levels for the year 2010. The government also used the crisis to accelerate the introduction of

pension reforms already on the agenda (but facing formidable political opposition). Retirement benefits were postponed by 12 months after reaching pensionable age, the pensionable age was scheduled to be adjusted according to changes in life expectancy from 2015 on, and the pensionable age for women in public administration was increased from 61 to 65 years, to start in 2012. In spite of these measures, a decline in the tax base over the 2010-2011 period kept the government from meeting its deficit goals.

In the face of a series of sharp spikes in the spread on Italian public debt in August 2011, the Berlusconi government came under intense pressure from the ECB, which sent a letter to the government (signed by Trichet and then Bank of Italy head Mario Draghi) demanding it advance the date for a balanced budget from 2014 to 2013 and that it pass further labor market and pension reform as conditions for the ECB's purchases of Italian public debt in secondary markets via the expansion of its LTRO mechanism. The Zapatero government, it was later revealed, was simultaneously sent a similarly co-signed letter, which prompted the Socialist government to speed through a constitutional amendment – with the support of the PP - committing Spain to limit any structural budget deficits to those authorized by the EU, both at the national and regional level, and capping them at 0.4% of GDP from 2020 onwards. In Italy (though not in Spain) the letter was leaked to press, and the *Corriere della Sera* (September 29, 2011) described its content as a veritable “government program”. The government responded to the ECB letter by passing a further package of cuts by decree aimed at producing a balanced budget by 2013. But it could not agree to the ECB and Commission demands on “seniority pension” reform, which was opposed by the Northern League as such pensions primarily affected one of its core constituency: large company employees concentrated in the North (see Sacchi (2013) for a more detailed description of the negotiations between the government and its Eurogroup partners and of the tensions within the coalition). The upshot was the collapse of the Berlusconi coalition

and the prime minister's resignation following the passing of a budget law for 2012 in November 2011.

The new governments of Mario Monti in Italy and of the PP, headed by Mariano Rajoy, in Spain, in turn, used the extraordinary circumstances in which they came to office to push for more aggressive pension and labor market reforms as demanded in the August 2011 ECB letters, at the same time attempting to use their new legitimacy to demand greater flexibility on the fiscal front from Eurozone core governments. Right upon taking office, the new Monti government passed a 30 billion euro emergency austerity package at the end of 2011 that included a number of tax increases (VAT and property taxes), cuts in health spending and a rise in the state pension age to 66 (It was subsequently raised to 67 for all workers as of 2021 and made subject to further revisions based on the evolution of life-expectancy). This was balanced by a 5 billion euros package of measures to increase investment in infrastructure (in particular in the South, where employment shedding had been greatest). In February 2012 the Monti government also approved a package of measures to deregulate services (including taxi licensing, local transportation, and increased price competition in pharmacies, petrol stations, health care and legal services). The single most significant measure as regards the character of the Italian social model, however, was the July 2012 labour market reform, named for the Labour Minister Elsa Fornero, which involved two particularly important changes: it altered the legal framework of employment protection for workers on indefinite contracts in companies with more than 15 employees (the most protected category of workers under Article 18 of the Italian Workers Statute of 1970) and included a significant reform of unemployment income protection. The latter consisted of the abolition of existing unemployment pay schemes and the introduction of a universal unemployment benefit regime (*Assicurazione Sociale per l'Impiego*, or *ASPI*), although only after two full years of contribution, phasing out the exiting closed unemployment and mobility allowances (Sacchi 2013).



In Spain, the Rajoy government, in turn, began its tenure in December 2011 by announcing a further 15 billion euro austerity program, including 6.9 billion euros in tax hikes (in income taxes for middle to high income earners, property, and capital gains taxes) and 8.9 billion in spending cuts falling largely on public employment (in particular in health care and education) (El Pais, December 30 2012). Much attention focused at this point on the regions. The Zapatero government had successfully reduced the contribution of the central government to the public deficit, but it was not able to enforce a similar contraction in spending by the regions (which accounted for approximately 36 percent of total public spending and were in charge of most social spending beyond the social security (pension) system). At the end of 2011, international credit rating agencies downgraded the public debt of several regions and in mid-January 2012 Standard and Poor's imposed a further 2 point cut of Spanish national debt based on the state of its regional debt. Meanwhile, the Eurogroup leadership demanded that the Rajoy government maintain the Zapatero governments' commitment to reduce overall public deficit to 4.4 percent in 2012.

The new government responded with a program of drastic cuts worth over 15 billion euros on regional government receipts, in spite of intense opposition from regional governments controlled by the PP (as well as those controlled by the PSOE), which decried the pro-cyclical effect social cuts would have. Following a private meeting with Merkel in late February, Rajoy finally announced that his government would not meet the promised overall deficit reduction in 2012 because of the impact that this would have on the economy. But it did announce a radical labor market reform package (see more below) to placate international rating agencies and its Eurozone partners (El Pais, February 29, 2012).

While the Zapatero reforms carried out by decree were criticized by both unions and employers, they had reflected an underlying consensus among all

parties that the overuse of temporary contracts had favored a trend towards low-cost, low value added jobs that needed to be reversed. The labor market reform announced by the Rajoy government in early February of 2012 – following yet another failure of unions and employers to reach an agreement - went considerably further to assuage European partners, leading both the unions and the opposition to accuse the government of seeking to take advantage of the crisis to shift the balance of power in favor of employers. The most controversial measure in the package was the redefinition of the conditions under which companies could dismiss workers and have the dismissal be considered “objective” or justified (with dismissal costs limited to 20 days pay per year and a maximum of 12 month pay). The February decree allowed companies to dismiss workers under this modality by simply showing a drop in sales or revenues (no matter how small) for three consecutive trimesters. In the case of collective dismissals, it eliminated the need for firms to wait for administrative approval, and required judges to deem such lay-offs justified as long as the company could show the three semesters of revenue decline. The decree also altered the long-established principle of “ultra-activity” by which the conditions of collective bargains remained in force as long as no new bargain had been reached. This qualitatively altered the balance of power between labor and employers, as it left unions with the choice of agreeing to a new bargain within a 2 year time frame or face the prospect of leaving workers without any contract (El Pais, 10 February 2012). The reform package re-established the two year limitation on the use of consecutive temporary contracts for the same individual (which had been introduced by the Zapatero government but then suspended), but at the same time made it much cheaper for employers to offer part-time jobs, a modality that given the universal subsidized child care system had never been extensively employed in Spain. The unilateral reform of employment conditions was followed in the announcement in the summer of 2012 of a second package of austerity measures, worth 65 billion euros

to be carried out over two years, including a second increase in the VAT and an across the board cut in the number of municipal council members by 30%.

All in all, the Rajoy government can thus be said to have been far more aggressive in its approach to reducing labor market dualism, but it did so by placing almost the full burden of this adjustment on a reduction in employment protection for those on indefinite contracts. It was also more aggressive in its austerity measures, which doubled those imposed in Italy. Implemented in a context of ongoing public spending cuts, the labor market reform was followed by a further large bout of employment shedding (as had, indeed, occurred with the first reform imposed by the Zapatero government. In the year and a half following the reform, employment fell by a further 700,000, of which over half a million represented a net decline in indefinite contract jobs. Whether this net employment destruction was necessary to encourage a further reduction in labor costs and productivity gains is, questionable as both processes were well underway at the time of the 2012 labor market reform. The effect was a further large decline in public revenue and large scale exit of foreign capital by institutional investors.

In Italy, we see a pattern of stronger resistance to change for the duration of the Berlusconi government, both by the CGIL, which took a stronger stance of opposition to reforms than the CISL and in some cases the UIL, and political parties (the Northern League and the PD faction closest to the CGIL) pushed back against austerity measures and reform during the Berlusconi period. This was followed by the Monti government's attempt to impose far more radical reform measures, in particular with the Fornero labour market reform, which was designed in a technocratic fashion, with consultation playing a very limited role (Sacchi 2013). Monti's strategy, however, backfired politically as reflected in his dismal electoral performance in the 2013 election, which were marked by the decline of the vote for the established parties and the rise of Grilli's Five Star movement.

By September of that year, the country was back in a stand-off between Berlusconi's PDL, which opposed a further increase of the VAT pushed by the European Commission, and the Letta government seeking to address those external demands. Remarkably, however, given the Rajoy government's aggressive labor market measures and greater responsiveness to EU demands, and given the evidence of strong internal devaluation in Spain, the debt spreads of Italy and Spain public debt vis à vis the German bund remained virtually undistinguishable. This remained true after the 2013 Italian elections, which further raised the level of political uncertainty regarding the Italian government's ability to implement EU demands.

One way in which the externally driven reform process had a clear impact was in reducing the ability of governments to participate and sustain social bargains. This raises some important questions, as a recent literature has argued that major economic crises may be "institution eroding," tilting the balance of power between capital and labor in a way that reduces, rather than enhances, the capacity of social actors to reach negotiated agreements (see Sacchi et al. 2010; Hyman 2010; Glassner and Keune 2010; Glassner, Keune and Marginson 2011; Lehndorff 2011; Ibsen, Andersen, Due and Madsen 2011), or producing a "disorganized" rather than organized decentralization and radical welfare retrenchment that undermines social compromise (see Doherty 20; Dukelow 2011).

In Italy and Spain, external demands for pro-cyclical austerity measures and unilateral government action placed a heavy strain on bargaining among social actors and governments. Collective bargaining reform, in particular, threatened the core of the national labor confederations' leadership capacity. However, there are also differences between the two countries, notably in the ability of the confederations to maintain a united stance. In the case of Spain, the Zapatero government's 2010 austerity program provoked a general strike and widespread public protests. Yet the strike action, social cuts and reforms of pensions and labor regulation did not

entirely destroy the concertation process. Although annual union-employer negotiations on wage guidelines ground to a halt in 2009, producing no agreement that year, the process was resurrected in 2010 with an agreement that set nominal guidelines for 2010 through 2012. Even in the face of the Rajoy governments' austerity program and far more radical employment reforms, this bipartite bargaining process continued. In January 2012, employers and unions reached another three year framework agreement setting wage of 0.5 percent for 2012 (a strong downward revision of the previous agreement for that year), 0.6 percent for 2013 and 2014. The new wage pact also departed from all past wage pacts in that it aimed explicitly to produce a fall in real wages. This bipartite piece of concertation, at least, did not break down and is widely considered to have been central to the internal devaluation in wages that took place in Spain (a devaluation that, as the Bank of Spain conceded in February 2014, was considerably more acute than aggregate official statistics reflected once the changing composition of workers in terms of skills and years of experience was taken into account).

The UGT and CC.OO. appeared intent on maintaining their position as social bargaining partners on the wage front even as their collision with the government on employment law was mounting. Following the decree instituting the 2012 labor market reform, for instance, the confederations agreed to postpone an immediate general strike in favor of a course of "ascending" popular mobilization with the aim of achieving a softening of the reform as it went through the parliamentary approval process. This moderation provoked intense criticism and pressure from regional nationalist unions in Galicia, Catalonia and the Basque Country to escalate labor action. Nevertheless, the two national confederations also continued negotiations on other fronts, signing a pact with the government to subsidize youth employment in late February (El Pais February 22, 2012).

Unlike Spanish unions, Italian unions were divided in their reaction to the Berlusconi government's crisis response policies (the CGIL uniformly

hostile, CISL broadly accepting them, and the UIL disagreeing with some but not all). Nonetheless, the bipartite dialogue between unions and employers also continued here, producing, for example, an agreement to reform the collective bargaining system by the CSIL and UIL, though without the CGIL in January 2009. The CGIL opposed the promotion of company bargaining on productivity and competitiveness and the introduction of 'opening clauses' in collective agreements to assist restructuring efforts. The same month, the CSIL and UIL also signed a renewal agreements for public sector employees (which the CGIL opposed) and declared their willingness to negotiate proposals based on a White Paper released by the Italian Minister of Labour, Health and Social Policy in May 2009, which emphasized the need to transfer resources from the pension system to 'social shock absorbers' (EIROnline, Italy 06, 2009). The CGIL's call for a four-hour national strike by all workers for 12 March 2010 - demanding increases in unemployment benefit duration and redundancy benefits - was in turn opposed by CISL and the UIL. The split was further accentuated over the course of 2010 by developments at two of Fiat's major production plants at which workers, including those represented by the CGIL's metal sector federation (FIOM) agreed to company level conditions that were more flexible than those allowed by the national sectoral agreement (Eironline, November 1, 2011).

The rift between the Italian unions was, nonetheless, patched up by an intersectoral agreement between all three confederations and Confindustria in June 2011 that specified the procedures to follow in situations - such as the one at Fiat- where workers chose to approve company level agreements that undercut conditions agreed in national sectoral bargains. The main thrust of this agreement was to allow company agreements that include temporary departures from national sectoral agreements on an experimental basis (Eironline, September 1, 2011). After the Italian parliament passed a new law in September 2011 allowing company-level bargains to opt out of national sectoral bargains on a wide range of matters

(including working hours, worker classification and hiring procedures), Confindustria and the signed an addendum to the June intersectoral agreement, which committed both side to abide with that agreement “by fully implementing its provisions and ensuring that all their respective structures are applied at all levels.” (EiroOnline, October 1, 2011). This represented a major shift in the CGIL’s position. But it also illustrated employer’s desire to contain the level of uncertainty surrounding collective bargaining that had been created by some of its moves in the Fiat negotiations and the new collective bargaining law.

The arrival of the technocratic Monti government in December 2011, provided only short-lived political relief from the climate of confrontation that had marred the Berlusconi period. The new premier promised to seek agreements with unions and employers when taking office. Yet, following the announcement of the new government’s austerity measures - which included 26 billion euros in spending cuts, a 30 billion increase in taxes (VAT), and a two year increase in the contributory period for retirement pensions (from 40 to 42 years) – confrontation soon resumed. The most divisive issue was the government’s planned labour reform, which involved the repeal of Article 18 of the 1970 Workers’ statute allowing workers to sue companies for reinstatement of their job after a lay off. The proposed law allowed companies to fire workers for economic reasons without the threat of such a legal challenge as long as they paid compensation of between 15 and 27 week of salary. At the same time, it also restricted the ability of firms to hire workers on a temporary basis. While UIL and CISL showed some willingness to contemplate the change in return for more extensive unemployment compensation for younger workers, CGIL and Confindustria both opposed it (the first because it regarded Article 18 a key element of employment protection, the latter because it opposed the restriction on atypical and temporary work contracts. This led the government to tone down the bill so as to allow courts to reverse lay-offs under special circumstances and to ease some of the restrictions on the use of temporary

contracts opposed by employers. Nonetheless, the unions and Confindustria both expressed dissatisfaction with the reform after it was passed by the Italian Senate in April (FT, March 20 and April 5, 2012).

Following the 2013 elections, the Letta government, again requiring the support of both the Right and the Left, also sought to strike an even handed tone, promising tax cuts for those on lower income and extending pension coverage for people that had been caught with insufficient contribution histories by the Fornero reform. The Renzi government that came to office in early 2014 also moved to expand the coverage of the unemployment system by extending its coverage in time, and set out on a new anti-austerity course, informing the Commission that it would put off the requirement of keeping the budget deficit at 3 percent for a year in order to kick start the economy through a 10 billion euro tax cut for low income households.

While the Italian labor reform did not go as far as that carried out by the Rajoy government in Spain because it did not touch on questions of internal flexibility (personnel and job classification, working hours, job description, absenteeism) reforms in both countries have reduced the scope for labour unions to negotiate specific aspects of the employment relationship, thereby reducing the role of collective bargaining. By allowing lower level bargains to undercut higher level bargains, the Spanish reform in particular threatens the ability of the national confederations to exert influence over the collective bargaining stances of their affiliates. To a lesser extent, the 2011 agreement between the labor confederations and Confindustria did something similar in Italy, but it was produced through a social pact process and introduced only on a temporary, experimental level. What effect these changes have in the long-run remains to be seen. But, in the event of economic recovery, barring a reversal of collective bargaining reforms introduced during the crisis, developments in both countries appear consistent with the view that the crisis may ultimately produce a form of institutional erosion that

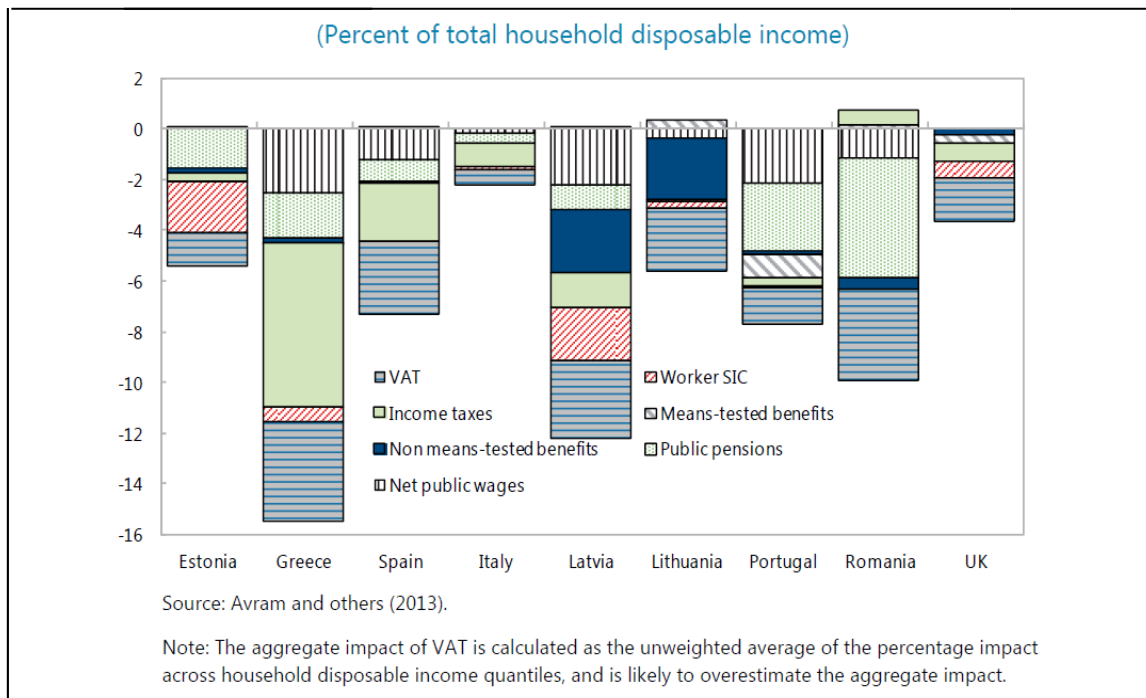


undermines the ability of governments and social actors to reach – and implement – agreements in the future. This seems particularly important in light of the role that the national unions have played in moderating wage increases and providing political legitimacy for adjustment measures (including pension reform).

The contrast between the hardline approach pursued in Spain and the more moderate pace of spending cuts and regulatory reforms in Italy (largely as a result of political stalemate) is reflected in the much greater impact that austerity measures (including increases in taxes, cuts in net public wages, and cuts in means-tested benefits) have had on household disposable income in Spain than Italy over the 2008-2012 period (Figure 11). Tax increases (foremost in VAT and then income taxes) accounted for the largest share of this difference, with reductions in net public wages and means-tested benefits in third and fourth place.

It is noteworthy that the social spending programs that were hardest hit (such as the elder and disabled care program stipulated in the Spanish dependency law of 2006 which was virtually stopped in its tracks by regional governments, the youth emancipation rent, which was abolished in 2012, and cuts in unemployment benefits after 6 month precisely as the proportion of long-term unemployed rose) were all key features of the transformation of the Spanish welfare state in the two decades prior to the crisis which had moved its structure of social spending closer to that of the Northern European states. Nonetheless, it is noteworthy that despite the more aggressive cuts and far more drastic drop in household disposable income, and the far more dramatic rise in unemployment, the more developed Spanish social protection system (in particular the unemployment benefit system) was able to limit the rise in the proportion of people at risk of poverty or social exclusion to less than 4 per cent between 2008 and 2012, compared to Italy’s rise to slightly above 5 per cent.

Figure 11: Simulated Aggregate Effect and Composition of Fiscal Consolidation Measures  
2008-2012

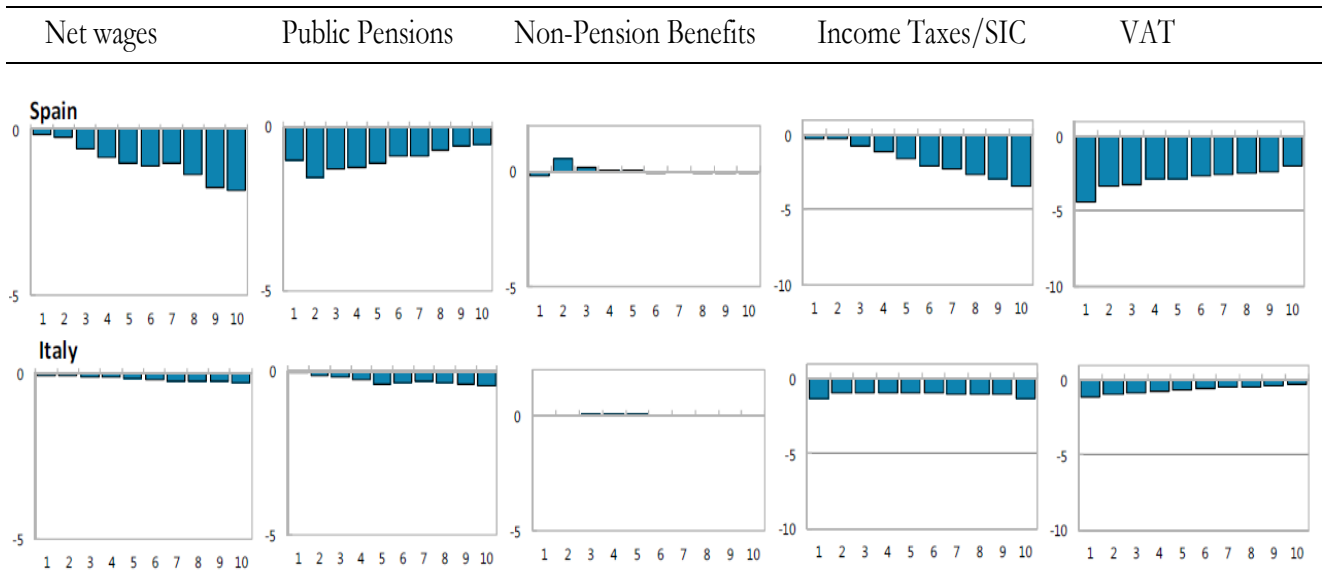


Source: IMF (2014, p. 51)

Figure 12

Change in Household Disposable Figure by Type of Measure and Income Group 2007-2012

(Percentage)



Source: IMF (2014) p. 53

Notwithstanding the last point, the balance of austerity measures in Spain (in particular the large increase in the VAT and considerable cuts in public pensions) all contributed to the fact that Spain suffered the biggest rise in inequality among the nine European countries that implemented substantial austerity packages in the wake of the financial crisis (IMF 2014). The contrast to Italy, in this regard, is clearly illustrated in Figure 12, which shows the changes in household disposable income on different income deciles that can be attributed to different types of austerity measures in the two countries. When we add this to the counterproductive effects austerity had on employment, bank balance sheets and ultimately the public debt, it is striking just how much damage Spain's compliance with the pro-cyclical austerity measures dictated by the EU had caused in Spain compared to Italy over the 2008-12 period.

## 5. Conclusion: Social Model Outcomes of the Eurozone crisis

The view that the problems of the Eurozone's deficit countries are rooted in their social models has been a commonplace in debates about the currency union. It is reinforced by the propensity among comparative welfare state and VOC scholars to emphasize the similarities between countries such as Spain and Italy, even to view them as instances of a similar historically rooted model of capitalism that places them at a competitive disadvantage in a globalized economy. This view – which we can term the “competitiveness thesis” - has also been accepted, when not embraced, by economic policy elites in Italy and Spain and served to justify the demands of creditor governments for measures intended to force adjust-

ment through internal devaluation. Such measures – consisting of fiscal austerity in the midst of recession and simultaneous cuts in employment protection and social benefits - were pushed by the EU Commission and ECB (in tandem with national central banks) as conditions for ECB support even when this meant stepping far outside the legal remit of EU institutions. While the tendency among policy elites has been to accept the competitiveness thesis, it is widely understood by financial market actors that the Eurozone is deeply flawed in its macro-institutional architecture. These flaws include the absence of a confirmed lender of last resort for governments and banks, the lack of real time banking union (including a common resolution fund and deposit guarantee), and the absence of mutualizing public debt instruments with a collective guarantee that could redress the perception of sovereign default and/or redenomination risks, and to address the kinds of asymmetric financial flows that are to be expected in a currency union. The repeated episodes of sovereign debt market contagion, of large interest rate spreads on government debt issues, and the acute fragmentation of public debt and credit markets (which impede the transmission of monetary policy in central bank parlance) are all evidence of these macro-institutional shortcomings. Given the protracted failure to reach agreement on such macro-institutional reform of the Eurozone, the burden of adjustment has been placed – often with perverse consequences – on the transformation of debtor country social models by way of “structural reform” (the prevailing euphemism for labor market liberalization and social spending cuts).

This paper has offered a number of reasons why we should doubt the premises behind the competition thesis and the prescriptions to which it has led. First, the evolution of the Italian and Spanish social models in the decades prior to the Eurozone crisis diverged significantly, with Spain moving further in an activation and flexibility oriented direction by rebalancing social spending than Italy and showing much greater labor market flexibility (albeit through temporary work contracts) than

Italy. This divergence illustrates important differences in the political dynamics of regulatory change in the two countries; differences that challenge the conventional wisdom about a historically persistent dynamic of social model development.

Social model change was influenced by different sets of economic and political constraints and by the different macro-economic conditions with which the two countries joined the Eurozone. Spain’s more orthodox fiscal policies in the decades prior to EMU allowed it to join the Euro with a particularly low level of public debt whereas Italy joined with the burden of one of the highest public debts. However, the disjuncture between Spain and not just Italy but also other major Eurozone countries set the Spanish economy up for unbalanced growth. Given the different starting points (high public debt and consequently high fiscal constraint in Italy and other major Eurozone economies, low public debt and low fiscal constraint in Spain), the shift to a single interest rate policy in the Eurozone gave rise to very different macro-economic dynamics and behaviors in the two countries. For Spain, EMU meant a shift to a significant laxer monetary policy stance than would have been taken by its central bank, and the combination of this laxer monetary policy with the absence of external fiscal constraint (given the country’s low and improving public debt position and what Fitoussi and Saraceno (2013) call the Eurozone’s constitution) led to a boom in domestic private credit (backstopped by interbank flows from the rest of the Eurozone). This allowed the country to make even larger strides in reshaping its social model such as to encourage labor force activation (seen as the central challenge of Southern welfare states at the start of the period) and provide a greater measure of “flexicurity.” Given a low level of public debt and ample room for private lending, this allowed for very fast demand driven employment growth but also skewed the character of that growth, leading to a real estate bubble of unprecedented dimensions.

By contrast, Italy, which adopted the Euro with a high level of public debt (most of it accumulated prior to the electoral reform of 1993) saw a decade of continuing slow growth, with both public and private investment restrained by the continuing need for fiscal consolidation. These different macroeconomic contexts played an important role in shaping the course of social model reform in the two countries: facilitating social model transformation in Spain while creating obstacles and reinforcing resistance in Italy. Indeed, the dominant feature of the Spanish social model that may have contributed to the Spanish economic dynamic – the high share of fixed-term employment – was one that imbued the labor market with a great deal of flexibility, even if in a segmented manner. And this leads us to question the extent to which the troubles of Spain and Italy in the Eurozone can be attributed to social model features as opposed to other factors, such as sectoral growth and demand patterns that were reinforced by dynamics at work in the Eurozone at large during the run-up to the crisis, such as the much noted rise in financial flows from richer to poorer countries in the area.

Secondly, governments and social actors in both countries were effective in maintaining real wage moderation. However, while labour compensation grew at low or moderate rates by Eurozone standards, both countries experienced low per hour labor productivity growth measured at the aggregate level relative to other countries following entry into the Euro, resulting in rising current account deficits. However, this apparent loss in competitiveness cannot easily be attributed to social model characteristics. As noted, in the case of Spain this low productivity growth in the aggregate was primarily a reflection of a sectoral composition effect given the disproportionate growth of employment in lower wage and productivity sectors. There is some evidence that a similar shift in sectoral employment and growth patterns was at work in Italy, albeit in a context of much lower domestic demand. One feature of the social model - the reliance on fixed-term employment (much higher in Spain but on the rise as well in Italy

following the reforms of 1997 and 2003) – may have abetted these sectoral trends, further skewing employment growth towards low productivity sectors. But, it is noteworthy that the cost and price performance of the tradables sectors in both countries was good throughout the period and that the deterioration in their current account positions was due primarily to price-developments in the non-tradable sector. This, as others have argued, is the signature of a demand (rather than a competitiveness) shock that can be attributed to the rise in financial flows from richer to poorer Eurozone countries in the run up to the crisis.

Third, the reasons behind Spain and Italy's perceived sovereign debt risk were fundamentally different, and clearly understood to be so (high levels of real estate related private debt coupled with a sharp drop in employment in Spain, political stalemate surrounding the issue of pension reform and high public debt in Italy). Such different situations would seem to call for different responses. In Spain, pro-cyclical austerity measures promised to worsen the outlook for Spanish banks and this in turn the credit rating of Spanish public debt (since the public sector would have to rescue the banking sector). Over 60 per cent of that debt was held among the assets of the domestic banking sector itself, hence creating a classic negative feedback loop between the quality of bank assets and sovereign debt (Angelini et al. 2014). Yet, the reforms demanded from 2010 on by their Euro partners were fundamentally the same (austerity and labor market liberalization that would facilitate internal devaluation to boost exports). In the case of Spain, where the largest problems involved employment shedding and associated private credit defaults, austerity contributed to the self-fulfilling prophecy that bond markets had feared (the collapse of part of the banking sector) and that led to the 2012 Memorandum of Understanding on the ESM financed rescue of the banking sector. That memorandum, in turn, set the basis for the 2012 labor market reform and further austerity measures that produced a further contraction of employment and a continuing rise in credit delinquencies. The



one measure that could have broken the cycle between private and public debt quality – allowing the ESM to inject capital directly into Spanish banks rather than force the Spanish governments to socialize losses - was blocked by the German government.

Fourth, where social model institutions do seem to have made a difference is in mediating the labour market impact of the Eurozone crisis. Yet here too the record challenges the Brussels-Frankfurt consensus on the way to address the Eurozone crisis. In spite of Spain's significantly greater movement in the direction of an activation friendly social policy, faster and more extensive implementation of labor market reforms responding to Eurogroup demands than Italy, and in spite of a far more extensive internal devaluation and enviable export performance, its unemployment rate still more than doubled that of Italy at the end of 2013 and its growth prospects for the following two years were no better than that of its neighbor (OECD Economic Outlook, November 2013).

The contrast in the evolution of employment in the two countries –with Spain registering strong improvement in (per hour worked) labor productivity growth at the expense of a large net employment contraction and Italy experiencing far greater employment stability but slower productivity growth - can largely be explained by prior macroeconomic conditions. Because Italy did not experience a Spanish style demand boom and real estate bubble, it also did not face the rapid collapse of employment in an overgrown construction and related sectors that was part of Spain's rollercoaster. But regulatory and political conditions also mattered. First, the particularly high share of fixed-term employment in Spain facilitated job shedding from the start. Secondly, once efforts to counter the negative effects of the financial crisis through countercyclical policies in 2008 and 2009 were cut short by the Eurogroup (with the help of the ECB, as reflected in the August 2011 letters to the Berlusconi and Zapatero governments), governments in both countries tried to couple austerity with labor market measures to facilitate internal devalu-

ation by lowering employment protection. Holding an absolute majority, the Rajoy government in Spain was able to move much further and farther in this direction than the Monti or Letta governments in Italy. However, as it was implemented in the midst of procyclical fiscal cuts, the reduction in employment protection for workers on indefinite contracts in Spain resulted in more employment shedding than creation. In Italy the intensity of employment destruction was far lower thanks to the use of employment sharing arrangements and the parliamentary roll-back of the most radical features of the Fornero labor-market reform at the end of the Monti government period.

The more aggressive approach in Spain, which already had a more flexible labor market and social protection system, resulted in a considerable reduction in unit labor costs by raising aggregate productivity measures. This did not occur in Italy. Yet the internal devaluation achieved in Spain was largely the result of the destruction of employment and its result was an almost continuous aggravation of the economic crisis, with an important rise in the proportion of long-term unemployed and the associated risks of hysteresis in the labor market. Italy failed to achieve such an internal devaluation, structural reforms or the kind growth in exports displayed by the Spanish economy. Yet remarkably, in spite of all this and a considerably higher public debt burden than Spain's, its sovereign debt risk spreads versus the bund did not differ much from Spain's after 2011. This must be largely attributed to the fact that the slower pace of reform in Italy also limited the vicious circle between employment destruction, banking sector solvency and sovereign debt we see in Spain. The very pace of labor market reforms, job shedding, internal devaluation and collapsed demand in Spain fed directly into the continued perceived instability of the Spanish economy in relation to its apparently far more sclerotic Italian counterpart. In the absence of any reasonable growth prospects (given the utter collapse of domestic demand and continuous drop in household disposable income), labor market deregulation showed little sign of contributing to a

recovery. Indeed, by producing further unemployment outlays it continued to threaten Spain's ability to escape the debt crisis, raising the question of whether the Spanish governments' more aggressive path will ultimately pay off. Indeed, although the slow pace of reform in Italy has largely been the result of political stalemate, Italian governments may have been better able to contain the social and financial repercussions of the ongoing Eurozone crisis by building (for an extended period of time) on non-market mechanisms in its institutional arsenal to encourage work time sharing and eschewing improvement in productivity measures that were achieved largely through employment destruction in Spain. Such a conclusion also finds support in the fact that the two countries' sovereign debt remained virtually indistinguishable as of 2013.

Meanwhile in both countries spending cuts have fallen heavily on education, health care and other public investments linked to long-term economic success. In Spain, a good part of the welfare state recalibration intended to promote labor market activation (minimum income support and care for the elderly and disabled) has also suffered large cuts. The ultimate effects of all this on the social models of the two countries remains to be seen. To date, however, the inability of governments to accompany labor market and social spending reforms with measures to support economic recovery appears to have forced them into a set of perverse trade-offs between maintaining employment and increasing productivity in the short run, and between short term austerity goals and long term growth prospects. In the context of a still institutionally highly flawed Eurozone which cannot prevent further episodes of self-inflicted financial crises, this carries at least as large a risk of political upheaval and social discontent as it does a way out of the economic crisis.

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## ENDNOTES

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2. It is estimated that in 2006, some 70 per cent of the Italian unemployed did not receive any form of income assistance (Jessoula 2011))
3. Prior to this point, all contracts outside seasonal work (in agriculture and tourism) were deemed to be indefinite.
4. There is some evidence that union confederations began to restrain and coordinate wage demands unilaterally in Spain from the 1994 on as well (Perez, 2000; Molina and Rhodes 2011).
5. Large Italian firms appear to have preferred this situation because wage compression acted as a “productivity whip” that encouraged both employers and employees to engage in sophisticated education and training programs supporting their higher quality production strategies (Hancke and Herrmann 2007) and they opposed efforts by the small firm wing of Confindustria to reform the status quo in the early 2000s (Molina and Rhodes 2007).
6. The purpose of the latter was to cover regulatory vacuums that had been left by the PSOE’s 1994 labor market reform in those provinces where no employers association existed to regulate work conditions through collective bargaining.
7. Although workers covered by national-sectoral agreements rose from 10 percent in 2001 to 25 percent in 2006, as many as 53 percent of workers were still covered by provincial sectoral agreements at the end of that year.
8. The national leadership of both the union and employer confederations set out to reduce the fragmentation of bargaining that allowed the sheltered sector of the economy to set the rate of pay increase, thereby undermining competitiveness. But the national employer confederation was unable to use the voluntary commitment of the national social pact to prod along their provincial sectoral affiliates which preferred to keep most workers covered by bargaining at the provincial sectoral level (Perez 1999, 2000).
9. In the face of a second bout of employment shedding in Spain following the 2012 labor reform, the Eurogroup proposed a further reduction in dismissal costs, a plan later endorsed by the IMF (See *El Diario*, May 14, 2013 and *El Pais*, June 19, 2013). Both institutions put similar heavy pressure on the Letta government in Italy.
10. This may be indicative of the fact that the overall unemployment figures in Italy do not capture considerable underemployment for non-youth due to work-time sharing (see more on this below).

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11. The coefficient of variation of employment rates in Spain fell from 10.8 to 7.5 overall between 1999 and 2007 (and from 17.6 to 11.8 for women), whereas Italy's regional employment disparities remained the highest in the EU 27 – declining more marginally from 17.4 to 16.3 overall, but more notably for women from 30.2 to 26.4.

12. As Martin Wolf has pointed out, there was a strong connection between changing public and private debt positions in all major OECD countries, with countries experiencing reductions in their public debt seeing commensurate expansion of private debt, and public debt compensating for declines in private lending.

13. Domestic demand in Spain grew by an average annual rate of 4.2 percent in the period of 1999-2008, compared to an average of 1.2 percent in Italy (OECD Economic Outlook n.84; Annex) The final consumption expenditure of the general government in Spain was consistently lower than in Italy (by two percentage points at 17.1-17.8 per cent in 1996-2004 before converging on Italy's 21 per cent in 2007-9 (though the EU 15 average was still one point ahead).

14. Gross fixed capital formation by the private sector, which stood at a similar 17 per cent in both Italy and Spain in 1995 (in line with the EU15 average) also grew at a much faster rate in Spain (to 24.8 per cent Spain in 2008 compared to 18.5 per cent in Italy). Capital formation was concentrated in production and infrastructure, as reflected in a particularly high level of equipment investment in the 1999-2007 period in Spain.

15. The magnitude of purchases by Eurozone surplus banks of Spanish bank issued covered debt can be garnered from the BIS study of van Rixtel and Gasperini (2013) and from a European Commission Study of Eurozone country surpluses (European Commission 2012b, pp.47-53). See also the *Wall Street Journal* June 27 and September 24, 2012).

16. There is considerable evidence that employers in Spain use temporary contracts either as screening device or as a way to lower their overall labor costs, with most workers during the boom years moving from a temporary position to an indefinite position either prior to the completion of their first contract or at the 3 year point when they could no longer be employed on a temporary basis (Guell and Petrolongo 2003).

17. There is some question as to whether some of the changes that were designed to promote female labor force activation can be considered a cause or consequence of this shift in social protection. The latter can be said of the 2006 Dependency Law and the 2007 plan to extend free childcare to ages 0-2.

18. Based on figures from Eurostat's harmonized Labour Force Survey Database. Net job shedding of temporary workers began in 2007.

19. Skill intensity is most commonly measured in the literature by the share of students enrolled in vocational training (Estevez-Abe et al. (2001), though see Culpepper (2007) for an alternative measure, and the analysis of Barro and Lee (1994) suggesting that enrolment rates do not show a significant impact on growth, while average years of secondary education does). The OECD's

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Continuing Vocational Training Database suggests that the proportion of employed persons participating in continuing training and education in Italy was, at 36 percent in 2010, barely different from that of Germany (39%). In Spain, it was considerably higher, at 48 percent. Broader measures of human capital offer a complex picture. Both countries scored particularly low in the ranking of average literacy and numeracy measures offered in the OECD's Adult Skill's survey (OECD 2013), but there are reasons to question the relevance of these ranking differences for aggregate labour productivity among the top 15 advanced industrialized countries. The 1997 through 2009 Pisa rounds show that both countries were characterized by a disproportionately high percentage of working age population with "below upper secondary education" compared to other Eurozone countries (46 and 38 percent for Spain and Italy respectively in the last round). But both also reduced this percentage significantly over the period (Spain by about twice as much as Italy). On the other hand, Spain had a high proportion of population with tertiary education (30 percent as opposed to Italy's 14 percent), a reflection of its higher spending on upper education prior to the crisis.

20. Employment protection for indefinite workers in terms of dismissal costs was considerably lower in Italy than in Spain (or in Germany for that matter) because Italian law never envisaged automatic monetary compensation for unjustified layoffs (for further discussion, see Sacchi 2013). Moreover, although Italian law in some ways creates greater uncertainty for employers in firms with more than 15 workers by prescribing that workers get the choice of full reinstatement with seniority in the case of a judgment in their favor, when monetary compensation is granted, the amounts (number of days of compensation per year) were lower than in Spain.

21. Figures are based on Employment data from the OECD's National Accounts Database.

22. Indeed, in the Italian case, where a significant decline in the share of employee compensation in GDP might have been a boon to investment, wage moderation may have had a negative effect on productivity by providing higher rents for uncompetitive companies (the undoing of the productivity whip) and further depressing domestic demand. Even the governor of the Bank of Italy bemoaned low wage growth and its contribution to slow economic growth, although he attributed this to low productivity gains compared to firms in Britain and France (*l'Occidentale*, October 30, 2007).

23. A sectoral shift in resource allocation to lower productivity sectors may already have been encouraged in Italy by the abolition of the *scala mobile*, which, because of its effect of wage compression, is also thought to have worked as a "productivity-whip" on Italian firms (Hancke and Hermann, 2007).

24. The predominance of very small firms has also long been identified as one of the major factors behind low productivity growth since the 1980s in Italy by Pagano and Schivardi (2003) and Amatori et al. (2011) who attribute Italy's problems to the failure of the institutional environment to provide incentives for firm growth.

25. Indeed, only in the case of France, the authors find, was export competitiveness a significant determinant of a growing current account deficit.

26. Major institutions, including Deutsche Bank announced that they were working on contingency plans for such an outcome.

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27. As was subsequently revealed by the Spanish and Italian press, and in the memoir of Rodriguez Zapatero, the ECB, with the support of the two countries national central banks and backed by the Commission, sent virtually identical letters to the Italian and Spanish executives on August 5, 2011 spelling out the social model reforms it expected as conditions for its continued bond buying of Italian and Spanish debt and the extension of new Long Term Refinancing Operations. The Memorandum of Understanding signed by Spain to obtain the credit line for its banking sector rescue also committed the government to advance labour market and bargaining reforms in line with Eurogroup demands.
28. The depth of Spain's employment crisis suggests that this may ultimately have had deleterious effects given that labor market liberalization was carried out in the context of highly pro-cyclical austerity measures.
29. Calculations based on OECD National Account figures, GDP at constant prices (output method). It should be noted that the Spanish economy continued to grow into 2008. Calculating the contraction from 2008 through 2012 renders a cumulative 5.6%.
30. The total number of jobs at the end of 2011, for instance, was still 4 million higher than it had been in 1999. Labour force participation (for those in the 16-64 age group) also still remained relatively high at 73 percent in 2011.
31. Employment in the construction sector dropped 57 per cent between 2008 and 2011. In industry (excluding construction) the drop was of 20 per cent, and in services only 3 percent (figures calculated from the Labour Force Statistics section of the OECD's Main Economic Indicators Series).
32. As in Spain (although involving fewer people) the brunt of the employment contraction fell on those on 'atypical' work contracts, the share of which had risen following the Treu and Biagi reforms. Thus, in the year up until March 2009, Italy lost 261,000 temporary and atypical jobs, primarily workers with no eligibility for unemployment benefits or other forms of social support. (OECD Economic Outlook, 2009; Molina and Rhodes 2008; Berton, Richiardi and Sacchi 2009). In both countries disadvantaged groups, such as youth, immigrants, and low-skilled workers, all overrepresented in the temporary and atypical contract segment, bore the brunt of job losses. The job shedding in Spain also had a strong gender bias, with far more men losing employment than women initially, due to the sectoral nature of the contraction. However, as the Zapatero government, and subsequently the Rajoy government imposed increasingly hard cuts on the public sector, women, with strong concentrations in the education and health care sectors, also began to see higher rates of unemployment. Unemployment for immigrants stood at 28 percent by the end of 2009 (OECD Employment Outlook 2009).
33. The government approved 8 billion Euros in subsidies for a program supporting local employment initiatives and allowing local governments to increase their deficit spending. A law in March 2009 provided subsidies to companies hiring unemployed workers, and lowered social security charges for companies reducing working hours in lieu of dismissals.
34. Introduced in 1991, the "mobility allowance" was a generous unemployment benefit separate from ordinary unemployment benefits, equal to around 80 per cent of the previous wage for 12 months, extendable to 48 months but only available to those permanent workers. Workers on atypical contracts were also excluded from the ordinary unemployment benefit, which required at least two years of insurance payment and contributions paid for at least 52 weeks in the two years prior to unemployment.



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Only 7 per cent of unemployed workers in 2005 could claim ‘ordinary unemployment benefit’. Atypical workers who met contribution criteria (most did not) could access a reduced unemployment benefit with a maximum duration equal to the days worked in the previous year, up to a maximum of 180 days, and replacement rates between 35 and 40 per cent.

35. It also facilitated so-called “express dismissals” first introduced in 2002 whereby companies could dismiss workers without having to justify the dismissal, waiting for administrative approval, or risking a legal sanction by paying the maximum severance pay of 45 days per year worked up front.

36. In the words of the Labor Minister, Valeriano Gomez, the government preferred to have “one more worker on a temporary contract rather than one more unemployed worker.” (El Pais, August 26, 2011).

37. The measure was opposed by both unions (who regarded it as a way to undermine minimum common standards) and employers (who sought to protect the ability of their provincial affiliates to act as the principal actors in collective bargaining (El Pais, June 6, 2011)). The government also created the legal basis for the introduction of lifelong individual capitalization funds that workers would be able to use in the future in cases of dismissal or transfer to another location (a scheme widely referred to as the “Austrian-model” that had been pushed by the unions as an alternative to the collective bargaining reform).

38. The expansion would take place in December 2011 via low cost 36 month loans made available to banks allowing government securities as collateral, and was critical to make sure that banks were able to pay off their own maturing debt in the first three months of 2012. It also allowed for mortgage backed securities as collateral and became the precursor of the Outright Monetary Transactions (OMT program) announced in August 2012.

39. It also put in place some changes to prevent abuse of atypical work contracts and placed a small labor tax penalty of 1.4% on temporary contracts.

40. The Rajoy government responded by creating an 8 billion euro credit line to advance payment to regional governments, many of which had fallen severely behind in their payments to providers but remained firm in its demands (El Pais February 28, 2012 and March 5, 2011).

41. In January, Standard and Poor’s had announced that it would impose further rating cuts on Spain if the new government did not impose a sufficiently radical labor market reform (El Pais January 13, 2012).

42. Reflecting this consensus, in November 2009, the government had also passed a ‘sustainable economy bill’, a large part of which was devoted to professional training reforms.

43. The design of the reforms was marked by tension within the new government between the Labor and Finance Ministers on one hand (who are understood to have opposed some of the most radical elements in the reform package) and the new Economy minister, who was deployed as the main interlocutor with other Euro-zone finance ministers and pushed to a more radical reform to assuage international markets.

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44. The reform also cut the maximum established severance pay for “unjustified” dismissals to 33 days per year (this applies to all hires from the date of the decree, as well as to any years worked by current holders of indefinite contracts past the date of the decree) with a maximum of 24 month pay.
45. It also introduced new subsidies for employers who employ youth (up to the age of 30) or those over the age of 45 (with a larger subsidy offered for women than men in this last category).
46. It sets adjustments for inflation to inflation that exceeded the ECB’s 2 percent target and even takes into account a rise in oil prices, so that part of inflation accounted for by oil price rises should not be compensated.
47. The fact that the number of younger workers, workers with lower skills and workers with less years of experience dropped significantly during the period of employment destruction means that the real drop in wages is masked by the fact that the labor force in 2012 was made up of a greater proportion of higher skilled and experienced workers (Bank of Spain 2014).
48. El Pais, February 12, 2012. As part of their efforts, CC.OO. leaders met with the Popular Party parliamentary delegation after the passing of the labor market decree in this effort (El Pais, February 23, 2012)
49. This aggravation of inequality occurred despite efforts to protect, and even raise, benefits accruing to the most vulnerable members of society, including a minimum social assistance payment for the long term unemployed introduced under the Zapatero government and the Rajoy government’s decision to raise the top tax rate (for those earning above euros 300.000) up to 55 per cent.
50. There is some evidence discussed below that some features of the Spanish and Italian production regimes (such as the firm size structure of the private sectors) and the prevalence of temporary employment, in particular in Spain, may also have been a contributing factor.