

Defusing Leverage: Liquidity Management and Labor Contracts *

Edoardo Maria Acabbi¹ and Andrea Alati²

¹*Universidad Carlos III de Madrid*

²*London School of Economics*

March 15, 2021

Abstract

Rigidities in firms' payroll structures are likely to increase the transmission of shocks to firms' cash flows and profitability. By using Italian administrative data on workers careers and firms' balance sheets, we study how the use of permanent and fixed-term labor contracts affects this pass-through. First, we confirm that a higher labor share is associated with more volatile cash flows following unexpected real shocks, a telling indication of operating leverage at work through labor costs. Second, we show that firms with a greater share of temporary contracts are characterized by a smoother time-series behavior of their cash-flows. In particular, the smoothing effect is stronger for firms with higher labor share related to the permanent workforce. We complement this analysis with the study of the 2001 labor market reform that lifted constraints on the creation of temporary contracts. Exploiting the staggered implementation of the reform across different collective bargaining agreements, we show that, following the reform, firms increased on average their share of temporary contracts and decreased average labor compensation. In addition, we show that, only among firms with an ex-ante more rigid labor cost structure, earlier transition to a more flexible workforce composition led to a 1 percentage point increase in profit margins (against a -1.6pp average variation around the event) and a 5 percent decrease in the cross-sectional standard deviation of profits.

JEL Classification: E24, G30, J23, J24, J30, J41, J42, M55

Keywords: leverage, labor share, dual labor markets, liquidity, event-study

*We would like to express our deepest gratitude to Raffaele Saggio and Vincenzo Pezone for sharing their data on collective bargaining agreements. This study uses anonymous data from the Italian Social Security Institute (INPS). Data access was provided as part of the VisitINPS Scholars initiative. We are grateful to Massimo Antichi, Alfredo Arpinelli, Tito Boeri, Daniele Checchi, Maria Cozzolino, Edoardo Di Porto, Maurizio Franzini, Pietro Garibaldi, Monia Monachini, Paolo Naticchioni and all the staff of Direzione Centrale Studi e Ricerche at INPS for making the VisitINPS programme possible and to Massimo Ascione for his help with the data. For many helpful comments on this project we thank Martina Uccioli, Luca Citino, Giuseppe D'Achille, Edoardo Di Porto, Luigi Guiso, Paolo Naticchioni, Giovanni Pica, Vincenzo Scrutinio and participants to the VisitINPS seminars. Acabbi thanks the financial support from Comunidad de Madrid (Programa Excelencia para el Profesorado Universitario, convenio con Universidad Carlos III de Madrid, V Plan Regional de Investigación Científica e Innovación Tecnológica).

The findings and conclusions expressed are solely those of the authors and do not represent the views of INPS. All errors are our own.

Acabbi: edoardomaria.acabbi@uc3m.es

Alati: a.alati@lse.ac.uk

1 Introduction

Rigidities in firms' payroll structures are likely to increase the transmission of shocks to firms' cash flows and profitability (Acabbi, Panetti and Sforza, 2020, Favilukis, Lin and Zhao, 2020). Despite a recent declining trend in aggregate labor shares across all developed countries (Karabarbounis and Neiman, 2014), labor costs still constitute a sizable fraction of firms' cost structure. Nonetheless, they are often overlooked as a source of financial risk, and most macroeconomic models assume that labor is a flexible input in production.

Given wage rigidities and adjustment costs, labor costs committed to incumbent workers can become a source of operating leverage. The choice over the mix of contractual arrangements to offer to their own workforce has thus important implications for firms' liquidity management. In almost all advanced economies an increasing fraction of employment relationships is regulated by temporary contracts.¹ Temporary contracts allow firms to avoid paying any severance cost at a pre-defined expiration date. The use of temporary contracts can thus help firms reduce their labor-induced operating leverage, and provides them with an additional tool to help smoothing the effects of unexpected shocks.²

By using Italian administrative data on workers careers and firms' balance sheets, we study how the use of permanent and fixed-term labor contracts affects firms' pass-through of exogenous shocks. We provide novel evidence on the role of fixed-term employment contracts as a margin of adjustment to "defuse" firms' exposure to labor-induced operating leverage.

Our study is organized in two parts. In the first part, we conduct a panel data analysis to provide evidence of the existence of labor-induced operating leverage for Italian firms. We do so by estimating the variability of firms' financial outcomes over time in response to external aggregate shocks. We then analyze how, in the time-series, firms choice of increasing their share of temporary workers is associated with a decrease in the volatility of firm fundamentals (profits, cash-flows, employment). Lastly, we show that this effect is stronger the greater the degree of firms labor induced operating leverage. In the second part, we conduct an event-study analysis of the liberalization of temporary contracts' use that took place in Italy in 2001. We provide causal evidence on how firms responded to the liberalization by increasing their use of temporary contracts, how this in turn impacted their profitability and finally how the benefits of employing a more flexible workforce are heterogeneous depending on firms' ex-ante operating leverage.

In the first part of the study, we focus on a comprehensive panel data covering non-financial firms balance sheets and workers' careers for a period from 1998 to 2018. The objective is to analyze the variability of firm level outcomes in response to exogenous

¹The *OECD Labour Force Statistics* (OECD, 2020) indicate that in 2019 approximately 12% of dependent employment in OECD economies is covered by temporary contracts. In Italy, the country we use for our analysis, the same measure has grown from approximately 5% in 1990 to 17% in 2019.

²Caggese and Cuñat (2008) show that more financially constrained firms rely more on fixed-term contracts to avoid incurring in potential firing-costs.

shocks, for which we use aggregate business cycle fluctuations, in relation to firm-level cost structure and with particular reference to labor costs variation. In order to proxy for exposure to more rigid workforce costs, and thus labor-induced operating leverage, we focus on firms long-term average labor share, and in particular the portion of it determined by permanent workers. As permanent contracts relationships tend to be sticky in the data, and labor costs related to permanent workers constitute a slowly moving variable, permanent workers' labor share is a natural choice to indirectly proxy for operating leverage. We verify that the volatility of profits, cash-flows and employment in reaction to business cycle fluctuations is increasing in this measure of labor rigidity. In a similar way, we also verify that firms appear to use their share of temporary workers as a smoothing device of external shocks: when firms increase their share of temporary workers the volatility of their profits or cash-flows in response to shocks is dampened, while on the contrary the volatility of employment is increased. Most importantly, we show that the dampening effect through the share of temporary contracts varies across labor leverage exposure. Highly leveraged firms, in the top tercile of the labor share distribution, benefit more from having a higher share of temporary contracts, and the effect monotonically decreases at lower labor shares. The choice over the menu of differently flexible contracts for workers thus plausibly alters the trade-off between short term profitability and financial stability. The choice arguably implies different incentives depending on firms exposure to operating leverage and cost rigidity, as determined by production processes and workforce development over time.

In the second part of the study, we complement the descriptive evidence of the first part with causal evidence on the relationship between the use of temporary contracts and firm level outcomes. Importantly, we find heterogeneous effects of this relationship based on ex-ante exposure to labor leverage. We conduct an event study of the 2001 labor market reform that lifted constraints on the creation of temporary contracts for the Italian labor market. The causal identification of the exercise is based on the staggered implementation of the reform across different collective bargaining agreements, which allows us to compare plausibly as-good-as-random early adopters to late adopters of the reform (Darulich, Saggio and Di Addario, 2020).

We show that the liberalization of temporary employment in Italy had a significant impact on firms and workers alike. Following the reform, Italian firms significantly increased the share of temporary contracts in their workforce and, in parallel, reduced both their total labor costs and the average wage paid to employees. The reform caused an average increase in firms profit margins without boosting firms' size and with none of the positive employment benefit the reform intended to achieve. Consistently with our descriptive analysis, the event study results suggest that temporary contracts offer firms a way to transfer part of their risk to workers. The reform did not alter the protection of incumbent workers, thus strengthening a *duality* in the labor market setting, with effects concentrated on the youngest cohorts, more likely to be in temporary employment.³

³The pervasiveness of temporary contracts among young workers has spurred a large number of studies aimed at quantifying the influence of these employment relationships for firm choices, workers careers and

When looking at the heterogeneity of these effects conditional on firms' permanent workers labor share we also uncover profound differences across firms. In particular, we see that the 2001 reform had a particularly beneficial effect for firms characterized by a high labor share to start with. We observe that the average positive effect on profit margins is entirely driven by these firms. This happens despite the fact that firms increase their use of fixed-term contracts or reduce labor labor costs similarly, regardless of their labor share characteristics. Following the intuition from the panel regressions, we then estimate the effects of the reform on the measured standard deviation of profits, measured within a province (a local labor market in Italy) among firms with the same collective bargaining agreement. We discover that, even in this case, firms with greater ex-ante exposure to labor leverage experienced a significant (cross-sectional) *reduction* in the volatility of their own profits, whereas less exposed firms experienced no significant change.

To put the magnitude of these effects into context, an earlier transition to a more flexible workforce composition for high labor-leverage firms led to a 1 percentage point increase in profit margins (against a -1.6pp average variation around the event) and a 5 percent decrease in the cross-sectional standard deviation of profits.

We interpret these heterogeneous effects on firm profitability and real outcomes as evidence of the existence of a possible trade-off between the stabilization benefits of temporary employment and the higher costs associated with workers' churning, startup costs, and the likely within-firm contrasts and fairness concerns regarding unequal treatment of permanent versus temporary workers (an insiders versus outsiders condition per Lindbeck and Snower 1989, 2001). It is apparent from our results that the smoothing benefits are sufficiently high only for firms that are highly exposed to labor leverage to start with. At the same time, the measured deterioration in profit margins for low labor leverage firms suggests that firm managers themselves seem to fail to anticipate correctly the implicit costs of this trade-off.

Our results show how financial management decisions pertaining labor at the firm level interact with employment policy and affect firms productivity. We thus provide important information to firm managers and policymakers alike regarding the potential implications and tradeoffs implied by the presence of dual labor market regulations, the full consequences of which are interesting topics of analysis in a research agenda in corporate finance and personnel economics.

Related literature. This paper contributes to five main strands of academic literature.

First, we contribute to a literature in corporate finance analyzing capital structure determination in connection with financial frictions, and especially the growing literature focusing on the financial frictions that might emerge in relationship to labor composition

labor market frictions(Bentolila and Bertola, 1990, Cappellari, Dell'Aringa and Leonardi, 2012, Cingano et al., 2016). Our works is based on Daruich, Saggio and Di Addario 2020, who conduct an empirical exercise analogous to ours, but with a special emphasis on worker-level outcomes. We remand the reader to that study for a detailed analysis of the effects of the reform on incumbent (permanent) workers as opposed to younger workers.

and financing.⁴ Specifically, we follow Donangelo et al. (2019), Favilukis, Lin and Zhao (2020) and Acabbi, Panetti and Sforza (2020), in highlighting the importance of labor expenditures for firms' financial stability. We contribute to these studies by exploring the role of labor contracts as an additional margin that affects firms' labor-induced leverage and that can be actively used to manage it.

Second, we contribute to the related literature regarding the labor financing. Labor possesses characteristics that can make it akin to a quasi-fixed factor in production and an investment good from the firm's standpoint, which should in turn require long-term financing (Oi, 1962, Hamermesh, 1989, Hamermesh and Pfann, 1996, Benmelech, Bergman and Seru, 2015, Benmelech, Frydman and Papanikolaou, 2019, Acabbi, Panetti and Sforza, 2020). From this perspective, we highlight how the presence of worker-related costs, such as hiring, search or training costs, generates a trade-off between optimal liquidity management and workers' performance improvement.

Third, by exploring the role of labor contracts for the pass-through of aggregate shocks to firms we touch upon the literature on rent-sharing and insurance between workers and firms (Guiso, Pistaferri and Schivardi, 2005, Card, Devicienti and Maida, 2014).⁵ These parallel strands of literature analyze labor compensation determination and its relationship to firms performance as a function of firms' greater tolerance for risk (insurance) or labor market frictions making workers imperfectly substitutable (rent-sharing). Our results indicate that firms can reduce the insurance provided to new workers and increase financial flexibility, while at the same time incumbent workers become more protected while employed and get greater compensation stability, according to an insiders-outsiders opposition logic (Lindbeck and Snower, 1989, 2001). Our results are thus coherent with a model of within-firm and across-workers bargaining.

Fourth, we show that the contractual composition of firms' workforce can be an important element in explaining the pass-through of shocks to firm-balance sheets. Although the firm-dynamics literature has not often focused on this specific margin of adjustment,⁶ it is likely that the availability of labor contracts subject to different employment protection legislation can have important implications on how companies respond to shocks using the labor market (e.g. Giroud and Mueller 2015, Cestone et al. 2020, Caggese, Metzger and Cunat 2019, Faia and Pezzone 2020) and on how firms compete for and allocate workers, which can have repercussions also on the dynamics of between-firm competition (e.g. Gouin-Bonenfant 2020) and thus generate spillovers from labor to product markets.

⁴Also see among others, Danthine and Donaldson (2002), Caggese and Cuñat (2008), Schoefer (2015), Xiaolan (2014), Simintzi, Vig and Volpin (2015), Serfling (2016), Favilukis and Lin (2016), Ellul and Pagano (2019), Favilukis, Lin and Zhao (2020), Bai, Fairhurst and Serfling (2020), Donangelo (2021).

⁵Other recent notable works on the matter are Jarosch (2015), Ellul, Pagano and Schivardi (2018), Lamadon, Mogstad and Setzler (2019), Lamadon (2020). Guiso and Pistaferri (2020) provide a handy review of the topic of within firm insurance. In a recent related working paper Acabbi, Alati and Mazzone (2021) provide a tractable framework to analyze models of the labor market with heterogeneous firms and workers, insurance provision incentives and endogenous labor cost rigidity creation.

⁶A notable recent exception is Pérez (2020), that using Chilean data, shows that temporary employment constitutes a valuable margin of adjustments for firms facing a strict regulatory framework.

Finally, we follow recent methodological developments in the extensive literature on the implications of labor market frictions for workers,⁷. This literature focuses on how the institutional setting regarding employment protection alters firms' incentive to employ different kinds of workers, and how in turn this affects workers' careers in the long run. We extend the focus of the analysis from workers to firms, by looking at hiring as an investment decision which has extensive ramifications for firms liquidity management. In particular, we complement the analysis carried out in Daruich, Saggio and Di Addario (2020) by exploring a novel margin of heterogeneity when estimating firm-level effects of labor market reforms, showing that firms can exploit the duality in the labor market as a tool to smooth aggregate and firm-level shocks and manage their liquidity needs.

Structure of the paper. The paper is structured as follows: Section 2 briefly discusses the mechanisms linking labor leverage to temporary contracts; Section 3 provides an overview of the main administrative data used in the study; Section 4 discusses the role of the labor share and temporary employment contracts for the pass-through of aggregate shocks to firms using panel regressions; Section 5 presents our causally identified event-study; finally, Section 6 concludes.

2 The link between contract composition and firm leverage

Labor payments are still a large fraction of GDP in all major economies.⁸ A characteristic feature of labor payments is their smoothness relative to firms' cash-flows and operating profits. In fact, as highlighted in the corporate finance literature (e.g. Donangelo et al. 2019, Favilukis, Lin and Zhao 2020) and as shown in Figure 1, firms' labor expenditures exhibit a significantly lower volatility compared to firms' operating surplus. This decoupling is the source of an operating leverage that, contrary to the financial leverage commonly studied in the corporate finance literature, has its roots in firms' commitments to labor payments. Firms are more exposed to this specific form of leverage the higher their labor share is, i.e. the higher payments accruing to labor inputs are. Similarly to financial leverage, labor leverage is a source of amplification of real shocks and therefore an element of financial risk that is not captured by classic indicators used in the literature (e.g. financial leverage itself, or indexes such as in Whited and Wu 2006.). As it is a source of amplification of real shocks, intuitively we should expect firms more exposed to the labor leverage channel, i.e. with a higher ex-ante average labor share, respond more to external shocks than firms that devote a lower share of their value added to labor compensation.

The smoothness of labor payments can be justified by different factors, from the insurance role of firms (e.g. Guiso, Pistaferri and Schivardi 2005, Lamadon 2020, Acabbi, Alati and

⁷See for example, Bentolila and Bertola (1990), Boeri and Garibaldi (2007), Cappellari, Dell'Aringa and Leonardi (2012), Cingano et al. (2016), Devicienti, Naticchioni and Ricci (2018)

⁸In Italy in 2017 52.2% of GDP went to wages and salaries on aggregate. In the same period, in the Euro Area and the EU27 the share was 58.3% and 57.7% respectively according to the Penn World Tables 9.1 (Feenstra, Inklaar and Timmer, 2015). For a reference regarding recent global trends in the aggregate labor share see Karabarbounis and Neiman (2014).

Mazzone 2021) to the regulatory framework on wage minima, employment protection legislation and contract types (permanent versus temporary). Wage minima or the options in the menu of legal labor contracts introduce a direct source of downward rigidity on firm labor payments (e.g. Card, Devicienti and Maida 2014, Fanfani 2019, Faia and Pezone 2020) firms have no *direct* control on. The *choice over* the menu contract types, on the other hand, is part of firm optimization and provides an additional margin of flexibility at the extensive margin through shifting the contractual composition of firms' employment over time.

The possibility of employing a fraction of workers under temporary contracts implies that firms are able to exploit this margin of adjustment to economize on firing and separation costs and, at the same time, smooth fluctuations in their revenues.⁹ By construction, workers under temporary contracts do not benefit from the guarantees associated to permanent contracts, and separation from them is thus not subject to onerous severance payments. Because of this feature, temporary contracts were conceived to ease the employment of seasonal workers, or workers filling temporary positions (substitutions of sick workers or maternity leaves, for instance), or as stepping stones (screening devices) for young, inexperienced workers. However, temporary contracts can also generally be used by firms to control more easily the extensive margin of their labor expenditures. The intuition for this rests on the observation that a firm routinely employing a larger share of temporary workers would be able to react more quickly to an unexpected drop in its cash-flows, for example by not renewing part of its temporary workers, compared to a similar firm facing an analogous shock but relying more on permanent workers.

The consequence of these considerations is that firms with a high share of temporary workers should exhibit a lower pass-through of exogenous shocks to their balance sheets and, at the same time, experience a higher volatility of their employment. This is because they can make extensive margin adjustments more easily and adjust the number of employees without incurring in the large firing costs associated to permanent contracts, which also makes labor hoarding less useful for liquidity management.

The greater flexibility in extensive margin adjustments, however, can be subject to a broad range of set-up costs (e.g. search, training etc.) that might make the smoothing benefits of temporary contracts viable only for specific firms. By the same token, if temporary contracts are utilized as a smoothing device they are more likely *not* to be upgraded to permanent positions within the firm. This increases in turn the churn of workers, likely hampering workers' training, on-the-job human capital accumulation, and increasing within-firm inequality and contrasts between insiders (protected incumbents) and outsiders (young temporary hires). Therefore, from the firms' perspective, the use of this type of contracts is likely subject to a smoothing-churning trade-off. Given their higher relative susceptibility to exogenous shocks by virtue of their greater exposure to labor leverage, firms with a high labor share devoted to permanent workers are natural

⁹For a reference on alternative, non-wage related adjustments in labor costs see also Babecký et al. (2012).

candidates for being on the positive side of this trade-off and enjoying larger benefits from the use of temporary contracts.

In light of these considerations, we check whether the smoothing benefits of employing temporary contracts is higher for firms characterized by a high permanent workers labor share. Specifically, we analyze whether featuring a larger share of temporary contracts, for these firms, is associated with an increase in their profitability and a stabilization of their profits.

We put forward five hypotheses, which we aim to test in the data:

H1. *Firms more exposed to labor leverage (proxied by permanent workers labor share) exhibit more volatile fundamentals.*

H2. *Featuring a greater share of temporary workers in the workforce is associated with a lower variability of firms' real fundamentals (cash-flow, profits).*

H3. *The smoothing benefits from employing temporary workers are stronger the higher firms' exposure to labor leverage.*

H4. *The benefits of increasing the use of temporary contracts on profitability dynamics are concentrated in firms highly exposed to labor leverage.*

H5. *On the contrary, firms with relatively low labor share are likely to benefit less from increasing the employment of temporary workers, and might actually incur in increased costs associated with higher workers' churn.*

In the remainder of the paper we provide empirical evidence in support of these hypotheses.

3 Data

Our analysis relies on administrative data provided by the Italian National Social Security Institute (INPS) through the VisitINPS program. We complement these data with detailed information on the pattern of renewals for national labor contracts (CCNL).¹⁰

In particular, we rely on three main data sources: i) firm-level balance sheet data for incorporated firms in Italy from 1998 to 2018 from *Cerved*¹¹; ii) anonymized data on the universe of employment relationships in Italy from 1998 to 2018 available through the VisitINPS program (the *Uniemens* database); and iii) data on national collective bargain agreements reporting the renewal dates of national labor contracts (CCNL).¹²

¹⁰We thank in this regard Raffaele Saggio and Vincenzo Pezone for separately sharing their own scraped data with us.

¹¹The *Cerved* dataset is based on standardized reports filed annually by firms with the local Chamber of Commerce. It does not include private partnerships and sole proprietorships, which are in general means of incorporation adopted by much smaller firms.

¹²The *Uniemens* database provides administrative information on the CCNL associated with each job. The *Centro Nazionale dell'Economia e del Lavoro* (CNEL) provides a digital archive of all CCNLs signed in Italy, from

With these data, we conduct a panel level analysis of the relationship between labor leverage, flexible contracts usage and firms real activity (Section 4 and a causally identified event study based on the approval of the Decree 368/2001 liberalizing the use of temporary contracts in Italy (Section 5). The data used for the panel regression analysis span the years between 2000 and 2018, whereas the event study only comprehends, by design, firms active before 2002 up to 4 years after the reform approval. Apart from this, we adopt analogous criteria for sample selections across the two empirical analyses.¹³

3.1 Sample selection and summary statistics

We use worker-level data to select the main employment relationship for each worker in each year of our sample and collect the relevant information on the prevalent type of CCNL used. The contract-level data allows to identify job spells at the monthly level. For each worker we observe information on demographics, sector of operation (*Ateco* 2007 classification), earnings, working days, contract type (temporary or permanent), and the working time arrangement (part-time or full-time). Given the nature of the data, we are able to compute firm size and relative contractual composition of firms' workforce from the employer-employee records. In order to have a consistent number of firms in our panel analysis and event study analysis, we select firms with non-missing values for employment, total assets and net income, and for which contract types within firms are correctly specified in INPS data. Given that these criteria are contingent on merging firm level balance sheets to the matched employer-employee dataset, only workers belonging to firms present in *Cerved* are included.

For the causally identified event study, we exploit information on the relevant national labor contract for each spell. We are able to identify the prevalent CCNL for each firm in each year (and thus before the enactment of the 2001 reform), and thanks to the data on CCNLs renewals we are able to recover the year of the first renewal for each CCNL after 2001. This is important as it allows us to correctly time the implementation of the 2001 labor market reform at the firm level.¹⁴

We combine detailed employment and salaries data from *Uniemens* with firm level balance sheet data from *Cerved*. We calculate permanent workers' labor share, our measure of exposure to labor leverage, as the ratio of permanent workers salaries to value added. We calculate profit margins as the ratio between net income over sales. In the analysis, we also consider an aggregate measure of labor costs which comprehends other labor-related administrative costs but which, by its nature, cannot be easily split between or apportioned to permanent and temporary workers.

which information can be obtained on the renewal years. We refer the reader to Daruich, Saggio and Di Addario (2020) for details regarding the collection process for this database.

¹³Appendix B reports in detail the cleaning and sample selection.

¹⁴The reform was effectively incorporated in Italian labor market regulations at the time of the first renewal of each CCNL after the decree 368/2001 was signed into law (September 6, 2001). We discuss more in details the institutional setting in Section 5.

Table 1a reports aggregate descriptive statistics for our main sample of analysis at the firm level. After data cleaning, our final panel sample consists of approximately six-hundred-thousands firms spanning the whole size distribution. Given that our data, conditional on the required matching, cover potentially the universe of the Italian labor market, we can keep track in our study of firms of all sizes, including the very small ones. Average firm size, as measured by headcount employment, is 11.5 and the distribution is positively skewed as common in firm-level data, with the median firm in our sample reporting six employees and the presence in the sample of a right tail of very big firms (with thousands of workers). Importantly for the purpose of this paper, our sample contains firms over a broad range of permanent workers labor share too. The average and median firm in the sample report both a permanent workers labor share of 40%, indicating a symmetric distribution for our primary measure of exposure to labor leverage. An additional benefit of our data is that our sample covers all incorporated firms in Italy while many studies in the finance literature rely mainly on listed firms.

Table 1b reports descriptive statistics for the cross-section of firms in selected years, before and after the implementation of the 2001 reform. On average, Italian firms employed approximately 7% of their workers under temporary contracts before 2001, a measure that has significantly increased in the years after the reform, reaching 14% in 2018. It is worth noticing that the distribution of temporary contracts is also highly positively skewed with firms in the top 10% of the distribution reporting between a quarter and half of temporary contracts in their workforce.

4 Labor share, contracts and the variability of firm-level outcomes

In this section, we conduct an analysis of firm-level pass-through of aggregate shocks into real activity as in Schoefer (2015), Donangelo et al. (2019). Ideally, to quantify the role of rigidities in labor costs for this pass-through we would want to explore the relationship between aggregate fluctuations and firms' labor expenditures assigning different degrees of wage rigidity to otherwise identical firms. In practice, however, correctly measuring wage rigidity and its cyclicity is challenging, especially at the firm level.¹⁵ Therefore, we do not proxy firms' exposures to labor leverage using a cyclical property of firms' labor expenditures, we rely instead on a persistent and slowly-adjusting one: their permanent workers labor share. In fact, as noted also by Donangelo et al. (2019), the labor share is a central element of the labor leverage channel, with high labor share amplifying any labor-induced leverage and operating profits volatility. In order to avoid simultaneity bias and capture a persistent component in labor share, we construct our proxy measure by taking the three-years lagged MA(3) of permanent workers' labor share, measured as payroll over value added.¹⁶

¹⁵For example, as noted by Schoefer (2015), the realized cyclical variation in wage rigidities can be biased by other factors such as product or even firm-specific demand shocks.

¹⁶Taking lagged averages over time helps mitigating both the concerns about simultaneity and the possibility that labor share is predominantly driven by productivity swings. *All* the reported specifications in this paper,

We show three main facts on the relationship between firms' workforce and their financial outcomes. First, we provide evidence of the existence of a labor induced operating leverage. In particular, we show that firms' financial outcomes and real activity (net income, employment, cash flow) are more correlated to cyclical aggregate fluctuations for high labor share firms. Second, we explore the potential benefit of employing temporary contracts as a smoothing device for real activity fluctuations by showing that a higher share of temporary contracts is associated with lower variation of cash-flows and profits in response to aggregate shocks. Finally, we combine the first two facts to show that the smoothing effect of temporary contracts seems to be stronger the higher firms' labor share, i.e. the higher firms' exposure to labor leverage. All specifications discussed in this section are robust to the inclusion of firm-level controls such as leverage, financial constraint index (Whited and Wu, 2006) and labor productivity. In all specifications we cluster the standard errors at the two-digits sector by province level and we weight the regression by lagged total assets to make sure that possible latent heterogeneity in the firm size distribution is not confounding our measure. For all specifications, results are qualitatively unchanged when weighting by lagged sales, employment or if regressions are unweighted.

4.1 The role of labor share for labor leverage amplification

In this section we test the following hypothesis:

H1. *Firms more exposed to labor leverage (proxied by permanent workers labor share) exhibit more volatile fundamentals.*

To quantify the role of labor leverage amplification for the transmission of aggregate shocks to firms' outcomes we use the following specification and for a firm f we measure:

$$\Delta y_{f,t} = \alpha_f + \sum_{\tau=1}^3 \beta_{\tau} D_{f,\tau} \times Y_t + \phi_t + \epsilon_{f,t}, \quad (1)$$

where α_f is a firm-fixed effect; $D_{f,\tau}$ is a dummy variable that equals one if firm f belongs to the τ labor share tercile, computed using the three-years lagged MA(3) average of the labor share of permanent workers; Y_t is the cyclical component of real GDP (Hamilton filtered, with two leads and one lag) and ϕ_t is a year fixed-effect.¹⁷ As dependent variable, $\Delta y_{f,t}$, we consider the first-difference of various firm-level outcomes.

The main parameters of interest are the set of coefficients linked to the interaction term between the labor share terciles dummies and the cyclical component of GDP, $\{\beta_{\tau}\}_{\tau=1}^3$. These interactions capture how changes to aggregate fluctuations in the economy are reflected in firms' fundamentals conditional on firms' labor leverage exposure.

however, are robust to controlling directly for the (time-varying) effect of firms' labor productivity. Results available on request.

¹⁷All results are robust to adding additional controls, such as firm size and age bins, among the fixed effects.

4.1.1 Results

Equation (1) estimates the correlation between the business cycle and yearly variation of three firm-level outcomes: i) Cash-flows, ii) Employment and iii) Profits (net income). We report the interaction terms between the labor share dummies and the cyclical component of GDP in Figure 2.¹⁸

Cash-flows. If labor is a quasi-fixed input in production and there are frictions to labor cost adjustment, one should expect labor costs to be a persistent drain on firms' cash-flows. This would in turn imply that operating leverage through labor costs should make the response of firms cash-flows (and net income) to real shocks relatively more volatile. We thus expect cash-flow sensitivities to real shock to be higher the greater our measure of labor leverage, permanent workers' labor share.

Figure 2a plots the interaction terms between the labor share terciles and the cyclical component of GDP from Equation (1) using the first-difference of firms' cash-flow as dependent variable. As shown in the figure, the coefficients are positive and increasing in labor share terciles, indicating that firms characterized by an higher labor share are associated with higher variability in their cash-flows, an effect that is similar in nature to the more classic financial leverage but rooted in firms' labor expenditures.

Employment. If labor leverage constrains firms' ability to freely dispose of operating and net income of the firm, one would also expect hiring (and firing) cyclicalities to be impacted and amplified by it. In this sense firms more exposed to rigidities in incumbents labor costs would be less able to optimize investment in workers as investment opportunities arise, and would thus forced to adopt a more procyclical hiring policy.¹⁹

We use the first-difference of total employment as the dependent variable in Equation (1) and report the labor share specific sensitivity to aggregate shocks for employment in Figure 2b. Similarly to the cash-flow case, the interaction coefficients are positive and increasing, indicating that an higher labor share induces a larger pass-through of aggregate shocks also on firms sizes.

Profits. Following an analogous logic to the previous section, Figure 2c plots the effect of high labor share for the pass-through of aggregate shocks on firm profits. The amplification effects of labor leverage is broadly confirmed also in this case. The point estimates across

¹⁸To account for negative values in cash-flows and profits we take the inverse hyperbolic sine of both variables before computing the first-difference. Employment variation is the yearly log-difference. The inverse hyperbolic sine is concave transformation similar to the logarithm (in the sense that it limits the influence of scale and outliers in empirical specifications) and has the additional benefit of being defined for null and negative values.

¹⁹One might object that firms should be able to smooth exogenous shock through credit. First, this is unlikely to be true with respect to aggregate risk determined by cyclical fluctuations. Secondly, it has been shown that firms more exposed to labor leverage tend to rely predominantly on short-term credit, plausibly due to the *unpledgeability* of labor human capital as collateral Acabbi, Panetti and Sforza (2020). This necessarily implies that (short-term) credit supply is more salient for these firms, another factor which increases their overall riskiness.

terciles are not in this case monotonically decreasing, but the second and third tercile estimates are evidently higher (and statistically significantly different) from the lowest quartile estimate.

4.2 The role of temporary contracts

In this section, we turn to the analysis of the potentially strategic use of workforce contracts' composition as a liquidity management device for firms and thus we test the following hypothesis:

H2. *Featuring a greater share of temporary workers in the workforce is associated with a lower variability of firms' real fundamentals (cash-flow, profits).*

To investigate if the contractual composition of firms' workforce has a bearing on the variability of firm outcomes, we use the following specification:

$$\Delta y_{f,t} = \alpha_j + \beta Y_t + \gamma FX_{f,t-2} + \delta Y_t \times FX_{f,t-2} + \epsilon_{f,t}, \quad (2)$$

where α_f is a firm fixed-effect, allowing us to exploit within-firm variations as the main source of identification for the correlation of interest; $FX_{f,t-2}$ is the two-years lagged MA(3) share of fixed-term workers, as we want to avoid simultaneity bias and capture average reliance on flexible workers in previous years; and Y_t is the cyclical component of real GDP. The dependent variables are constructed analogously as in Equation (1). Clustering is done at the 2 digits sector by province level and regressions are weighted by lagged total assets to ensure that the distribution of firm sizes does not affect our results.

4.2.1 Results

Table 2 reports the estimated parameters from Equation (2). The main coefficient of interest, the interaction term between the cycle component of GDP and the lagged share of temporary contracts, δ , is significantly negative for the specifications with variation in profits and cash-flows as dependent variable. Instead, it is significant and positive for employment, as predicted by our hypothesis.

The negative coefficient for financial outcomes indicate that the pass-through of aggregate shocks to firms' profits and cash flows is attenuated for firms with a larger share of temporary contracts. Thus, firms experience lower procyclicality of profits and cash-flows when they feature a more flexible workforce, as opposed to when their own workforce composition veers towards having more permanent workers.²⁰

The positive and significant coefficient on the volatility of employment, instead, confirms that firms respond more to aggregate shocks by adjusting their workforce at the extensive

²⁰The reader should also keep in mind that, by virtue of the inclusion of firms fixed effects in the specifications, the results is *entirely* driven by within-firm variation.

margin when their share of temporary contracts is greater, as it is cheaper to separate from temporary workers (or even hire them).

Taken together, these correlations indicate that managing the composition of labor contracts plausibly helps firms smooth the effects and attenuate the transmission of aggregate shocks for liquidity management and income variability.

4.3 Labor leverage and contract composition

Given the results discussed in the previous section, one would expect that the potential beneficial effects of adopting a more flexible workforce for a firm would be particularly pronounced for firms relatively more exposed to labor leverage, and symmetrically less relevant for relatively unconstrained firms.

In this section, therefore, we aim to test precisely this hypothesis:

H3. *The smoothing benefits from employing temporary workers are stronger the higher firms' exposure to labor leverage.*

We measure these interaction effects using the following specification at the firm level:

$$\Delta y_{f,t} = \alpha_f + \sum_{\tau=1}^3 [\beta_{\tau} D_{f,\tau} \times Y_t + \gamma_{\tau} D_{f,\tau} \times FX_{f,t-2} + \delta_{\tau} D_{f,\tau} \times FX_{f,t-2} \times Y_t] + \phi_{\tau} + \epsilon_{f,t}, \quad (3)$$

where α_f is a firm fixed-effect; $FX_{j,t-2}$ is the two-years lagged MA(3) share of fixed-term workers; $D_{j,\tau}$ is a dummy variable that equals one if firm j belongs to the τ labor share terciles, measured as in Equation (1); Y_t is the cyclical component of real GDP. We again cluster standard errors at the 2 digits sector by province level and we weight the regression by lagged total assets.

4.3.1 Results

Figure 3 reports the main coefficients of interests from Equation (3). In particular, we are interested in two components of the regression. First, we look at the interaction terms between the labor share tercile dummies and the cyclical component of GDP, $\{\beta_{\tau}\}_{\tau=1}^3$. These terms capture the sensitivity of firm outcomes to cyclical variations in aggregate output, and we want to confirm that the positive correlation between labor leverage and real outcomes cyclicalities is maintained also in these specifications. In fact, the specification indirectly allows us to check that the relationship previously identified in Section 4.1 is not simply a matter of variation in ex-ante temporary contracts employment. Second, and more importantly, we focus on the triple interactions between the labor share dummies, the share of temporary contracts and cyclical GDP, $\{\delta_{\tau}\}_{\tau=1}^3$. These coefficients measure how strongly the smoothing effect of using temporary contracts is, conditional on firm exposures to labor leverage. Even in this case, we expect the the absolute values of measured sensitivities to be positively correlated with exposure to labor leverage, as more

leveraged firms are hypothesized to be the ones that stand to benefit the most from increasing flexibility in their employment mix. We again analyze the role of temporary contracts for three main outcomes variation: cash-flows, profits and employment.

Cash-flows. Does employing a greater fraction of flexible workers help “defusing” the effect of labor leverage in amplifying the impact of future shocks on cash-flow and profit variation? Our results unambiguously suggest that it does. The left panel of Figure 3a reports the sensitivity of cash-flows to aggregate fluctuations conditional on the labor share. The coefficients are increasing, confirming the presence of labor induced operating leverage regardless of past composition of the workforce. The right panel of Figure 3a reports the coefficients for the triple interactions. Notably, they are negative and monotonically decreasing in the terciles of the labor share, indicating that the smoothing effects on cash-flow variability of employing a greater share of temporary workers are stronger for firms that are highly exposed to labor leverage.

Employment. Figure 3b plots the main coefficient of interest for firm employment. The left panel of the figure shows how a higher labor share is associated with a higher volatility of employment. In this case, the coefficients on the triple interaction, reported in the right panel, are monotonically increasing, indicating that featuring a higher share of temporary contracts is associated to higher employment volatility for firms. We see that the effect is also monotonic, indicating that the use of temporary contracts increases employment variability more for companies that are highly exposed to labor induced operating leverage (i.e. are characterized by a high permanent worker labor share).

Profits. Figure 3c plots the main coefficient of interest for firm profits. Also in this case, a higher labor share is associated with a greater variability of firm profits, as shown by the coefficients in the left panel. Similarly to the results for cash-flows, the effect of an higher share of temporary contracts is stronger the higher the labor share on permanent workers.

Taken together with the effect on cash-flows and profits, this result shows how firms that are characterized by a high labor share and are thus more affected by volatility determined by aggregate risk are more willing to tolerate a greater employment variation. At the same time, these firms are also the ones that can benefit the most from the stabilizing effect of employing more flexible workers, which allows them to economize on labor hoarding.²¹

4.4 Robustness

We test, and find evidence, for the robustness of our results to the controlling for firms’ exit and attrition from the dataset. In our main analysis we run the regressions on a possibly

²¹The lack of information in INPS data on workers’ skills for the period of analysis prevents us from analyzing whether, as one would expect, hoarding incentives and the use of temporary contracts meaningfully interact with workers’ required skills within the firm. Acabbi, Panetti and Sforza (2020) show that high skill workers, given their lower substitutability for the firm, are likely to be stronger drivers of labor leverage effects.

unbalanced panel, and do not control for firms exit or failure. One might be concerned that the shifting composition of firms in the panel matters for the results, or only partially characterize them if the effects of negative shocks leading to firm exit are never correctly measured. For these reasons, we run all our specifications on a sample of firms which do not fail during our time of analysis.²² Running our specification on the sample of survivor firms introduces a survival selection bias in our results, but is still informative regarding the robustness of our results. Figure A.1, Table A.1 and Figure A.2 report results ran on the sample of surviving firms. Results are both quantitatively and qualitatively robust in this subsample.

5 Event-study design

The analysis of Section 4 indicates that the contractual composition of firms' workforce can be used to dampen the transmission of aggregate fluctuations to firms' financial outcomes and real activity.

In this section, we provide causal evidence regarding the fact that, as the possibility is given to employ flexible contracts arrangements more freely, firms tend to strategically alter their workforce contractual composition to reduce labor leverage.

Therefore, we thus now focus on our fourth and fifth hypotheses:

H4. *The benefits of increasing the use of temporary contracts are concentrated to firms highly exposed to labor leverage.*

H5. *On the contrary, firms with relatively low labor share are likely to benefit less from increasing the employment of temporary workers, and might actually incur in increased costs associated with higher workers' churn.*

We follow Daruich, Saggio and Di Addario (2020) and exploit the quasi-experimental variation introduced in the Italian labor market from a reform implemented in 2001 that liberalized the use of temporary employment relationships by reducing the requirements necessary to *start* a temporary contract. The reform, in fact, can be seen as a reduction in the implicit cost of temporary contracts. This introduces an additional margin of adjustment that firms can effectively use to smooth the pass-through of aggregate shocks and that was previously unavailable. As stated in **H4** and **H5**, the consequence of this incentive structure is that firms more exposed to labor leverage should have benefited more from the reform, and if our hypotheses are correct, by revealed preferences, we should see a stronger adoption of temporary arrangements on their side.

²²The virtually complete coverage of all active firms in the economy on the part of INPS allows for a precise identification of exiting firms.

5.1 Institutional background and identifying variation

The Italian labor market is characterized by stark differences in the employment protection legislation between permanent and temporary contracts. Prior to the fundamental changes implemented by decree 368, signed into law on September 6, 2001, Italian firms were allowed to use temporary contracts only for very specific reasons and firms were required to formally notify the motivating circumstances for the use of temporary contracts to the social security institute.²³ The reform lifted many restrictions on the *creation* of temporary contracts without modifying the protection on permanent contracts and de facto liberalizing the use of fixed-term employment relationships. In addition, the reform did not in any way affect current employment protection provision for existing (and permanent) contracts, thus creating a strong asymmetry in the protection of workers under different contractual regimes, and further increasing *dualism* in the labor market.²⁴

Importantly, the reform established that the new norms on temporary contracts were to become effective in a given sector in a staggered way, following the renewal of the associated national labor contract (CCNL).²⁵ Given that CCNLs in Italy are negotiated separately by different unions, they have different expiration dates defined in advance upon signing of each renewal. The decree 368/2001 did not interfere with the renewal patterns of CCNLs and therefore the new norms on temporary contracts have been introduced at different times across CCNLs, depending on their pre-determined renewal schedule. We use Daruich, Saggio and Di Addario (2020) data on the patterns of renewals for 181 CCNLs to identify the year in which each CCNL adopted the 368/2001 decree and effectively liberalized the use of temporary contracts.

The staggered and plausibly exogenous timing of implementation of the reform offers a quasi-experimental source of variation in the regulation of temporary contracts across CCNLs. We use it to justify the identification of a causal effect of the liberalization of temporary contracts on Italian firms' real activity. As such, the reader should keep in mind

²³See Daruich, Saggio and Di Addario (2020) and Cappellari, Dell'Aringa and Leonardi (2012) for a comprehensive description and analysis of different reforms to the Italian labor market up to 2001.

²⁴Interestingly enough, dualism and young workers employment instability (*precariato*) associated with the alleged abuse of temporary contracts were among the reasons mentioned for the labor reform enacted by the Renzi government between 2014 and 2015, which aimed to introduce a unique contract with employment protection increasing in tenure disciplining the Italian labor market. The reform was accompanied by the temporary introduction of subsidies for the hiring of permanent workers. Part of the provisions of the reform, especially regarding public employees, were neutralized by a judgment of the *Corte di Cassazione* in 2016. Still in 2016, a popular referendum was passed to abolish labor *vouchers*, a contractual form utilized to pay salaries and regularize extremely flexible temporary or seasonal employment. In 2018 a further labor reform, commonly known as *Decreto dignità*, was enacted by the newly appointed Conte government. The reform was aimed at severely increasing the cost of utilizing temporary employment contracts. To this date and despite all these reforms, barring a temporary decrease during the period in which permanent contracts were directly subsidized by the state, temporary contracts have steadily increased as a share in total contracts in the economy. No reform has substantially modified the dualism between incumbent and new workers developed over time in the Italian labor market.

²⁵In Italy almost all employment relationships follow a common set of regulations stated in a national labor contract (CCNL). Even if CCNLs are not specific to a single sector, there is a large overlap between sectors and the prevailing CCNL in each of them. In terms of representativeness, CCNLs negotiated by unions are valid *erga omnes*, that is even for all workers that are *not* union members. At the time it was impossible to opt out of any CCNLs under any condition.

that the causal identification is determined by the comparison of as-good-as-randomly early treated to units with later-treated ones.

5.2 Empirical strategy

In our *baseline* specification we quantify the effect of the reform on relevant firm-level outcomes, such as employment levels, profit margins, total labor costs, total assets, the labor share itself, financial leverage and average wages (for all workers and by contract subgroup) and the standard deviation of wages for incumbents at the time the reform is implemented. We complement this analysis reporting novel heterogeneous effects of the reform for firms at different points of the permanent workers labor share distribution (*Heterogeneity by labor share*). With a similar logic to the one in Section 4.1, we consider the average labor share in the years before the enactment of the reform (from 5 to 1 year in the pre-period), in order to leverage differences in the long-run persistent component of permanent workers compensation.

Baseline analysis (average effects). The baseline specification of our event-study is based on the following regression at the firm level:

$$y_{f,t} = \psi_f + \lambda_{p(f),t} + \sum_{k=-4}^4 \mathbb{I}\{t = t_{c(f,2001)}^* + k\} \theta_k + \varepsilon_{f,t}, \quad (4)$$

where $t_{c(f,2001)}^*$ denotes the reform implementation year for a firm that had c as the most common national labor contract in 2001; $\mathbb{I}\{\cdot\}$ is an indicator function that identifies a year dummy for each year of a $(-4,+4)$ window around the reform implementation year for contract c . We also include ψ_f to account for firm fixed-effects and $\lambda_{p(f),t}$ for province by time fixed-effects (where $p(f)$ indicates the province where firm f is located).

Heterogeneity analysis by permanent workers' labor share. To quantify possible heterogeneous effects linked to firms' labor share, we include an interaction term between the dynamic estimation coefficients and the terciles of the labor share on permanent workers. The specification we use is the following:

$$y_{f,t} = \psi_f + \lambda_{p(f),t} + \phi_{\tau,t} + \sum_{\tau=1}^3 \sum_{k=-4}^4 \mathbb{I}\{t = t_{c(f,2001)}^* + k\} \times D_{f,\tau} \theta_{\tau,k} + \varepsilon_{f,t}, \quad (5)$$

where all variables follow the same definition of Equation (4) and $D_{f,\tau}$ is a dummy variable that takes value one if firm f belongs to the τ tercile of the labor share distribution; ϕ_{τ} are labor share terciles fixed effects.

Given the staggered implementation over time of the reform, we normalize two θ_k coefficients to correctly identify the dynamic effects of the reform. In all specifications we

normalize θ_{-4} and θ_{-1} to zero and we cluster the standard errors at the CCNL by province level.²⁶ The specifications of the event study are unweighted.²⁷

5.2.1 Results: baseline specification

The liberalization of temporary contracts determined a significant relative increase in the share of workers employed under these kinds of contracts. Our estimates indicate that the liberalization promoted by the 2001 reform induced a relative increase in the share of temporary contracts of approximately 7 percentage points for early adopters with respect to late ones, as shown in Figure 4a. In context, the average pre-period share of temporary workers in our sample was 8%, with approximately null average variation to the post-period and a 16% standard deviation.²⁸

This increase in the use of temporary workers has not been accompanied by an expansion in employment levels which are, if anything, mildly decreasing in the long run (almost 4% after 3 years).²⁹ On the other hand, when one considers the effect on firm size (measured by total assets), it is clear that the reform did not stimulate investment and overall firm growth. Results regarding firm size specifications are shown in Figure 4b. In both cases, we see that the liberalization of temporary contracts has surely *not* been matched by an increase in firm sizes.³⁰

The reform also had sizable consequences on the firms' overall labor costs. As highlighted by Figure 5a, after the reform, firms were able to significantly reduce their labor costs, up to around 10%. As shown in the figure, these adjustments have happened mostly through a stark reduction of workers' compensations, as highlighted by the significant decline in the average wage paid out by firms (around 5% after 3 years). To put the effect into perspective, the average (unweighted) variation in labor costs for all firms between their own pre- and post- period was .25, whereas the standard deviation was .62, thus indicating that the magnitudes of the adjustment implied by the reform was sizable. The

²⁶The CCNLs do not exactly overlap with ATECO sectors definitions, but nonetheless CCNLs broadly identify industrial sectors. The clustering choice is thus analogous to the one in the previous section, even if one should keep in mind that, while the unit of treatment is the CCNL, 2-digits sectors utilized in Section 4 tend to be fewer, and thus form a broader categorization.

²⁷The specifications tend to be slightly noisier but qualitatively unchanged when different weighting schemes are applied. Results available upon request.

²⁸Given the similarity of the empirical exercise, the magnitudes are broadly in-line with other recent estimates of the effects of this reform (Daruich, Saggio and Di Addario, 2020). It should be noted however that, by virtue of our access to the full *Uniemens* database, we are able to extend the analysis of Daruich, Saggio and Di Addario, 2020 to a wider cohort of firms and sectors, whereas their paper is limited to a representative sample of relatively larger manufacturing firms (and attached workers).

²⁹This surprising result is similar to the one in Daruich, Saggio and Di Addario (2020), who do not however find any significant decrease in firm sizes in their manufacturing firms sample.

³⁰ Another indication of the fact that the reform did not promote investment and funding capabilities of firm is given by the finding that we do not detect any significant effect on firm leverage (Figure A.3a in the Appendix). It is however possible that, in the long run, transitioning to a more flexible workforce composition allows firms to decrease their reliance on short-term fungible credit, as found in Acabbi, Panetti and Sforza (2020). This could in turn increase their financial capability and their demand for longer term and more stable credit, which would allow for more capital-intensive investment. Given that we do not have credit data available for this project and the event study under consideration is not appropriate for the analysis of long term effects, we leave this interesting question to future research.

reform substantially moderated labor cost increases over the period. The corresponding average variation for average wages was 0.18, with a 0.33 standard deviation.³¹

The reform led to a profound change in the firms hiring and separation strategies, which determined a further (relative) stabilization of the incumbent permanent workers positions and incentivized firms to let go temporary workers more often Daruich, Saggio and Di Addario, 2020, replace them with other temporary workers and thus relatively increase their churn rates. Figure 6 reports the effects of the reform on separations rates, with a decomposition for temporary and permanent workers. The reform led the separation rate in the post-period to decrease eventually by 6 percentage points for early treated firms (against a pre-period average of 26%). We decompose the effect by looking at how much of that is due to permanent and temporary workers. The downward trend is *entirely* driven by the decrease in permanent workers share of separation rates over employment, and a contemporaneous increase in the share of temporary contracts that were not converted to permanent. It is thus clear that temporary workers, while still a relatively minor share in total employment, are responsible for a strongly increasing share of separations. During the same period, as seen in Figure A.4 in the Appendix, the hiring rate of temporary workers increased on average for treated firms.

The stark reduction in labor costs has been matched by a significant increase in profit margins, measured as net income over sales, of up to 0.6 percentage points, as shown in Figure 5b. Also in this case, the effect is both statistically and economically significant against an average *decrease* from the pre- to post- period of 1.6 percentage points and a standard deviation of 0.1. In the next section, we show that, especially on this particular margin, the average actually hides substantially heterogeneous dynamics across different firms.

5.2.2 Results: the role of labor leverage

Figure 7 reports the heterogeneous effects from the event-study in Equation (5) for the top and bottom labor terciles of permanent workers' labor share for three main outcomes: firm profit margins, the share of temporary contracts and the average wage paid by the firm. Following our hypotheses, firms in the top labor share tercile are the *most* exposed to labor-induced operating leverage, while those in the bottom tercile are the *least* exposed to this leverage effect. From the figure one can immediately notice that, even if the employment strategies of different firms in response to the reforms are qualitatively (and quantitatively) similar, a drastically different effect emerges as regards profitability dynamics.

Figure 7a and Figure 7b report that, at the onset of the reform's implementation, firms at opposite sides of the labor share distribution (bottom and top terciles) behaved similarly. In both sets of firms, average increases in the employment of temporary workers are detected, with an almost 8 percentage points increase in the point estimate of temporary workers' share after three years for firms least exposed to labor leverage, and approximately a 6

³¹These dynamics allowed firms to reduce their own labor share (Figure A.3b) by 2 percentage points on average, against an average 6% *increase* between firms pre- and post- periods.

percentage points increase for the most exposed (high labor share). As a consequence of the employment policy changes, firms were able to compress their labor costs and average wages. Notably, firms in the top terciles of labor share are the ones that end up compressing the most wages and thus arguably achieving the greatest direct labor costs savings (-12.5%). Despite qualitatively similar changes in their employment policies, the dynamics for profitability of the two sets of firms are drastically different. Figure 7c reports the estimated effect of the reform on profit margins for firms in the top and bottom tercile of the labor share distribution. As shown in the figure, it is evident that the positive average result presented above is predominantly driven by firms in the top tercile, the ones with the greatest exposure to labor leverage, which benefit from an almost 1 percentage point increase in profit margins. The corresponding effects for the bottom labor share tercile are not significantly different from zero in any post-period year, and if anything the trend is mildly decreasing.

As a consequence of the reform and consistently with the average results, both kinds of firms experienced an overall relative decrease in total separation rates, driven by the lower likelihood for incumbents to separate from the firm (Figure 8). A decomposition exercise of this result analogous to the one in Section 5.2.1 reveals that, upon adoption of the reform norms, firms most exposed to labor leverage decreased *less* separation rates for permanent workers and increased *more* the ones for temporary workers. Appendix Figure A.5 shows that both kinds of firms experienced a relative very similar increase in hiring rates of temporary workers.

The previous results indicate that, given a similar relative response in the adoption of temporary contracts, comparable relative declines in labor compensations and similar labor adjustment policies, firms with high labor share have benefited more from the liberalization of temporary employment. Thus, the result suggests that the marginal benefits from increasing contractual flexibility of the workforce might be decreasing the lower ex ante labor leverage, whereas the efficiency costs might be correspondingly increasing. This is consistent with what discussed in Section 4. Given that firms with high labor share are more sensitive to aggregate shocks and temporary contracts can effectively be used as a smoother, the liberalization of this type of contracts has been particularly beneficial for firms that were more exposed to operating leverage. Low labor leverage firms, on the other hand, tend to feature a lower share of inflexible labor costs to start with, and do not benefit much from reducing their exposure to this inflexible factor in production.

The results in the section are consistent with a model in which there is an optimal degree of workforce flexibility. In such model, marginal benefits would derive from lower separation costs. Marginal costs, on the other hand, would be plausibly associated with start-up costs (e.g. the difficulty to continuously integrate new workers in the team-work), fairness and workforce morale concerns, and possibly an under-appreciation of the value of training workers with general and firm-specific human capital. Given the likely short-term nature of the savings and the plausible longer-term nature of the costs, our empirical estimates

suggest that firms themselves might fail to correctly assess costs and benefits and might have been tempted by the immediate short-term savings of embracing dual employment.

5.2.3 Robustness

In this section, we run additional exercises to assess the robustness of our results to different empirical and interpretation concerns.

Possible attrition. First, we address the concern that in the event study the identification of the coefficients of interest is based on a shifting distribution of firms in presence of firms' exit. We thus run our empirical event study specifications in Equation (4) and Equation (5) on the set of surviving firms up to the end of their own relevant period of analysis. On the one hand, this exposes us to a second kind of bias, that is survival selection bias. However, the set of firms included in the empirical specifications is now consistent across years given the structure of the staggered diff-in-diff specification.

Results from running the specifications on the sample of surviving firms are qualitatively similar to the ones for the full sample, even if some results show slightly different dynamics. For example, we see that in the survivors' sample size adjustment and wage or labor costs adjustments tend to be slightly stronger on average. In the heterogeneity results by labor share we uncover an even more striking pattern. Average results on profit margins are now generally weaker (Figure A.7b). As shown in Figure A.10, this is due to the fact that among surviving firms profit margins for high labor share firms increase by the same magnitude as in our main sample, while for firms in the bottom tercile of the labor share we estimate a *negative* impact of the reform.³² The effects on the share of temporary workers and firm sizes (Figure A.6), average wages (Figure A.7a) and flows (Figures A.8, A.9, A.11 and A.12) are however qualitatively similar to what we find in our main sample.³³

Alternative factors. Second, the reader might be concerned that what we label as labor leverage exposure might actually be a spurious result determined by other factors. For instance, one might think that the effect is not driven by financial exposure to workers per se, but is just a by-product of the firm being older, relatively less dynamic and employing older, highly paid and less productive workers. If this was the case the entirety of the effect would be just captured by the age structure of the workforce. Our hypothesis, instead, is that labor leverage might emerge *regardless* of this concerns, for firms at all productivity levels. Some firms, in fact, might need to invest in their workforce (high skilled workers to be trained, for instance). As workers' human capital is not pledgeable, labor leverage might emerge as a by-product of this (Acabbi, Panetti and Sforza, 2020). A related possibility is

³²We do not find significant effects on exit in our analysis, but the results seem to suggest that the baseline sample, if we believe to the results on the survivors' sample, misses firms that, had they not exited, would have been even *more* negatively impacted. Regardless of this hypothesis, one can still notice that, albeit not significant, full results in Figure 7c seem to suggest the presence of the same trend for low labor share firms.

³³Interestingly, while qualitatively similar, the results on the full sample seem to detect slightly stronger effects for firm sizes (Figure A.6b).

that, by virtue of product specialization, firms might structurally need to maintain a high share of value added compensating labor. Investment-like dynamics and labor adjustment cost concerns (Oi, 1962) might drive labor hoarding policies (Giroud and Mueller, 2015) that firms find useful to employ better adapt to the business cycle, or idiosyncratic or sectoral shocks. For this reason we rerun all specifications while removing the mechanical effect due to workforce aging, and show that all our labor leverage results from Section 5.2.2 are absolutely robust.³⁴

One might also be concerned that labor share is masking characteristics of firms that actually proxy for financial constraints, and in this sense our results are only spuriously reporting effects that are standard in the finance literature (Caggese and Cuñat, 2008). For this reason we re-run all our specifications while controlling for financial leverage directly and for a measure analogous to the Whited-WU index (Whited and Wu, 2006).³⁵ All our results are robust to the addition of these controls, thus indicating that the labor leverage mechanisms captures a relatively novel and distinct source of financial frictions affecting firm dynamics.³⁶

Figures A.13, A.14 and A.15 report results of the estimations where we saturate our empirical model with non-parametric controls for median age, median tenure (in the pre-period), the Whited-Wu index and financial leverage (average of the pre-period), in the form of interaction of tercile of the distributions of the variables with year dummies.

5.3 Variability of firms' profits

One would expect that one of the main benefit of employing a more flexible workforce, by allowing firms to better manage their liquidity, would be to decrease the volatility of firms' financial outcomes and improve their overall stability. In this section, we follow this intuition and check if the reform caused any change in the variability of firm-level profits. If the use of temporary contracts truly alleviates the amplification effect of shocks due to operating leverage, the overall process of firms profits should become less volatile post reform.

Directly observing the data generating process for firms' cash-flows and net income is impossible: after all, we only observe one realization at a time of these outcomes, and we would be interested on the other hand in its standard deviation at each moment, not over time. We thus adopt a slightly different approach. Given the structure of our analysis, we assume that firms with same prevailing CCNLs, belonging to the same local labor market (an Italian province) and with similar salient characteristics (in this case, the permanent workers labor share) are likely to have very similar data generating processes underlying

³⁴The lack of education and occupation level data for the period of analysis prevents us from verifying hypotheses related to labor investment and their possible relationship with leverage-like dynamics. See Acabbi, Panetti and Sforza (2020) and Baghai et al. (2020).

³⁵We cannot exactly compute the Whited-Wu index in our data, because we lack information on dividend payouts. We thus compute the index without that component.

³⁶Importantly, we are not claiming that results previously found in the literature are not present or valid. As a matter of fact, in unreported results we confirm that the predictions of the theory in Caggese and Cuñat (2008) are true in our data.

their fundamentals. We thus collapse our dataset at the year by CCNL by province by labor share bins level, and compute the standard deviation of firm-level (hyperbolic arcsine of) net income, weighting observations by total assets in the year before reform enactment for each CCNL by province. Therefore, in the following specifications the depended variable, $sd_{q,t}$, is the standard deviation of firm-level profits at time t *within* cell q (CCNL by province by average labor share tercile in the pre-period).

Baseline. Our baseline specification follows Equation (4) and therefore, for a cell q , we estimate the following:

$$sd_{q,t} = \lambda_{p,t} + \sum_{k=-4}^4 \mathbb{I}\{t = t_{c(q,2001)}^* + k\} \theta_{\tau,k} + \varepsilon_{q,t}, \quad (6)$$

where $\lambda_{p,t}$ are province by year fixed effects and the indicator $\mathbb{I}\{\cdot\}$ identifies the (-4,+4) window around the reform enactment year in the cell.

Heterogeneity by labor share. To estimate the heterogeneous effects by labor share we follow Equation (5). Thus, for a cell q we measure:

$$sd_{q,t} = \lambda_{p,t} + \phi_{\tau,t} + \sum_{\tau=1}^3 \sum_{k=-4}^4 \mathbb{I}\{t = t_{c(q,2001)}^* + k\} \times D_{\tau} \theta_{\tau,k} + \varepsilon_{q,t}, \quad (7)$$

in which the additional regressors compared to Equation (6) are $\phi_{\tau,t}$ and D_{τ} . They are respectively, a labor share terciles by year fixed effect and a dummy variable that takes value one when cell q belongs to the τ tercile of the labor share distribution.

Regressions ran at the cell level are also weighted by the sum total assets each cell represents in the year before reform enactment. We again cluster the standard errors at province by CCNL level.

5.3.1 Results

We report the main results from Equation (6) and Equation (7) in Figure 9.

In particular, Figure 9a reports the average effect of the 2001 reform on the within-cell variability of firms profits. The graph indicates a significant reduction in the standard deviation of firm profits in the four years post reform, up to a maximum of -0.2 (against a starting pre-period weighted level of 3.5). The average result thus seems to be sizable in economic as well as statistical terms.

Looking at the heterogeneity by labor share, shown in Figure 9b, one uncovers a now familiar pattern: the stabilization effect of the reform, at this time on profits variability, is stronger for firms characterized by a greater labor leverage exposure, while it is not significant for firms that operate in the bottom tercile of the labor share distribution. The

effects are statistically distinguishable from each other from the year after the reform implementation onwards.

Combining this result with the one on firm profit margins (Figure 7c) we can see that the liberalization of temporary contracts has led to an increase in firms' profit margins *and* a reduction in the volatility of their profits. These effects, however, have been concentrated on firms characterized by a high labor share which were more exposed to the labor leverage. Firms least exposed to labor-leverage to start with do not get any benefit from increasing workforce flexibility on profitability (if anything, they might actually have it worsened). They also do not get any meaningful stabilization effect regarding profit volatility.

6 Concluding remarks

In this paper, we present new evidence on the role of temporary and permanent contracts for firms' management of labor-induced operating leverage. Given the smooth nature of labor payments, in fact, labor costs can give rise to a form of leverage that amplifies the transmission of aggregate shocks to firms financial outcomes. Using a panel-regression setting, we provide evidence of labor leverage at work for incorporated Italian firms. In addition, we show that temporary contracts are associated with a lower variability of firm cash-flows and profits, acting as a smoother for the pass-through of aggregate shocks. Importantly, we provide evidence that the smoothing effects of temporary employment is stronger the larger firms' exposure to labor leverage.

We complement this analysis by studying the 2001 Italian labor market reform and focusing on a novel dimension of heterogeneity: firms' labor share, a proxy for their labor leverage. Using an event-study design, we show that firms highly exposed to labor leverage benefited more from easier creation of temporary contracts. Notably, however, these beneficial effects on firms profits were not matched by larger responses on the use of temporary contracts nor on the reduction in labor costs. In fact, firms along the entire labor share distribution responded to the reform in similar ways on these margins, reducing labor costs and increasing the share of temporary workers. We interpret the stronger effects on profits of high labor share firms as evidence that the use of temporary contracts hides a fundamental trade-off: the possibility of defusing firms' labor leverage, stabilizing financial outcomes at the cost of incurring in higher expenditures of managing the workforce.

Our results, together with the worker level results in Daruich, Saggio and Di Addario 2020, strongly suggest that, in the face of more flexible workforce, increasing temporary workers' employment in an unbalanced two-tier system, in which some workers are more protected and some are not, can lead to productivity decreases. In such a setting, only very constrained and ex-ante illiquid firms actually benefit from higher flexibility of employment. Even if we lack specific data on the matter, our results are consistent with the presence and relevance of significant ex-ante unanticipated start-up costs for new workers, fairness concerns across the workforce and eventually what becomes a persistent contrast

between privileged insiders and unprotected outsiders to the system, an idea which dates back to (Lindbeck and Snower, 1989). The interesting results from our analysis is that, beyond probable long run scarring effects for workers determined by employment instability, harder career progression and low on-the-job training (Acabbi, Alati and Mazzone, 2021), firms themselves seem to fail to anticipate the inefficiencies inherent in the dual employment system. A deeper analysis of these trade-offs, of the long-term effects for workers of the dual system and of the financial implications for firms of these long-term effects are extremely interesting and constitutes a fundamentally important and exciting research challenge that we leave for the future.

Tables

Table 1. Descriptive statistics

(a) Aggregate sample

	Mean	SD	p25	p50	p75	p90	# firms	N
Employees	11.53	30.60	3.00	6.00	12.00	24.00	648290	4,171,203
Total assets	2054.82	3021.13	367.12	900.08	2296.66	5376.44	644323	4,145,829
Total sales	2158.81	3096.91	395.04	973.43	2472.41	5653.94	640347	4,090,730
Perm. w. labor share	0.40	0.25	0.28	0.40	0.52	0.65	634,293	4,008,774
Profit margin	-0.01	0.12	-0.00	0.01	0.03	0.07	634,569	4,046,495

(b) Descriptive statistics for selected years

	Mean	SD	p25	p50	p75	p90	# firms
1999							
Employees	13.01	26.35	3.00	6.00	14.00	29.00	135,164
Total assets	2504.25	3579.48	475.70	1145.61	2833.10	6498.17	134,386
Total sales	2831.54	3799.93	563.83	1381.24	3354.56	7342.24	132,559
Perm. w. labor share	0.29	0.24	0.20	0.30	0.40	0.51	129,802
% temp. w.	0.07	0.15	0.00	0.00	0.09	0.25	135,164
Profit margin	-0.00	0.08	-0.01	0.00	0.02	0.05	130,840
2006							
Employees	11.77	30.73	3.00	6.00	12.00	25.00	204,004
Total assets	2197.94	3138.47	404.90	992.69	2511.06	5730.70	202,634
Total sales	2467.09	3421.82	465.86	1150.28	2909.06	6436.97	200,256
Perm. w. labor share	0.36	0.20	0.26	0.36	0.46	0.56	196,567
% temp. w.	0.09	0.17	0.00	0.00	0.11	0.30	204,004
Profit margin	-0.01	0.10	-0.00	0.00	0.02	0.06	198,409
2013							
Employees	10.17	25.45	2.00	5.00	11.00	21.00	249,684
Total assets	1751.09	2620.21	313.92	752.42	1919.41	4563.33	248,491
Total sales	1676.98	2480.12	302.96	727.50	1858.62	4414.84	244,620
Perm. w. labor share	0.45	0.28	0.32	0.46	0.58	0.71	238,813
% temp. w.	0.10	0.20	0.00	0.00	0.13	0.36	249,684
Profit margin	-0.02	0.15	-0.01	0.00	0.02	0.06	241,586
2018							
Employees	12.41	36.41	3.00	6.00	13.00	26.00	223,354
Total assets	1945.01	2807.90	344.79	852.74	2181.38	5207.26	220,820
Total sales	2083.14	2895.47	401.12	962.49	2397.97	5494.25	218,149
Perm. w. labor share	0.44	0.22	0.31	0.45	0.57	0.68	215,911
% temp. w.	0.14	0.21	0.00	0.00	0.20	0.45	223,354
Profit margin	0.02	0.09	0.00	0.01	0.05	0.10	217,622

Note: The table reports the summary statistics aggregate and by year for the main sample of analysis. Referenced on page(s) and [8] and [9].

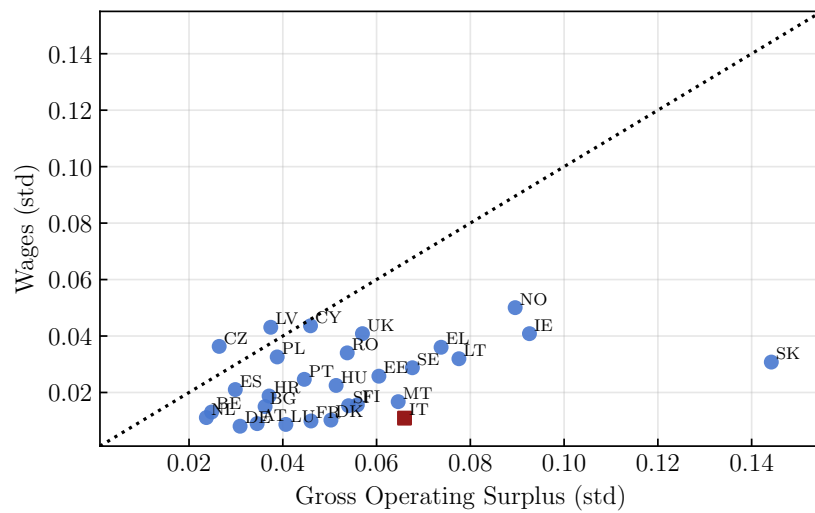
Table 2. Sensitivity to aggregate shocks and role of temporary contracts

Dep. Variable Δ	Cash-flows	Employment	Profits
GDP	3.207 (0.099)	0.369 (0.012)	5.116 (0.165)
Temp. Share	-0.126 (0.018)	-0.276 (0.006)	-0.298 (0.033)
GDP \times Temp. Share	-3.099 (0.443)	0.684 (0.079)	-4.499 (0.715)
Firm FE	Yes	Yes	Yes
R^2	0.168	0.189	0.121
N	2,490,015	2,490,015	2,490,015

Notes: The table reports the main coefficients of interests from the specification in Equation (2). Standard errors in parenthesis, clustered at sector by province level. All regressions weighted by lagged total assets. *GDP* is the cyclical component of real log-GDP, Hamilton filtered. *Temp. Share* is the two-years lagged MA(3) share of temporary workers. Outcome variables are the first-differences of the inverse hyperbolic sine for *Cash-flows* and *Profits* and the first-difference of log-employment for *Employment*. Referenced on page(s) [12].

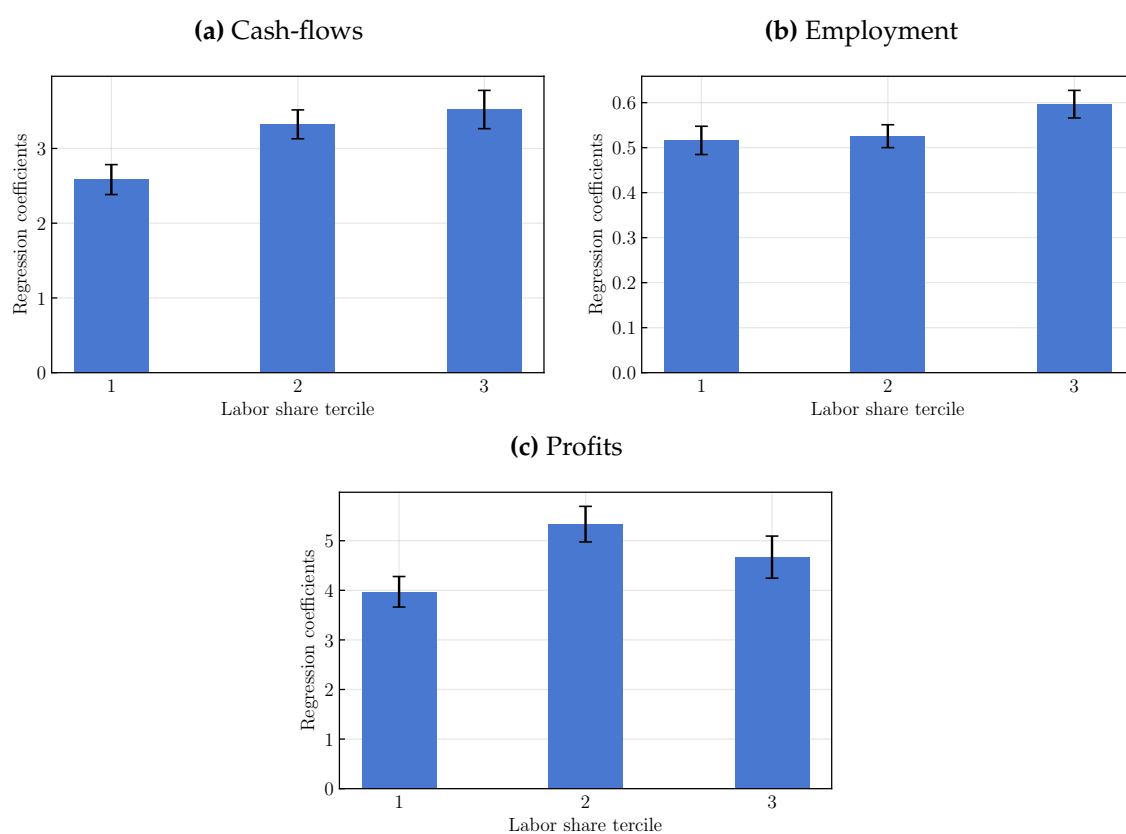
Figures

Figure 1. Relationship between the variabilities of firms' wage payments and operating surpluses



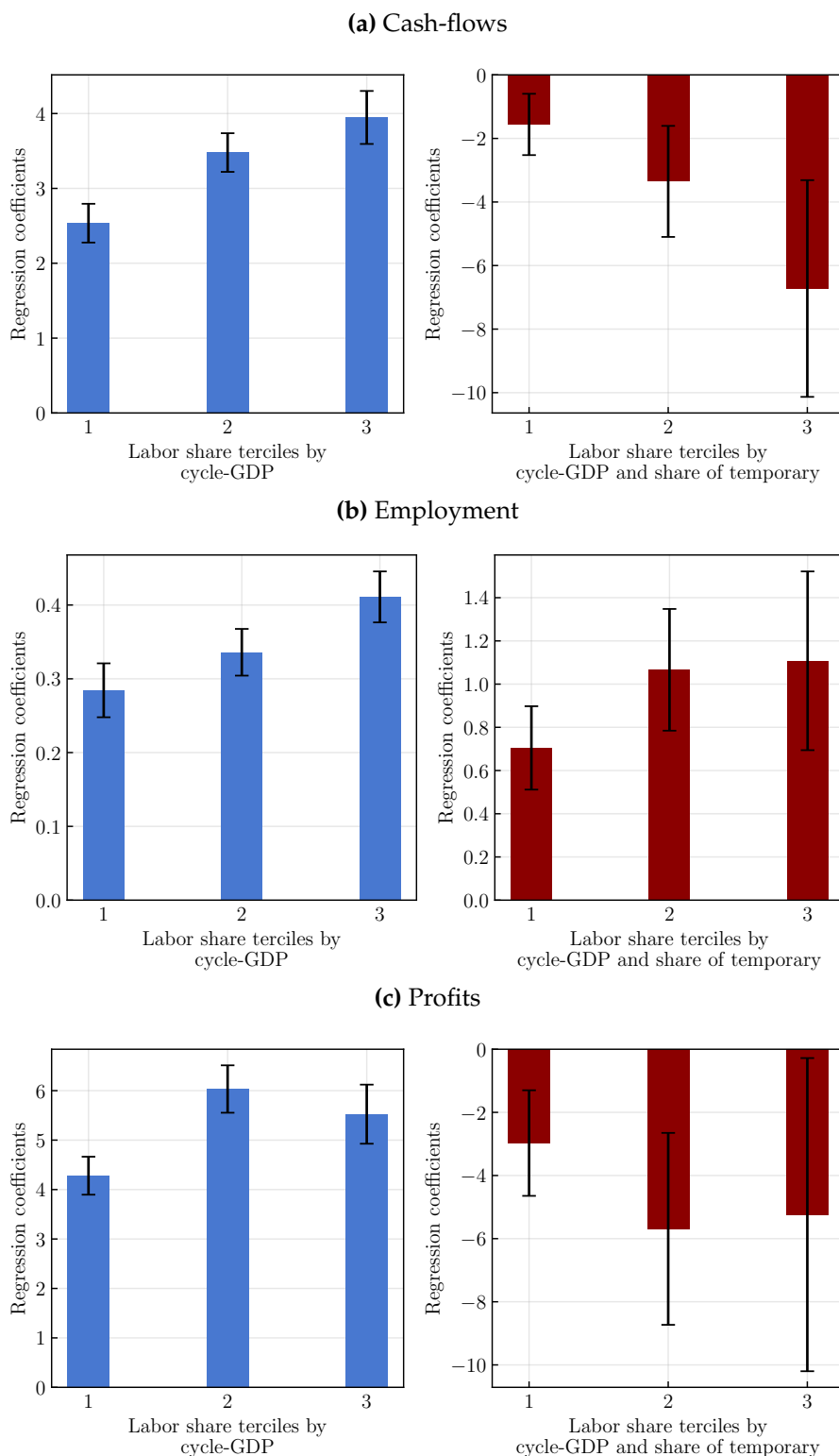
Notes: The figure plots the relationship between the standard deviations of the cyclical component of gross operating surplus and the cyclical component of wage payments for firms in 27 EU countries plus the UK and Norway. The dotted line is the 45° line. Data are log-transformed and filtered using an HP-filter (smoothing 6.25). *Source:* Eurostat, "Annual enterprise statistics for special aggregates of activities (NACE Rev. 2)", time period: 2009-2018. Referenced on page [5].

Figure 2. Labor share specific sensitivity to aggregate shocks



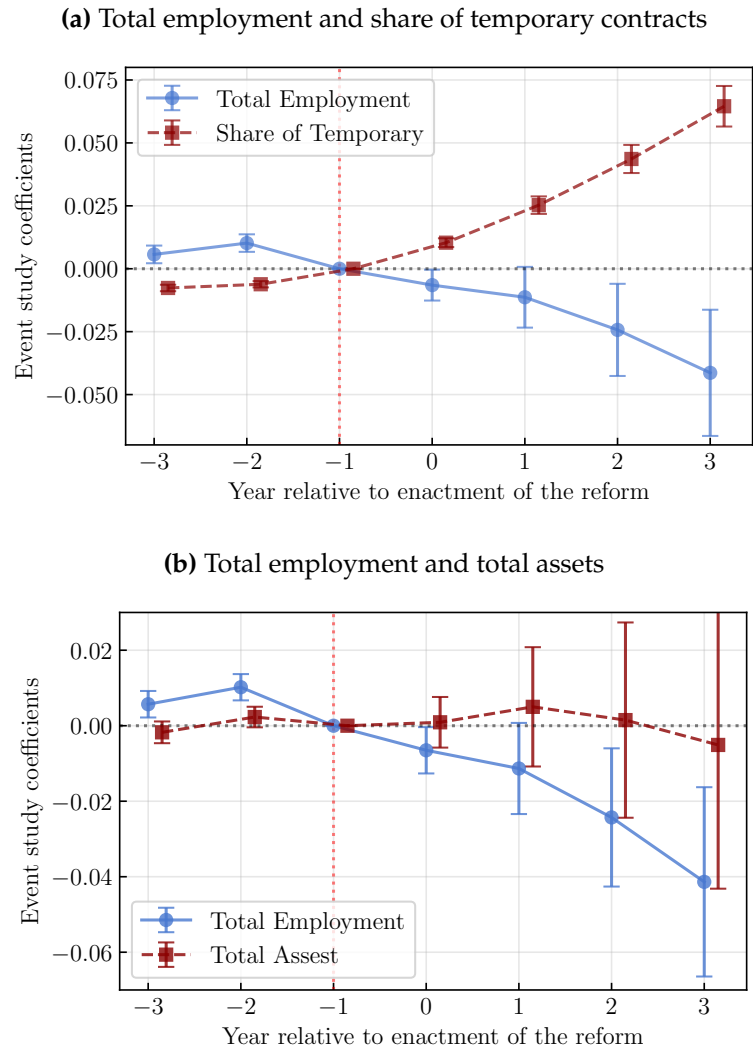
Notes: The figure plots the interaction terms between labor share tertiles and the cyclical component of real GDP as in Equation (1). Labor share tertiles are defined on the three-years lagged MA(3) average of permanent workers' labor share. Cyclical GDP is measured using an Hamilton filter with two leads and one lag. Standard errors are clustered at the sector by province level and the regressions are weighted by lagged total assets. Error bands are 95% confidence intervals. Referenced on page(s) [10] .

Figure 3. Labor share and contract specific sensitivity to aggregate shocks



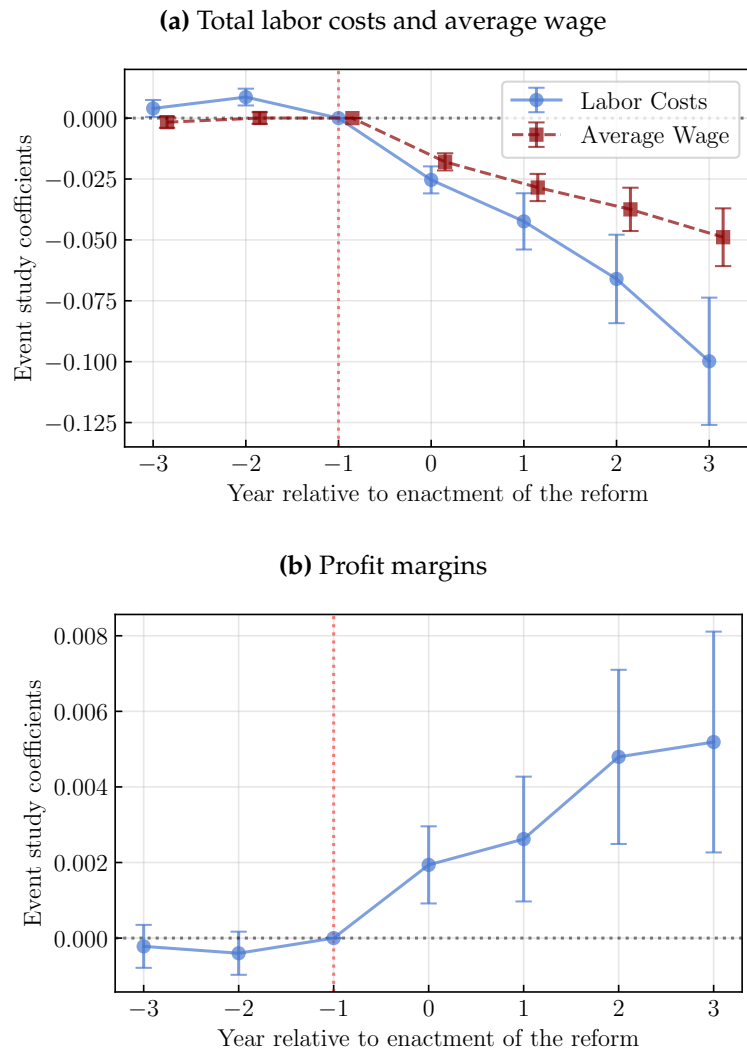
Notes: The figure plots coefficients from the specification in Equation (3) for the three different dependent variables. The reported coefficients are: i. (left panels) the interaction terms between labor share terciles and cyclical GDP (β_{τ}) and, ii. (right panels) the triple interaction terms between labor share terciles, cyclical GDP and the lagged share of temporary contracts (δ_{τ}). Standard error are clustered at sector by province level and regressions are weighted by lagged total assets. Error bands are 95% confidence intervals. Referenced on page(s) [13].

Figure 4. Effect of the reform on firms' workforce and size



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [18].

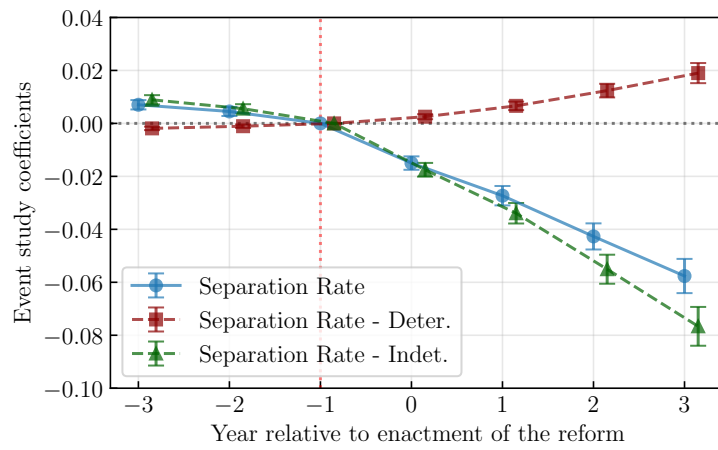
Figure 5. Effect of the reform on firms' costs and profitability



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [18].

Figure 6. Effect of the reform on firms' separation rates

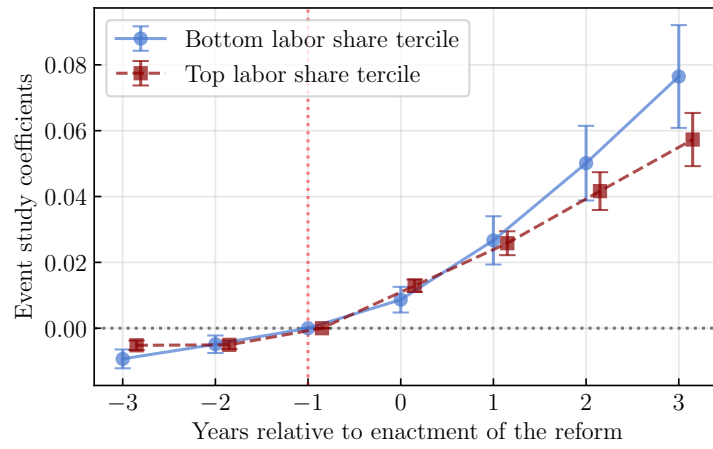
(a) Separation rates



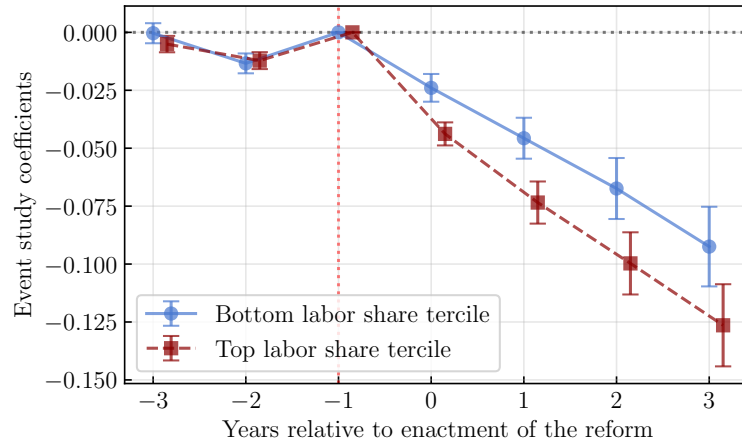
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The separation rate is defined as the number of separations (next year) over the period employment. Separations are split into separations of temporary and permanent workers, keeping the same denominator. By definition point estimates of temporary and permanent workers' coefficient sum to the total separation rate one. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [19].

Figure 7. Effect of the reform on firm outcomes by labor share tercile

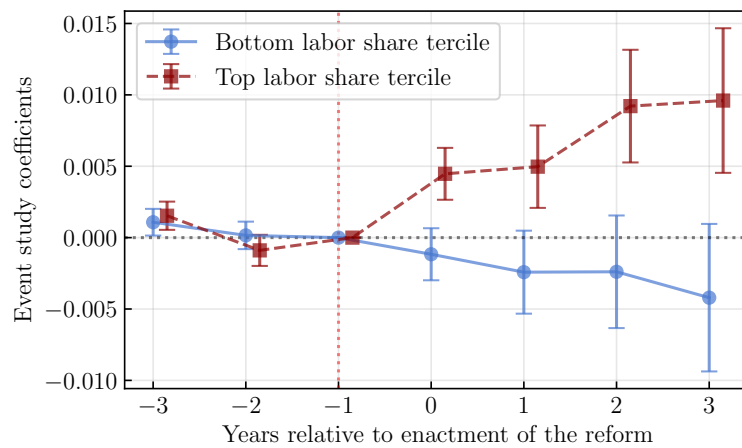
(a) Share of temporary contracts



(b) Average wage

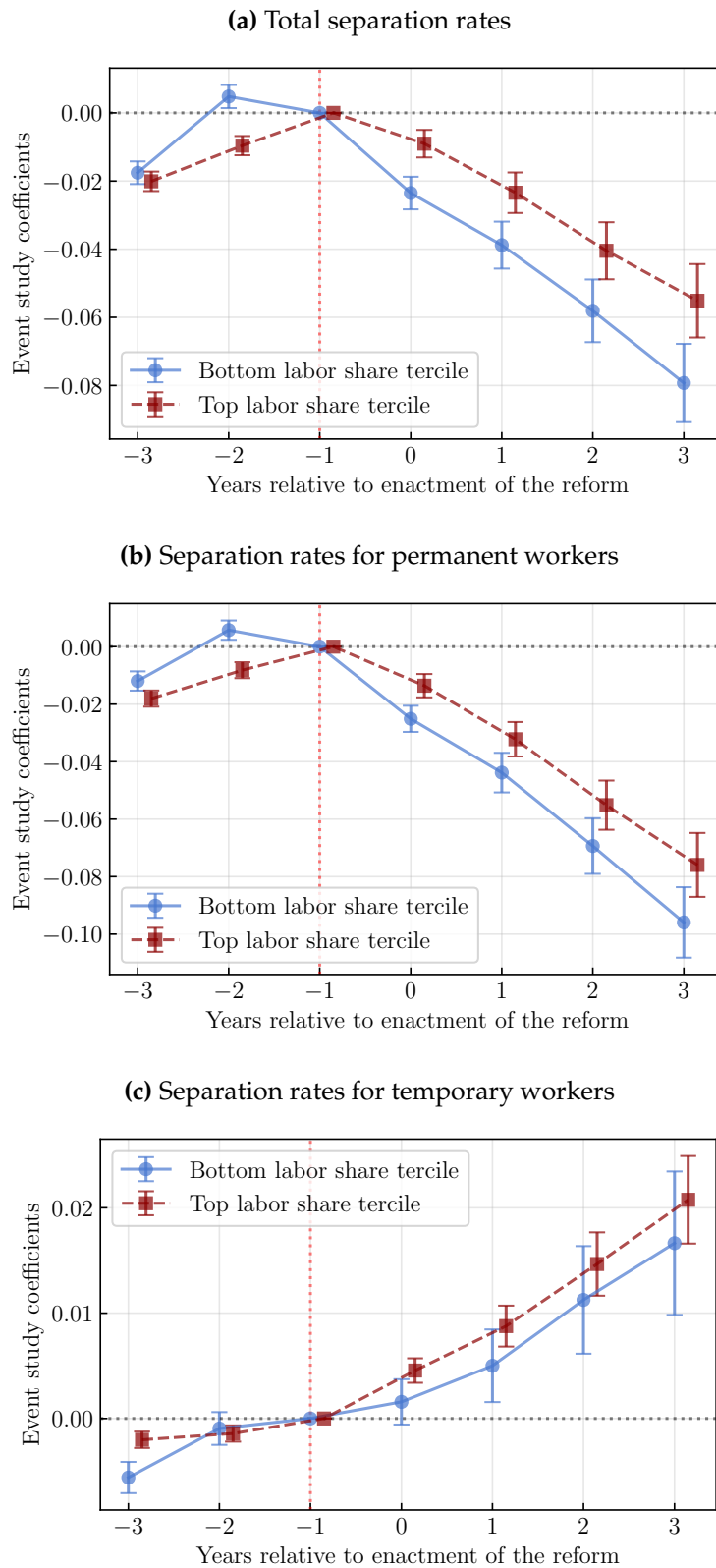


(c) Profit margins



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (5) for three firm-level outcomes. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [19].

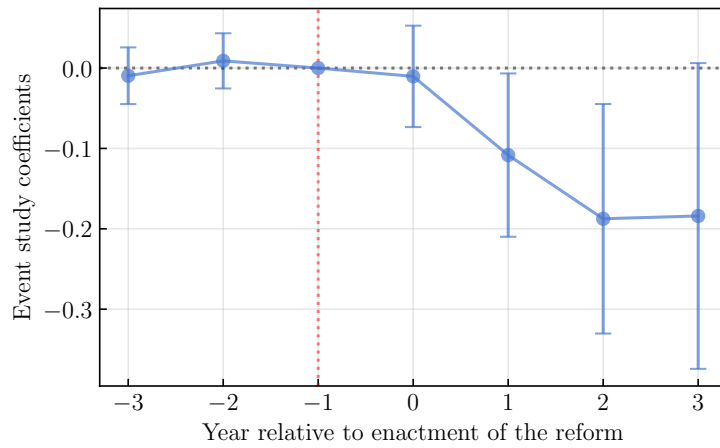
Figure 8. Effect of the reform on firms' separation rates by labor share tercile



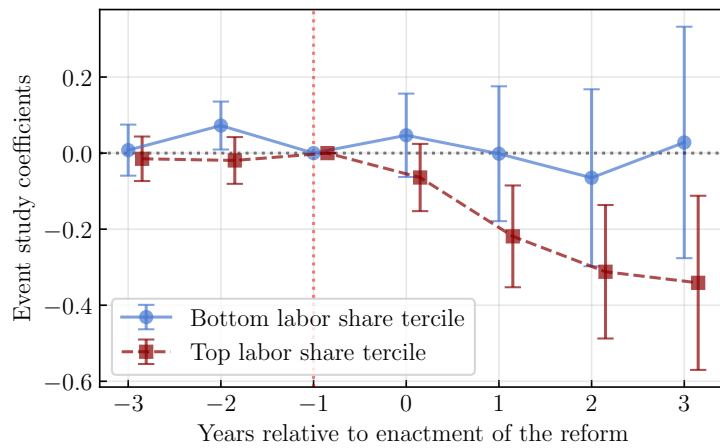
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The separation rate is defined as the number of separations (next year) over the period employment. Separations are split into separations of temporary and permanent workers, keeping the same denominator. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [20].

Figure 9. Effect of the reform on profits' volatility

(a) Average effect



(b) Heterogeneity by labor share



Notes: The figure report the dynamic effects of the 2001 reform on the within-cell standard deviation of firms' profits. Cells are defined as CCNL by province by labor share bin level. The coefficients are estimated following Equation (6) (Panel (a)) and Equation (7) (Panel (b)). Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Sample of surviving firms. Referenced on page(s) [23] .

References

- Acabbi, Edoardo M., Andrea Alati, and Luca Mazzone.** 2021. "Leveraging on Human Capital: Labor Rigidities and Sorting over the Business Cycle." [Cited on pages 4, 5, and 25]
- Acabbi, Edoardo M., Ettore Panetti, and Alessandro Sforza.** 2020. "The Financial Channels of Labor Rigidities: Evidence from Portugal." 118. [Cited on pages 1, 4, 11, 14, 18, 21, and 22]
- Babecký, Jan, Philip Du Caju, Theodora Kosma, Martina Lawless, Julián Messina, and Tairi Rõõm.** 2012. "How do European firms adjust their labour costs when nominal wages are rigid?" *Labour Economics*, 19(5): 792 – 801. [Cited on page 6]
- Baghai, Ramin, Rui Silva, Viktor Thell, and Vikrant Vig.** 2020. "Talent in Distressed Firms: Investigating the Labor Costs of Financial Distress." [Cited on page 22]
- Bai, John (Jianqiu), Douglas Fairhurst, and Matthew Serfling.** 2020. "Employment Protection, Investment, and Firm Growth." *The Review of Financial Studies*, 33(2): 644–688. [Cited on page 4]
- Benmelech, Efraim, Carola Frydman, and Dimitris Papanikolaou.** 2019. "Financial Frictions and Employment during the Great Depression." *Journal of Financial Economics*. [Cited on page 4]
- Benmelech, Efraim, Nittai K. Bergman, and Amit Seru.** 2015. "Financing Labor." [Cited on page 4]
- Bentolila, Samuel, and Giuseppe Bertola.** 1990. "Firing Costs and Labour Demand: How Bad Is Eurosclerosis?" *Review of Economic Studies*, 57(3): 381. [Cited on pages 3 and 5]
- Boeri, Tito, and Pietro Garibaldi.** 2007. "Two Tier Reforms of Employment Protection: A Honeymoon Effect?" *Economic Journal*, 117(521). [Cited on page 5]
- Caggese, Andrea, and Vicente Cuñat.** 2008. "Financing Constraints and Fixed-Term Employment Contracts." *The Economic Journal*, 118(November): 2013–2046. [Cited on pages 1, 4, and 22]
- Caggese, Andrea, Daniel Metzger, and Vicente Cunat.** 2019. "Firing the Wrong Workers: Financing Constraints and Labor Misallocation." *Journal of Financial Economics*, 133: 589–607. [Cited on page 4]
- Cappellari, Lorenzo, Carlo Dell’Ariaga, and Marco Leonardi.** 2012. "Temporary Employment, Job Flows and Productivity: A Tale of Two Reforms." *The Economic Journal*, 122(562): F188–F215. [Cited on pages 3, 5, and 16]
- Card, David, Francesco Devicienti, and Agata Maida.** 2014. "Rent-Sharing, Holdup, and Wages: Evidence from Matched Panel Data." *The Review of Economic Studies*, 81: 84–111. [Cited on pages 4 and 6]
- Cestone, Giacinta, Chiara Fumagalli, Francis Kramarz, and Giovanni Pica.** 2020. "Insurance Between Firms: The Role of Internal Labor Markets." [Cited on page 4]
- Cingano, Federico, Marco Leonardi, Julián Messina, and Giovanni Pica.** 2016. "Employment Protection Legislation, Capital Investment and Access to Credit: Evidence from Italy." *Economic Journal*, 126(595): 1798–1822. [Cited on pages 3 and 5]
- Danthine, Jean-Pierre, and John B Donaldson.** 2002. "Labor Relation and Asset Returns." *Review of Economic Studies*, 69: 41–64. [Cited on page 4]
- Daruich, Diego, Raffaele Saggio, and Sabrina Di Addario.** 2020. "The Effects of Partial Employment Protection Reforms: Evidence from Italy." 120. [Cited on pages 2, 3, 5, 8, 15, 16, 18, 19, 24, and 54]
- Devicienti, Francesco, Paolo Naticchioni, and Andrea Ricci.** 2018. "Temporary Employment, Demand Volatility, and Unions: Firm-Level Evidence." *ILR Review*, 71(1): 174–207. [Cited on page 5]
- Donangelo, Andres.** 2021. "Untangling the Value Premium with Labor Shares." *The Review of Financial Studies*, 34(1): 451–508. [Cited on page 4]

- Donangelo, Andrés, François Gourio, Matthias Kehrig, and Miguel Palacios.** 2019. "The Cross-Section of Labor Leverage and Equity Returns." *Journal of Financial Economics*, 132: 497–518. [Cited on pages 4, 5, and 9]
- Ellul, Andrew, and Marco Pagano.** 2019. "Corporate Leverage and Employees' Rights in Bankruptcy." *Journal of Financial Economics*, 133(3): 685–707. [Cited on page 4]
- Ellul, Andrew, Marco Pagano, and Fabiano Schivardi.** 2018. "Employment and Wage Insurance within Firms: Worldwide Evidence." *The Review of Financial Studies*, 31(4): 1298–1340. [Cited on page 4]
- Faia, Ester, and Vincenzo Pezone.** 2020. "The Heterogeneous Cost of Wage Rigidity: Evidence and Theory." 64. [Cited on pages 4 and 6]
- Fanfani, Bernardo.** 2019. "The Employment Effects of Collective Bargaining." 72. [Cited on page 6]
- Favilukis, Jack, and Xiaoji Lin.** 2016. "Wage Rigidity: A Quantitative Solution to Several Asset Pricing Puzzles." *Review of Financial Studies*, 29(1): 148–192. [Cited on page 4]
- Favilukis, Jack, Xiaoji Lin, and Xiaofei Zhao.** 2020. "The Elephant in the Room: The Impact of Labor Obligations on Credit Markets." *American Economic Review*, 110(6): 1673–1712. [Cited on pages 1, 4, and 5]
- Feenstra, Robert C., Robert Inklaar, and Marcel P. Timmer.** 2015. "The Next Generation of the Penn World Table." *American Economic Review*, 105(10): 3150–3182. [Cited on page 5]
- Giroud, Xavier, and Holger M. Mueller.** 2015. "Capital and Labor Reallocation within Firms." *Journal of Finance*. [Cited on pages 4 and 22]
- Gouin-Bonenfant, Émilien.** 2020. "Productivity Dispersion, Between-Firm Competition, and the Labor Share." [Cited on page 4]
- Guiso, Luigi, and Luigi Pistaferri.** 2020. "The Insurance Role of the Firm." *The Geneva Risk and Insurance Review*, 45(1): 1–23. [Cited on page 4]
- Guiso, Luigi, Luigi Pistaferri, and Fabiano Schivardi.** 2005. "Insurance within the Firm." *Journal of Political Economy*, 113(5): 1054–1087. [Cited on pages 4 and 5]
- Hamermesh, Daniel S.** 1989. "Labor Demand and the Structure of Adjustment Costs." *American Economic Review*, 79(4): 674–689. [Cited on page 4]
- Hamermesh, Daniel S., and Gerard A. Pfann.** 1996. "Adjustment Costs in Factor Demand." *Journal of Economic Literature*, 34(3): 1264–1292. [Cited on page 4]
- Jarosch, Gregor.** 2015. "Searching for Job Security and the Consequences of Job Loss." [Cited on page 4]
- Karabarbounis, Loukas, and Brent Neiman.** 2014. "The Global Decline of the Labor Share." *The Quarterly Journal of Economics*, 61–103. [Cited on pages 1 and 5]
- Lamadon, Thibaut.** 2020. "Productivity Shocks, Long-Term Contracts and Earnings Dynamics." [Cited on pages 4 and 5]
- Lamadon, Thibaut, Magne Mogstad, and Bradley Setzler.** 2019. "Imperfect Competition, Compensating Differentials and Rent Sharing in the U.S. Labor Market." [Cited on page 4]
- Lindbeck, Assar, and Dennis J. Snower.** 1989. *The Insider-Outsider Theory of Employment and Unemployment*. Vol. 1, The MIT Press. [Cited on pages 3, 4, and 25]
- Lindbeck, Assar, and Dennis J. Snower.** 2001. "Insiders versus Outsiders." *Journal of Economic Perspectives*, 15(1): 165–188. [Cited on pages 3 and 4]
- OECD.** 2020. *OECD Labour Force Statistics 2020*. [Cited on page 1]
- Oi, Walter J.** 1962. "Labor as a Quasi-Fixed Factor." *Journal of Political Economy*, 70(6): 538–555. [Cited on pages 4 and 22]
- Pérez, Francisca.** 2020. "Estimated Dynamic Industry Equilibrium Model with Firing Costs and Subcontracting." 30. [Cited on page 4]
- Schoefer, Benjamin.** 2015. "The Financial Channel of Wage Rigidity." [Cited on pages 4 and 9]
- Serfling, Matthew.** 2016. "Firing Costs and Capital Structure Decisions." *Journal of Finance*,

71(5): 2239–2286. [Cited on page 4]

Simintzi, Elena, Vikrant Vig, and Paolo Volpin. 2015. “Labor Protection and Leverage.” *Review of Financial Studies*. [Cited on page 4]

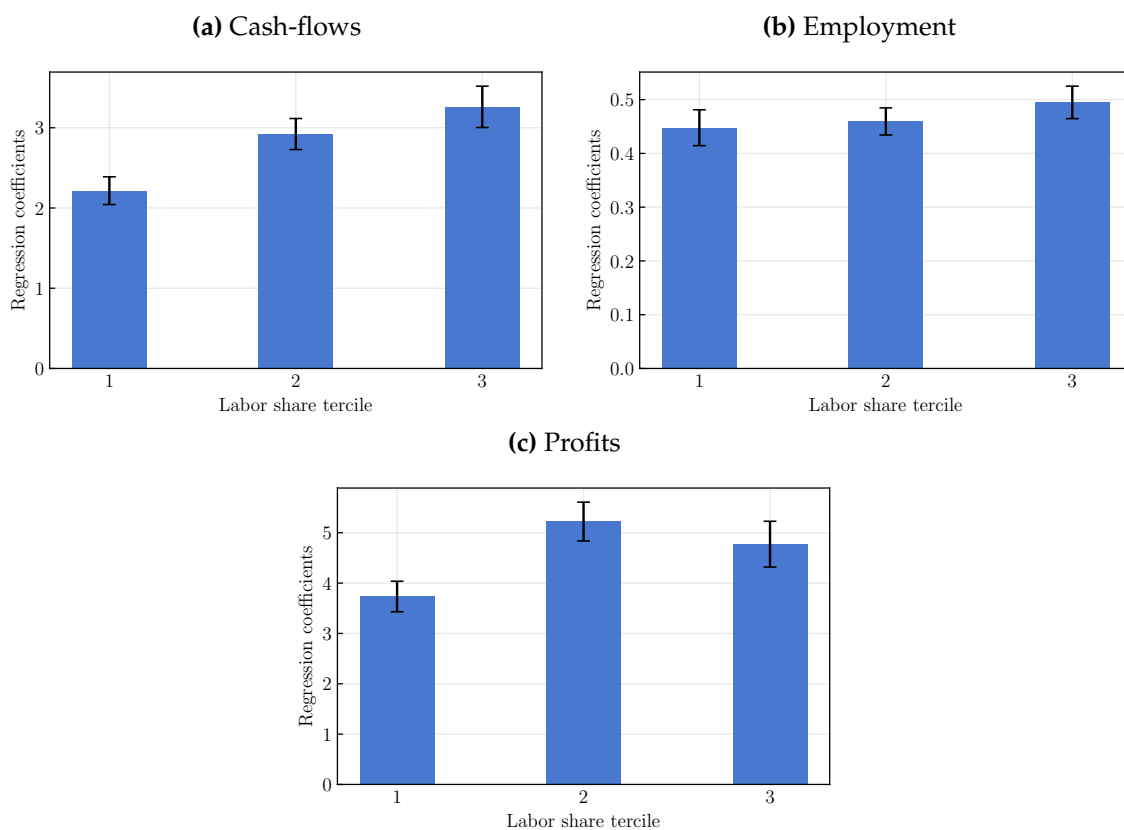
Whited, Toni M., and Guojun Wu. 2006. “Financial Constraints Risk.” *Review of Financial Studies*, 19(2): 531–559. [Cited on pages 5, 10, 22, 48, 51, 52, and 53]

Xiaolan, Mindy Z. 2014. “Who Bears Firm-Level Risk? Implications for Cash Flow Volatility.” [Cited on page 4]

A Robustness checks

In this section, we report the main robustness checks of our analysis.

Figure A.1. Labor share specific sensitivity to aggregate shocks, survivor firms



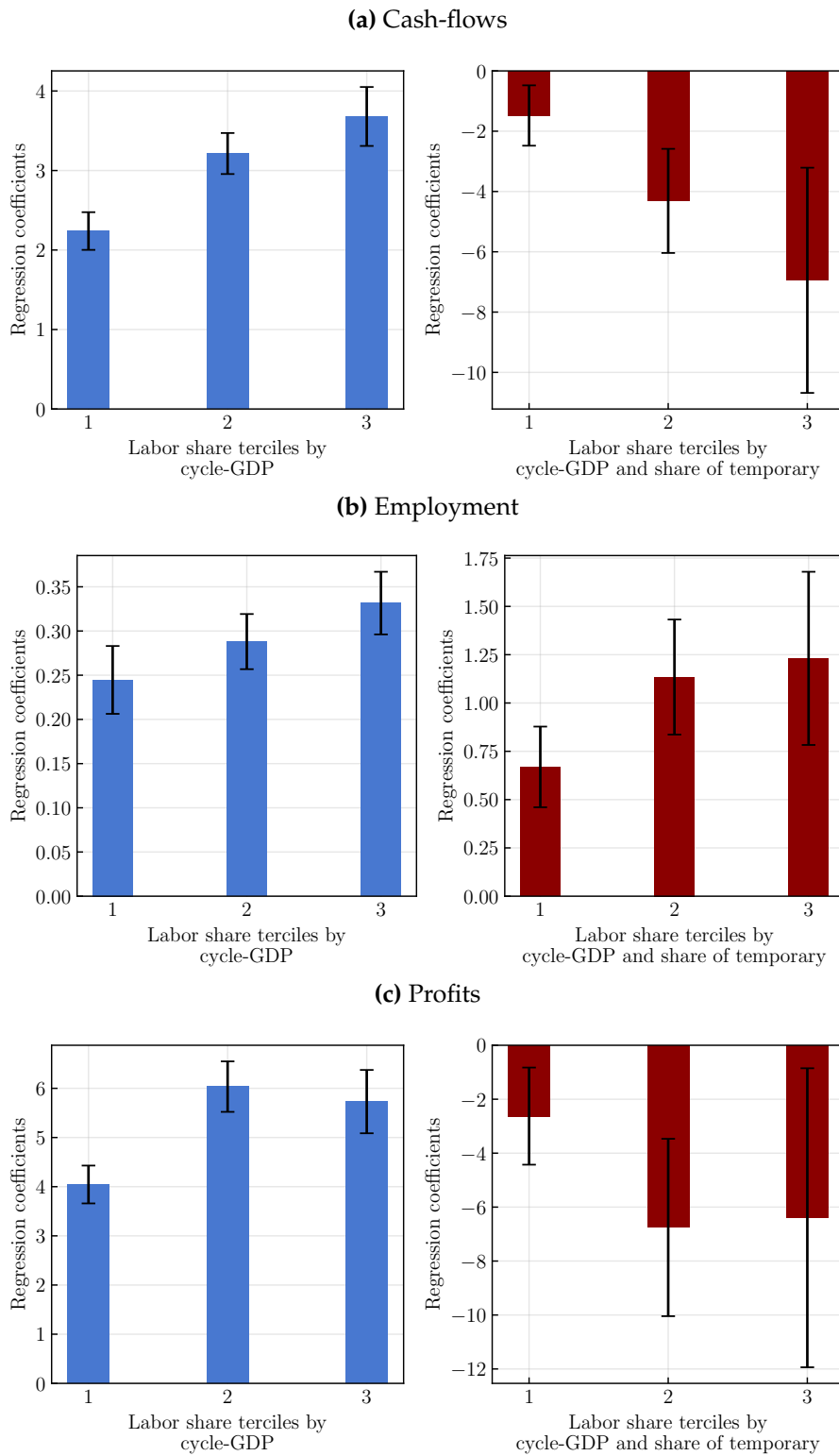
Notes: The figure plots the interaction terms between labor share terciles and the cyclical component of real GDP as in Equation (1). Labor share terciles are defined on the three-years lagged MA(3) average of permanent workers' labor share. Cyclical GDP is measured using an Hamilton filter with two leads and one lag. Standard errors are clustered at CCNL by province level and the regressions are weighted by lagged total assets. Error bands are 95% confidence intervals. Referenced on page(s) [14] .

Table A.1. Sensitivity to aggregate shocks and role of temporary contracts, survivor firms

Dep. Variable Δ	Cash-flows	Employment	Profits
GDP	2.905 (0.098)	0.315 (0.012)	5.059 (0.173)
Temp. Share	-0.107 (0.019)	-0.268 (0.006)	-0.299 (0.035)
GDP \times Temp. Share	-3.230 (0.460)	0.696 (0.085)	-4.710 (0.790)
Firm FE	Yes	Yes	Yes
R^2	0.151	0.173	0.111
N	2,024,627	2,024,627	2,024,627

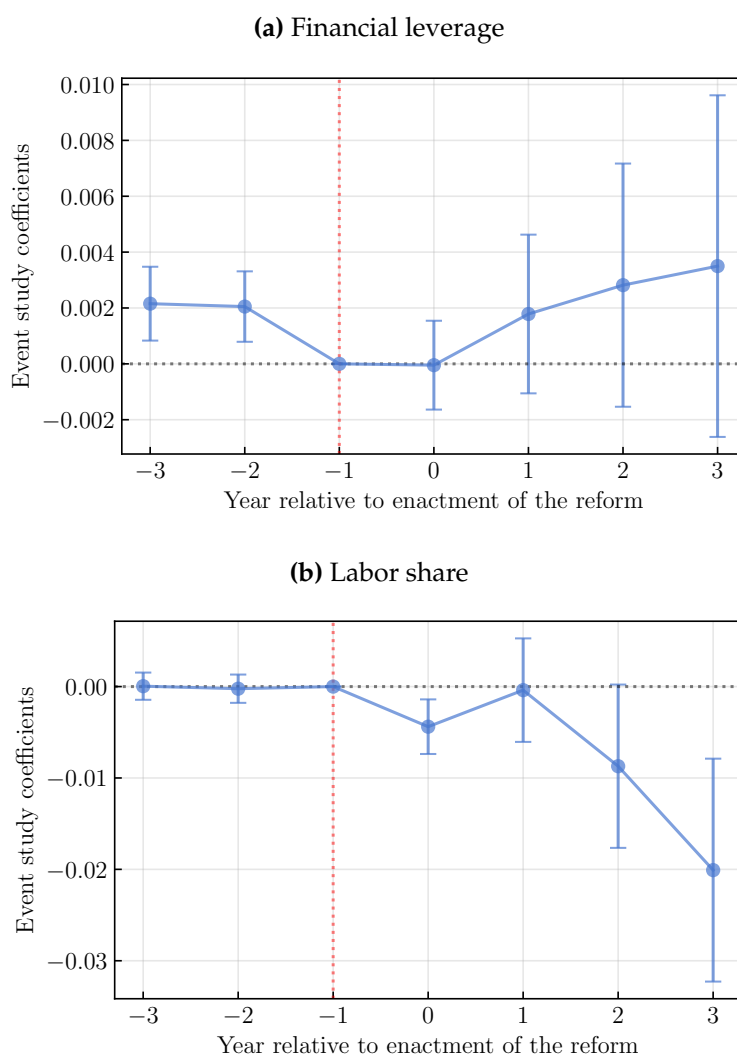
Notes: Sample of surviving firms. *GDP* is the cyclical component of real log-GDP, Hamilton filtered. *Temp. Share* is the two-years lagged MA(3) share of temporary workers. Outcome variables are the first-differences of the inverse hyperbolic sine for *Cash-flows* and *Profits* and the first-difference of log-employment for *Employment*. Standard errors in parenthesis, clustered at 2d-sector by province level and all specifications weighted by lagged total assets. Referenced on page(s) [14]

Figure A.2. Labor share and contract specific sensitivity to aggregate shocks, survivor firms



Notes: The figure plots coefficients from the specification in Equation (3) for the three different dependent variables. The reported coefficients are: i. (left panels) the interaction terms between labor share terciles and cyclical GDP (β_τ) and, ii. (right panels) the triple interaction terms between labor share terciles, cyclical GDP and the lagged share of temporary contracts (δ_τ). Standard error are clustered at 2d-sector by province level and regressions are weighted by lagged total assets. Error bands are 95% confidence intervals. Referenced on page(s) [14]

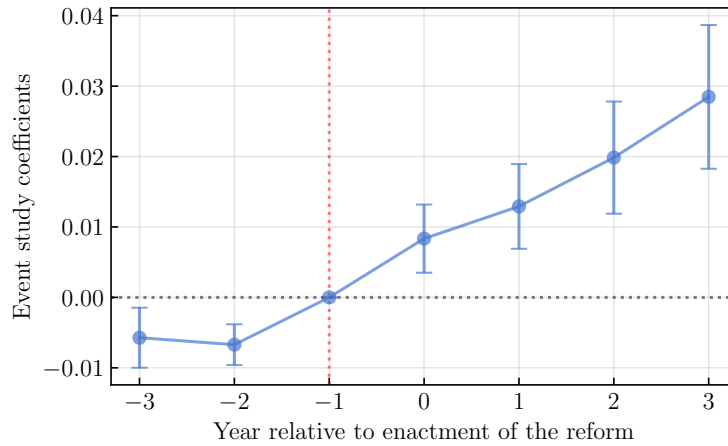
Figure A.3. Effect of the reform on firms' leverage and labor share



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). Financial leverage is defined as financial indebtedness over total assets. Labor share is defined as the firm's total payroll over value added. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [18] and [18].

Figure A.4. Effect of the reform on firms' hiring rates

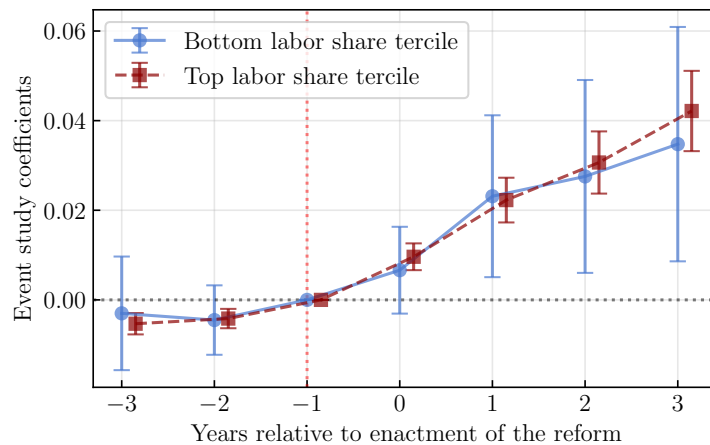
(a) Hiring rates



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The hiring rate of temporary workers is defined as the number of hirings (next year) over the period employment. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [19].

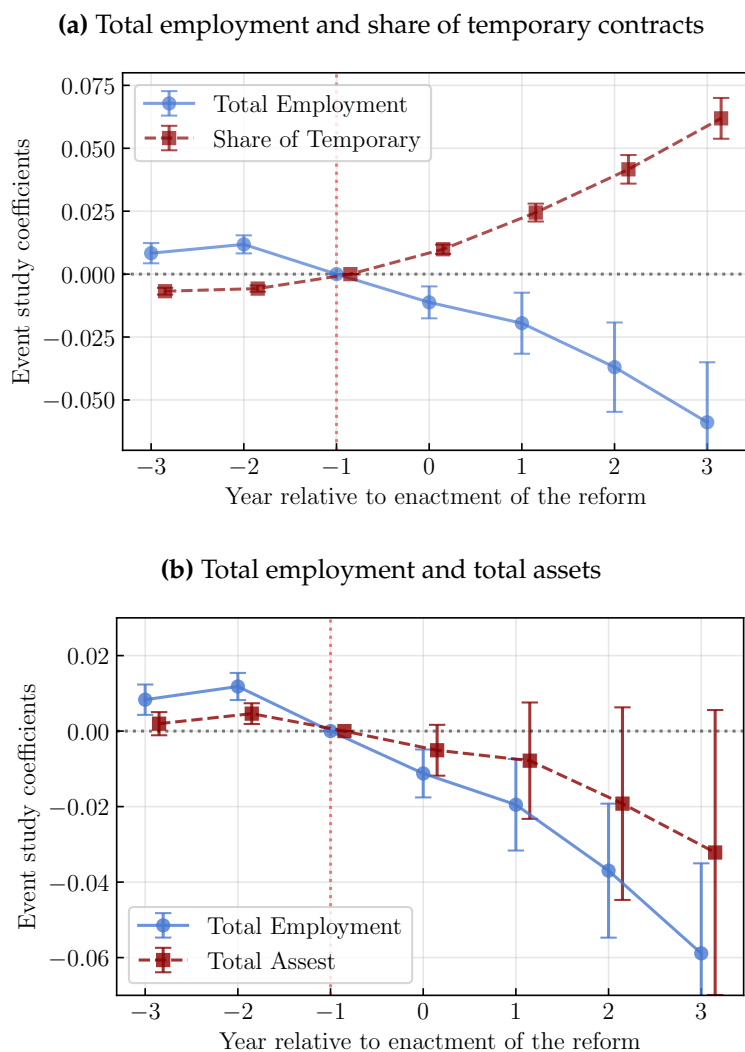
Figure A.5. Effect of the reform on firms' hiring rates by labor share terciles

(a) Hiring rates



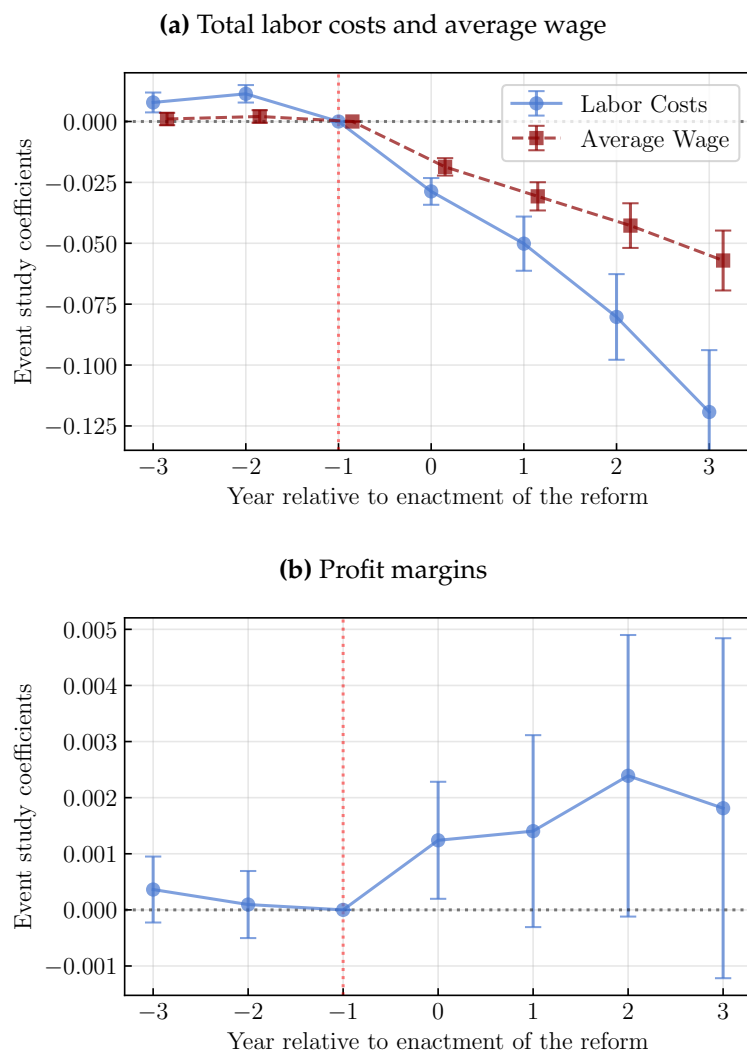
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The hiring rate of temporary workers is defined as the number of hirings (next year) over the period employment. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [20].

Figure A.6. Effect of the reform on firms' workforce and size, survivor firms



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

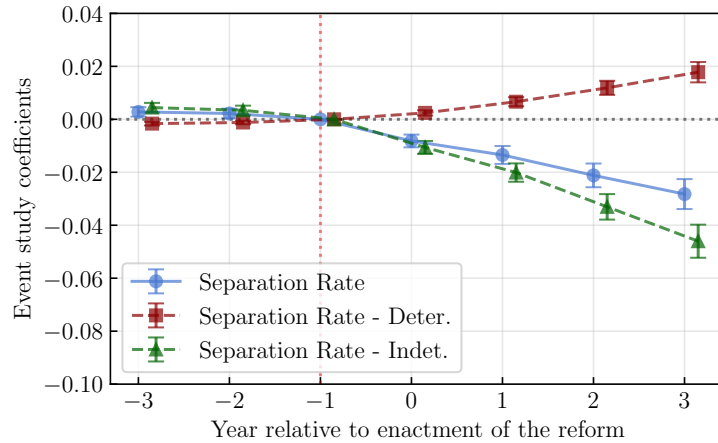
Figure A.7. Effect of the reform on firms' costs and profitability, survivor firms



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

Figure A.8. Effect of the reform on firms' separation rates, survivor firms

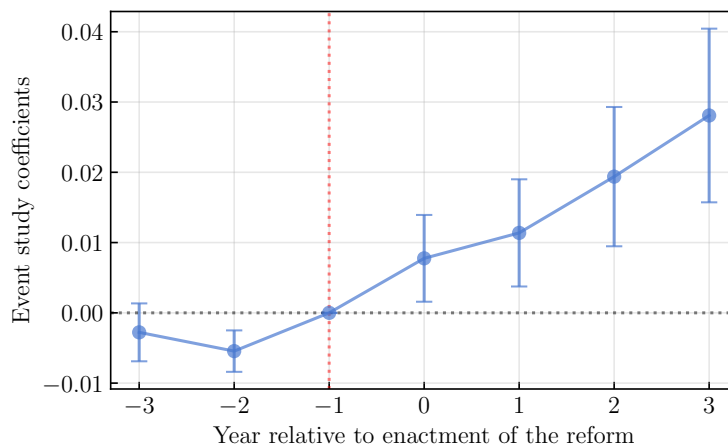
(a) Separation rates



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The separation rate is defined as the number of separations (next year) over the period employment. Separations are split into separations of temporary and permanent workers, keeping the same denominator. By definition point estimates of temporary and permanent workers' coefficient sum to the total separation rate one. The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

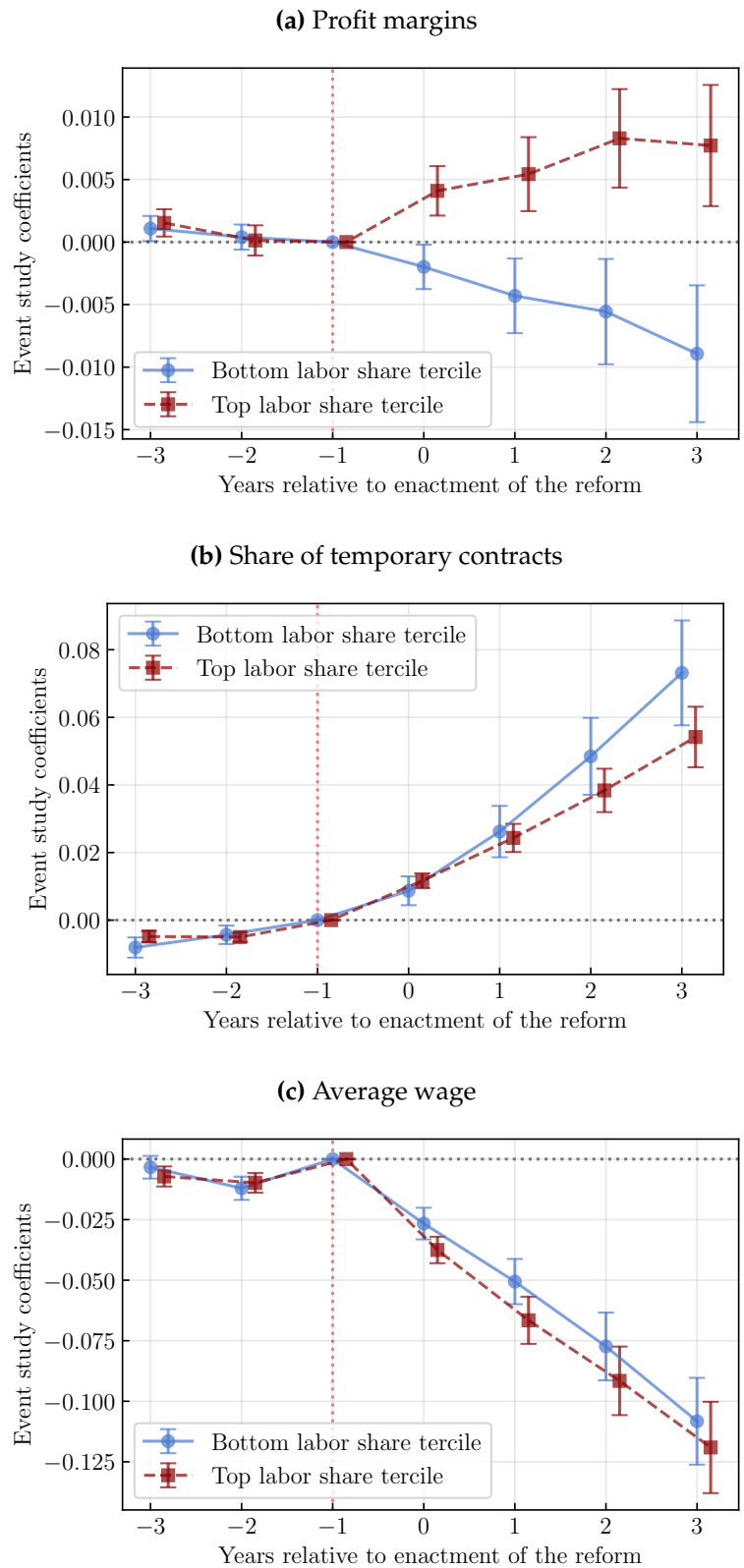
Figure A.9. Effect of the reform on firms' hiring rates, survivor firms

(a) Hiring rates



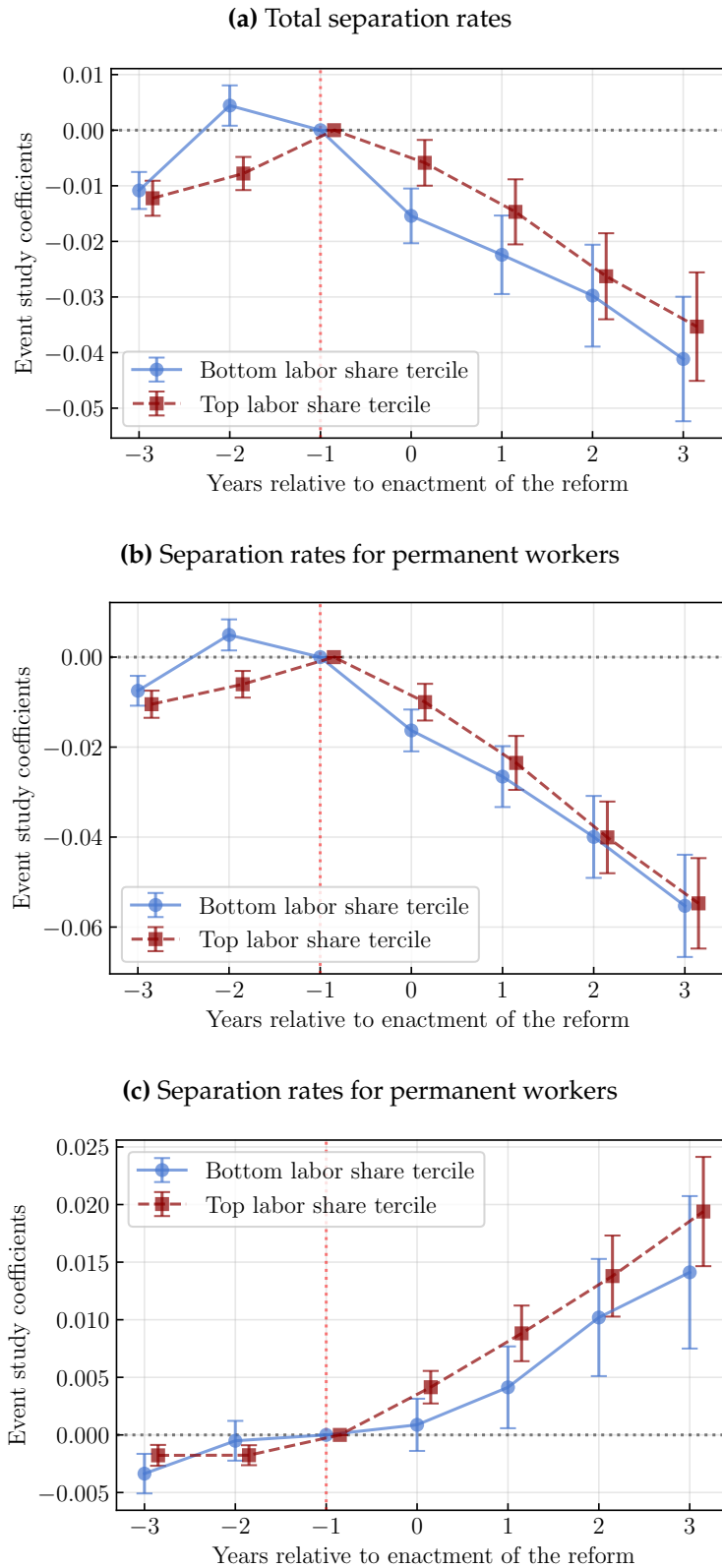
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The hiring rate of temporary workers is defined as the number of hirings (next year) over the period employment. The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

Figure A.10. Effect of the reform on firm outcomes by labor share tercile, survivor firms



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (5) for three firm-level outcomes. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Additional controls for leverage, financial constraints (Whited-Wu Index Whited and Wu 2006), age and tenure composition are added as variable terciles by year fixed effects. The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21]

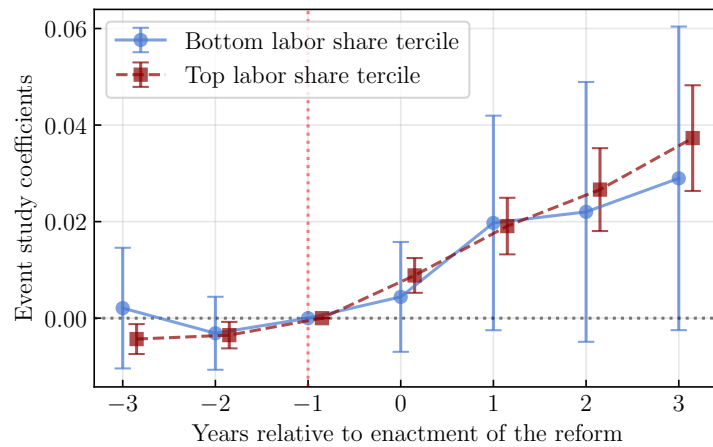
Figure A.11. Effect of the reform on firms' separation rates by labor share tercile, survivor firms



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The separation rate is defined as the number of separations (next year) over the period employment. Separations are split into separations of temporary and permanent workers, keeping the same denominator. The effects are reported for firms in the top and bottom terciles of the labor share distribution. The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

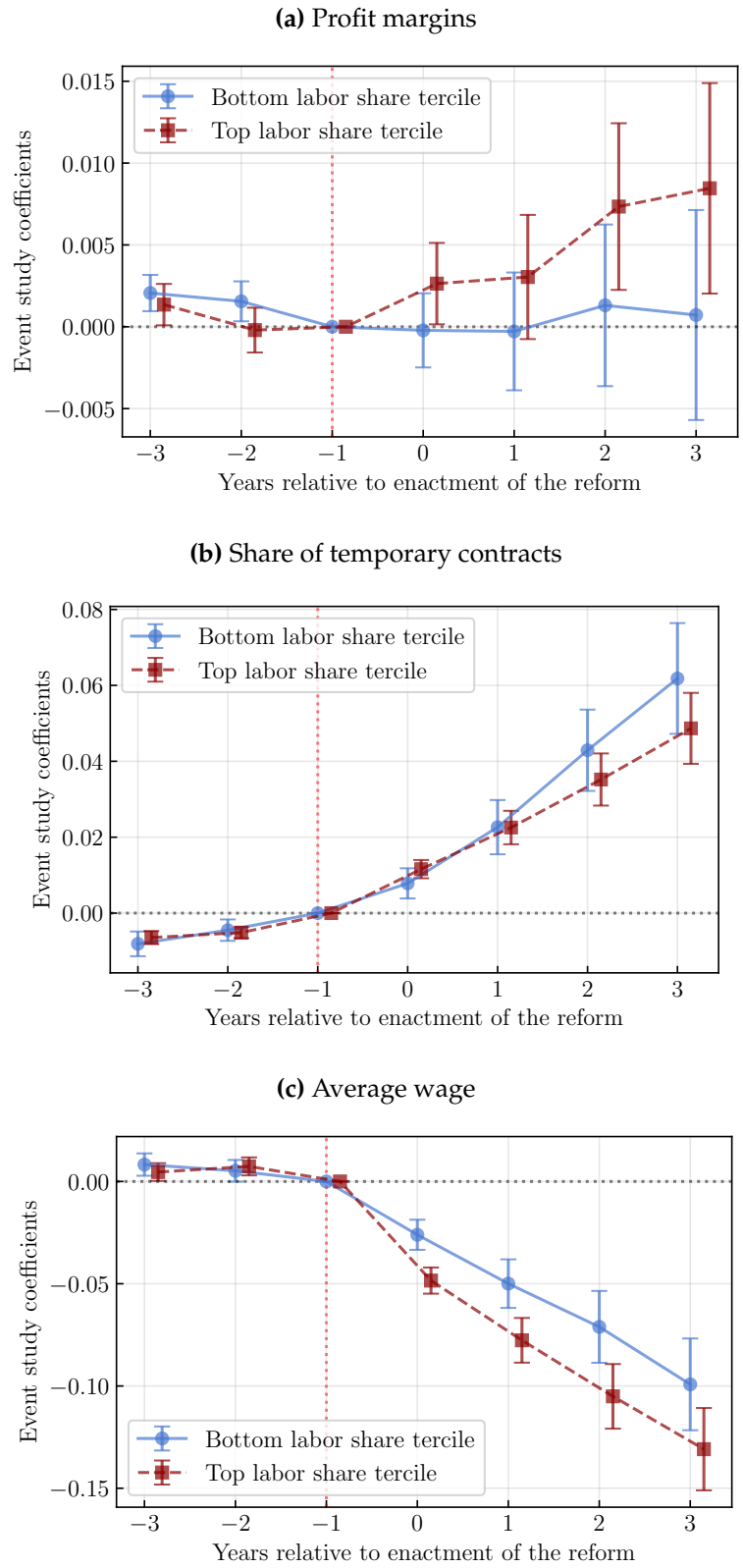
Figure A.12. Effect of the reform on firms' hiring rates by labor share terciles, survivor firms

(a) Hiring rates



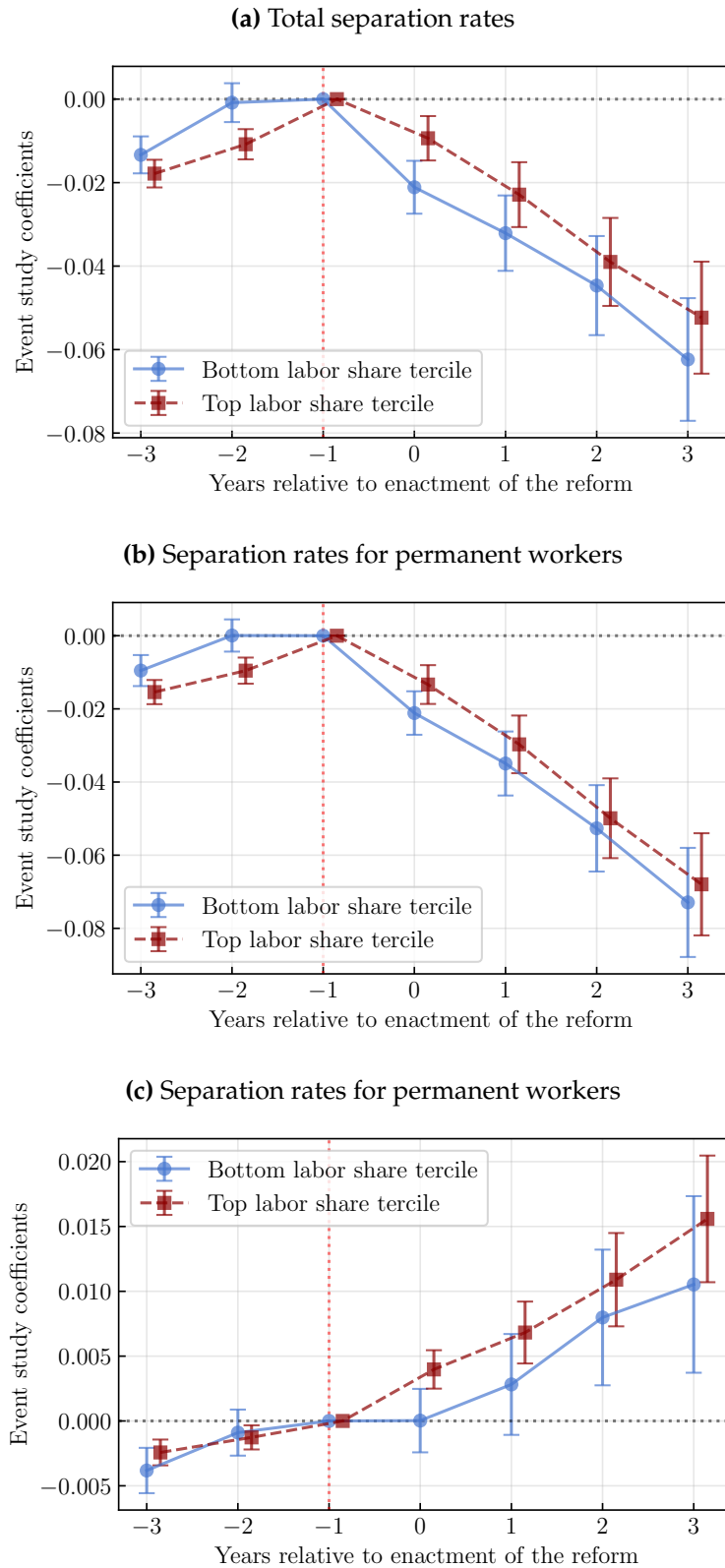
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The hiring rate of temporary workers is defined as the number of hirings (next year) over the period employment. The effects are reported for firms in the top and bottom terciles of the labor share distribution. The sample only includes firms which survive up until the end of the post-period. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [21].

Figure A.13. Effect of the reform on firm outcomes by labor share tercile, controlling for leverage, financial conditions, age and tenure composition



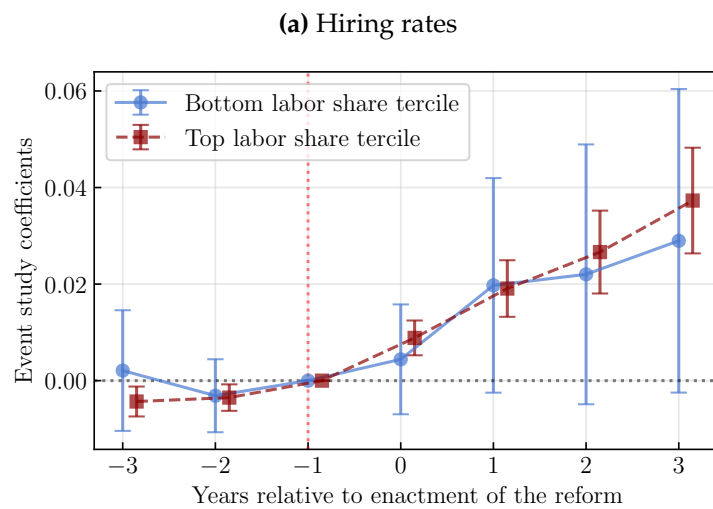
Notes: The figure plots the dynamic effect of the reform following the specification in Equation (5) for three firm-level outcomes. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Additional nonparametric controls for leverage, financial constraints (Whited-Wu Index Whited and Wu 2006), age and tenure composition are added as variable terciles by year fixed effects. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [22].

Figure A.14. Effect of the reform on firms' separation rates by labor share tercile, controlling for leverage, financial conditions, age and tenure composition



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The separation rate is defined as the number of separations (next year) over the period employment. Separations are split into separations of temporary and permanent workers, keeping the same denominator. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Additional nonparametric controls for leverage, financial constraints (Whited-Wu Index Whited and Wu 2006), age and tenure composition are added as variable terciles by year fixed effects. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [22].

Figure A.15. Effect of the reform on firms' hiring rates by labor share terciles, controlling for leverage, financial conditions, age and tenure composition



Notes: The figure plots the dynamic effect of the reform following the specification in Equation (4). The hiring rate of temporary workers is defined as the number of hirings (next year) over the period employment. The effects are reported for firms in the top and bottom terciles of the labor share distribution. Additional nonparametric controls for leverage, financial constraints (Whited-Wu Index Whited and Wu 2006), age and tenure composition are added as variable terciles by year fixed effects. Error bands are 95% confidence intervals, standard errors clustered at CCNL by province level. Referenced on page(s) [22].

B Data construction and sample selection

We rely on two main data sources provided by INPS through the VisitINPS Program: i) data on employment relationships in Italy from 1998 to 2018, ii) balance sheet data for incorporated Italian firms from 1998 to 2018. We complement these data with information on the renewal dates for 181 CCNLs provided by Daruich, Saggio and Di Addario (2020).

B.1 Worker-level data and contract types

Starting from data on virtually the universe of Italian employment relationships at the contract level, we calculate for each worker her yearly gross real earnings and for the workers with multiple contracts we selected the information associated to the highest paid contract in the year and we find the associated annualized income using information on the number of actual weeks worked.

We restrict our focus on workers employed under either full-time or part-time working schemes and with either temporary or permanent contract and between 16 and 65 years old. Importantly, we also have information on the national labor contract (CCNL) regulating each employment relationship.

B.2 Firm-level data

At the firm level, we combine two datasets: i) information on the workforce characteristics for Italian firms from *Uniemens* and ii) balance sheet data from *Cerved*.

From *Uniemens* data we can construct the share of temporary contracts employed by each firm in our sample in every year. Firm size is calculated from worker-level data using the main contract to uniquely assign workers to firms. The intuition for this choice is that a central variable in this paper is firms' precommitted labor costs, we opt for being conservative and include only workers that have their main job at the firm.

In addition, for each firm we can identify the *prevalent* CCNL exploiting the worker-level data discussed above. This information is crucial to time the implementation of the 2001 reform for Italian firms correctly.

From *Cerved*, we have access to firm balance sheet data. We drop firms that report an account before their founding year and that have negative fixed assets or a negative value of production or that report zero labor costs. We also exclude financial services, health and utilities (ATECO codes: 64-66; 35-39 and ≥ 84) and winsorize our main variables at the 5% level (two-sided).

Table B.2. Descriptive statistics by labor share terciles

	Mean	SD	p25	p50	p75	p90	# firms
Low LS							
Employees	7.29	10.94	2.00	4.00	8.00	17.00	232,006
Total assets	2570.55	3704.26	460.79	1128.20	2913.80	6815.19	232,006
Total sales	2750.21	3781.99	532.15	1273.57	3208.21	7242.25	228,696
Perm. w. labor share	0.16	0.21	0.09	0.17	0.25	0.34	231,542
Profit margin	0.01	0.09	-0.00	0.01	0.03	0.08	232,006
Leverage	0.24	0.21	0.04	0.21	0.40	0.55	107,291
Medium LS							
Employees	12.43	15.53	3.00	7.00	15.00	29.00	259,606
Total assets	2309.28	3270.00	432.24	1072.59	2674.04	5997.50	259,606
Total sales	2771.75	3579.44	583.08	1419.29	3384.27	7078.06	257,595
Perm. w. labor share	0.32	0.14	0.26	0.32	0.37	0.45	259,230
Profit margin	0.01	0.07	-0.00	0.00	0.02	0.06	259,606
Leverage	0.23	0.20	0.05	0.21	0.37	0.51	121,771
High LS							
Employees	13.26	16.73	4.00	8.00	16.00	31.00	239,012
Total assets	1756.85	2739.61	294.94	764.10	1946.46	4449.30	239,012
Total sales	2150.61	3054.69	400.18	1017.93	2505.54	5512.68	237,860
Perm. w. labor share	0.49	0.22	0.37	0.45	0.56	0.76	238,233
Profit margin	-0.02	0.09	-0.02	0.00	0.01	0.03	239,012
Leverage	0.22	0.20	0.03	0.19	0.36	0.51	106,537

Note: The table reports the descriptive statistics by labor share terciles for the sample of firms used in the event-study described in Section 5.