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LABOR COST AND PROFITABILITY: AN ANALYSIS OF NORTH WEST ITALY

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ABSTRACT

The paper deals with Labor Cost in SMEs (Small and Medium size enterprises) and investigates its role of key success factor in enterprise performances. A better understanding of the labor cost variable is crucial in these companies, as SMEs account for more of 90% of the economic fabric both in Italy and in the rest of the European Union.

Moreover, Labor and occupation have a major social impact in our society that triggers the close attention of politics: work is one of the primary means people have to reach self-fulfillment and to guarantee to the families a respectable lifestyle.

Starting from these assumptions, this paper has three main purposes. First, we describe northwest of Italy (Piedmont, Lombardy, Ligure and Aosta Valley) in terms of SMEs and we set the database for our analyses including variables such as economic dimensions and main financial indicators (revenue, R.O.E. total labor cost, labor cost per employee, economic result). We made this choice since we wanted to investigate this very important area of Italy which is part of the “economic engine” of the Country.

Second, we want to analyze and compare small versus medium sized enterprise in order to draw some conclusion and highlight similar trend.

Lastly, the final part of the paper focuses on the correlation between labor costs and profits: we verify if (and to what extent) a rise in labor cost leads to an increase in the economic performance of the SMEs.

Keywords: Labor Cost, investments, resources, Corporate Welfare, profitability, growth.

INTRODUCTION

Scholars have been wondering about what the main purpose of an enterprise is. The most obvious answer may appear to be “profit”. Even if positive economic results are vital for an Enterprise, we cannot assume profit as the only driver for the Company success in the actual Society.

For example, one of the most widespread business theories, argues that the creation of value represents the main long-term goal for a company. Value creation itself is not easily decomposable, due to the complexity and number of variables interacting with each other.

Stakeholders for example are often involved in value creation: more specifically, they are all those individuals who bear interests in the organization. They can be internal or external to the company (e.g. members of the management, shareholders, employees, suppliers, customers, Treasury etc.). Some then, argue that the creation of value towards stakeholders is a necessary condition for the success of a company.

To the extent of this paper, it is very important the relationship between the company and its employees: in fact they are those who make possible the production of the goods/services object of sale and, from their productivity, also depends the trend of the corporation. It is necessary a serene and stimulating working environment to be able to have an active production cycle.

From this point of view, an adequate and fair treatment of the personnel, granting the appropriated benefits to the employees, creating a stimulating working environments with possibility of growth, are some elements which certainly lead to an higher yield and, as a consequence a productivity growth, which then lead to the fulfilment of the market and to the improvement of the results.

This paper investigates the role of work cost in small-medium sized enterprises which represent the vast majority of the Italian enterprises: for these indeed, labor cost can be considered a critical success factor as they usually have less resources compared to Larger companies.

For the aim of this paper we consider labor cost as an investment (or Asset) which should lead to high economic benefits and guarantee the prosecution of the company's activities.

In these terms it can be argued that labor cost represents an asset for the company: it requires a constant expense that results into a favorable context, which guarantees a performance improvement.

Everything we have seen and defined so far is part of a general concept called "*corporate Welfare*".

This theme of Welfare and the various benefits granted to employees has changed over time, in relation with changes in the lifestyle of people and in their needs. Some examples are Company Canteens, Cars, Mobile Phones, Nursery for children of Employees, assistance the abroad workers and additional insurance protection.

All these elements demonstrate the increasing attention on the part of the companies to the conditions of their workers also aimed at motivating the employees.

Surely, the global economic crisis has hindered the concept of corporate Welfare and has put the strain on companies. The work has been strongly affected: In Italy, for example, youth unemployment rate has soared over 30%.

Despite this the corporate Welfare and social balance will surely have a role to play in the years to come, along with the economic recovery, with an increasing number of companies (small or large) that in different ways will follow this road.

This paper then will reinforce the concept that labor cost is not a simple cost, but rather a resource, and like all resources must be protected and facilitated, in order to draw more advantages and to be able to pursue the objectives set.

The paper is organized as follows: Section 1 presents a literature review on the topic, Section 2 introduces the research design and methodology illustrating the sample for the analysis. Section 3 includes findings while section

LITERATURE REVIEW

The importance of labor costs in the business context is demonstrated by the numerous studies that have analysed this subject under different circumstances for companies, including those who have tried to provide labor cost has a strategic relevance for the enterprises.

Bowers, Martin and Luker (1990) – stressing the importance of workforce for the Companies – suggested strategies to improve the relationship with employees in order to obtain strategic advantages. One of the ways they illustrated, for example, was to treat them as customers (and vice-versa) in order to improve the quality of services offered by decreasing costs and increasing customer satisfaction. This statement was born from the fact that employees are usually more in contact with the customers.

Also recent Scholars and Consultancy firms such as John Wiley & Sons LTD (2014) or Punjaisri, Balmer (2016) reflect on the relevance of the workers, in order to increase the overall business value.

Another element related to the matter of this paper, is the U.C.L (Unit Labor Cost) or the cost of work per unit produced (referred to a single employee). Indeed, it represents an important indicator of productivity and it has been crucial also in several studies. For example, Van Bart, Stuivenwold, YPMA, (2005) used the U.C.L. to study of competitiveness, while on the contrary Myant (2016), argued that UCL may not be the best indicator in measuring it.

Another element taken into account is the economic crisis that has affected Europe since 2007. Cuestas, Ordóñez, Staehr (2018), analyzed the effects of production cost reduction measures to "exit" the recession in the four *GIPS Countries* (Greece, Italy, Portugal and Spain) and comparing them to German and Dutch benchmarks with the effects on production and employment.

From a social point of view, a recent issue that is at the heart of debates in European countries is the policies geared towards guaranteeing the legal minimum wage; Herzog-Stein, Alexander; Logeay, Camille; Stein, Ulrike; Zwiener, Rudolf (2016) take into account the case of Germany and the effects that this law produced. Moreover they compare Germany to other European countries, concluding that legal minimum wage-oriented policies lead to advantages in relation to the macroeconomic context. More specifically, all the positive aspects that these policies generate and which are not limited only to

income earners, but to the economy as a whole. On this issue also Fabo, Belli (2017) gave their contribution by analysing the differences between the minimum wage and the minimum wage for living, highlighting strong deviations of values especially in the peripheral EU countries.

Finally, directly linked to the subject of this paper, Lavoie, Stockhammer (2013) argue how workers' wages influence domestic demand and therefore, a policy geared towards them would lead to an increase in productivity and economic growth. This process, opinion of the authors, has a greater impact rather than profits.

This paper supports the thesis that labor cost is one of the main variables that lead to positive results for business and consequently to general economic growth.

This work aims to be a starting point for a broader investigation focused on the labor cost and the effects it brings in European Economies, as well as the analysis of its structure in the different European countries.

METHODOLOGY

Research Design

This paper involves a quantitative methodology: a sample of enterprises was selected in order to observe some data and indicators and to draw objective conclusions. Descriptive statistics methodologies were adopted to outline the labor cost trend under analysis.

The sample included companies from the North-West Italy and investigated some balance sheet items and financial ratios. These in fact represent a primary source of information and are strictly regulated by the Italian Legislation; the main normative source is the Italian Civil Code, on the fifth Book (Labor), V Title (Companies).

	Small Companies	Medium-Sized Companies
Legal Status	Actives	Actives
Registered office	Piemonte, Lombardia, Liguria, V. Aosta	Piemonte, Lombardia, Liguria, V. Aosta
Legal Form	Limited Liability Companies	Limited Liability Companies
Number of employees	Between 10 and 50	Between 50 and 250
Revenues	Between 2 Mln € and 10 Mln €	Between 10 Mln € and 50 Mln €

Table 1. *Research Strategy for Aida.*

In addition to the data exposed in the "Table 1", we considered only companies that have a known value of: Cost of Labor per Employees, R.O.E. (Net Result on Equity), total amount of cost of labor and net profit. We considered the data for the three years 2015-2017. The sample included more than 14,000 companies and this allows to draw some relevant and reliable trends. However, this paper presents some limitations: first of all it focuses on a single area which, although vast, does not represent a macro-

region at European level but only at national level. Anyway, the research may be considered as a starting point to underline differences between North-West of Italy and other European regions. Secondly, by inserting the research strategy shown in the next paragraph, certain companies that do not have the necessary requirements are excluded. Therefore, it should be recalled that the research conducted has conclusions that do not reflect the whole area taken into account but a part of it.

The study has been conducted on the small and medium-sized enterprises, established in the north-west part of Italy. It represents the initial step of a broader research, which will compare the data of the entire Northern Italy with those of the Center/South Italy to verify the accuracy of the definition of Italy as a "two-speed" Country. A further step of the research will be represented by the enlargement of the sample taking into account enterprises from European countries to verify the homogeneity of labor cost trend between the various EU States.

Data Collection and Procedures

The research was conducted using the Aida database provided by Bureau Van Dijk, which contains the data of a multitude of Italian companies. As already mentioned in the introduction, it was decided to focus on small and medium-sized enterprises: for the definition of SME's (small and Medium-Sized Companies), we followed the "User guide to the SME Definition" (by the European Commission, Ref. Ares 956541 - 24/02/2016) which includes in small businesses those with less than 50 employees (but at least 10) and with a turnover of between 2 Million € and 10 Million €. An enterprise is considered medium-sized if it employs between 50 and 250 workers and it has a revenue between 10 and 50 million Euros.

As anticipated in the previous paragraph, legally active limited companies have been selected in the research strategy (located in Piedmont, Liguria, Lombardy and Aosta Valley), which had among the available data the Return On Equity, revenue (between 2 million and 10 million for the Small and between 10 million and 50 million for averages), the number of employees (between 10 and 50 for small and between 50 and 250 for averages), the total cost of labor, the index of labor cost per employee and the net profit/loss.

These research criteria led to a sample of 12,354 "Small" companies and 2,616 "Medium" companies; For a total of 14,970 enterprises.

In order to investigate the different aspects of the labor cost the following research questions were formulated:

- 1) How are the Small-Medium Sized Enterprises subdivided in the North West Italy and what are the main differences of the SMEs among the different regions?
- 2) What are the main differences and similarities between small and medium-sized enterprises?
- 3) Does a higher cost per employee also correspond better results for companies?

In order to answer the three research questions, the results were synthesized in tables to highlight the data and divide them into the various categories (analyzed by region or by size).

With reference to the first RQ, a comparative analysis of the results was carried out displaying on a table the composition in the various regions and the economic data available and the same was done for the second question.

In order to answer the third question, the labor cost per employee was analysed. The enterprises in the sample were ordered in ascending order, then divided into quartiles. Lastly, the economic data was analysed with reference to the quartile range in order to draw conclusions about the possible correlation between labour costs and economic indices of profitability in the various sub-categories. Differently from the first two points, in order to focus the attention on the cost of the worker, it was necessary to remove the outliers from the sample. This, in order to avoid including in the research data that could have a distorting effect on the result; in these terms, the choice of excluding the companies that had a labor cost per employee less than €30,000 (annually). As a result of this modification, the sample went from 14,070 companies to 13,531 companies, i.e. eliminating about 3.8%.

FINDINGS

As already mentioned in section 2 “*Methodology*”, data was extracted from the “Aida” database which included results for more than 14,000 companies. The extracted data refer to the three-year period 2015-2017 and for these the average of the three-year period was calculated to obtain a single datum to be able to compare. The results obtained have been summarised in tables.

As a starting point, as already mentioned, the 14,070-company sample is decomposed into 12,354 small and 2,616 Medium-size enterprises. Since the sample is limited to SMEs incorporated in the form of limited companies, as can be easily predicted, S.R.L (Ltds) constitute over 90% of the sample while S.p.A. represent only 10% of the sample.

With reference to the medium enterprises instead, the S.P.A constitute 58% of the sample while the S.R.L. represent 42%. Thus, it is observed an increase of the companies by shares and of the limited liability companies which constitute however a good number.

After having obtained an indication on the structure of the sample, we proceed with the presentation of the data obtained in reference to the three questions of the paper:

1) How are the Small-Medium Sized Enterprises subdivided in the North West Italy and what are the main differences of the SMEs among the different regions?

It is a widely known that Lombardy, and the area nearby Milan in particular, is the “economic engine of Italy. The results observed within the research seem to confirm this hypothesis, at least with reference to the sample: about 74% of the small and medium-sized enterprises, have the registered

office in Lombardy; followed by the Piedmont (around 20.5% of SMEs); while about 5% of the SMEs have the registered office in Liguria (for both categories) and lastly, only 0.5% in the Aosta Valley. As can be seen from data, Enterprises are not distributed evenly on the territory: Lombardy region, although smaller than Piedmont, has about 3.5 times the number of companies included in the sample. After this first glance of the enterprises distribution among the regions, other different trends may emerge in terms of economic results. Starting from the occupation point of view, the average number of employees is almost homogeneous among all of the regions, which count more than 20 employees in small enterprises and around 100 employees in the Medium-sized ones. Also, in relation to employment, it is relevant to underline the results on the of labor cost per worker index. With reference to this index similar results among the regions are observed: Lombardy ranks first in terms of Labor cost per worker (46,803 Euro per worker), followed by Liguria (45,927 Euro per worker), Piedmont (44,283 Euro per worker) and eventually by Aosta Valley (42,345 Euro per worker).

It is also relevant to observe the average revenues (for the three-year period 2015-2017) in the different regions. In this case, however, it is necessary to split the analysis between small and medium-sized enterprises, as revenue is one of the parameters adopted by for the definition of the categories. Even in this situation, the trend already seen stands in line with each other the ones observed above: small companies perform an average amount of 4.5 million € in all of the four regions, while Medium-sized perform:

- about 23 million Euro in Lombardy, Piedmont and Liguria;
- around 18 million in the Aosta Valley.

This can be explained by the nature of the territory and of the economic pattern of the Aosta Valley which may foster smaller entrepreneurship.

Having completed a general analysis on the dimensions, it is worth to analyze the profitability of the companies. This analysis relies on the net profit (or loss) for each observation and on the R.O.E. (one of the most important profitability index, which is often taken into account by shareholders and stakeholders).

First, the net result reflects the economic management of the company. As said in the introduction, profit is a necessary (even if not sufficient) condition for Enterprises willing to survive on the market. In this sense it is still a fundamental indicator of status of the health of enterprises, so it is worth noting the excellent trend showed by Lombardy. Indeed it presents an average net profit of the three-year period of about € 170,000 for small companies and about € 938,000 for the Medium-sized. However, there is also an excellent result for the Piedmont, with € 166,000 of small and almost € 970,000 of Medium-sized; a bit "lower" the Liguria companies, with € 108,000 (Small) and € 780,000 (Medium). At last, the Valle

d'Aosta, which is the one with the lowest number of companies, presents €76,500 (the lowest) of net profit in smalls and €1,460,000 in Medium-sized (the highest).

The Return on Equity (R.O.E.) is one of the best-known profitability index: it measures the remuneration of the equity, namely, of the resources provided by shareholders to the Company. R.O.E. is a key index for the investors as it measures the (potential) profitability of the investment.

From this point of view, as for the other indicators, the ROE analysis show convergent results amonge the diferrent regions. The small enterprises in Lombardy, Piedmont and Liguria regions show a ROW around 13% while the Aosta Valley alone stops at 6.53% (this in line with its lower net profit). Differently from small sized enterprises, medium-sized ones show an average R.O.E. aligned among all four regions. In this case the index exceeds 10% and Liguria has the highest one at 12.04%.

Based on the above, we can anticipate some conclusion and observe that small-medium sized enterprises based in the North-West of Italy usually have excellent economic results and, generally speaking, aligned among them. Nonetheless, Lombardy emerges among the others.

2. What are the main differences and similarities between small and medium-sized enterprises?

The second research question focuses on the difference that may emerge between the two categories of enterprises rather than on their geographical location.

This second part of the analysis then highlights the interesting differences that emerge comparing enterprises on the base of their size.

This analysis adopts, of course, a different approach from the previous part and it is based on the parameters adopted to define the categories that are:

- Revenue, a company is considered a small enterprise if its revenue is below 10 million euro, while it is considered to be a medium sized enterprise if its revenue between is between 10 and 50 million Euro;
- Number of employees, a company is considered a small enterprise when it does not employ more than 50 workers, while it is considered a medium sized enterprise if it employs 50 to 250 workers.

Starting from the latter, it is observed that small enterprises employ on average of 22 workers while medium sized enterprises employ 100 workers on average.

As far as revenue is concerned, the value of small enterprises amounts to 4.5 million euros while for Medium-sized it is 23.2 Million euros. In order to make objective comparisons between the two categories, the average incidence of labor cost on revenue has been computed.

Both the two categories present an average incidence of labor cost over revenue above 20%. More specifically, small sized enterprises present 21.97% while medium sized present 22.94%.

This indicates that, regardless to the dimension of the company, the labor cost absorbs a relevant portion of the revenue.

Moreover, the labor cost per worker is higher in medium sized enterprises (49.8 k euro compared to 42.5%).

From another point of view, a significant difference emerges however comparing the average operating results; Even in this case the same is inevitable given the values that make up the balance sheets of the two types of companies. With regard to Medium-sized we have an average of about € 943,000 while for the small the value is around to €166,000.

Focusing on the R.O.E. index, which allows to make comparisons, we observed that small companies have a higher ROW compared to Medium-sized (13.27% versus 10.31%).

We may ask where does this difference come from?

In this case we observe that smaller companies usually have a lower equity, so we can argue that the answer lies in the denominator of the ROE formula.

In conclusion, we can affirm that, albeit composed of quantitatively different data, we have the similarities between small and medium-sized enterprises in the values related to the incidence of labor costs on revenue, of the cost per worker (albeit slightly different) and ROE. These elements help to understand the Italian realities of the northwest that can be defined on average with good performances.

3) Is it true that at a higher cost per worker also corresponds better results for companies?

The third question of the paper is perhaps the most interesting one as it is closely linked with what has been said so far about the cost of work and the role that it has within a company.

As anticipated in the *methodology* section, we eliminated the outliers of the sample to avoid taking into account unrealistic data (the Aida software provides data and, in some cases, there may be errors) and thus obtaining a final sample of 13,531 companies.

The evaluation was done separately for small and medium-sized enterprises (as for the previous ones). The companies were ordered in ascending order according to the labor cost index per employee excluding values below euros 30,000. The order obtained was thus subdivided into homogeneous quartiles so as to have in the first the set of companies with the lower value of labor cost per worker, to arrive at the last quartile, the one with the highest value.

With regard to small companies, the following table summarizes the results.

Quartiles	Cost per employee average	Average turnover	Average personal cost Tot.	Incidence% labor cost on turnover	Average result of Es.	ROE Medium
Q1	34,090	4,181,502	715,571	18.91%	132,799	13.22%
Q2	39,874	4,439,254	884,893	21.78%	164,406	12.77%
Q3	45,722	4,675,815	1,033,218	24.00%	166,385	12.20%
Q4	58,740	5,089,258	1,230,996	26.42%	229,836	13.76%

Table 2. *Small companies divided by quartiles in relation to the labor cost per worker*

The first column displays the quartiles, while the second displays the average cost per employee.

The table shows that an increase of labor cost is followed by an increase of the average result of the company, while ROE does not seem to be influenced by the cost per employee. This evidence is also followed by the average percentage incidence of labor costs on revenues, since between the first and the last quartile the distance is about 8%. As for the two final values, the average of the net profit increases by moving from one quartile to another while the ROE of the last quartile is higher than that of the first, although the latter is greater than the two intermediates.

With reference to medium-sized enterprises are concerned, Table 2 summarizes the results.

Quartiles	Cost per average attendant	Average turnover	Average personal cost Tot.	Incidence% labor cost on turnover	Average result of Es.	ROE Medium
Q1	38,003	20,695,399	3,939,950	21.02%	640,803	9.85%
Q2	45,707	21,911,973	4,504,177	22.63%	823,694	9.22%
Q3	52,363	24,720,641	5,203,387	22.81%	931,069	10.52%
Q4	66,521	26,059,730	6,214,999	26.10%	1,440,834	11.07%

Table 3. *Medium-sized companies divided by quartiles in relation to the labor cost per worker*

Leaving aside obviously the trend of the cost of labor per worker (which follows the quartiles in ascending order), it is worth noting how the average revenue increases much more than in the small companies. The average cost of total work also almost doubles the value in the last quartile with respect to the first.

The average percentage incidence of labor costs on revenue increases but less than small ones (the last quartile is greater than the first of about 5 percentage points). As regards the average operating result and ROE, we observe a greater increase than in small companies. With the average of Q4 profit more double than Q1 and with ROE rising by nearly 2 percentage points (while in the case of small about 0.5%).

CONCLUSIONS

As anticipated, this study represents the beginning of an analysis that is going to be extended to a broader sample, in order to be able to draw a trend at national level and to make a comparison with other European countries.

Despite the geographically limited sample, this research has provided interesting data in order to draw a general picture of the Italian northwest.

Firstly, Lombardy has confirmed to be the region, among those analyzed, with the strongest presence of enterprises, both small and medium-sized, counting over 70% of the sample, with about 11,000 companies on 14,970 totals. The economic data confirm this trend, albeit less evident. Lombardy is the leading region for average sales and for labor costs per worker. With regard to the average R.O.E., the Piedmont region has the highest value in relation to small businesses, while Liguria is the one for the medium-sized. Lastly, the average operating result presents the highest values in Lombardy for the only small companies, as for the averages the Valle d'aosta, which is certainly complicit in the privileged fiscal aspect and the lower number of the sample.

It can therefore be concluded that, overall, the average economic data of the sample analyzed are homogeneous and positive; which means that the area of the Northwest, at the entrepreneurial level, is generally full of resources.

Moving on to the second point dealt with in this paper, that is the comparison between small and medium-sized companies apart from the region of belonging, an interesting general picture emerges. For example, the average incidence of staff costs on revenue can be seen that in both cases this item of income statement exceeds 20% (albeit with different nominal values); This shows that regardless of the size, the cost of labor is a component that "weighs" in a business balance sheet. Another comparable data is ROE, which is around 13% in small and 10% in averages; They are both positive results but which show that in this case the equity is important, because at the numerical level, the average profit of medium-sized enterprises is inevitably higher than that of small ones, this makes the denominator in ratio for the calculation of ROE (the equity) is decisive to make it invert the tendency on the index (a lower asset leads to a greater result being the denominator in the ratio). From this evidence you can see how small businesses in the northwest are a pulsating engine of the economy albeit with smaller numbers.

In The final analysis we see the importance of labor costs demonstrated by the numbers; Taking in fact as a reference the labor cost index per employee we have seen how it is shown that the increase in the index on average increases the incidence percentage of labor cost on revenue, increases the average of the operating result (net profit) and finally, the ROE also increases; What does all this mean? That the cost of labor is a variable that is not limited to the cost function but which, together with a whole range of other components, can allow companies to improve their results. This type of analysis can obviously not be limited to the numbers, but it cannot be separated from them as they are the only tool to be able to do it.

The importance of labor costs, as anticipated in the introduction, is also demonstrated by other factors such as corporate Welfare or political attention, etc.; But it must find (and it found) inevitably reflected in the numbers.

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