

WAGE RIGIDITY INCREASES UNEMPLOYMENT: EVIDENCE FROM ITALY

Nationwide pay agreements have restricted labour market flexibility and increased unemployment in Italy, according to research by **Francesco Devicienti** and colleagues, published in the November 2007 issue of *The Economic Journal*.

'Real' wage rigidity – where workers resist below inflation pay awards – has been the most important source of wage inflexibility. This was an important factor that prevented labour markets adjusting, especially during downturns.

The study finds that such rigidities led both to higher job turnover and to higher local unemployment in Italy. But the authors note that recent changes have increased labour market flexibility. In particular, the abolition of the price indexation clause (*scala mobile*) in 1993 has lessened the problem of real rigidity.

The authors conclude that a more decentralised and flexible wage bargaining system coupled with low and stable inflation, may help to minimise the negative effects of wage rigidities at an economy-wide level.

Wage rigidity has traditionally been of interest to economists looking at macroeconomic phenomena and the functioning of the labour market. Wages are said to be downwardly rigid if institutional or behavioural factors make it difficult for the wages of some workers to fall despite underlying supply and demand pressures for decreases.

Firms may be impeded from adjusting wages, for example, because workers resist nominal wage cuts. This phenomenon is called 'downward nominal wage rigidity'.

Workers can also avert real wage cuts, as when nationwide collective bargaining institutions impede firms from increasing wages by less than a given wage norm, usually related to expected inflation. This phenomenon is known as 'downward real wage rigidity'.

Wage rigidities are standard culprits for the high and persistent unemployment that has long plagued many European countries. The nature and extent of wage rigidity is also important for the debate on monetary policy rules and the optimal rate of inflation. For example, a positive rate of inflation may relax the constraint posed by nominal rigidity, whereas more decentralised wage settings may be more relevant when real wages are downwardly rigid.

This study uses data from the Worker History Italian Panel to estimate the relevance of downward wage rigidity in Italy for the period from 1985 to 1999. The results show that in Italy, downward real rigidity is larger than downward nominal rigidity, owing to the dominant role that national collective contracts have in the wage bargaining process.

But wage rigidities have declined over time, a pattern that is entirely consistent with the various labour market reforms Italy has experienced and, more specifically, with the abolition of the price indexation clause (*scala mobile*) in 1993.

The researchers also provide support for the view, often heard among economists, that when firms are constrained from cutting wages as required by economic conditions, they may resort to employment adjustments. In fact, the researchers find that downward wage rigidities are conducive both to higher labour turnover flows and to higher local unemployment rates.

Overall, the results suggest that a more decentralised and flexible wage bargaining system, as well as low and stable inflation, may help to minimise the negative effects of wage rigidities at the macroeconomic level, especially in a country where national collective contracts are still rather influential.

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Notes for editors: 'Downward Wage Rigidity in Italy: Micro-based Measures and Implications' by Francesco Devicienti, Agata Maida and Paolo Sestito is published in the November 2007 issue of *The Economic Journal*.

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