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WHY IS ITALY DOING SO BADLY AFTER DOING SO WELL?

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Why is Italy doing so badly after doing so well?

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Abstract

We present the current Italian economic crisis as a phase of a major systemic decline. The Italian socio-political-economic framework has abandoned a “dynamic” view of comparative advantage which is crucial for sustained economic growth. Instead an implicit contract between the socio-political elites and the civil society has imposed a “static” view of specialization. Creative destruction has been hampered and the indispensable sectoral restructuring has not taken place, leading to stagnation. The roots of this decline lay in a collective action problem sealing the implicit contracts between elites and civil society. Solving this problem and prompting a “dynamic” view of comparative advantage entails a dramatic socio-political-economic shift.

Keywords: sustained growth, comparative advantage, collective action, Italy

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1. Introduction

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 (Rossi, 2007, *passim*; Emmott, 2012, ch 3). Every crisis has been dismissed often as an episodic event that the so-called “Italian exceptionalism” could tame. The current crisis is biting worse than did previous ones and Italians are feeling restless. They were unprepared for it. The crisis fell on Italy as a sudden shock from another dimension. It should have not. The truth is that Italian decision-making elites and the mass public have for a long time ignored easily detectable signals of an impending decline that they have brought upon themselves. The “global crisis” has exposed severe structural flaws in the Italian socio-political-economic system and not created them. Nevertheless, Italian decision-making elites have tended to present the crisis as a consequence of the global recession, as a by-product of Italy entry into the Euro area, or as a mixture of the two. These elites cannot accept the impending predicament as an endogenous systemic crisis vis-à-vis warnings about productivity decline from different sources (Daveri and Jona-Lasinio, 2005; Rossi, 2007; (Hine 2001); Hassan and Ottaviano, 2013).

We claim the Italian economic slowdown has been determined by a *static view of comparative advantage* which has brought about many of the Italian economy’s rigidities and has obstructed the Schumpeterian process of creative destruction. The declining growth in total factor productivity (TFP), the loss in competitiveness, and labour markets rigidities are nothing other than the consequence of policies which favoured a *static vision* of labour division and comparative advantage. The roots of this predicament lay in a socio-political-economic system, which is based on a long-standing *implicit contract* between the mass public and the elites. This contract has generated and fostered an anti-growth culture,¹ hindering restructuring. It rests on an Italian operational form of government, *particracy with corporatism*, rooted in a *collective action problem*. The article is organized as follows. In Section 2, we present a short reminder of major results in economic growth research. In Section 3, we briefly outline relevant stylized facts showing the long-run structural nature of the Italian crisis. In Section 4, we discuss the roots of the crisis and suggest that these rest in an implicit contract sealed by a collective action problem obstructing beneficial economic reforms. In Section 5, we conclude with further considerations and suggestions for potential remedies.

2. A Sketchy Survey of Fundamentals of Sustained Economic Growth

A growth strategy, though it has to be country specific and context specific, must respect fundamentals.² Economic Growth entails a trade-off between current and future consumption, as it requires investment which is in turn justified by the existence of potential markets wherein to sell goods and services. There exists mounting evidence that economic growth is a decentralized bottom-up process requiring 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 post WWII Italy, in order to take off would specialize in the sectors where it has its relative strength. Often a weak currency through appropriate devaluations or managed depreciation would help the economy’s international competitiveness (Zemanek, 2010). Eventual success would boost international trade, increase income, capital intensity and real wages. *The triggered economic advancement could be sustained if and only if continuous innovation through competition is taking place, since technological progress*

¹ We use the term culture in its anthropological sense to designate the behaviour, outlook and values of a society or some subsets of the life of that society (e.g. political culture).

² We present well-known results available in established textbooks such as Jones and Vollrath (2013) and Weil (2013). At advanced level see Acemoglu (2008), Aghion and Howitt (2009), Barro and Sala-i-Martin (2003). In our presentation, we have followed the exceptionally clear and focused presentation of Spence (2011).

outdoes the constraint imposed by diminishing returns and allows for sustained increases in productivity. Thus, economic growth must be open to innovation, learning and knowledge to promote improvements in productivity and the associated necessary restructuring. Such indispensable transfer and/or creation of knowledge calls for sufficient levels of skills and understanding (especially in a technologically advanced world) and so for investment in human capital through education and learning by doing. Though knowledge is a non-rival/non-excludable good, innovators may enjoy a temporary market advantage. Processes of restructuring and creative destruction have to occur if an economy wishes to sustain its own growth. *In a context requiring a “dynamic 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.

Proactive government action should sustain reliance on markets and incentives (Spence, 2011, see in particular chs 11, 12, 13, 14). Government must guarantee settings where private investment is profitable. Public investment in infrastructure, human capital and information diffusion institutions are crucial to support 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. These actions should warrant inclusiveness as an indispensable ingredient for investing behaviour, since agents will be willing to renounce current consumption for investment if and only if this choice will benefit the future of his/her household. Defective government behaviour could harm economic growth and at times be fatal (Lewis, 1955, p 376; Drazen, 2001).

3. From rags to riches back to rags?

There is no doubt that Italian economic slowdown is a long standing structural issue and not just a recent upshot of the global 2007-9 crisis (Pelloni and Savioli, 2014; Rossi, 2007; Emmott, 2012, ch 3; Toniolo, 2014. Cf Emmott, 2012, ch 3, for a discussion aimed at a larger audience). The evidence suggests Italy has been challenged to change structurally by forces such as the end of the Cold War, the Globalization process, the IT revolution and has failed to meet the challenge. In this section, we wish to stress some elements of the mentioned analyses and place them in a specific perspective.

First Italy has experienced a lack of restructuring in the production side. An imaginary snapshot of the production specialization structure of Italy taken twenty years ago would not be much different from one taken today. The Italian economy was and is inhabited by a multitude of micro enterprises specializing in the production of commodities with low technological content in both the manufacturing and service sectors (European Commission, 2012; Toniolo, 2014). Because of their modest dimensions, these micro firms tend not to expand and to stay in the same sector without bringing technological innovation. Larger dimensions are needed to face the R&D costs and to exploit the associated economy of scale. The reasons for so many micro/small enterprises are:³

- An archaic, complex and anti-efficiency legal-administrative system that is the product of a culture with similar characteristics;⁴
- Difficult and complex access to credit;⁵
- High start-up costs;⁶
- A complex tax system characterized by high corporate taxation;⁷

³ Cf also Rossi (2007).

⁴ The Economist, (July 19th, 2014)

⁵ Acemoglu (2001) and The World Bank Group (2014)

⁶ Fonseca et al. (2001). For the high start-up costs in Italy see <http://www.doingbusiness.org/data/exploretopics/starting-a-business>.

⁷ Pelloni and Savioli (2014). Huge fiscal pressure is the companion of high and increasing values of the Debt-GDP. This pressure is particularly high at corporate level: the total corporate tax rate is about 25% higher than the OECD average. The major source of this discrepancy lies in labour tax and contributions.

- Corruption and organized crime pressure;⁸
- A highly centralized form of bargaining between employers and trade unions.⁹

This restructuring deficiency comes along with a severe retard in education, high public debt, high levels of corruption, increasing income inequality and poverty levels.

While Italian's investment in physical capital has not been deficient, at least quantitatively, human capital intensity has been low.¹⁰ Though Italy has largely overcome problems of illiteracy and expanded education at the lowest levels of schooling since the end of WWII, its improvement in terms of minimum education is insufficient to cope with the demand of the contemporary high-tech environment. Italy fares very badly in terms of tertiary education where it is lagging with a widening gap with respect to the other advanced economies.¹¹ As seen above an economy needs skills, learning and knowledge to accommodate the information flow indispensable for creative destruction, restructuring and economic growth. Thus, this education gap has a severe impact on economic growth. It also increases the costs of capitalism¹² and affects income distribution.¹³

The debt-GDP ratio (higher than 100% since 1990) has been 130.4% in 2013 and is expected to grow above 135% in 2014. An oversize public sector with its ramifications and a substantial underground economy are the main determinants of this outcome. A usual justification for high taxation-high public expenditure-high running deficits is the return in terms of social fairness, equality and inclusiveness (Melchiorre and Rocca, 2013). The "Great Gatsby" curve does not corroborate this justification for Italy (Figure 1). Along the vertical axis, we have the intergenerational earnings elasticity. A higher value of this elasticity corresponds to lower intergenerational income mobility. The Gini coefficient on the horizontal axis proxies income inequality. The higher is the value of the index, the higher the income inequality. Italy is located on the top right hand corner of the graph: a bleak performance on both accounts.¹⁴

Figure 1

If high taxation and high public spending are not positively related to inclusiveness, what are they positively related to? Beyond anecdotal stories and news reports, there are strong signals of links with corruption.¹⁵ Italian Fiscal Policy is strongly pro-cyclical, which is a signal of public sector corruption.¹⁶ The Corruption Perceptions Index¹⁷ (CPI) also corroborates a high level of corruption characterizes the Italian economic and social system (Table 1).

Table 1

⁸ Schiffer and Weder (2001)

⁹ Emmott (2012)

¹⁰ Pelloni and Savioli (2014)

¹¹ These symptoms of human capital shortage become more disturbing when one takes into consideration quality (Baccini et al., 2014; Pelloni, 2010).

¹² Smith (1776, 1982) and Ferguson (1980) foresaw the dangers of specialization and self-centred agents intrinsic in a modern, capitalist society, and pointed to education as the most important remedy to those problems. Failure at educational level endangers societal stability (Herman, 2002, pp 209-216 and 419-421). Probably Italy missed the modernizing influence of the Scottish Enlightenment with its focus on the theory of improvement. The concept of *politeness* not as just as good manners but as representative of all the strengths of a sophisticated culture (Herman, 2002, ch. 3, p 72) has never permeated the Italian public discourse. We thank Pietro Bassi for background research, which reinforced our view.

¹³ Insufficient investment in human capital, insufficient adjustment to restructuring and rent seeking may severely influence income distribution.

¹⁴ About the deteriorating income distribution in Italy, see also OECD (2008) and Eurostat (2014).

¹⁵ Corruption in Italy is a well-known and established plague (Del Monte and Papagni, 2007). Portugal, Slovenia, Spain and Italy are the EU countries where corruption is a serious concern (European Commission, 2014).

¹⁶ See Alesina et al. (2008) and Aghion et al. (2011). Krugman (2013) in his "quick and dirty mini-RR for the period 1950-2007" finds that the RR (Reinhart and Rogoff, 2010) negative correlation between debt and economic growth and the Debt/GDP 90-percent threshold are borne out only for Italy and Japan within the G7 countries. He ascribes the Italian and Japanese results to potential reverse causation. We gather that the Italian and Japanese outcomes are more likely to reflect misuse of public resources within countries marred by corruption.

¹⁷ The CPI by Transparency International captures informed views of analysts, business people and experts in countries around the world.

Corruption is a major obstacle to economic growth because it wastes government revenue, facilitates policies aimed at fostering opportunities for bribery, undermines the rule of law and weakens the judicial system (Weil, 2013, ch 12). Crucially important for economic growth is the link of public sector corruption and kleptocracy with start-up costs and the resulting creation of barriers to entry. Djankov et al. (2002) provided evidence that “[c]ountries with heavier regulation of entry have higher corruption and larger unofficial economies”. *A “grabbing hand” hampers restructuring.*

Italy, though successful in the 1950’s and 1960’s, has been stagnating for quite a long time. There are clear signals that the fundamentals of sustained growth have been violated as Italy

- has relied on choices and policies backing a *static view* of comparative advantage;
- has kept a tight rein on economic freedom.

These strategic choices have hindered the restructuring of the productive system that, with the associated job-labour and capital mobility, is indispensable for a process of sustained growth. A set of interrelated problems has emerged: low competitiveness and FDI flows; partial exclusion from the fast trade dynamics involved by globalization and the ICT economy; low knowledge transfer; low human capital accumulation; neglect of inclusiveness inducing low participation, decreasing labour productivity and draining of talent. The Italian decision-making elites should have been alarmed by the above signals. They were not.

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

The major signals of decline, already apparent in the early 1990’s, have materialized with the end of the Cold War, the emergence of Globalization and the ICT revolution. Why has Italy been caught unprepared? Why neither the decision-making elites nor the civil society at large have responded to the challenges? The explanation is that they are/were entrapped in a “static” view of comparative advantage.

Historians have maintained that Italian political elites have been acting in their own interest, that of associated lobbies/subgroups and not that of the public interest. Bull and Newell (2005, ch 6 and references thereafter) point out that, after WWII, political elites transformed traditional clientelism into bureaucratic and political clientelism, with the consequence that political parties took over the role of the landowners in the patron-client relations. It also involved the expansion of the public sector and the politicization of the new State agencies and companies according to a sharing out scheme (*lottizzazione*) between political parties and factions. The governing class embraced clientelism as a ruling operational method and manipulated clientelism to exploit State economic resources in order to win consent and so cling to power. Clientelism corresponds to a rejection of the value of universalism based on a personalized use of power defined by an individualistic exchange for mutual benefit between patron and client. Clientelism “undermines the principles of modern democracy by transforming “rights” into “favours” so undermining confidence in institutionalized authority and reinforcing the use of arbitrary power. Clientelism laid the basis for the development and spread of corruption” (Bull and Newell, 2005, p 104).

Corruption per se, though a negative factor, is neither sufficient nor necessary to hamper growth. How is the historical development of corruption-clientelism linked to the current crisis? The Italian executive power has always lacked vigour and strength. The *raison d’être* of the second Republic was its promise to transform Italy in an effective modern liberal democracy with a strong executive within an equally strong system of constitutional accountability. The recent scandals, popular discontent and its impact at the polls, and the fractious confrontations inside political parties are signals of the Second Republic failure.

Notwithstanding sluggish and weak governments, the democratic dynamics between executive and electorate should have generated some positive action. Instead, we can observe poor and inefficient public services alongside very high public expenditure, harmful private-public sectors links and an unflinching support for a complex and bureaucratic centralism. We gather these democratic dynamics could not correct these failings because of the clientelism-corruption drive (Bull and Newell, 2005; Emmott, 2012).

The Italians have chosen a form of operational government that supports the clientelism-corruption mechanism: *particracy* (*partitocrazia*). This structure has gone unchallenged because an effectively organized part of the country is extracting high rents out of it. The over-dimensional and inefficient public sector is a powerful instrument for the appropriation of these rents. The public sector is not fulfilling its fundamental tasks in terms of economic growth but it could prop up “successfully” the *rentiers*. Such an environment may foster cronyism, nepotism and rent seeking.

In a *particracy*, the political parties control the political process and not the electorate. In Italy, *particracy* was the outcome of the constituent assembly’s decision of weakening executive power through an extreme form of proportional representation where votes were asked for collective lists of names drafted in each Electoral College by each political party. This mechanism “enabled five or six party secretaries to acquire exceptional authority and become more powerful than other politicians, often almost as powerful as the prime minister who had to accept their nominations to his cabinet and their decisions about policy” (Mack Smith, 1997, ch 59). None of the subsequent electoral reforms has managed to curb the power of the parties.

At economic level, the *particracy* rule has been put into practice via “corporatism”. As the market mechanism could reduce party power, a market driven economy would hardly be the preferred economic system of a *particracy*. Italian *particracy* necessitates corporatism where specific “guilds” extract rents for their members independently of market signals. *Particracy* needed to create rigidities, which in turn create rents. Corporatism is the economic framework within which *particracy* could thrive. Italian society is divided into guilds subordinated to political parties. Employers and employees are organized into industrial/professional guilds serving as organs of political representation and controlling the persons and activities within their jurisdiction. Signals coming from markets are subordinated to the guilds’ interests or suppressed by the system. The consequences of such a socio-political-economic organization have been pervasively harmful (Bull and Newell, 2005; Emmott, 2012). The machinery of the State has become subservient to the advantage of political parties and decision-making elites, thus bringing about a colonization of the State machinery and fostering a culture of silos. Party membership has become a decisive factor for employment and advancement in government and public administration. This machinery has become a reservoir of patronage, subservient to the advantage of political elites, where professional impartiality is not permitted. It also has resulted in a failure to bring about “a proper organization of political parties” with well-defined operational programmes except for informal practices to control the State machinery and political power (Hine, 2001). A deep fear of a free market system has been and is pervasive as economic freedom is a potential threat to such organizational structure. Private enterprises have to be controlled and linked to the political mechanism. Strict regulations and subsidies are widely used to control entry, exit and survival of firms. We label this regime as “*particracy with corporatism*”.

However, since the end of WWII, Italy is a democracy (albeit an imperfect one)¹⁸ and a certain amount of consent from the bottom is needed. This consensus has been warranted by an “*implicit*

¹⁸ Italy scores poorly in Democracy rankings. Democracy is not necessary for economic growth; however, a good democracy may help (Spence, 2011) as it could favour economic freedom, which is a necessary condition for growth. Italy has a low economic freedom score just above the world average and below the regional average.

contract” between the decision-making elites and the civil society. As pointed out above, clientelism, as a protective relationship, and its offshoots have been the tools of this implicit contract. In exchange for security and benefits, voters would guarantee support to political lobbies: elites would extract the higher individual rents while the general public’s 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 arrangement created “*the jobs delusion*”: jobs have to be safe. Thus, the Public Sector instead of providing infrastructure and education, and fulfilling its other basic tasks, mostly warrants the survival of firms and jobs and absorbs workforce into the public sector. By protecting jobs, the socio-political-economic elites did/do not protect workers but look after themselves. In exchange, the decision-making groups would enjoy bargaining power and control over the resources of the State. Such a system 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, diffusion of technological innovation is sluggish, productivity slows down and the system loses competitiveness and stagnates with high unemployment. As developing countries have shown, *fast transition* is the name of the game for sustained growth. Italy has kept static.

Are the political class and the associated elites wholly responsible? Clearly, they have to take major responsibility. However, this responsibility should be put in a wider perspective. Italy, as a unified country, has a short and tormented history and its population had to overcome huge obstacles towards an updated and upgraded view of citizenship. Nevertheless, would it be unreasonable to charge that the fault is not *just* in the “*stars*” of the Italians, but also in the Italians themselves? Or to claim “*Toute nation a le gouvernement qu'elle mérite*”(Joseph de Maistre, 1853)? Perhaps it is not. A sort of collaboration between the decision-making elites and the mass public existed and exists. The institutions governing Italy are the product of the country’s political culture. The civil society has been subscribing an implicit contract for a long time and it is reluctant and/or unable to modify it, notwithstanding signs of potential default. Italians are “*trapped*” in some sort of path-dependency. The current paradigm has become deeply rooted in the society at large and persists because of the generated legacy notwithstanding its low quality.

We claim that the underlying mechanism that sealed this implicit contract and made it so resilient is a particular form of the collective action problem (CAP)¹⁹ where privileged groups are coincident with special-interest/distributional/rent seeking organizations.²⁰

In its simplest formulation, the CAP refers to a state of affairs where a group of economic agents would gain from the provision of a public/collective good. If the cost (c) of the action would exceed the gross benefits (v_j) accruing to the individual j then the net benefits (a_j) of the individual from his/her own contribution to the group would be negative. In such a situation, an agent would not contribute to the group’s provision of collective good. If there is no individual for whom $a_j = (v_j - c) > 0$ then the group will not provide the collective good. Such a group is called a *latent group*. If there exists at least some j s.t. $a_j > 0$ the group is *privileged*²¹ and will succeed.

The signals emitted by the three mentioned indicators of inequality, low intergenerational income mobility and corruption together with declining GDP offer support to this claim. Special-

¹⁹ Olson (1971, 1982). We wish to thank Tom Barbiero for pointing out to us the potential presence of a CAP in Italy. We also thank Pranab Bardhan for further discussion on this issue. Emmott (2012) also hints briefly at the potential presence of a CAP, though he does not fit it in a specific mechanism.

²⁰ We follow Olson (1982) in using these terms as synonyms.

²¹ We agree with Hardin (1982) that a group to be privileged does not need to be small. Size is an empirical fact not a logical necessity within the CAP.

interest organizations tend to redistribute income rather than generate it, to lower efficiency and aggregate output and to make political life more divisive (Olson, 1982). The Constitution and electoral legislation have conferred exceptional power to party secretaries with respect to weak governments and unstable political coalitions. Political parties and/or subgroups around their secretariats have the characteristics of privileged groups and if the analyses of historians like Bull, Emmott, Hine, Mack Smith and Newell are correct, there is strong association between these privileged groups and clientelism, sharing out schemes and public sector corruption. Such privileged groups are at the heart of the political system and supportive of the patron-client relationship which buttress it.

Thus, the Italian institutional setting has been conducive to the formation of rent seeking (privileged) groups at the expense of the general public. On the other hand, that same setting held back the establishment of encompassing organizations²² and favoured the latency of any group aiming at beneficial social, political and economic reforms. The benefits-costs structure of patrons (who form a privileged group) is linked to those of clients whatever way they are organized (latent or privileged groups). In fact, if the total costs of patrons are equal to the total benefits of clients, the total costs of patrons divided by the number of clients correspond to the individual benefit of a client. Thus, total costs of patrons divided by the number of clients must exceed the individual cost for a group of clients to be privileged. Thus, clienteles could form privileged groups which are subsidiaries of the privileged groups at the top of the pyramid. Most privileged groups have specific vested interests in the current status quo and oppose socially beneficial economic reforms. The enactment of such beneficial reforms would likely make obsolete the investments in physical and human capital and networks of some of these privileged groups, and reinforce their reciprocal support to defend strenuously the status quo.

The electorate at large is, almost by definition, a latent group since the individual's benefits of a collective action, such as the abolition of the patron-client and the introduction of a bottom up democratic electoral system, would be highly diluted in the short run with respect to the costs. Behaving in such a way the Italian electorate is committing two fallacies (Hardin, 1982, ch 8). First, a "*fallacy of composition*" whereby as citizens they are thinking in individual terms and not collectively and are not maximizing social welfare. Second, a "*fallacy of static generalization*": agents think statically and not dynamically disregarding the future in their choices. They inhabit a sort of classical static solution to the prisoner's dilemma in which individuals choose the social inefficient outcome. If the electorate were to take into account a long run multi-period perspective, players would cooperate and not defect in order to obtain an infinite stream of extra-profits.

Why did Italy prosper in the 1950's and 1960's while now it does not? In the aftermath of the WWII upheaval, Italy had a relatively small amount of special-interest organizations and it would take time for these organizations to form under the protective umbrella of the electoral system. In the 1950's and 1960's, Italy's structure was in the making and the leading paradigm could not be operational yet. In that period, Italy used comparative advantage to launch its industrial sectors and exploit a relatively weak currency to sustain competitiveness. It was able to take full advantage of the potential of its human capital, cultural heritage and natural resources. There were not yet many obstacles to creative destruction. However, once special-interest groups' control became fully operational and "*particracy with corporatism*" got control of the country they hindered the required flexible upward modernizing adjustment necessary for the Italian economy to sustain the relative Italian position in international markets. This state of affairs was exacerbated in the early 1990's with the end of the Cold War and the take-off of globalization.

²² An encompassing or inclusive organization is a group which includes a large segment of society instead of a narrow one.

5. Further Considerations and Conclusions

Governments' distortions and mismanagement with the implicit consensus of the mass population have stifled the process of growth. Italy should tackle this issue in order to stop its decline and reverse it. In order to do so it needs to abandon the "*particracy with corporatism*" model and take on a dynamic view of comparative advantage. This reform would entail a dramatic shift in its socio-political-economic structure and it would be necessarily painful at different levels. This is the only route Italy could follow to stay on course for sustained economic growth. Attempts by economists, non-party technocrats and politicians to "re-start" Italy by progressively introducing degrees of liberalization in the labour market, and/or by cutting public expenditure without touching power centres, have been failures. Italian growth cannot be re-started and sustained by tinkering with the labour market and public sector.²³ The breakdown of the Monti Government, which tried to fulfil its technocratic mandate with a step-by-step political consensus, is symptomatic. Italy needs a fast, drastic and dramatic change. It needs to erase the implicit basic social contract that has been ruling it over several decades. Only the Italians can do that. It would need a jump in self-awareness and social cohesiveness. Not a reform but a new foundation. This re-foundation implies a new mind-set for the Italian mass public, an outlook where it would stop playing the role of the ruled and where it would instead get control of its intellectual, moral and political life. Such massive change of direction would meet strong opposition from powerful distributional organizations. Only those wishing to keep the status quo would advertise this change as utopian instead of feasible. In the short run, a fast demand management response²⁴ is needed to avoid collapse. Demand problems are ubiquitous. Demand is low across the international spectrum. However, in Italy aggregate demand expansion would be meaningful if and only if it were fitted into the long run perspective and could support the supply side transformation. *The removal of "particracy with corporatism" is a necessary condition for the potential implementation of successful growth policies.* Of course, it would not be sufficient: such a removal would have to be accompanied by a new form of government compatible with free markets, favourable to economic growth and devoid of any vestige of "*particracy with corporatism*".

As Emmott (2012) points out alongside a "bad Italy" there is a good "Italy". There is potential for revitalization. Positive signals are coming from some sectors of the Italian economy (Mediobanca and Unioncamere, 2012):²⁵ the chemical, food, pharmaceutical and asset management²⁶ industries show vitality and dynamism and are a source of hope. 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 regeneration and restructuring of the productive system. From recent, firm-level reports we could informally infer that 20% of the Italian industrial system is solid and can do innovation, 20% is solid but cannot do innovation. In our view, Italian banks must manage the resources generated by the ECB's targeted long-term refinancing operations (TLTROs)²⁷ strategy to support this healthy 40% of the economy and avoid waste on deadwood. Facilitating the expansion of healthy and dynamic firms capable of coping with globalized markets will also allow absorbing and rescuing those components of the productive system which are squandered by entrepreneurial failure.

Italy enjoys an enviable degree of goodwill abroad and has a strategically important role within the Euro area. Contrary to the common Italian belief of a hostile Germany and international

²³ Andreatta (1992) pointed out the damages of gradualism and the inability of Italian governments of "taking the bull by the horns".

²⁴ Carlo D'Adda (2013, 2014) stressed the necessity of restarting the Italian economy through demand management.

²⁵ 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 this issue.

²⁶ <http://www.reuters.com/article/2014/09/25/italy-funds-idUS16N0RA00R20140925>

²⁷ http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html

environment, Italy would not probably have 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. The vital, though time inconsistent,²⁸ 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 Italian quarters is called for. If Italy could generate *reliable signals* of reform, it could also more easily appeal for a less stringent austerity from the EU, which could help its recovery.

The regeneration of the public sector has to confront the CAP and its ramifications. Acceptable and transparent public expenditure and tax systems are indispensable to generate social trust, support and cohesiveness while the current systems are largely viewed as arbitrary and oppressive. Such regeneration demands reforms of the Italian Constitution and electoral system. This objective could be reached without sweeping constitutional changes. The strictly necessary amount of corrections should be introduced to the existing constitutional text, as a massive rewriting would be tantamount to 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. It should bring in an electoral system whereby the natural bottom up process is restored and the power of political parties drastically diminished.

Introducing the required minimum redrafting could be done quickly and efficiently if public opinion were able to compel political forces to act in the general interest and not only in their own. Privileged organizations would not relinquish easily their advantageous position in favour of a cohesive collective action. Selective incentives and/or extra-rational motivations (Olson, 1971, 1982; Hardin, 1982; Drazen, 2001) may provide solutions. We wish to stress that to re-launch a sustainable growth, policy makers cannot hope that patchwork implementation of commonly prescribed policies could firmly put Italy on a new stable growth path. In order to resume a virtuous path those measures should be framed in a perspective of overcoming the CAP, bringing down *particracy with corporatism*, and dissolving the implicit contract. Of course, 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. Entry barriers should be lowered alongside start-up costs. These and similar measures would help to move towards a dynamic view of comparative advantage indispensable for economic growth. They will be unattainable on a firm basis as long as the CAP, cementing the foundations of the current status quo, remains unsolved. A main test will be that associated with TLTRO. The potential formation of privileged groups within/across the banking sector and the productive system could channel the TLTRO resources towards the healthy fraction of the productive structure itself. This can constitute a massive forward push. If those resources were wasted to rescue deadwood (because of clientelism or related reasons) then, not only a huge opportunity will be missed, but Italy would take also a step further towards the abyss.

There is another encouraging factor. As noted above, there is a strong interlinking between the costs-benefits structures of patrons and clients. The current crisis has been weakening this link. Patrons’ costs have been increasing in an unsustainable way and have not translated directly into clients’ benefits. This trend may be fatal for special interest/rent seeking organizations as it may help solving the general public’s CAP by encouraging the formation of encompassing organizations while at the same time making it impossible for distributional coalitions to solve their CAP.

In order to save itself,²⁹ Italy must recognize its weaknesses, accept radical reforms and change course of action. This step implies more than just constitutional restructuring; it requires a “cultural revolution”. To make our view as clear as possible, let’s paraphrase Johnson (1976): “Italians should

²⁸ We wish to thank Alexander Weaver for pointing out the time inconsistent incentives for countries like Italy of the ECB bond buying program as soon this started in 2012.

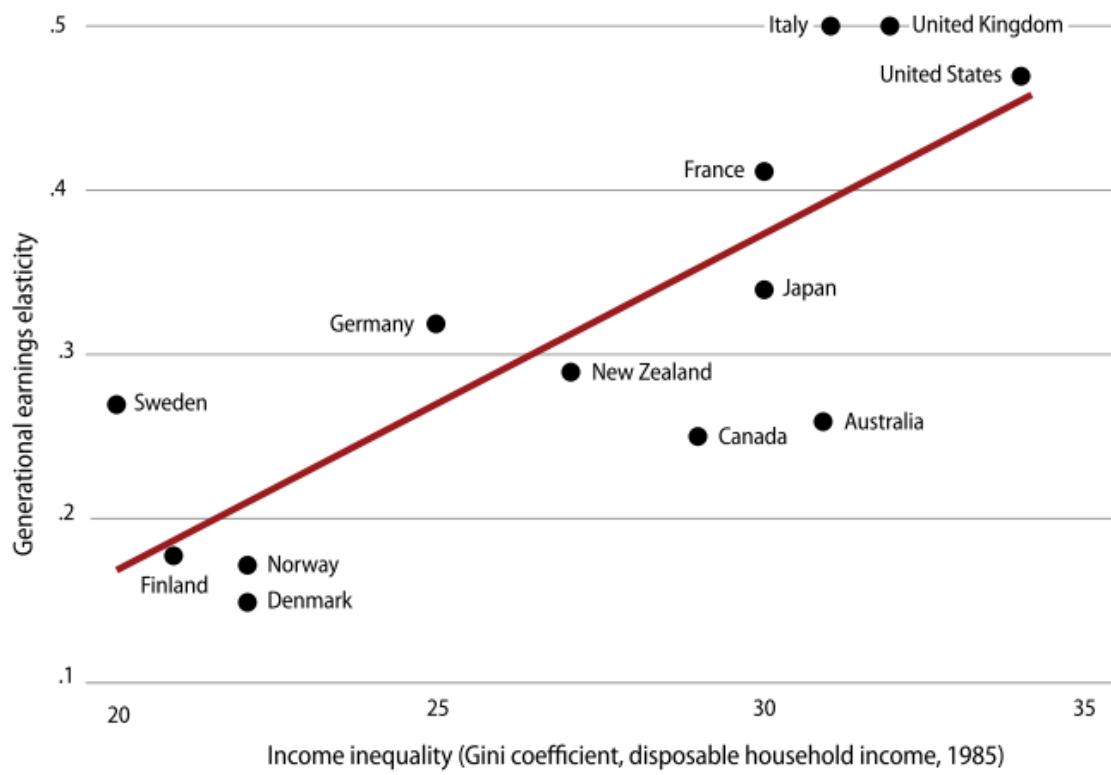
²⁹ Italy risks more than economic decline, it is in danger of turning into a dystopia.

avoid the temptation of envisaging as “revolution” a change in the names and origins of personnel in charge (however ethically impeccable are their intentions and motivations), since this would inevitably have the counter-revolutionary effect of substituting a new cast of characters in a re-enactment of the same old play. Instead Italians need to rid the society of control by outmoded forms of organization and ways of doing and deciding things, in order to free it to cope more realistically and effectively with its problems.” Such peaceful revolution would then allow for the indispensable dynamic view of comparative advantage. Italians should understand that there is no alternative to this path towards modernization other than economic and institutional decline.

Figures

Figure 1

The Great Gatsby curve (Corak, 2012)



Tables

Table 1

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

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