

Compelled to reform, unable to deliver

- by: *Henry Ergas*
- From: [The Australian](#)
- November 19, 2011 12:00AM



Italians smoke and chat in Naples this week. Unless Italy's fundamental vices are addressed, the repeated failure of reforms shows its problems will persist and worsen. Picture: Getty Images *Source: Getty Images*

IT is not just Berlusconi financial markets have lost confidence in. It is the sistema Italia -- the complex interplay of economics, social relations and politics that characterises modern Italy.

From the ruins of fascism and war, that interplay made Italy one of Europe's most prosperous countries. But it contained the seeds of its own destruction, and unless its fundamental vices are addressed, the repeated failure of reform efforts shows today's problems will persist and worsen.

The strengths and the weaknesses of the sistema Italia emerged early in Italy's post-war history. The fascist regime had run a tightly, albeit ineptly, regulated economy. After the interregnum between the fall of Mussolini in 1943 and the elections in 1948, a determined group of economic liberals managed to bring galloping inflation under control and dismantle some of the most harmful interventions of the fascist era. Two liberalising moves proved particularly important.

The first was a substantial liberalisation of trade and capital movements. While the 1950 tariff was still set at relatively high levels, the relaxation and removal of import quotas

reduced protection - and for agriculture too. As of late 1947, the lira was effectively convertible, at least as far as export receipts were concerned, facilitating international trade and rewarding exporting firms.

The second change was the removal of restrictions on internal migration, which Mussolini had strictly limited. The result was a freeing up of the labour market, allowing growth as the underemployed of the south flocked to the north's expanding industries.

Combined, the pressures and opportunities of international trade, low inflation and a newly flexible labour market provided the basis for the "economic miracle".

From 1952 to 1963, national income more than doubled, with Italy's economy rivalling the growth rates of Germany and Japan. Public expenditure remained under control while public debt stabilised at low levels.

But hidden under the glamour of *la dolce vita*, problems built up. As agriculture's share of employment fell from 40 per cent in the early 1950s to 20 per cent in the mid-1960s while manufacturing's rose from 25 to 40 per cent, the industrial centres of the north became crowded with recent migrants living in substandard housing that lacked access to basic services. A revolution of rising expectations was under way but the political system was incapable of meeting its demands.

Politics was, in effect, locked in what became known as "imperfect bi-partyism".

The Communist Party provided an electoral challenge to the ruling Christian Democrats, but under the conditions of the Cold War it could not become the government, absolving it of responsibility for developing and implementing viable policies.

As for the Christian Democrats, fearful that tackling the inefficiencies that plagued the supply of basic services would alienate their traditional constituencies, they concentrated on shoring up patronage networks, not least as a way of reducing their direct dependence on the Catholic church.

In the process the Christian Democrats became a loose and ever-shifting alliance of regional party bosses whose power depended on the ability to dispense benefits to local clients, but who had neither the incentive nor the ability to resolve pressing dysfunctions in the industrial north.

With all the tensions unresolved, the result was a wave of industrial unrest that reached a first peak in 1962-63.

Faced with an outbreak of industrial militancy over which they had limited control, the communist-dominated unions tried to reclaim leadership by pressing reforms that began a long process of re-regulating the labour market.

Particularly disastrous was the prohibition on wage differentials between north and south, which, given that productivity levels in southern Italy were 30 per cent below those in the north, destroyed the commercial viability of large parts of the south's trade-exposed industries.

To this the Christian Democrats reacted by bolstering the state sector as an alternative source of employment. This had the advantage that it gave local party bosses an important gift to allocate *il posto*, the government job, whose security, relatively high pay and social status were particularly attractive in the south. But it did nothing to address the root causes of industrial unrest that exploded again on a greater scale in the "hot autumn" of 1969.

The result was an economic and political disaster.

The settlements reached in successive negotiations put the larger Italian firms on the road to collapse. The passing in 1970 of the "workers' statute" made matters even worse as its provisions crippled management prerogative. And steep wage rises created inflationary pressures that monetary policy largely accommodated, unleashing a wage-price spiral.

The politics were even more poisonous. In an atmosphere of insurrection, terrorism became a daily phenomenon.

Particularly after the 1976 elections gave the communists more than a third of the votes, the two main parties tried to find a way of jointly bringing the situation under control in the so-called "historic compromise".

By the mid-1980s, the "years of lead" had come to an end, thanks to police operations on an unprecedented scale and the erosion of many civil liberties. But by then the oil shocks had delivered more blows to Italy's economy.

Caught in the whirlwind, and fearing a political cataclysm, the Christian Democrats, now allied to the socialists, reacted by trying to manage the symptoms.

Public employment creation was stepped up, accounting for almost half of employment in the south. So too was spending on pensions, which became a repository for the unemployed.

At the same time, to hide galloping inflation, price controls were extended in the 1970s to more than 40 per cent of private sector output. As this destroyed the private sector's profitability, industrial subsidies were increased, reaching almost 20 per cent of industrial value added.

To further protect employment, laws were introduced preventing the opening of supermarkets, sheltering the myriad small shops that absorbed under-employed labour but at the expense of productivity growth in retailing.

The characteristic feature of all these interventions was that they involved discretionary administrative decisions. They were therefore very different from the northern European welfare state that impersonally attributes entitlements in line with rights.

These were favours, granted through processes as complex as they were opaque. They cemented a politics of patronage and clientelism. They also proved an ideal breeding ground for corruption, which became a pervasive national phenomenon, creating a powerful constituency for an ongoing supply of corruption opportunities.

The overall result was fourfold. First, public spending rose faster than tax revenues, so budgets that had been balanced or even in surplus sank into greater deficits.

Public debt, stable at some 30 per cent of GDP from the 1950s to the mid-1970s, skyrocketed, reaching 80 per cent of GDP in the mid-1980s and 100 per cent of GDP a few years later.

Second, hit by draconian restrictions on labour mobility and the obvious target for periodic attempts to increase tax collections, the large industrial enterprises that had dominated Italy's growth shrank where they did not simply disappear, with employment in those enterprises falling by almost 70 per cent in the 20 years from 1970.

As their capital base became more tenuous, they increasingly relied on creative accounting to survive, leading to spectacular corporate scandals and collapses, such as those of the Ferruzzi-Montedison group in the late 1980s and of Parmalat in 2003.

Third, while those firms were in free fall, there was a massive shift of output to small industrial enterprises. While these firms had enormous resources of creativity and flexibility, they were also heavily dependent on access to a rapidly increasing pool of illegal migrants, on the ability to ignore regulations and on tax evasion.

Fourth, corruption became more entrenched and the line between corrupt but essentially legitimate activities and organised criminality became more blurred.

Corruption reached its peak under the socialist government of Bettino Craxi (referred to as "Nero" in a popular song of the time) who, having served as prime minister from 1983 to 1987, died in exile in Tunisia in 2000. But even more damaging was the Italian state's seeming loss of control over the use of violence, as forms of organised crime long present in Italy's south expanded to control an ever broader range of activities nationwide.

Understandably, all this provoked serious efforts at reform. But despite the real attempts made, the outcomes were at best mixed and often disappointing.

The "clean hands" drive that the Italian magistrates began in 1992 with the discovery of tangentopoli (a tangente being a bribe) involved a frontal assault on corruption. Combined with the realignments brought by the end of the Cold War, its revelations caused the collapse of the entire structure of political parties. And it did end the careers of a large number of politicians and public servants.

Yet on every indicator, the gains were not sustained - unsurprising, when one knows that by 2006, almost 80 people condemned for corruption were serving as members of parliament.

There was also a concerted push in the 1990s to implement administrative reform. The number of ministries was reduced; measures such as price and rent control were wound back and in many cases abolished; regulatory functions were transferred to independent agencies; and public enterprises were privatised and exposed to competition.

Yet here too, initial gains proved difficult to sustain, and in some areas there was substantial backsliding.

Moreover, in the crucial area of employment regulation, little progress was made, so the labour market remained highly distorted, creating costs that fell especially heavily on younger and older workers.

This created continuing pressures for the public sector to act as an employer of last resort, either directly or by facilitating early retirement for older workers.

Given those pressures, efforts at fiscal consolidation proved problematic. A first set of large scale efforts in 1988-92 was unsuccessful, in part because tax increases were insufficient to offset rising interest payments on public debt.

Fiscal outcomes were better in 1992-97, when Italy was striving to meet the criteria for admission to the euro, but the improvement was largely driven by one-off tax collections, postponements to capital spending and other "quick fixes".

After that, annual increases in public spending, even excluding interest payments on public debt, always exceeded the medium-term fiscal targets, with the exception of 2002 and 2008.

Taking the entire period 1998-2008, the growth rate of public spending, excluding interest payments on public debt, exceeded the fiscal targets by 50 per cent. Yes, each time the situation got out of hand, tax collections were increased; but the efforts proved difficult to continue, and even more important, any persistent rise in revenues was dissipated in higher spending.

All this reflected two fundamental weaknesses: a deeply distorted labour market that could not provide people with decent jobs, increasing the pressure on the state to ensure some form of social safety net through public spending; and a political system that became even weaker with the collapse of the Cold War antagonists, the Christian Democracy and the Communist Party, and hence even less able to resist both the pressures on, and the temptations of, power.

Electoral reform in 1993 tried to reinforce the political system by moving away from almost pure proportional representation; but that made only a modest difference, and in any event was largely reversed in 2005. As a result, the political system remains less cohesive than ever, and the elections that are likely to occur next year will only confirm that fact.

It is against that backdrop that the successive Berlusconi administrations must be judged. Berlusconi himself made his fortune under the Craxi regime, of which he was a major beneficiary.

With the collapse of that regime, and with it of the entire party system, he entered politics largely to protect his assets. But if he was successful in doing so, it was because he could both bring together, out of the shifting sands of Italian politics, classic coalitions of local notables and appeal, over the heads of the politicians, to the desire of Italians for a new, cleaner or at least much-streamlined government.

However, partly because of the constraints created by his coalitions, he did little to deliver on his promise of winding back the state. What he did do, on the other hand, was undermine the controls "mani pulite" had created against corruption, and even more so, erode the protections against corporate fraud. Of those changes, he was by no means the only beneficiary in parliament. The loss of his majority reflects not any renewed move to reform but rather the realisation by his coalition partners that the time had come for a change.

They were, in that sense, playing the classic Italian strategy, famously expressed by Tancredi in Giuseppe Tomasi di Lampedusa's *The Leopard*, that "if we want things to stay as they are, things will have to change". But the question must be whether that strategy remains viable.

To that question, there is no simple answer. On the one hand, the constraints of the euro mean something must be done, at least in terms of implementing the further fiscal consolidation Berlusconi promised.

And yes, it is possible for Italy to materially improve its short-term budget position, and somewhat reduce public debt, by another round of increases in taxes and some slowing of spending growth. Italian governments have done that in the past; Berlusconi was on the road to doing it; and a Monti administration could do it as well.

But what Italy needs is not another short-term fiscal consolidation - that has failed, as the revenues raised from increased taxes are soon wasted.

Rather, its greatest need is real progress in labour market reform. For unless the labour market is substantially deregulated, fiscal consolidation will fail again.

Yet it is by no means obvious that the political coalition this requires can be created soon, especially with the prospect of general elections in less than 18 months.

Italy is trapped between the constraints of a euro that impels reform and a political system incapable of delivering it. The Italian state has grown beyond its capacity for governance and beyond its capacity for reform.

This is what the economic liberals whose market-oriented reforms underpinned Italy's phase of rapid growth feared. It is only if Mario Monti can renew their legacy that Italy stands any chance of success.