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From Rags to Riches back to Rags? The Slow Economic Decline of a Successful Nation: Italy 1950-2013

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Abstract

In this paper we present the current crisis of the Italian economy as a phase of a major systemic decline. The social political system has led to a framework that has violated the fundamentals of sustained economic growth. An unhealthy implicit contract between the social-political elites and the civil society has imposed a “static” view of comparative advantage. The indispensable sectoral restructuring of the economy has not taken place, leading to stagnation. Defenceless positions have often been hiding the structural problem behind the screen of Italian exceptionalism. We stress that a growth strategy, though it has to be country and context specific, it cannot violate fundamentals. We suggest that Italy must take on again, as quickly as possible, a “dynamic” view of comparative advantage. That would entail a dramatic shift in its economic-political-social structure and it would be necessarily painful at different levels. However, this is the only route Italy could follow to stay on course for sustained economic growth.

Keywords: sustained growth, comparative advantage, technological progress, corruption, Italy

JEL codes: O52, O38, O32, N14

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1. Introduction

"If even the Simpsons are taking the mickey, isn't it time to start asking ourselves a few questions?"

An Italian woman on television after the uproar created by an episode of the Simpsons cartoon mocking Italy's "corrupt" politics

The quote at the top could be read as the motivation of the present work, though our work started long before its appearance. This paper cannot be an alarm bell about the Italian economic performance. Signals of alarm should ring before the dangers hit the target. Italy has already been hit and it is too late to raise an alarm. This paper instead is a call to arms to confront a dramatic state of affairs and widespread complacency. The Italian condition is akin to that of a family sitting in the living room and pretending that the basement is not on fire. Either that family acts quickly and efficiently or it would lose its home.

Italian policy makers, rarely an example of dynamism and speed, have been particularly inadequate in facing the rapid changes of globalization and the impact of the recent global crisis. The last IMF *World Economic Outlook Update* (January 21, 2014) has recently published upward revisions for 2014 for US, UK, Canada, Japan and all major Euro Area economies except Italy. Yet Italian public life, instead of promptly reacting to the signals, continues to be enmeshed in the polemics of "those rancorous and virulent factions which are inseparable from small democracies" (Smith, 1776).

A civil society, raised in a climate of paternalistic dirigisme and linked to the public sector by an unhealthy implicit contract, seems not equipped to compensate for the failings of the elites. Nevertheless, both groups need to rise to the challenges that the restructuring global economy poses or risk a massive collapse. We are not in a position to predict what would happen to the Italian society but we are in a position to put our fingers on some crucial features of this crisis and point to a potential way out.

2. Denial of a Systemic Crisis

Rumours of an Italian crisis are not new. Fears of a severe/irreparable crisis have been surfacing periodically over the history of the Italian Republic. However, every crisis has been dismissed as an episodic event that "Italian exceptionalism"[1] could tame. The current crisis is biting worse than did previous crises and Italians have started to feel restless. We Italians were unprepared for it. It fell on us as a sudden shock from another dimension: the demons of international finance that triggered the 2007-2008 global recession. It should have not. In fact, the truth is that Italian political "elites", social "elites" and civil society have for a long time ignored easily detectable signals of an impending decline that they have brought upon themselves. The "global crisis" has only exposed severe structural flaws of the Italian socio-political-economic system and not created them. Nevertheless, Italian political elites have presented the crisis as only a cyclical consequence of the global recession, as a by-product of Italy entry into the Euro area, or as a mixture of the two; as a "politically" induced economic crisis; as a structural crisis due to exogenous factors (???)[2]. These elites do not (and did not) view the impending predicament as an endogenous systemic crisis vis-à-vis warnings about productivity decline from

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[1] The expression "Italian exceptionalism" for us has no meaning except for the self-belief of many Italians of being exceptional.

[2] A one-to-one correspondence between our short list and the following public statements of members of Italian Governments can be easily detected. In 2005 Giulio Tremonti, the incumbent Minister of the Economy, declares "China, the WTO and the Euro changeover have precipitated Italy in a deep structural crisis". On January 27th, 2006, Giulio Tremonti, incumbent Italian Economy Minister, shouts "Go to back to Turkey" to Nouriel Roubini remarking the performance of the Italian economy at a Davos meeting (http://www.economonitor.com/nouriel/2006/01/28/italys-tremontis-temper-tantrums-on-emu-in-davosa-sad-embarrassing-episode-for-italy/). In January 2008, incumbent Prime Minister Romano Prodi rejects Spain's overtaking of Italy in GDP per-capita terms (http://www.loccidentale.it/node/11377). In August 2011, Incumbent Prime Minister Berlusconi rejects negative assessments of Italian economy, and claims that the crisis was born from international, rather than domestic, economic instability (http://theconversation.com/as-italys-debt-crisis-deepens-is-berlusconi-turning-a-blind-eye-2674). In January 2013, Giulio Tremonti, former Italian Economy Minister of Berlusconi's governments in 1994-1995, 2001-2004, 2005-2006 and 2008-2011, states that Italy's accounts were sound in 2011 and that the crisis is only a crisis of political superstructure helped by the Euro crisis (Panorama, 16-01-2013).

different sources (e.g. Daveri and Jona-Lasinio, 2005; Rossi, 2007; Hassan and Ottaviano, 2013). The Italian political classes have been clutching at straws not only for immediate electoral reasons. They were also at pain to avoid confronting a reality that represented and represents a threat to the foundations of their political power. They were and are willing to close their eyes to an impending catastrophe in order to preserve as long as possible a system in which their culture and power are rooted. As Alesina and Giavazzi (2011) have put it: "…country's leaders are in denial – it is as if they are trying to take aspirin to hide the symptoms of pneumonia".

Data leaves no doubt that the Italian Economic crisis is a slow burning structural process that predates the 2007-2008 global recession by decades. The cause of the crisis is that Italy has been violating the economic fundamentals of sustained economic growth. Governments' distortions and mismanagement with the implicit wide consensus of the mass population have stifled the process of growth. We claim that the roots of this predicament should be found in a cultural-socio-economic system that has been devised long ago and in its implementation. There has been a long-standing implicit contract between the mass public and the elites that has generated and fostered a culture that hinders structural restructuring and is "anti-growth". In this extreme situation, paradoxically, the global crisis could provide support to "anti-modernizing" lobbies. However, it could also be the tool for reversing the negative trend. In what follows we present a brief sketch of major results in Economic Growth research, framing Italian data into a perspective that shows the long-run structural nature of the crisis and then discuss its roots and potential cures.

3. A Sketchy Survey of Fundamentals of Sustained Economic Growth

It would be useful to summarize some of the fundamentals that characterize the process of economic growth[3]. It is in fact important to recall that, though a growth strategy has to be country specific and context specific, nevertheless it must respect fundamentals.

Economic Growth, by its nature, entails a trade-off between current and future consumption as it requires investment. This investment activity in turn is justified by the existence of large potential markets wherein to sell produced goods and services. There exists mounting evidence that economic growth is a decentralized bottom-up process that entails economic freedom, entrepreneurial activity and functioning markets. If an economy cannot access the relevant markets or ceases to be competitive in them, the growth process either will not take off or will not be sustainable. The notion of "comparative advantage" lies at the heart of the growth process. An economy, such as Italy in the post WWII period, in order to take off would specialize in the sectors where it has its relative strength. Often, in this dimension, a weak currency through appropriate devaluations or managed depreciation would help the economy to keep competitive vis-à-vis other economies. If the triggered trade process succeeds, it would affect positively the economy, increasing its income, capital intensity and real wages. However, this triggered economic advancement could be sustained if and only if continuous innovation through competition is taking place since technological progress outdoes the constraint imposed by diminishing returns and allows for sustained increases in productivity. If the amount of factors of production matters as much as innovation in determining the level of output per-capita, technological progress is crucial in determining the growth rate of output per-capita. Thus, economic growth must be open to innovation, learning and knowledge to bring about productivity improvements and the associated necessary restructuring. Such indispensable transfer and/or creation of knowledge calls for sufficient levels of skill and understanding (especially in a technologically advanced world) and so for investment in human capital through education and learning by doing. As knowledge is a non-rival and non-excludable good, knowledge transfer plays an important role in the growth process. Nevertheless, innovators may enjoy a temporary market advantage lasting until the next upgrading innovation. Processes of restructuring and creative destruction, where value is created and destroyed, have to occur if an economy wishes to keep its growth going. Thus, in a picture entailing a dynamic and non-static view of comparative advantage, entry and exit flows of product accompanied by reallocation of resources and large flows of job creation and destruction are indispensable. Opposing these forces would bring the growth process to a halt and perhaps reverse it.

[3] We present well-known results that can be found in established textbooks. Clear accessible expositions could be found in Jones and Vollrath (2013) and Weil (2013). At more advanced level, one may consult Acemoglu (2008), Aghion and Howitt (2009), Barro and Sala-i-Martin (2003). In our presentation, we have been following the exceptionally clear and focused presentation of Spence (2011).

As stressed by Spence (2011, see in particular chapters 11, 12, 13, 14), reliance on markets and incentives has to be held up by proactive government action. Government must guarantee settings where private investment is profitable. Public investment infrastructure, human capital and institutions aimed at information diffusion are crucial as they are supporting private investment, innovation and knowledge transfer. Public sector investments should be accompanied by growth-oriented policies that favour openness to global markets, guarantee economic freedom through an efficient and enforced legal system and fight corruption. All these actions should be taken to warrant inclusiveness as an indispensable ingredient for investing behaviour, as agents will be willing to renounce current consumption for investment if and only if this choice will bring benefits to the future of his/her household. Defective government behaviour could not only harm seriously economic growth, it could be fatal. As Lewis (1955, p. 376) pointed out "Governments may fail either because they do too little or because they do too much". If government behaviour could be unsuccessful in "good faith" for lack of correct judgment, it could be disastrous when tainted by corruption. Corrupt policy makers would hamper growth because they would waste government revenue and encourage governments to act in their own favour (and/or conniving groups) instead of collectivity. This sort of public sector behaviour would foster opportunities for bribery and patronage, undermine the rule of law, weaken the judicial system, impose barriers to entry and so hamper restructuring. Dysfunctional public governance paves the road of failed attempts to economic growth.

4. From rags to riches back to rags?

Data clearly show that the Italian crisis predates the recent global crisis and the euro crises and that the latter have just exposed the ongoing decline of the Italian model. In Figure 1, we observe the natural logarithm of the real GDP per-capita of five countries (including Italy). As we are looking at logarithms, the slope of the lines represents growth rates. The real GDP per-capita is usually assumed as the basic index of individual material affluence and its growth rate as the basic indicator of economic growth. The Italian economy grew at steady relatively high rates over the three decades of the 1950's, 1960's and 1970's. It has increasingly slowed down since then. While the reduced speed of the 1980's could be explained by the productivity slowdown that affected western economies, the subsequent declines in growth rates cannot be accounted for by it[4]. It cannot be explained also by a negative international business cycle. Its explanation has to be found elsewhere.

Figure 1

Behind output behaviour lies the behaviour of the factors of production. Let us first recall that a production function in intensive form is defined as:

$$Output\ per\ worker = productivity\ \times factors\ of\ production\ per\ capita$$

and so its growth rate is given by:

$$\begin{aligned} &Growth\ rate\ of\ output\ per\ worker \\ &\qquad = growth\ rate\ of\ productivity + growth\ rate\ of\ factors\ of\ production\ per\ capita \end{aligned}$$

Across countries, empirical evidence tends to suggest that, while productivity and the intensity measures of inputs are more or less equally relevant in determining the level of output per worker, productivity is the key determinant of the GDP per-capita growth rate.

Starting with the information supplied by capital, we can see that Italian investment in physical capital (slope of the natural logarithms of the physical capital stock plotted in Figure 2) has kept pace with Germany and France and has been relatively higher with respect to the EU especially up to the late 1970's. The two ratios (physical capital/output) and (physical capital/hours worked) presented in Figure 3 also show that there was no want of capital intensity.

Figure 2

[4] The real GDP percentage increments, after recording startling values in the 1950's and 1960's and the relatively lower ones in the 1970's and 1980's, have been dwindling since the early 1990's to a state of no growth or negative growth. Though all the European Union has slowed its pace of growth as well, Italy has fared even worse and has not been able to touch, let alone to exceed, the 2% growth ceiling over the last two decades.

Figure 3

However, a different picture surfaces if one looks at the human capital/hours worked ratio shown in Figure 4. Italy experiences a clear and alarmingly high deficiency in human capital intensity. Thus, while investment in physical capital has not been deficient, at least in terms of quantity, investment in human capital has been quite low. This could depend on the lack of inclusiveness that we shall discuss below.

Figure 4

Low human capital intensity is an alarming indicator, as an economy needs skills, learning and knowledge to accommodate the information flow indispensable for economic growth. This deficiency is corroborated by the education data. There is no doubt that Italy has taken giant steps in overcoming problems of illiteracy, inherited after the end of WWII, and in expanding education at the lowest levels of schooling (Figure 5, Panel A). The average number of years spent in education for the population older than twenty-five in 1950 was four, just below the minimum required to complete elementary schools. By 2012, it has more than doubled. However, it is still below countries like Germany, France and Canada. Even though there is a definite improvement in terms of minimum education, probably it is not still sufficient for coping with the demand of the contemporary high tech environment. Certainly, Italy fares very badly in terms of tertiary education (Figure 5, Panel B) where it is not only lagging with respect to the other advanced economies but its gap is also widening. These symptoms of human capital insufficiency become even more disturbing when one takes into consideration quality. Italian universities are relegated in lower and lower positions in the international rankings. This state of affairs has been exacerbated by the recent reform with emphasis on dirigisme and centralization[5].

Figure 5

Labour productivity, both measured in terms of output per worker and per hours worked (Figure 6), after registering a rapid increase in the post-war decades, has been slowing down (markedly since the early 1990's) and it is now stagnating. Figure 7 shows that Italy was the only country among the major economies that recorded a negative productivity growth in the manufacturing sector in the years 2000-2005. TFP, Total Factor Productivity[6], puts in the picture the effects of technological progress on productivity: it provides information about output increases brought about by the same amount of inputs. The signals are similar to those emerging from labour productivity. Italian TFP grew rapidly during the 1950's-1960's, it slowed down over the 1970's-1980's and started declining since the mid 1990's (Figure 8). As we have stressed above, an economy cannot keep up sustained economic growth unless it experiences sustained increases in productivity fuelled by innovation.

Figure 6

Figure 7

Figure 8

This limited amount of descriptive evidence should have been sufficient to set off an alarm for the Italian political and social elites to start asking some hard questions and take action to prevent a potentially incipient decline of the economy. It is necessary to add more information in order to understand the depth of the Italian elites' refusal to admit the possibility of a systemic crisis and to react to it forcefully. This observable gloomy perspective, already emerging in the early 1990's, should be compounded with Italian loss of competitiveness on global markets that has partly concealed by currency management until Italy's entrance in the euro area (Table 1).

Table 1

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[5] See Pelloni (2010) for a discussion of Higher Education in Italy and its failed reforms. We wish to stress the pernicious effects of the so called Gelmini reform. When Pelloni (2010) was published there was only one Italian University in the top 200 in the THE (Times Higher Education) World University Ranking (Bologna University, ranked 172nd in 2009). In the latest THE World University Ranking (2013-14) there is no Italian University in the top 200 (Trento University is between the 201 and 225 positions and Milano Bicocca, Trieste and Turin University are between the 225-250 positions. The other Universities are all ranked below the 250th position). This is further evidence of Italian resistance to needed liberalizing changes via the implementation of reactionary reforms aimed at strengthening dirigisme and political control. The outcome is clearly devastating.

[6] Sometimes also called multifactor productivity, MFP.

Clearly, this structural loss of competitiveness hindered growth and is linked to the inability to carry through the necessary restructuring required by a dynamic view of competitive advantage. This lack of restructuring is not accidental but linked to a deliberate policy choice aimed at protecting jobs and not workers, as we shall discuss later on in this work. For the moment, it suffices to note that Italian competitiveness weakened with an associated loss in terms of trade benefits including those from knowledge transfer. The low flow of net foreign direct investment (FDI) and the widening gap between the Italian stock of FDI and that of the EU27 (Figure 9) also bear out the potential presence of a structural trade frailty and a shortfall of knowledge transfer through trade (Oliva and Rivera-Batiz, 2002; Saggi, 2002).

Figure 9

The country's production specialization structure lies behind this deterioration of Italy on the global markets. The Italian economy is inhabited by a multitude of micro enterprises that specialize in the production of commodities with low technological content in both the manufacturing and service sectors (Table 2).

Table 2

Because of their modest dimensions, these micro firms tend not to expand, to stay on in the same sector, and not to invest in commodities with high technological content because much larger dimensions are needed to face the R&D costs and exploit the associated economy of scale. Why does Italy have so many micro and small enterprises? The reasons of such structure should be found in[7]:

- An archaic, complex and anti-efficiency legal-administrative system that is the product of a culture with similar characteristics;
- Difficult and complex access to credit[8];
- High start-up costs[9];
- A complex tax system characterized by high corporate taxation;
- Organized crime pressure.

As we shall see later, these factors can be seen as some of the tools for enforcing the implicit contract between the political-social elites and the mass public at industrial (and social) level. For the moment, it suffices to say that the implementation of these instruments has deterred the creation and destruction of firms, their potential expansion as well as entry and exit to and from sectors with consequent tightening of the production system. This state of affairs is reflected in a low level of economic freedom (Figure 10 and Table 3) with an Italian score just above the world average and below the regional average[10].

Figure 10

Table 3

The inadequate score in terms of economic freedom goes along with a poor and deteriorating score in the Democracy rankings (Table 4). If economic freedom is a necessary condition for growth, since growth is a bottom up process rooted deep in market activities, democracy is not necessary for growth. However, as Spence (2011) suggests, a good democracy may help.

Table 4

Among the mentioned determinants of the Italian industrial structure, we indicated corporate taxation. It is better to look at corporate taxation from the perspective of public finance. Italian public finance has come

[7] Cf. also Rossi (2007).
[8] Cf. Acemoglu (2001) and The World Bank Group (2014).
[9] Fonseca et al. (2001) show the negative impact of high start-up costs on employment for several countries including Italy. For the high start-up costs of Italy with respect to other advanced economies see http://www.doingbusiness.org/data/exploretopics/starting-a-business.
[10] The two most common indexes on economic freedom were surveyed (the Index of Economic Freedom by The Heritage Foundation and the Level of Economic Freedom by the Fraser Institute). The results for Italy were grossly the same.

under severe criticism for several decades[11] and has been the object of an endless debate. The Debt-GDP ratio has been higher than 100% since 1990 when it reached a value of 104.5%. In the first decade of the XXI century, the situation has deteriorated even further (Figure 11) stretching to 126% in 2012 with an expected value of 132% for 2013. Such high and increasing values of the Debt-GDP ratio come along with huge fiscal pressure, which has been particularly high at corporate level (Figure 12, Panel A, and Table 5). The Italian total corporate tax rate is 24.5% higher than that of the OECD and the major source of discrepancy lies in labour tax and contributions. The latter are undoubtedly very high. However, if and how big a realignment is necessary could be decided only in terms of the trade-off between welfare-redistribution and efficiency-sustainability. We shall look at some of these issues later on. It is evident from Table 5 that the relative high costs are also generated by the time required to prepare taxes. This holds in general for all sorts of Italian taxation and, though in decline, it is still much higher than the EU value (Figure 12, Panel B). It is worthwhile to point out that Italy until mid-1980's made an intensive use of the inflation tax (Figure 13) which tended to hide the real dimensionality of public deficit and accumulated public debt. It was only with the so-called divorce between the bank of Italy and the treasury that introduced a transparency needed to implement a discipline in public sector accounting.

Figure 11

Figure 12

Table 5

Figure 13

How is it absorbed the Italian public expenditure? A large part of it converges to pensions, compensation of employees and healthcare (Figure 14). Notwithstanding compensation of employees seems stable over the last 30 years, this part of public expenditure should to be investigated more thoroughly. More binding public employment policies have had a relevant effect on the rate of growth of Italian public employment, which had been dwindling from the beginning of the 2000's, and it has become even negative in the last 7 years. Therefore, something has happened to the per-capita compensation of employees. This result is confirmed by looking to the steep increasing series of the income per-capita of Italian public employment (Figure 15). Even though high per-capita wages characterizing general government could reflect higher human capital, wage moderation is needed at all levels of government. Moreover, serious asymmetries to be considered are the regional distribution of government jobs (a higher share going to workers of the *Mezzogiorno* compared to workers of the North) and the uniform per-capita wages (with respect to low Southern prices compared to Northern prices).

Figure 14

Figure 15

A usual justification for high taxation, high public expenditure and high running deficits is social fairness, equality and inclusiveness. This line of defence has often arisen in Italy alongside support for a rigid labour market and industrial structure. This claim could be easily checked by looking at the "Great Gatsby" curve (Figure 16). Along the vertical axis is measure the intergenerational earnings elasticity. The higher the value of this elasticity the higher the chance that a household generation would belong to the same income bracket of its previous generation (i.e. the probability that children/grand-children would have similar incomes to their fathers/grandfathers). The variable on the horizontal axis is the Gini coefficient which proxies income inequality. The higher the value of the index, the higher is income inequality. A country located on the North East side of the figure is scoring badly on both accounts. As we can observe, Italy is to be found on the top right hand corner of the graph and it is thus performing dismally. Therefore, it is difficult to argue that fiscal policy has been a tool for inclusiveness, fairness and social justice.

[11] In 1981, Beniamo Andreatta having foreseen the massive problems associated with Italian public finance, together with the then Governor of the Bank of Italy Carlo Azeglio Ciampi, masterminded the so-called "divorce" between the Bank of Italy and the Treasury. We think that Beniamino Andreatta, Carlo Azeglio Ciampi, Mario Draghi and Luigi Einaudi have been the four major modernizing figures in Italian public life. Their insights and work may have been ahead of their times and seen still modest realization but have laid the foundation for a more modern and better country (Einaudi, 1983; Andreatta, 1992).

Figure 16

If high taxation and high public spending are not positively related to inclusiveness, what are they positively related to? As advocated by several sources the answer could correspond to the Simpsons' mocking: corruption. Beyond anecdotal stories and news reports, there is strong evidence of the high level of Italian corruption[12]. Italian Fiscal Policy is strongly pro-cyclical, which is a signal of public sector corruption[13]. The Corruption Perceptions Index[14] (CPI) also bears out the high level of corruption that characterizes the Italian economic and social system (Figure 17 and Table 6).

Figure 17

Table 6

The Italian level of corruption is not only abysmally high (low value of the CPI) with respect to the top economies of the largest EU (France, Germany, UK) and all the more advance economies, but it is also lower of several underdeveloped countries or countries just on the verge of take-off. There have been signs of improvements in the late 1990's but after stagnating for about a few years it has declined since 2007. Thus, corruption remains high and strong notwithstanding many public cries against it. As widely acknowledged by economists, corruption is a major obstacle to economic growth. Following Weil (2013), we can encapsulate the negative links between corruption and growth in three encompassing categories: waste of government revenue; policies aimed at fostering opportunities for bribery; rule of law undermined and judicial system weakened. Among the negative consequences of a "grabbing hand"[15] is its link to start-up costs that creates barriers to entry. Djankov et al. (2002) provided evidence that "[c]ountries with heavier regulation of entry have higher corruption and larger unofficial economies". As pointed out (cf. also note 9 above), Italy has been experiencing high start-up costs, low level of restructuring and high corruption level. Economic growth is the victim of this unhealthy state of affairs.

In conclusion, of this section, Italy was very successful in the 1950's and 1960's, but now it has been stagnating for quite a long time. There are clear signals that Italy has not respected the fundamentals of sustained growth. The Italian economic system:

- Has kept a tight rein on economic freedom: the necessary bottom-up process for growth has been opposed with excessively burdensome bureaucratic processes and restrictions. An aspect we did not discuss above which has to be mentioned is "Corporatism": Italian society is subdivided into "guilds" subordinate to the state;
- Has relied on a static view of comparative advantage.

These strategic choices have hindered the restructuring of the Italian productive system. A restructuring which with the associated job, labour and capital mobility, is indispensable for a process of sustained growth. The effects and by products of this course of action were to make the Italian economy:

- Loose competitiveness;
- Keep FDI flows low;
- Be cut off from the fast dynamics of trade involved by globalization and the ICT economy;
- Keep knowledge transfer low;
- Keep human capital accumulation low;

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[12] Corruption in Italy is a well-known and established plague, for a scholarly discussion see Del Monte and Papagni (2007).

[13] See Alesina et al. (2008) and Aghion et al. (2011).

[14] Transparency international, each year, scores countries on how corrupt their public sectors are seen to be. The Corruption Perceptions Index captures the informed views of analysts, businesspeople and experts in countries around the world.

[15] Djankov et al. (2002) define public sector corruption and kleptocracy as "grabbing hand".

- Neglect inclusiveness with the consequence of discouraging workers, inducing low participation, decreasing labour productivity and draining talent.

This massive failure has been supervised by a highly corrupt public sector that distorted the necessary synergy (for growth) between private and public sector by favouring specific groups and subgroups. A massive and costly body of civil servants and public employees has characterized public sector.

What has happened? Is any decisive action being taken to stem the tide and reverse the trend? We will answer these questions in the next section.

5. Why is Italy doing so badly after doing so well?

"Corruptissima re publica plurimae leges"
(When the republic is at its most corrupt, the laws are most numerous),
Tacitus, The Annals of Imperial Rome, 3, 27

"Either the nation must destroy public credit or public credit will destroy the nation"
David Hume, Of Public Credits, in "Essays Moral, Political and Literary", pp.360-61, Indianapolis, 1985

As we have seen, major signals of decline started to emerge in the early 1990's. Globalization, the ICT revolution and the end of the "Cold War" caught Italy unprepared as it had linked herself to a "static" view of comparative advantage. Though these warnings were clear, neither the political and social elites nor the civil society at large responded to the challenge. The pervasive complacency we have referred to in the introduction was and still is the prevailing attitude in Italian economic, political and social circles. The question then is: why?

First, it looks like that the political and economic-social elites have not taken economic performance and growth seriously after the 1950's and 1960's and have contributed to form governments that did not have economic performance and growth as a priority. The disturbing high level of corruption suggests that governments and elites have not been able to tackle this issue successfully either. This failings have left them open to the criticism of having acted in their own interest and/or that of associated lobbies/subgroups and not that of the mass public. Whether this criticism is correct or not the observed outcome is an economic-social-political system that is to a large extent anti-innovation/anti-growth. Public action in human capital formation has been unsuccessful beyond the level of primary education. The school and university systems are outdated, regulated by a complex dirigisme, highly dependent on governments and so exposed to the vagaries of political life more than to educational objectives. Governments and elites have been unsuccessful in terms of inclusiveness and a future orientation as the great Gatsby curve clearly conveys. The astonishing fact is that mass of population, the civil society has not opposed these drifts and often has even cooperated with each other in building them up. It appears as though the political-social elites, on the one side, and the civil society, on the other, did not want and do not want to alter the status quo and take on the indispensable dynamic view of comparative advantage. Italy's image is that of a decadent, complacent, ossified society ignoring its ongoing decline and imminent collapse and unable to change its course of action. So why is nobody doing anything?

As Alexander Hamilton stated in the Seventieth Federalist: "Energy in the executive is a leading character in the definition of good government". Italian executives often lacked vigour. The so-called Italian Republic emerged from what has been considered the failings of the first Republic in terms of government and political accountability and transparency. An effective modern liberal democracy needs a strong executive but within an equally strong system of constitutional accountability. It looked like that Italian governments and the political parties, on which they depend, had enjoyed too much immunity at different levels. The recent popular discontent, its impact at the polls, the fractious confrontations inside political parties could be signals of failure of the Second Republic in this dimension as well.

Is this enough to reply to our question? Even in the presence of sluggish and weak governments, the democratic dynamics between executive and electorate should have brought about some positive action. Instead, we have to ask ourselves the following questions: why are public services so bad and inefficient in a country that spends so much on them? Why has no political party and/or government attempted to stand up to the over-dimensionality, the cost of public services and/or their arrogant and inefficient quality [notwithstanding occasional large majorities (e.g. Berlusconi Gov. 2004) or non-party technocratic administrations (e.g. Monti Gov. 2011)]? Why potential nefarious links between private and public sector have not been kept in check, subdued and possibly erased? Why in Italy has there been a strong support for a complex and highly bureaucratic centralism as the only option available (a support which has gathered momentum both in the first and second republic)?

The answer should be well known: Italians have chosen a particular form of "Partitocrazia" (Particracy) as a form of (operational) government supported by a corporatist economic system that nobody is willing to challenge. The majority of the country is unwilling to challenge it because the majority of the country is extracting rents out of it. The over-dimensional and inefficient public sector is a powerful instrument for the appropriation of these rents. The Italian public sector is not fulfilling its fundamental tasks with respect to economic growth but it seems to prop up "successfully" the *rentiers*. It is clear that such an environment may foster cronyism, nepotism and rent seeking. The European Commission (2014) stresses that Portugal, Slovenia, Spain and Italy are the EU countries where corruption is a serious concern. By paraphrasing Kafka, we could claim, "The manacles which torment mankind are wrought from the forms of the bureaucrat" (The trial).

In a particracy, the political parties control the political process and not the electorate. This weakening of the democratic process would not necessarily hinder economic growth if it did not necessitate a corporatist system where specific guilds extract rents for their members independently of market signals. However, if particracy is of a particular form with roots in "trasformismo" the potential damage could be so extensive as to lead the country to the brink of collapse. Some historians (Hine, 2001) ascribe the failings of Italy to its failure to become a modern liberal democracy[16]. We do not wish to bring the discussion into a political science dimension, but we share some of Hine's views about the origins of Italian weaknesses and we believe that some liberal prescriptions (especially those of a certain "revisionist liberalism") would have helped Italy to avoid some basic pitfalls. Following Hine (2001), we divide post 1860 Italian political history into four periods[17]:

1. 1861-1921: "trasformismo";
2. 1922-1945: "Fascism" (autocratic "trasformismo");
3. 1946-1992: two opposing blocks (closet "trasformismo");
4. 1993-2014 (and beyond?): "trasformismo" with vengeance;

and we define "trasformismo" (Hine, 2001, p. 215) as "a parliamentary culture built on individualist political entrepreneurship: a political market-place of extensive locally based clientele politics associated with a high degree of corruption." This culture and its practice has been fitted into the life of Italian political parties, generating what we may label the "particracy of transformism". Political parties have been ruling Italy through explicit "trasformismo" (1861-1921; 1993-2014) or implicit "trasformismo" (1922-1945; 1946-1992). If there were a gridlock of the party system (1922-1945 and 1946-1992) then a proliferation of "currents" within a political party would materialize. On the other hand, if such a deadlock did not exist then Italy would be infested by a proliferation of political parties.

"Corporativismo" (corporatism or corporativism) is the economic framework within which this political system could operate: Italian society is divided into "guilds" subordinate to the state and, so, largely to political

[16] It is our opinion that Italy had missed the modernizing influence of the Scottish Enlightenment with its focus on the theory of improvement that found its summit in Adam Smith's "The Theory of Moral Sentiments" (1759) and "An Inquiry into the Nature and Causes of the Wealth of Nations" (1776).

[17] Our main difference with Hine's subdivision concerns the continuity of "trasformismo" which we see as a characterizing factor even during periods 2 and 3. However, we are indebted to Hine (2001) for it and for much of the discussion which follows.

parties. Industrial and professional associations group employers and employees within guilds to control individuals and activities within their jurisdiction and to give political representation. Signals coming from markets are subordinated to the interest of the guild or suppressed by the system.

As Hine (2001) pointed out, the consequences of such an economic-political-social organization have been pervasively harmful. The machinery of the state became subservient to political parties and the advantage of social elites that brought about a colonization of the state machinery. Party membership became an important criterion for employment and advancement in government and public administration (civil service, judiciary, police, health services, local government payrolls, schools, university, state-run broadcasting corporation and also private one because of unsolved conflicts of interests). The inevitable consequence was that this machinery became a reservoir of patronage, subservient to the advantage of political elites, where professional impartiality was not permitted. It also resulted in a failure to bring about “proper political parties organizations” with well-defined operational programmes (except informal practices to control the state machinery and political power). It was unavoidable that a deep fear of a free market system would characterize the “ethos” of this society. Economic freedom has been seen as a potential threat to this political organization. Private enterprises had to be controlled and somehow associated with the political mechanism, thus the need for strict regulations and subsidies widely used to control entry, exit and survival of firms.

However, since the post Second World War period, Italy is a democracy (albeit highly imperfect) and so for any political system there is need for some consensus. There is a need to appease the mass public so, through the supervision of political parties (centre, left and right); an implicit contract has been subscribed to link together private and public sector. In exchange for security, people would guarantee support to political lobbies. Politicians and close allies would extract the higher individual rents while the general public individual rents would be much lower but safe and devoid of responsibility. Political parties, trade unions, central and local governments and other politically controlled organizations should guarantee the fulfilment of this contract. This way “the jobs delusion” was created: jobs have to be safe. The Public Sector must intervene not so much to provide infrastructure and education, and fulfil its other basic tasks, but mostly to guarantee the survival of firms and jobs and absorb workforce into the public sector when necessary. Occasionally, this state of affairs could have been made paradoxically easier by the presence of organized crime (another legacy of the early trasformismo). By protecting jobs, the political and social elites did not and do not protect workers but look after themselves. The system we have built is inherently static and in contrast to a dynamic view of comparative advantage. With no restructuring, industries that were once competitive but are not competitive any more stay on, new industries are not emerging, creative destruction cannot take place and the system loses competitiveness, tends to stagnate with potential high unemployment.

Should we assign the responsibility to the political class and the associated elites? Certainly, given the function of leadership that they should exercise they have to take some responsibility of the decline. However, this responsibility should be put in a wider perspective. We deem “The fault is not in the stars of the Italians, but in the Italians themselves”[18] or, as the French political philosopher Joseph de Maistre said (1853), “Toute nation a le gouvernement qu'elle mérite” (Every nation has the government it deserves). The political classes, the social elites and the mass public have collaborated in creating the conditions that have triggered the Italian economic decline. We are accomplices in the attempted murder of the Italian economy. The institutions that govern Italy are the product of the country’s culture, a culture that has emerged from a long, tormented and unfinished process of unification. The Italian civil society has subscribed a contract for a long time and it is reluctant to modify it, though now there are signs that one of the signatory is defaulting. The Italians are trapped into this arrangement because of some sort of path-dependence. The paradigm (partitocrazia with trasformismo) that was the first to emerge from the country unification has become deeply rooted in the society. It is persisting because of the legacy it generated, notwithstanding its low quality.

[18] A paraphrase of Cassius admonition to Brutus in Shakespeare’s Julius Caesar (act1, scene2).

A potential question is: why then was Italy successful in the 1950's and 1960's? The answer is simple. Italy was coming out of the war, its structure was in the making, and the leading paradigm was not operational yet. In that period, Italy was able to use comparative advantage to launch its industrial sector and exploit a relatively weak currency to sustain competitiveness. As time went by "particracy with trasformismo" got control of the country while the relative Italian position in international markets required a flexible upward modernizing adjustment that did not take place. A flaw that became dramatically evident from the early 1990's with the end of the Cold War and the take-off of globalization.

6. Further Considerations and Conclusions

The above discussion suggests that Italy must take on again, as quickly as possible, a dynamic view of comparative advantage. That would entail a dramatic shift in its economic-political-social structure and it would be necessarily painful at different levels. However, this is the only route Italy could follow to stay on course for sustained economic growth. We are sceptical of economists, non-party technocrats and politicians suggesting that to "re-start" Italy is enough to introduce some degrees of liberalization in the labour market, like the half-backed Fornero reform under the Monti Government, and/or to cut public expenditure without touching power centres[19]. The labour market and public sector that Italy has are the labour market and public sector we Italians wanted, e.g. the layers of corruption that lie beneath certain institutions have been moulded with the complicity of the Italian civil society itself. Italian growth cannot be re-started and sustained by tinkering with the labour market and public sector.[20] The failure of the Monti Government, which tried to fulfil his technocratic mandate with a step-by-step political consensus, is indicative of how even limited moderate reforms are unfeasible within the current system. Italy needs a fast, drastic and dramatic reform. Italy needs to erase the implicit basic social contract that has been ruling it over several decades. Only we Italians can do that. It would require a massive change of direction. It would need a jump in self-awareness and social cohesiveness: a huge cultural change. Not a reform but a new foundation.

This re-foundation implies a new mind-set for the Italian civil society, an outlook where it would stop to play the role of the ruled and where it would instead get control of its intellectual, moral, and political life. Of course, such a massive change would take time and meet strong opposition from powerful corners and can come across as utopian. Nevertheless, it is indispensable and would be seen as utopian only by those wishing to keep the status quo. However, as short run problems are pressing, some fast response in terms of demand management[21] is needed though it would be meaningful if and only if fitted into the long run perspective. Patchwork policies would not be sufficient and, at worst, they would be damaging.

A positive signal is coming from some sectors of the Italian economy (Mediobanca and Unioncamere, 2012)[22]: the chemical, food and pharmaceutical industries show vitality and dynamism and could be a source of future hope. Of course, these firms still represent a small fraction of the entire system but once projected in a new, pro-growth, healthy context they could be a springboard for the revitalization and restructuring of the Italian productive system.

Because of many factors such our culture, history and landscapes, another encouraging element that we Italians enjoy is an enviable degree of goodwill abroad. Furthermore, Italy has a strategically important role within the Euro area. Contrary to common Italian belief of a hostile Germany and international environment, Italy would not have probably been able to survive the 2011 crisis and carry on its current state of fragility, instability and passivity without the support of the Euro area, Germany included. The vital, but time inconsistent, interventions of the ECB would not have been possible without the consent of the Euro partners. However, Italy should not abuse this "benevolence". A prompt reaction from the Italian quarters is called for.

[19] With the esclusion of Francesco Giavazzi's support to the Gelmini's reform, we share most of the views expressed by Alesina and Giavazzi in many popularizing articles especially in the Corriere della Sera. Nevertheless, they present their claim for reforms as piecemeal actions outside an indispensable general reform structure.

[20] Beniamino Andreatta (1992) pointed out the damages of gradualism and the inability of Italian governments of "taking the bull by the horns". Unfortunately, his advice has fallen on deaf ears. This deafness shares a huge responsibility for the current decline.

[21] Carlo D'adda (2013, 2014) stressed the necessity of restarting the Italian economy through demand management.

[22] We wish to thank Carlo D'Adda for this reference and stressing this positive outlook. We thank Khawar Nasim and Giuliano Pancaldi as well for alerting us on stressing this issue.

The following policy measures should be taken as quickly and as efficiently as possible and the international goodwill will help Italy in its effort.

The regeneration of the public sector requires a sufficient amount of political stability. Probably the latter cannot be achieved without some reform of the Italian Constitution and electoral system. This objective could be reached with a minimum of corrections to the existing constitutional text and avoiding a massive rewriting that would be tantamount paralyzing the reform process. The constitutional redrafting should imply a simplification of the legislative system that, up to now, in its outdated, burdensome, complex structure has highly hindered the modernization of the country. Introducing the required minimum redrafting could be done quickly and efficiently if public opinion will force political forces to act in the general interest and not only in their own. We are deeply pessimistic that political parties would easily relinquish their advantageous position in favour of a cohesive action unless pressed by a forceful pressure from the general public.

In principle, Italian political classes should lead by example reducing the costs of politics[23]. Leading by example would empower policy makers to introduce necessary public expenditure cuts, taxation cuts and labour market reforms (for both the private and public sector). Corporate taxation should be brought down at least to European levels while income taxation should be simplified with respect to its current complex fragmentation and it should introduce a higher degree of progressivity. Acceptable and transparent public expenditure and tax systems are indispensable to generate social trust, support and cohesiveness while the current one is largely viewed as arbitrary and oppressive.

The questions are: would the Italian society be willing to struggle to provide this new context? Can a civil society, raised in a climate of paternalistic dirigisme and linked to the public sector by an unhealthy implicit contract have the strength, resilience and dedication for such a task? Alternatively, would it prefer to stick to its old mores and tastes, accept negative growth and abandon the club of the advanced economies?

[23] E.g. cutting parliamentary salaries and benefits, cutting the sizes of the house of parliament and the senate, introducing transparency and tighter external controls on public finance, eliminating sources of inefficiency and/or useless waste of resources like the unjustifiable simultaneous existence of “Regioni” and “Province” and the existence of the cost-enhancing “aziende municipalizzate” (municipalized companies).

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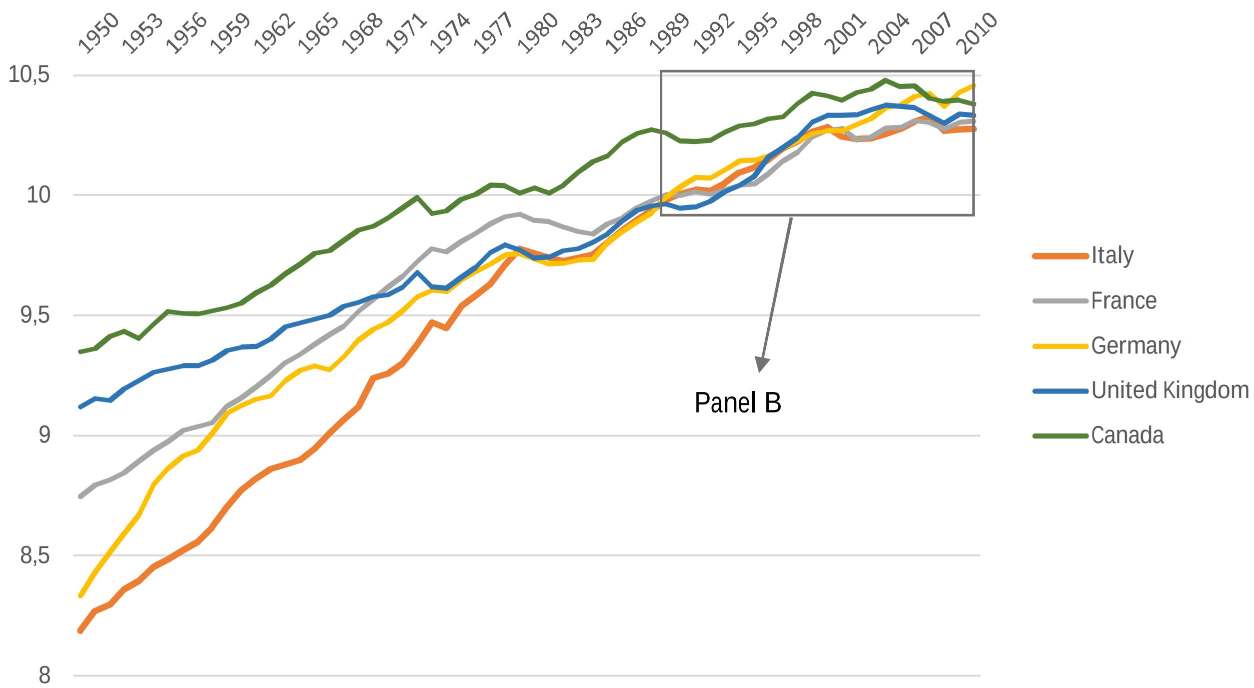
Figures

Figure 1

Panel A

Log of of the ratio of output-side real GDP at chained PPPs (in mil. 2005US$) over population (in millions) - Source: Penn World Table 8.0



Panel B

Log of of the ratio of output-side real GDP at chained PPPs (in mil. 2005US$) over population (in millions) - Source: Penn World Table 8.0

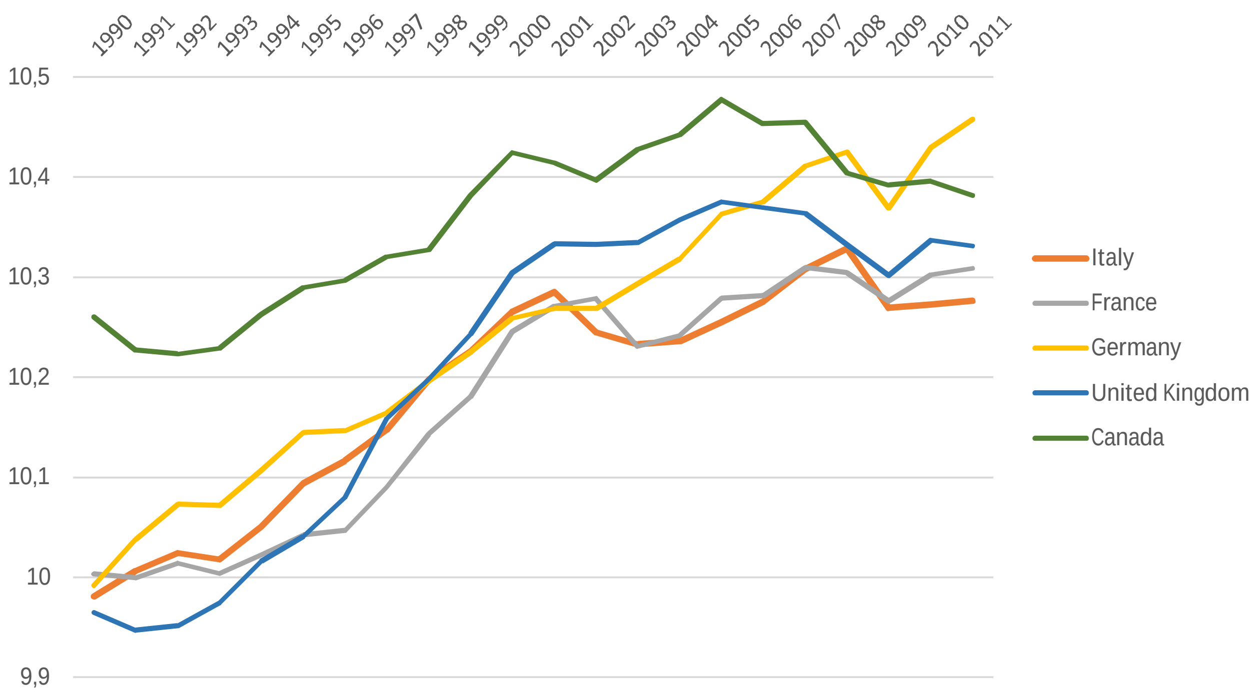
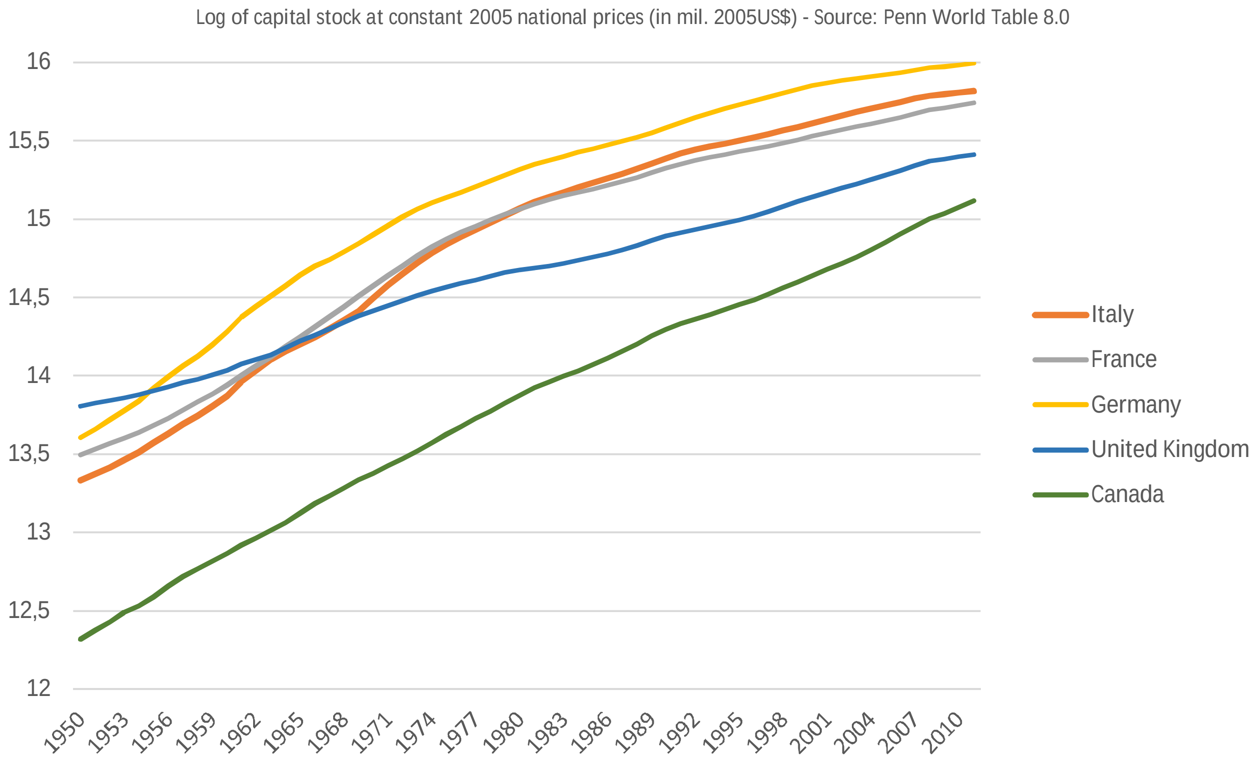


Figure 2


Log of capital stock at constant 2005 national prices (in mil. 2005US$) - Source: Penn World Table 8.0
16
15,5
15
14,5
14
13,5
13
12,5
12
1950
1953
1956
1959
1962
1965
1968
1971
1974
1977
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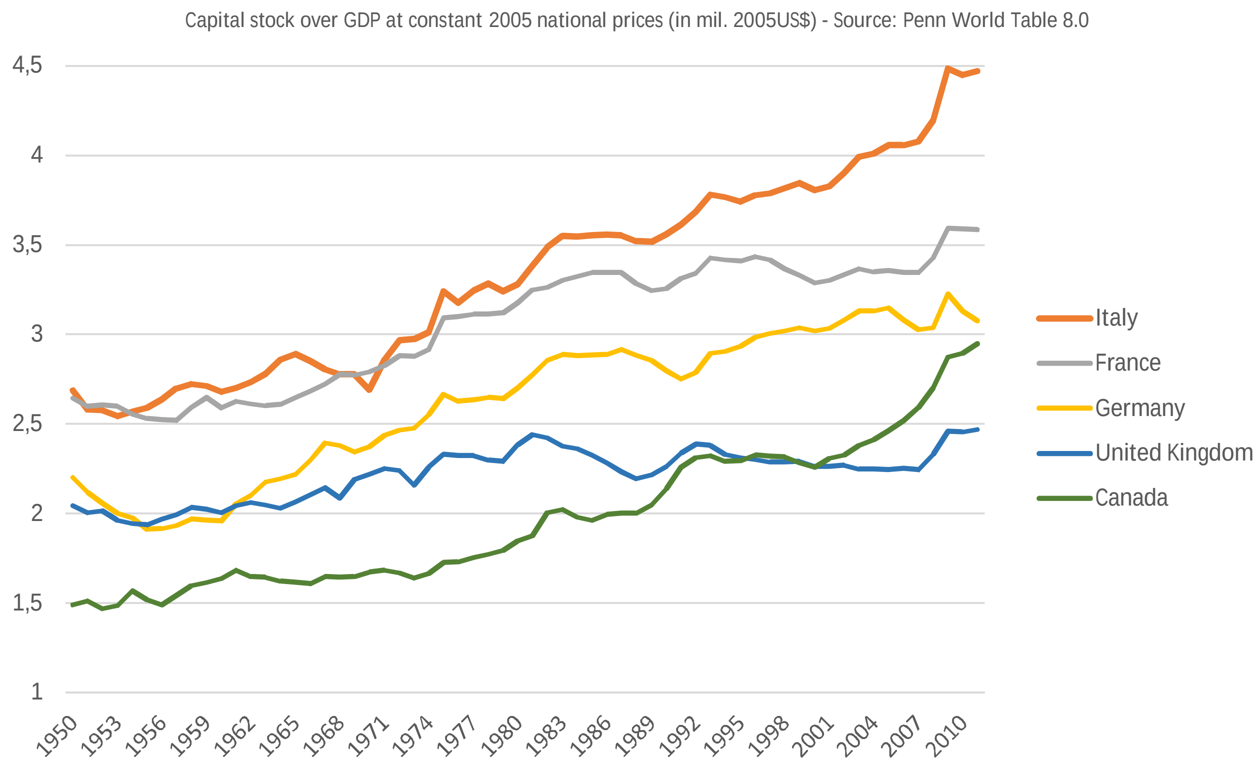
2001
2004
2007
2010
Italy
France
Germany
United Kingdom
Canada

Figure 3

Panel A



Panel B

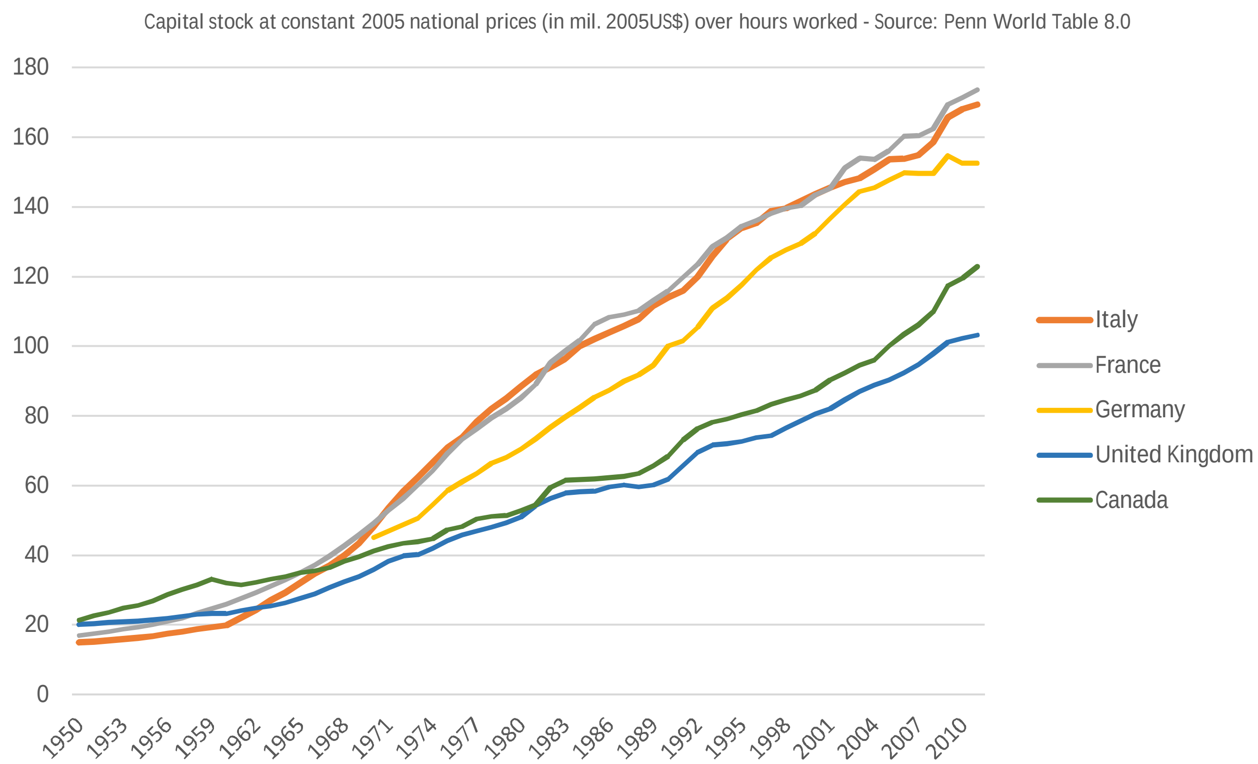


Figure 4

Index of human capital per person, based on years of schooling (Barro/Lee, 2012) and returns to education (Psacharopoulos, 1994) over average annual hours worked by persons engaged - Source: Penn World Table 8.0

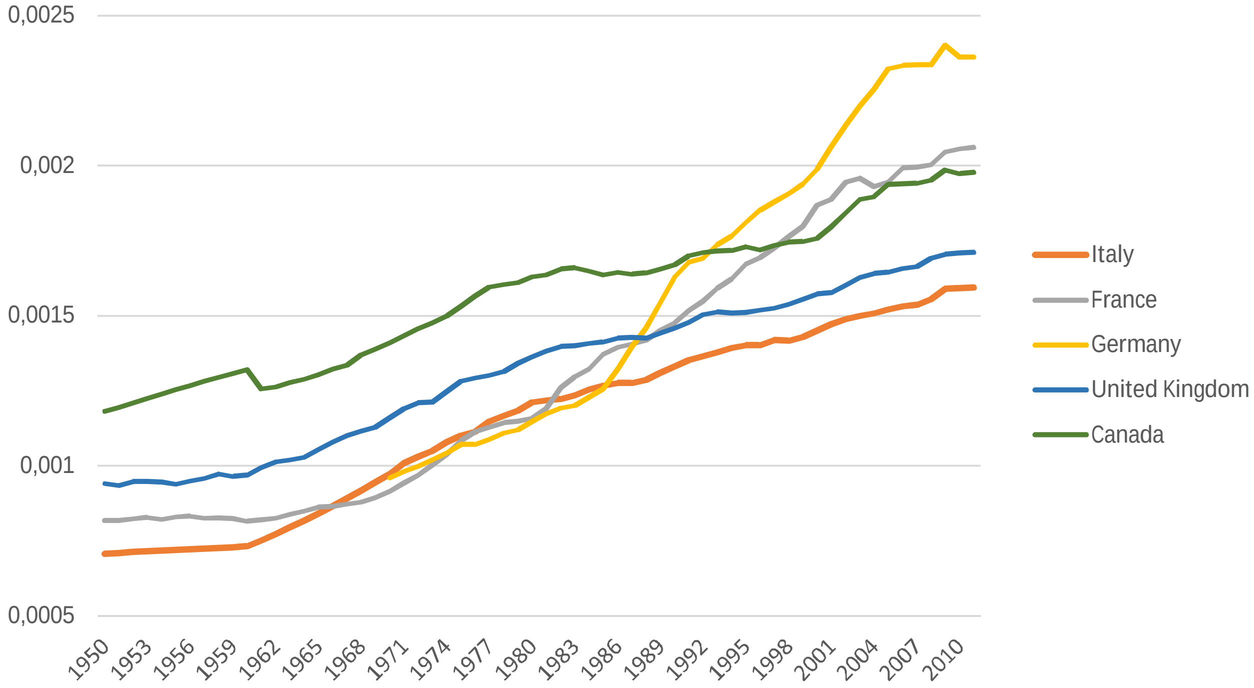
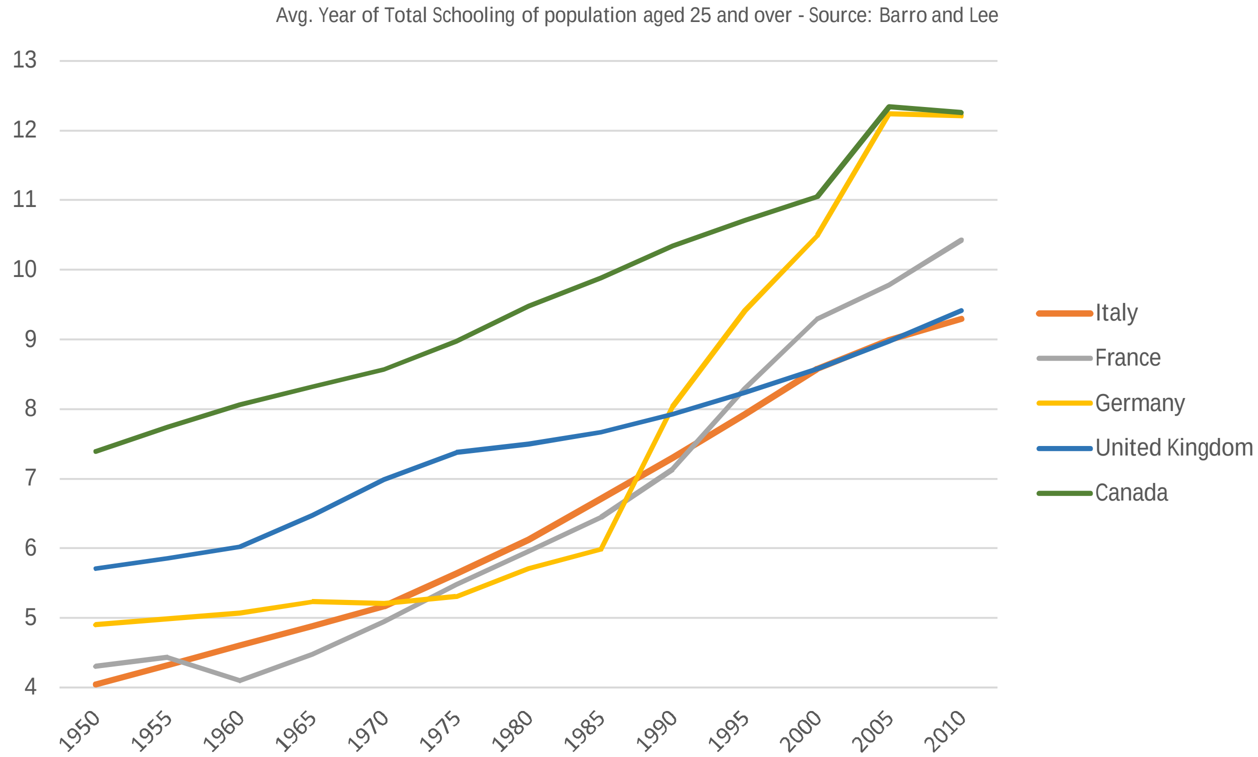


Figure 5

Panel A



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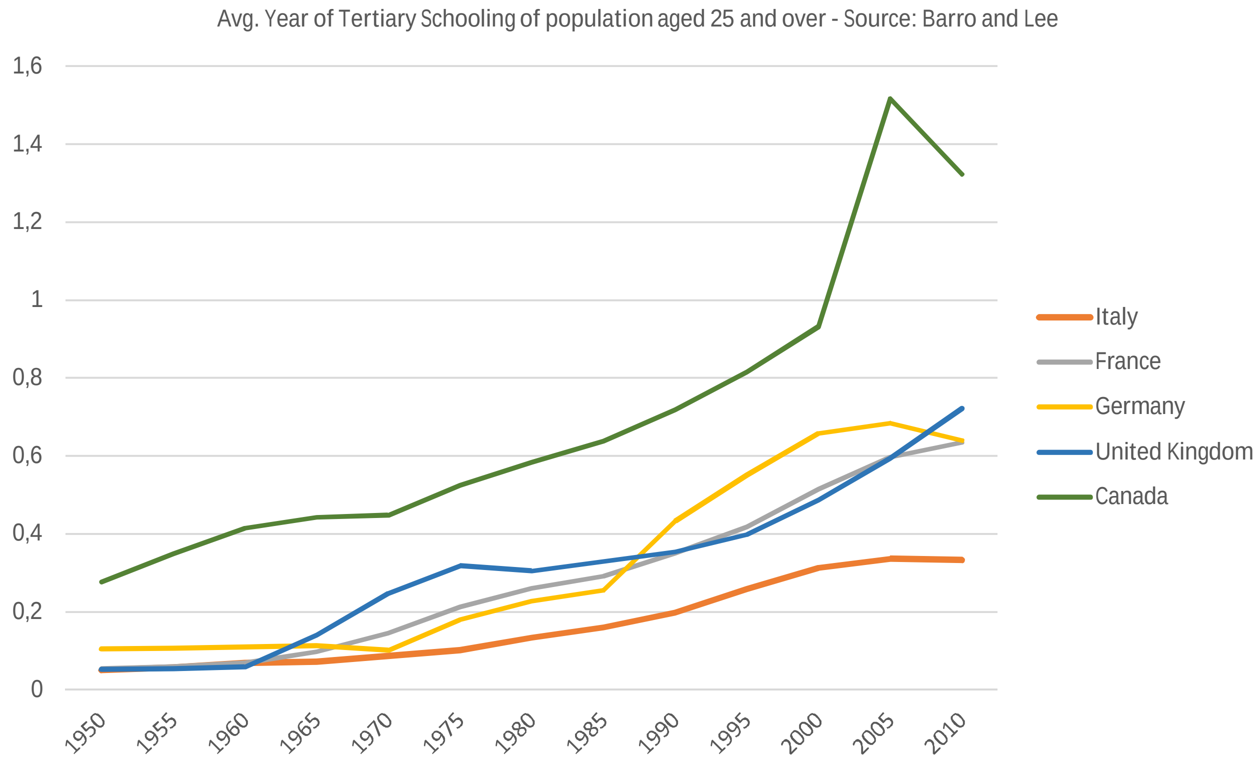
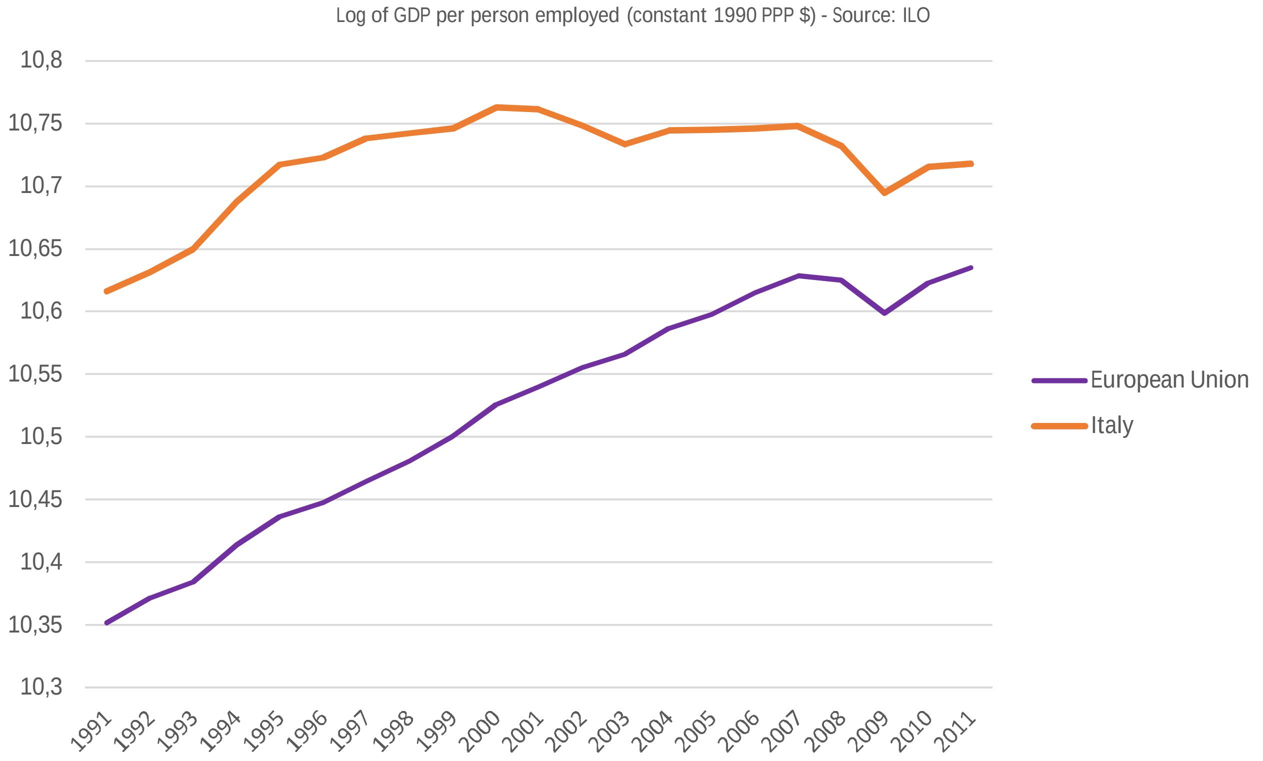


Figure 6

Panel A



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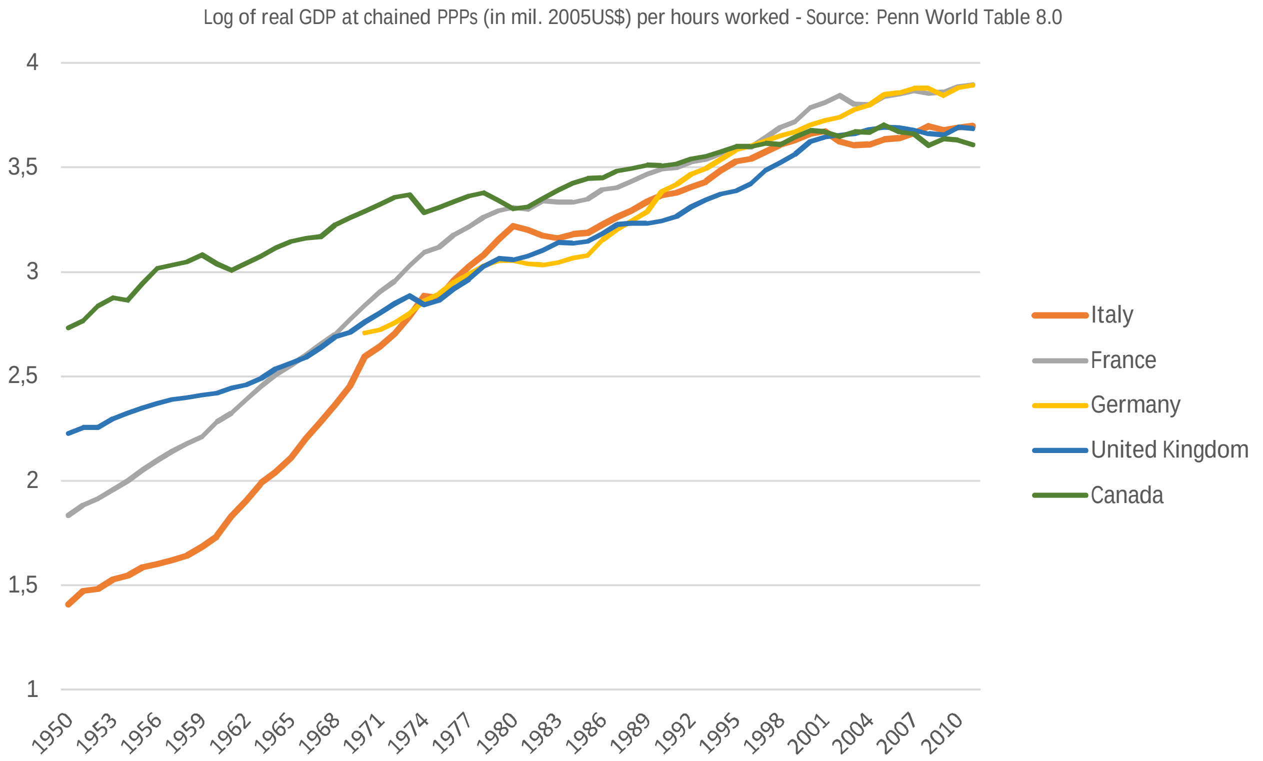
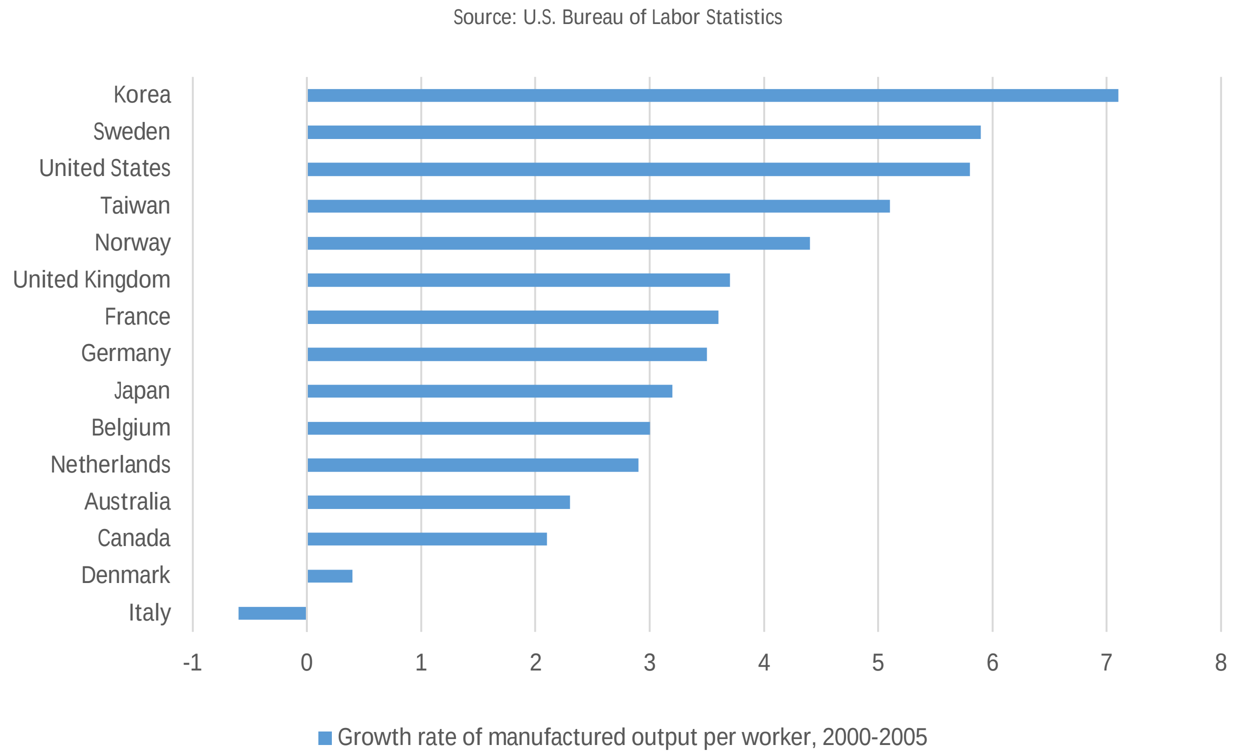


Figure 7


Source: U.S. Bureau of Labor Statistics
Korea
Sweden
United States
Taiwan
Norway
United Kingdom
France
Germany
Japan
Belgium
Netherlands
Australia
Canada
Denmark
Italy
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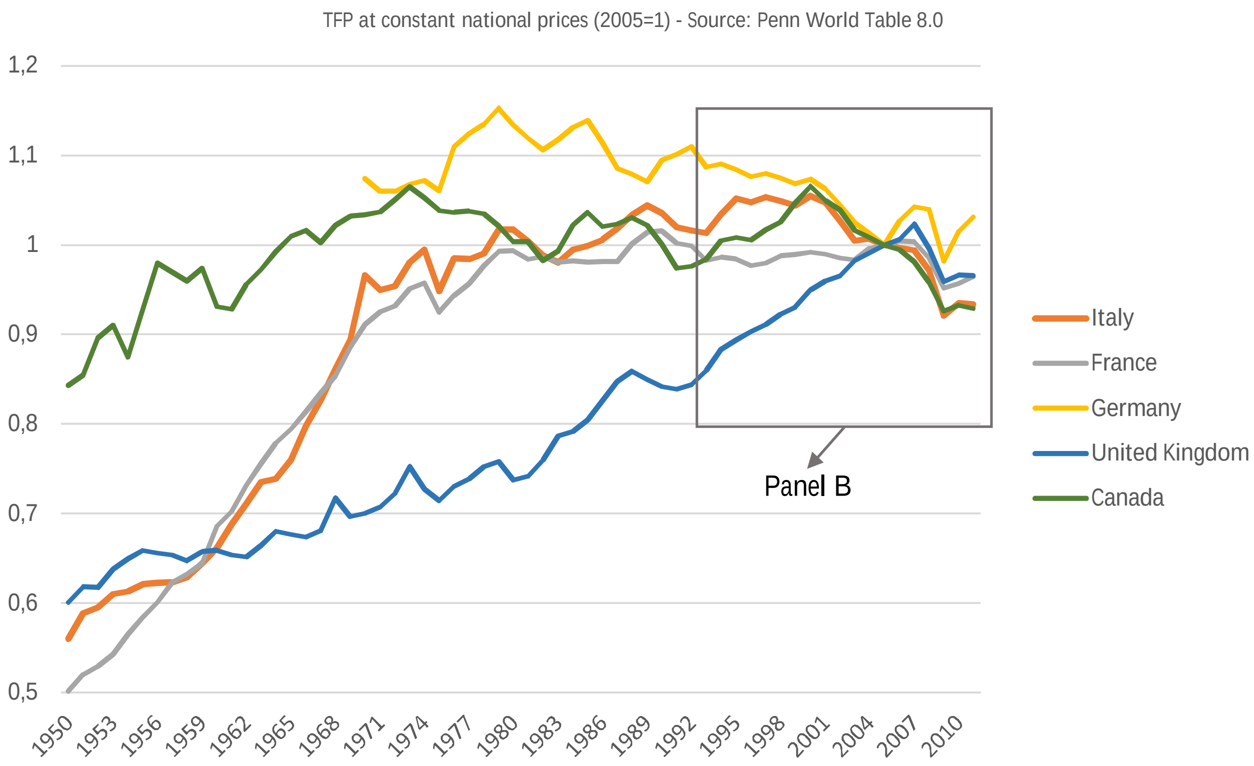
8
Growth rate of manufactured output per worker, 2000-2005

Figure 8

Panel A



Panel B

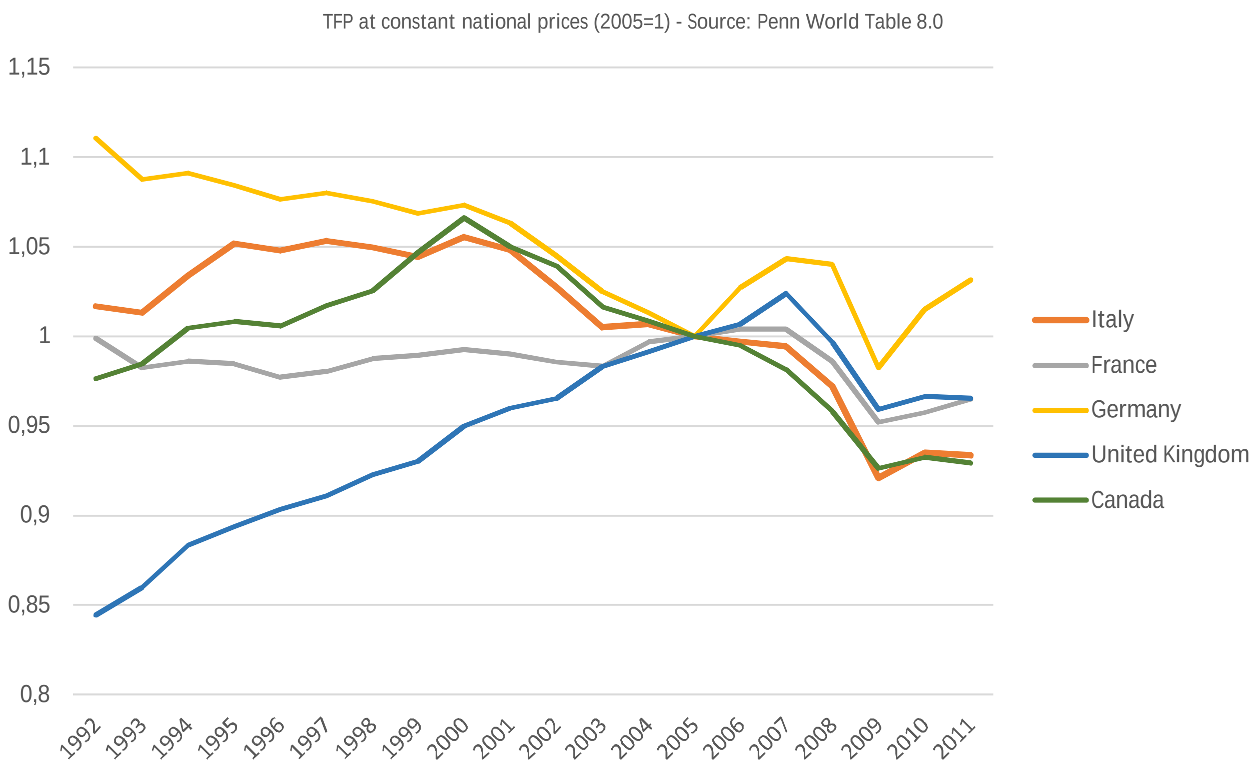
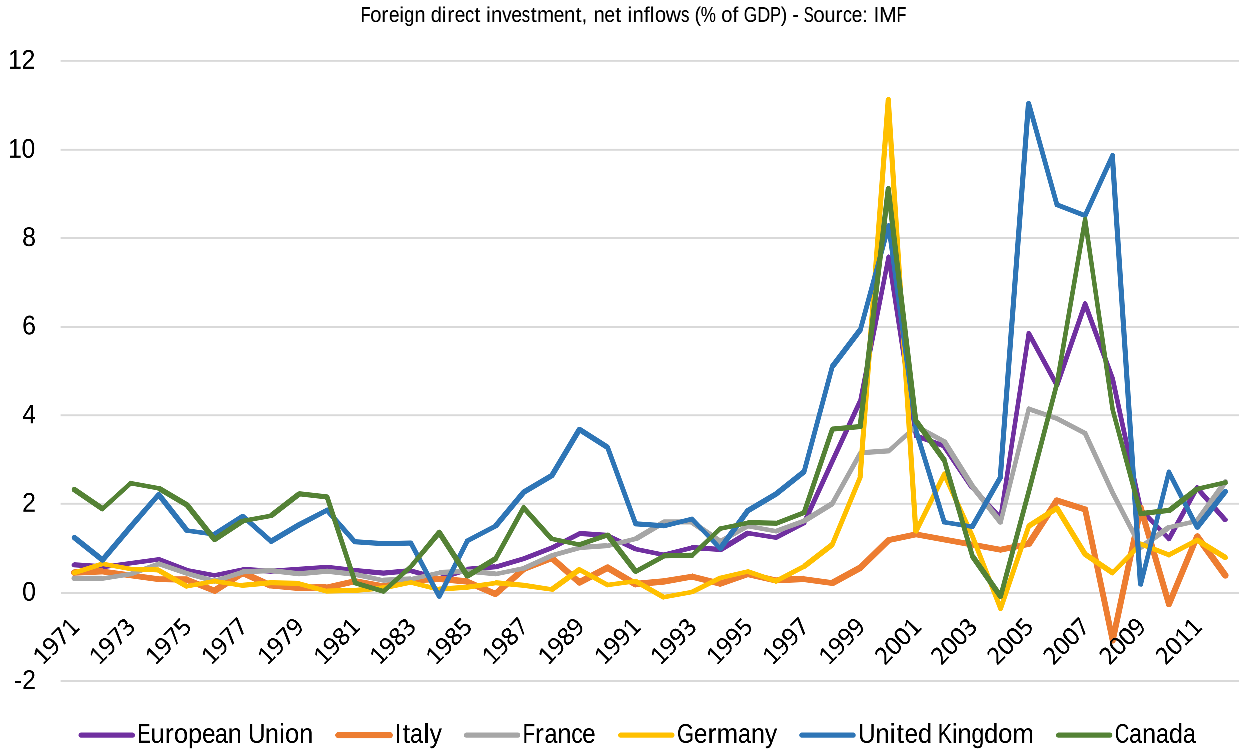


Figure 9

Panel A



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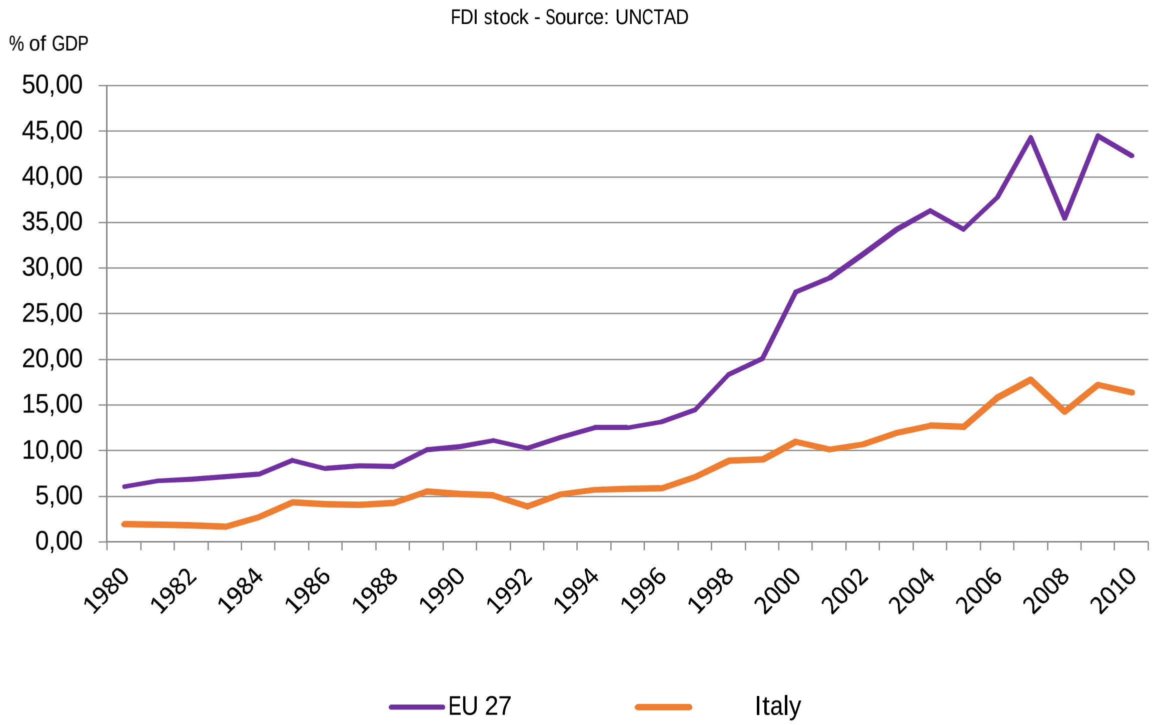
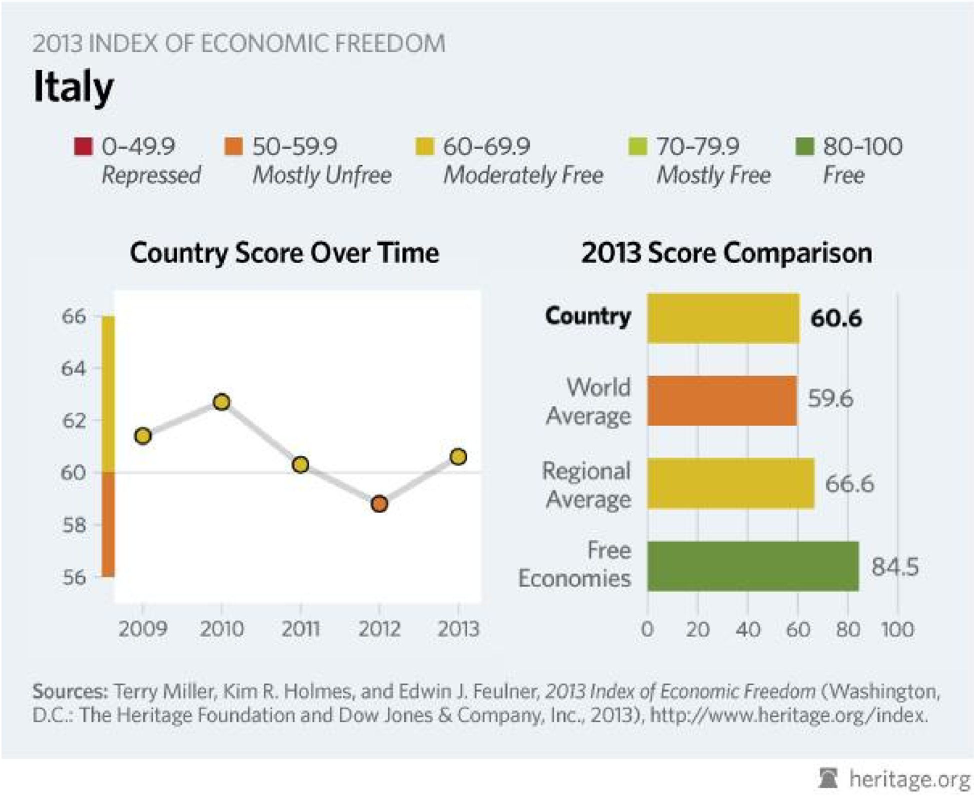


Figure 10

Panel A



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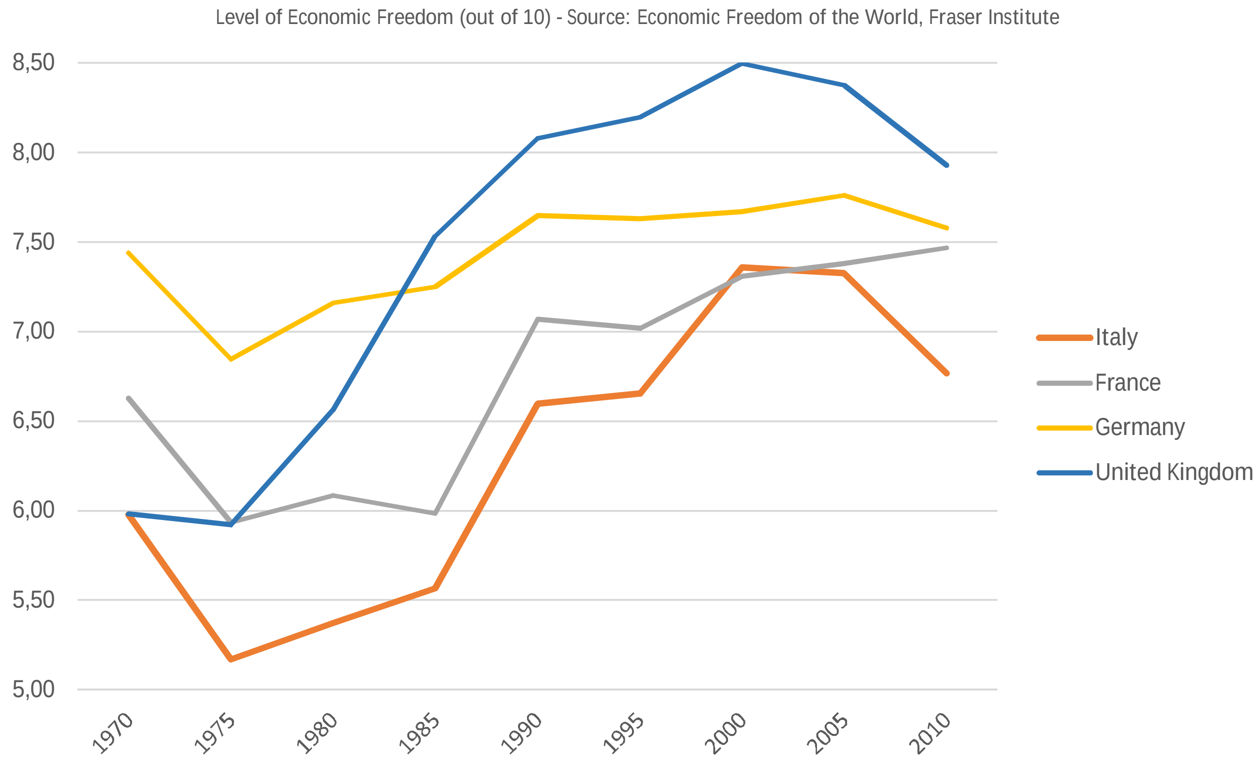


Figure 11

General government gross debt as a percentage of nominal GDP - Source: OECD Economic Outlook 89 Preliminary version, May 2011

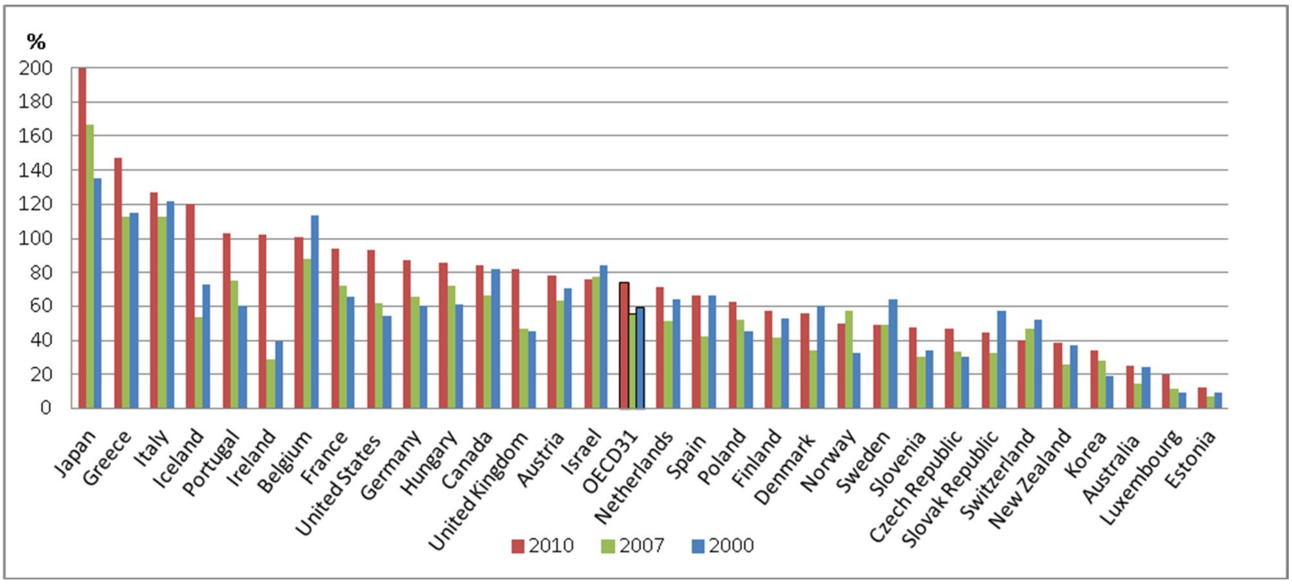
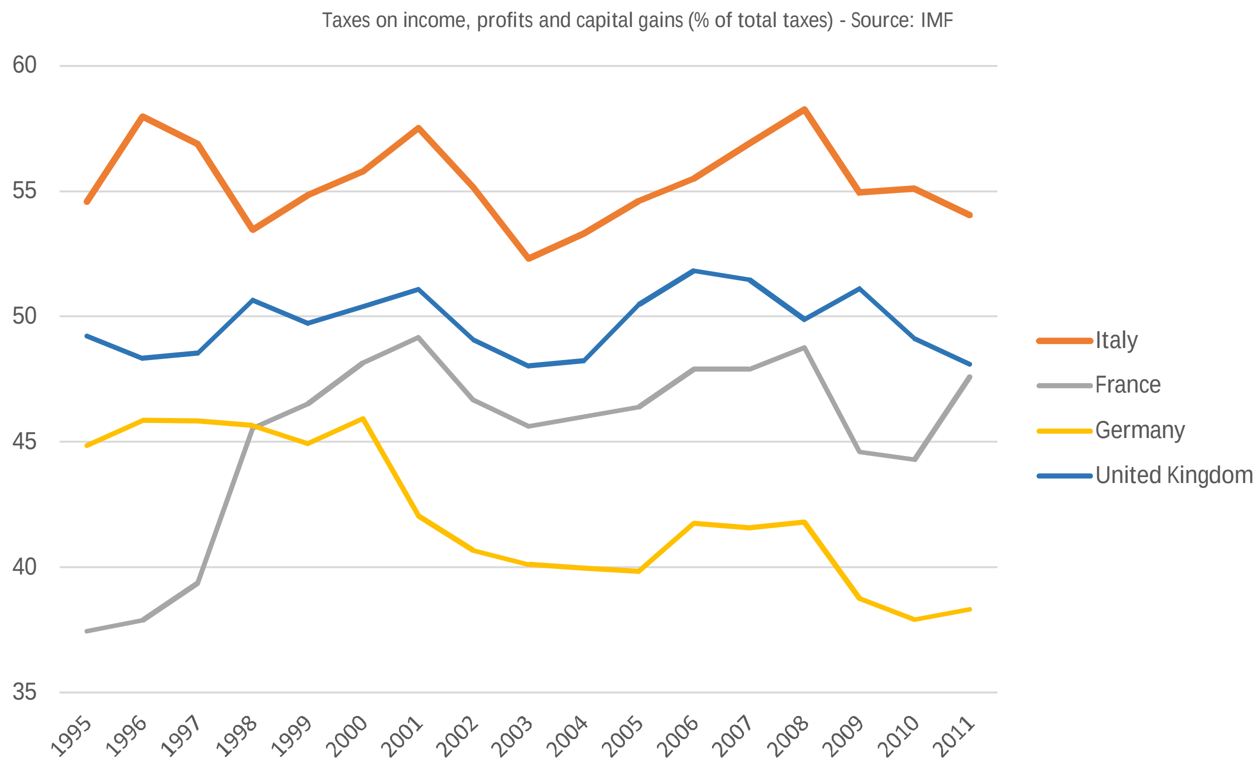


Figure 12

Panel A



Panel B

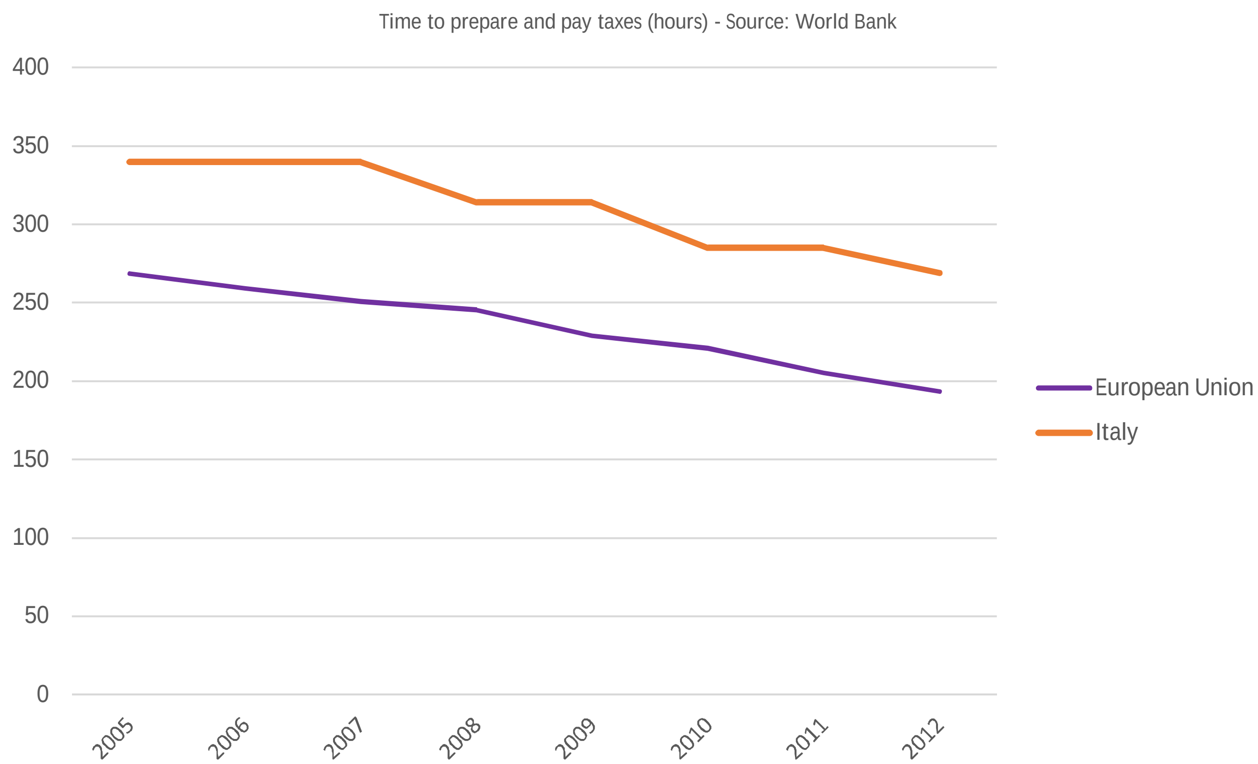


Figure 13

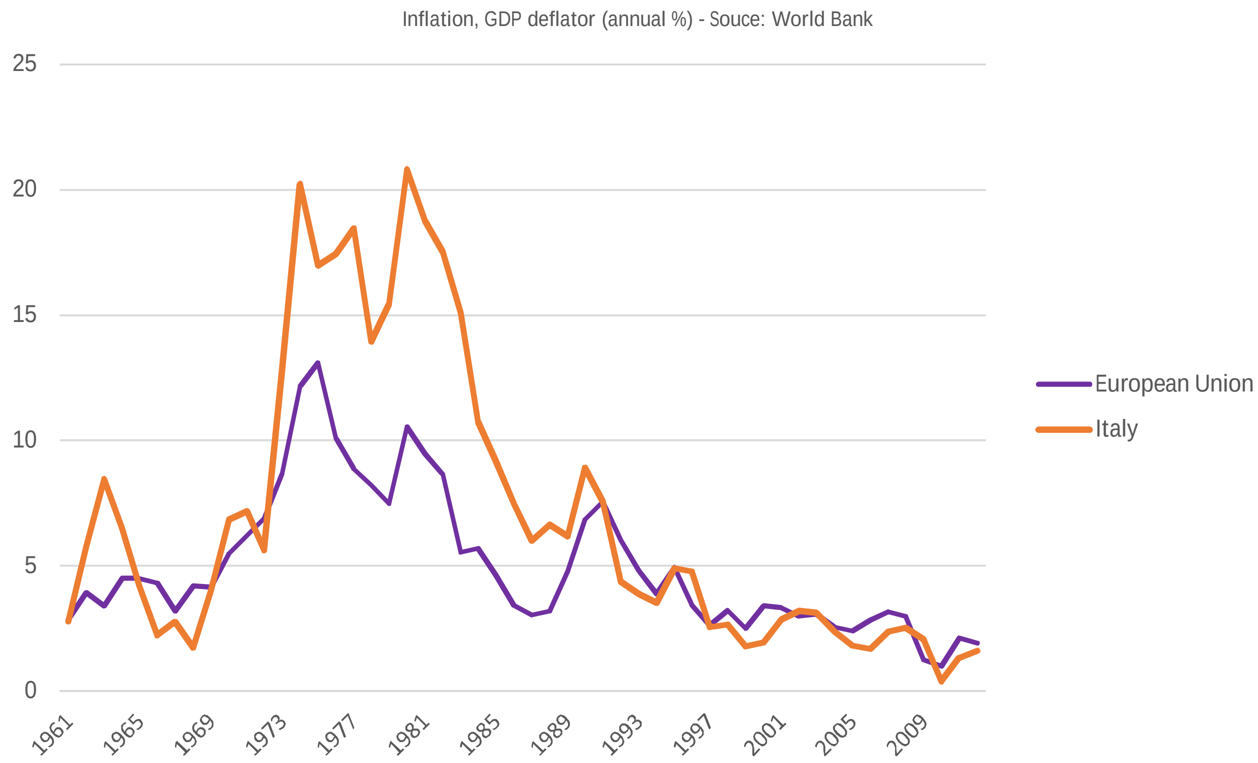


Figure 14

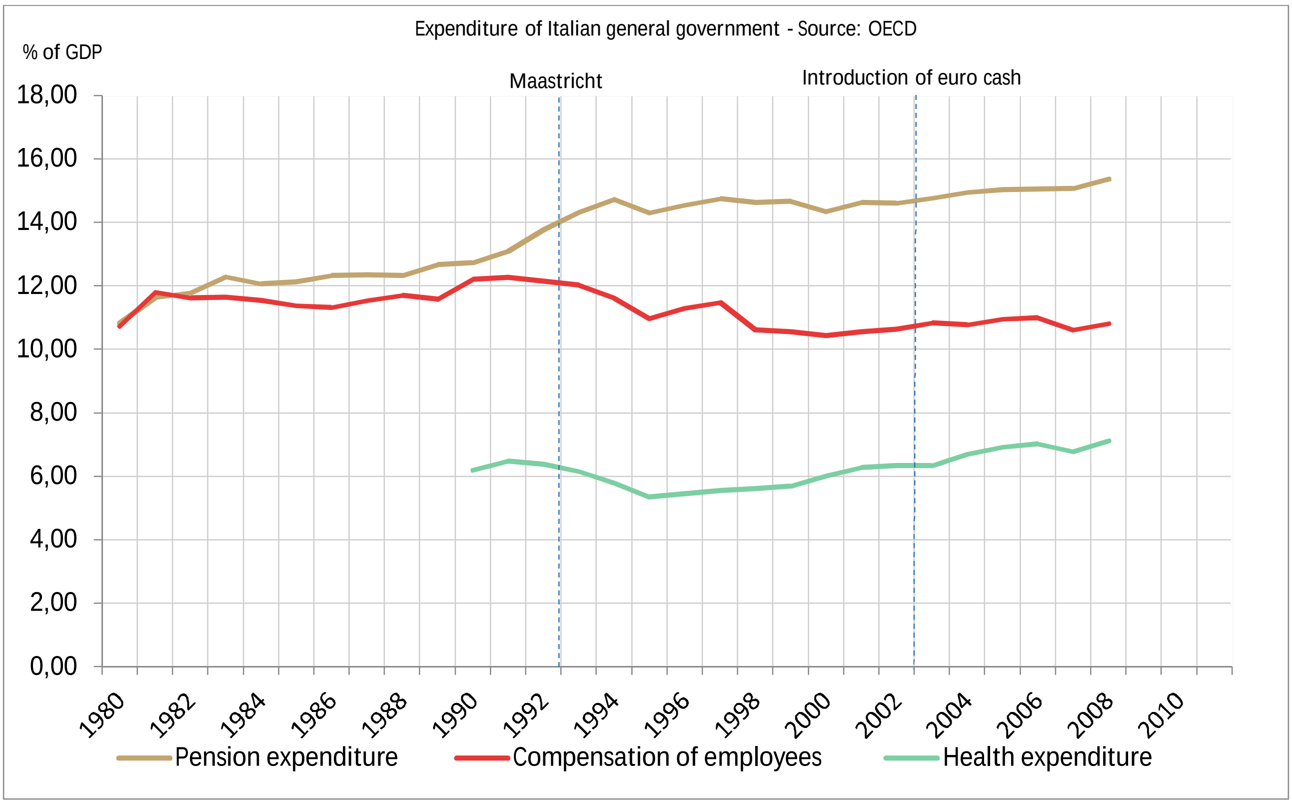
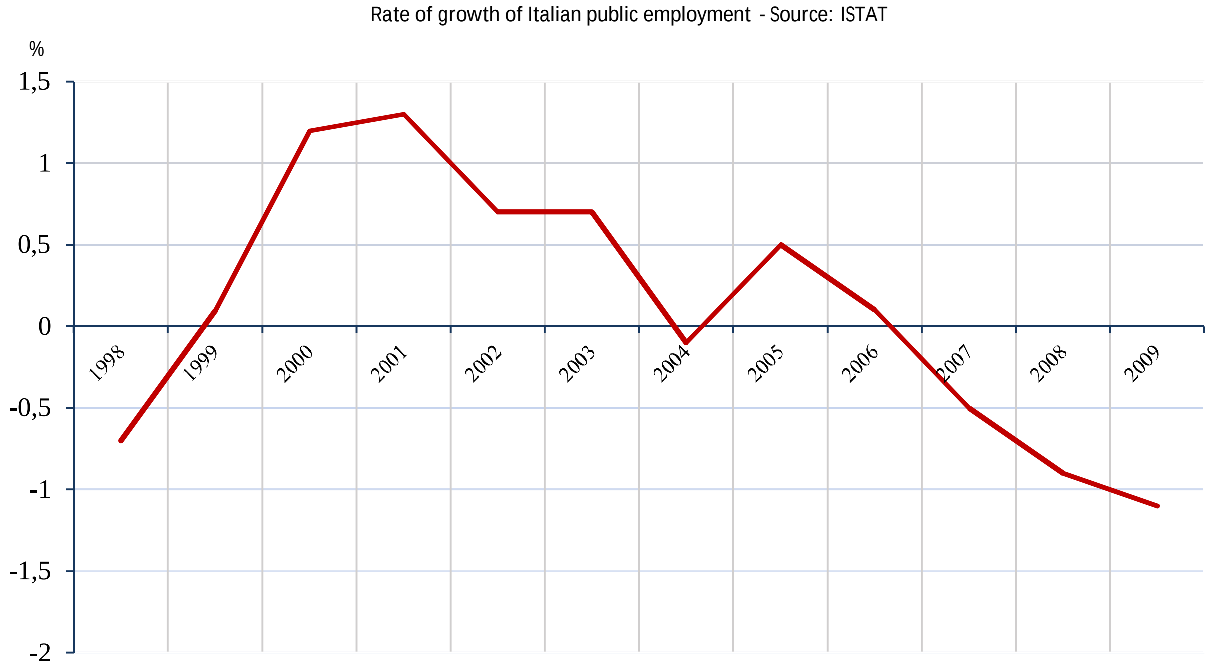


Figure 15

Panel A



Panel B

Figure 16

The Great Gatsby curve (Corak, 2012)

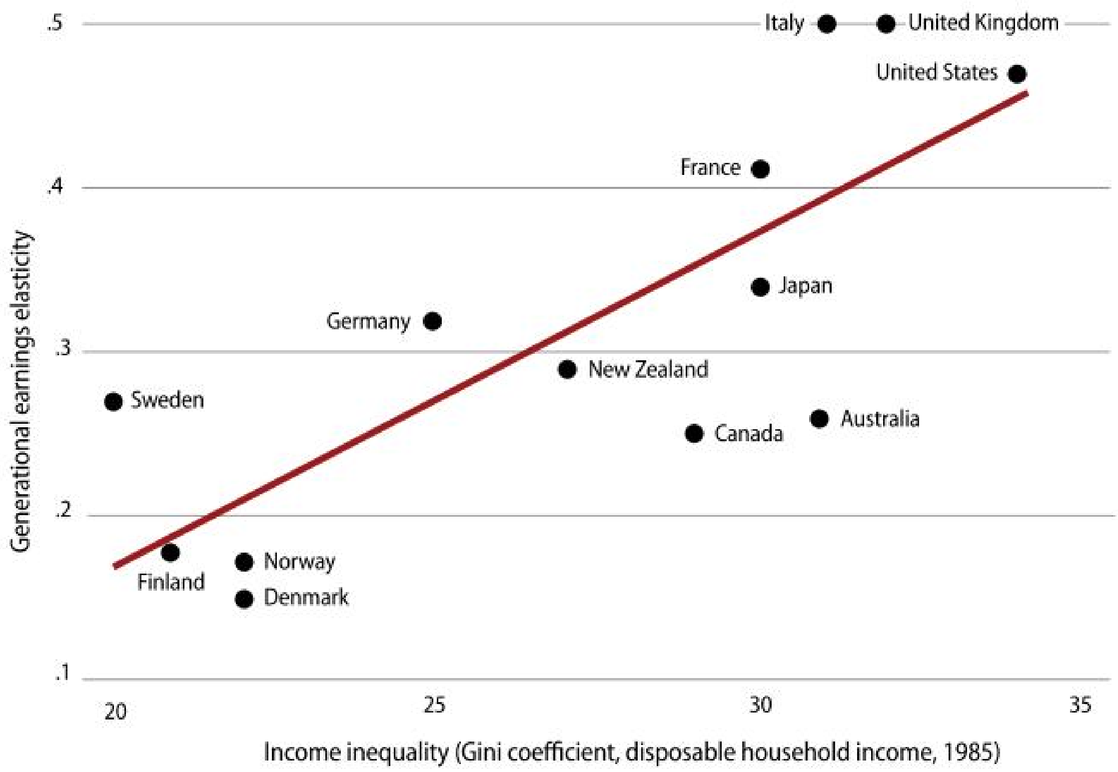
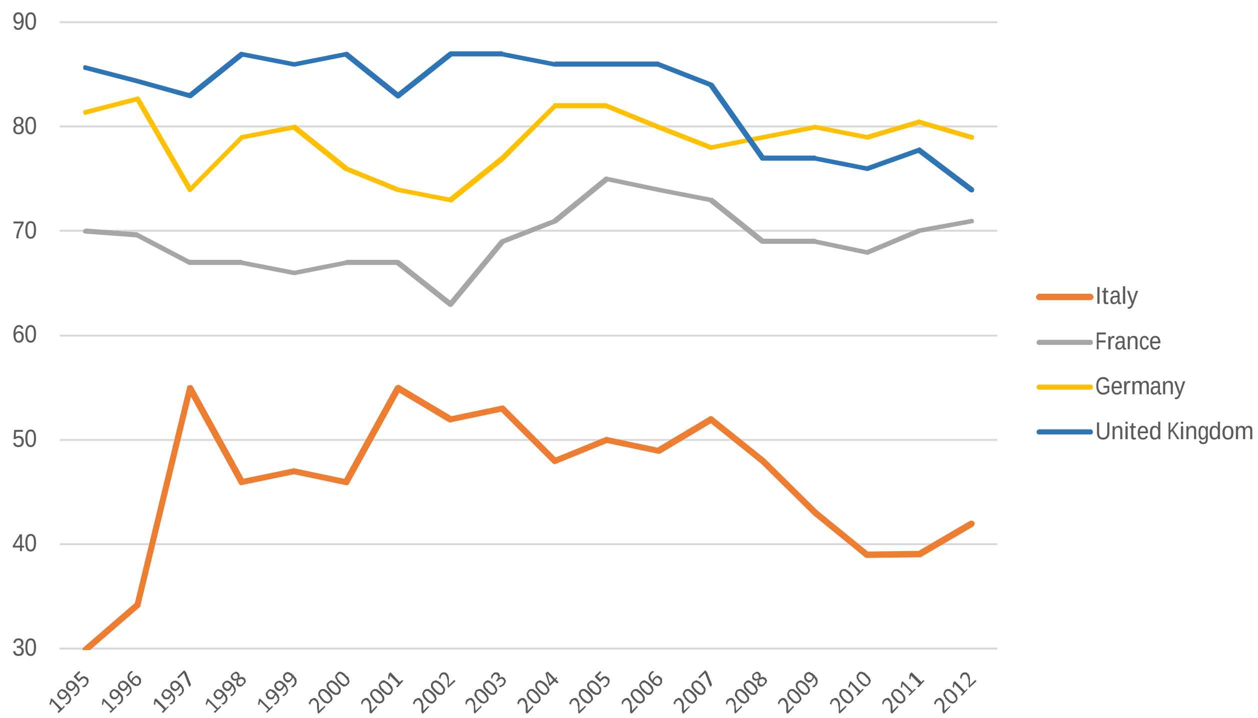


Figure 17

Corruption Perceptions Index - Source: Transparency International



Tables

Table 1

Global Competitiveness Index – Source: World Economic Forum

Country	Rank	Score	Rank	Score
	2006-2007		2013-2014	
Germany	7	5.48	4	5.51
United Kingdom	2	5.56	10	5.37
France	15	5.21	23	5.05
Italy	47	4.37	49	4.41

Table 2

Italian Industrial structure – Source: European Commission (2012)

Category	Employees	Italy	EU 27	Germany
Medium-sized	< 250	0.5%	1.1%	1.1%
Small	< 50	4.8%	6.5%	6.9%
Micro	< 10	94.6%	92.2%	82.5%

Number of SME in Italy → largest in Europe: 3.81 m in Italy vs 2.06 m in Germany
Micro dominant in Italy: Italian employees 82% > German employees
Because of modest dimensions, they contribute little to value added and employment, tend to remain in same sectors and do not expand

Table 3

Index of Economic Freedom – Source: The Heritage Foundation

Country	World rank	Region rank	2013 score
United Kingdom	14	5	74.8
Germany	19	10	72.8
France	62	30	64.1
Italy	83	36	60.6

Table 4

Democracy – Source: Global Democracy Ranking

Country	Rank	Score	Rank	Score
	2007-2008		2010-2011	
Germany	9	80.3	8	81.6
United Kingdom	10	80.1	13	79.7
France	17	77.3	17	76.3
Italy	23	72.4	29	70.7

Table 5

Corporate taxation – Source: Doing Business, The World Bank Group

Indicator	Italy	OECD
Payments (number per year)	15	12
Time (hours per year)	269	175
Profit tax	20.3%	16.1%
Labor tax and contributions	43.4%	23.1%
Other taxes	2.0%	2.0%
Total tax rate	65.8%	41.3%

Paying taxes in Italy: DB 2014 Rank: 138; DB 2013 Rank: 135

Table 6

Corruption Perception Index 2012 – Source: Transparency International

Country	Region rank	Score
Denmark	1	90
Finland	1	90
New Zealand	1	90
Canada	9	84
Germany	13	79
United Kingdom	17	74
France	22	71
Brazil	69	43
FYR Macedonia	69	43
South Africa	69	43
Bosnia and Herzegovina	72	42
Italy	72	42
Sao Tome and Principe	72	42