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Abstract

We present the current Italian economic crisis as a phase of a major systemic decline. We argue that "Italy's system" has forced the country to abandon a "dynamic" view of comparative advantage, crucial for sustained economic growth, in favour of 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 collective action issues and an implicit contract between elites and civil society. We suggest that solving these issues is indispensable in order to support a "dynamic" view of comparative advantage and so the re-start of the Italian economy and society.

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 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).

In this article we claim the Italian crisis is structural and that further tinkering with a flawed framework is useless and dangerous. Bacon and Eltis (1978) stressed "Those who seek to manage economies or advise on their management are either "tinkerers" or "structuralists" ". For Italy the time of tinkerers is over and it is now time for restructuring. The Italian economic slowdown has been determined by a *static view of comparative advantage* which 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 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 rooted in an *implicit contract* between the mass public and the elites. This contract generated and fostered an anti-growth culture,[1] hindering restructuring. It rests on the Italian operational form of government: *particracy with corporatism*. The latter is entrenched in a *collective action problem* (CAP). The pre-WWII patronage structure became embedded within particracy. In the post-war period, particracy was still in the process of establishing itself, the economic structure was more flexible and market signals could perform their function. These circumstances allowed the Italian economy to specialize in sectors with higher relative productivity and calibrate itself according to market signals. However, a market economy constituted a risk for an emergent particracy in need of controlling resources and distributing favours. Political parties, as they consolidated their hold on the Country, strengthened controllable guilds. This dirigisme drift hampered the functioning of markets and progressively congealed the economic structure. Political power guaranteed inefficient entrepreneurs' survival and workers' jobs thus obstructing creative destruction. The public sector absorbed workforce well beyond its own efficiency requirements. Almost fifteen years before the "Great Recession", a fast changing international setting exposed the Italian economy's intrinsic weaknesses and triggered its inexorable decline. How could such a system persist notwithstanding its failure? Our answer is that electoral laws eased the action of special interest groups which could coordinate their own actions to achieve their groups' goals. Instead, the civil society could not coordinate a collective action to bring about beneficial and progressive reforms which were in turn obstructed by special interest groups. An implicit contract between political parties and the general public secured this state of affairs along the traditional lines of patron-client relation.

The article is organized as follows. In Section 2, we present a short review of major results in economic growth research. In Section 3, we 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

[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).

an implicit contract sealed by a CAP. 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" is essential for economic growth. The take-off of an economy (as post-WWII Italy) calls for specialization in sectors with relative strength. A weak currency, through appropriate devaluations or managed depreciation, would help the economy's international competitiveness (Zemanek, 2010). Success would boost international trade, increase income, capital intensity and real wages. The triggered economic advancement could be sustained if and only if (iff hereinafter) continuous innovation through competition is taking place, since technological progress 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 productivity improvements and 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 enjoy a temporary market advantage. Processes of restructuring and creative destruction are indispensable for sustained economic growth. A "dynamic view" of comparative advantage is inseparably linked to entry and exit flows of product, reallocation of resources and large flows of job creation and destruction.[3] 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 are essential 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 incentive for investing behaviour, since agents will be willing to renounce current consumption for investment iff 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?

The long run structural nature of the Italian economic slowdown has been widely documented (Rossi, 2007, ch 3; Emmott, 2012, ch 3; Pelloni and Savioli, 2014; Toniolo, 2014, especially chs 1, 3, 4, 7, 12, 14, 16).

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[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 follow the remarkably clear and focused presentation of Spence (2011).

[3] Between 1990 and 2003, the US private sector created 8% of its jobs while destroying 7.7% of it each quarter thus providing a net growth in private employment of 0.3% per quarter. That amounts to a creation of 21-22 million jobs per year with an almost equal amount of job destruction. Similar patterns are shown in all major economies (Cahuc and Zylberberg, 2009).

The real GDP percentage increments have been dwindling since the early 1990's to a state of no growth or negative growth (Figure 1). While the "international productivity slowdown" could explain the reduced speed of the 1980's, the subsequent decline cannot be accounted for by it. Also it cannot be explained by a negative international business cycle. The Italian slowdown has been more severe than that of the rest of the European Union.

Figure 1

The above mentioned decline has been associated with a fall both in labour productivity (Figure 2) and total factor productivity – TFP (Figure 3). The indispensable persistent increases in productivity fuelled by innovation went missing.

Figure 2

Figure 3

Stylized facts suggest that Italy, though successful in the 1950's and 1960's, has been stagnating for a long time and the recent global crisis has just exacerbated the ongoing decline of the Italian model. A first stern warning came from the 1992-95 crisis pivoting over currency and public debt weaknesses (Rossi 2007, pp 74-79). At the same time, the end of the Cold War, the Globalization process, the IT revolution posed new challenges to the structure of the world economies. Different countries met these challenges with different degrees of success. Italy failed the test. We shall explain why in the next section. For the moment, we shall present some more relevant stylized facts.

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 change sector and not to expand. They cannot generate 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 (Rossi, 2007):

- An archaic, complex and anti-efficiency legal-administrative system that is the product of a culture with similar characteristics (The Economist, July 19th, 2014);
- Difficult and complex access to credit (Acemoglu, 2001; The World Bank Group, 2014);
- High start-up costs;[4]
- A complex tax system characterized by high corporate taxation;[5]
- Corruption and organized crime pressure (Schiffer and Weder, 2001);
- A highly centralized form of bargaining between employers and trade unions (Emmott, 2012).

This restructuring deficiency comes along with a severe retardation 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 (Pelloni and Savioli, 2014). 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

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

[5] Pelloni and Savioli (2014). Huge fiscal pressure is the companion of high and increasing values of the Debt-GDP ratio. 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.

contemporary high-tech environment. Italy fares badly in terms of tertiary education where it is lagging with a widening gap with respect to the other advanced economies (Figure 4).[6]

Figure 4

As seen above, an economy needs skills, learning and knowledge to accommodate the information flow indispensable for creative destruction, restructuring and economic growth. This education gap has been having a severe impact on Italian economic growth, has been increasing the "so called" costs of capitalism[7] and has been affecting income distribution.[8]

The public debt problems of Italy are well known. The debt-GDP ratio (higher than 100% since 1990) has been steadily increasing and is 132% in 2014. Public sector overmanning 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 5). 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 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.[9]

Figure 5

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.[10] Italian Fiscal Policy is strongly pro-cyclical, which is a signal of public sector corruption.[11] The Corruption Perceptions Index[12] (CPI) signals a high level of corruption characterizing the Italian economic and social system (Table 1).

Table 1

Corruption is a major obstacle to economic growth because it wastes government revenue, fosters opportunities for bribery, undermines the rule of law and weakens the judicial system (Weil, 2013, ch 12). The link between kleptocracy, start-up costs and the ensuing creation of barriers to entry is critical and revealing as "[c]ountries with heavier regulation of entry have higher corruption and larger unofficial economies" (Djankov et al. , 2002).

The evidence presented in this section is sufficient to signal that the fundamentals of sustained growth have been violated as Italy has opted for a static view of comparative advantage while keeping a tight rein on economic freedom (Figure 6).

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[6] These symptoms of Italy's human capital shortage become more disturbing when one takes into consideration quality (Baccini et al., 2014; Pelloni, 2010).

[7] 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 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.

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

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

[10] 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).

[11] 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.

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

Figure 6

The indispensable (for sustained growth) restructuring of the productive system and the related job-labour-capital mobility have been missing. As a consequence, a set of interrelated problems 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. Because of their "*negligence*", the Italian economy is now afflicted by acute structural weaknesses. This shortcoming poses a dramatic challenge. Most advanced or fast developing economies have their supply sides well organized while they are confronted by the current global demand deficiency. Italy has to face this demand crisis with a productive machine which is obsolescent and uncompetitive. Thus, demand deficiencies are compounded by severe supply problems. Italy should overhaul its economic machine while trying to keep its engine running as fast as possible. The task is daunting but possible.

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

The major signals of Italian 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 was there no effective response to these challenges? We claim the explanation resides in a "static" view of comparative advantage and its causes which have been informing the whole economy.

Historians maintain 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-political clientelism. Thus, political parties took over the role of the landowners in the patron-client relations. The governing class embraced clientelism as a ruling operational method. It manipulated clientelism to exploit State economic resources in order to win consent and cling to power. Public sector expansion and the politicization of the new State agencies and companies were unescapable consequences and were encased in a sharing out scheme (*lottizzazione*) between political parties and factions. Clientelism carries a high price as it harms the tissue of a modern society. It "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 epitomize its failure.

Notwithstanding sluggish and weak governments, the democratic executive-electorate dynamics 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 unfailing support for a complex and bureaucratic centralism. Why could not democratic dynamics fix these failings of the clientelism-corruption drive?

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 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 the executive power through an extreme form of proportional representation.[13] 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 operational 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. The corporatist triangle state-employers-unions has been providing the basic reference model. This triangular relationship has been uneven from the beginning. Italian guilds and the machinery of the State are 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. Markets signals are subordinated to parties-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 their allied 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)[14] and a certain amount of consent from the bottom is needed. This consensus has been warranted by an *"implicit contract"* between the decision-making elites and the civil society. 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. 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. By protecting jobs, the socio-

[13] Votes were asked for collective lists of names drafted in each Electoral College by each political party.

[14] Italy scores poorly in Democracy rankings. Democracy is not necessary for economic growth; however, a good democracy may help (Spence, 2011).

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 are no longer competitive 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 been showing, *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? 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 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 making resilient this implicit contract is embedded in the CAP (collective action problem).[15] The CAP deals with rational choice behaviour within a group of agents which could gain from the provision of a public/collective good. Olson (1971) showed it would be rational to free ride for a member of such group if her/his net benefits are negative. If there is no individual with positive net benefits then the group will not certainly provide the collective good. Such a group is called a *latent* group. The presence of at least an agent with positive net benefits is necessary for the production of the collective good. This kind of group is labelled as *privileged*.

In Italy, *privileged*[16] groups, coincident with special-interest/distributional/rent-seeking organizations,[17] are located at the very top of the power pyramid. Special-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 allied subgroups have the characteristics of privileged rent-seeking groups. If the analyses of historians like Bull, Emmott, Hine, Mack Smith and Newell are correct, there is a strong association between these distributional groups and clientelism, sharing out schemes and public sector corruption. Such groups are at the heart of the Italian political system and supportive of the patron-client relationship which buttress it.

The Italian institutional setting has been conducive to the formation of rent-seeking groups at the expense of the general public. On the other hand, that same setting held back the establishment of encompassing organizations[18] and favoured the latency of any group aiming at beneficial reforms. Furthermore, the enactment of beneficial reforms would endanger the investments in capital and

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[15] We thank Tom Barbiero who drew our attention to a potential CAP in Italy. We also thank Pranab Bardhan for further discussion on this issue. Emmott (2012) hints briefly at the potential presence of a CAP but does not develop the issue and does not fit it in a specific mechanism.

[16] 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.

[17] We follow Olson (1982) in using these terms as synonyms.

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

networks of special-interests groups by making them obsolete. This threat reinforces reciprocal support among special-interest organizations to defend strenuously the status quo. The benefits-costs structure of patrons is linked to those of their clients. Thus, clienteles could form privileged groups which are subsidiaries of the privileged groups at the top of the pyramid. All these privileged groups have specific vested interests in the current status quo and oppose socially beneficial economic reforms.

The electorate, the consumers and the taxpayers are, almost by definition, latent groups since the individual's benefits of a collective action (e.g. abolition of the patron-client relationship, introduction of a bottom up democratic electoral system, lower corruption, lower taxes, cleaner environment and a better quality education and university system) would be highly diluted in the short run with respect to the costs. Such behaviour of the Italian electorate entails 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 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? The answer lies in the time consuming process linked to the establishment of the "particracy" regime. In Italy, in the aftermath of the WWII upheaval, special-interest organizations had still insufficient power and it took them time to strengthen it under the protective umbrella of the electoral system. These groups' success led progressively to encourage the group activists to develop bureaucratic structures favouring an oligarchy where the leaders rip off the highest benefits (Lichbach 1998). In the 1950's and 1960's, Italy's structure was in the making and the particracy 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' via "*particracy with corporatism*" got control of the country they thwarted the required flexible upward modernizing adjustment necessary for the Italian economy to sustain its relative 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.

The power elites created the delusion of an Italian miracle based on the micromanagement dirigisme of those elites. It is a myth. The truth is that the Italian miracle took place because those elite could not yet hamper growth fundamentals. Since then every gimmick applied by the tinkering elites has been inadequate.

The Italian economy is afflicted by acute structural weaknesses. Most of the developed and fast developing economies have their supply sides well organized while they are confronted by a global demand deficiency. Italy has to face this international demand crisis with a productive machine which is obsolescent and uncompetitive. Italy should overhaul its supply side while trying to keep its engine running as fast as possible: a daunting task.

5. Further Considerations and Conclusions

Governments' distortions and mismanagement with the implicit consensus of the mass population have stifled the process of growth. How could Italy stop its own decline and reverse it?

First and foremost Italy must abandon *"particracy with corporatism"* and take on a dynamic view of comparative advantage. This reform would entail a dramatic shift in its socio-political-economic structure. It would be painful at different levels. However it is the only route Italy could follow to stay on course for sustained economic growth. Attempts to "re-start" Italy by "tinkering" (gradual and moderate liberalization of the labour market or public expenditure cutting without touching power centres) have been failures. The breakdown of the Monti Government is symptomatic.[19] Italy needs a fast, drastic, dramatic change and so to erase the implicit 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. What is needed is more than reforms. Italy needs a re-foundation. This new foundation requires 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 which would deem such change as utopian and unfeasible. It is not. However it would require determination, cooperation and leadership.

In the short run, a fast demand management response[20] 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. Demand management would not be sufficient as it would have to be complemented by a new governance willing to overhaul Italy's "productive machine". A governance favourable to free markets, economic growth and devoid of any vestige of "particracy with corporatism". The removal of "particracy with corporatism" is a necessary condition for the potential implementation of successful growth policies.

Alongside a "bad Italy" there is a "good Italy" (Emmott, 2012). There is potential for revitalization. Positive signals are coming from some sectors of the Italian economy (Mediobanca and Unioncamere 2012):[21] the chemical, food, pharmaceutical and asset management[22] industries show vitality and dynamism. 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. Italian banks must manage the resources generated by the ECB's targeted long-term refinancing operations (TLTROs) and the recent quantitative easing (QE) strategies[23] 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 the absorption and rescue of 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 a widespread but wrong Italian belief of a hostile Germany and international environment, Italy managed to survive the 2011 crisis and carry on its current state of fragility, instability and passivity also thanks to the support of the Euro area. The vital, though time inconsistent,[24] interventions of the ECB would not have been possible without the consent of the Euro partners. Italy should not abuse this "benevolence": a prompt reaction from Italian quarters is called for. The QE is a

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

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

[21] We wish to thank Carlo D'Adda, Khawar Nasim and Giuliano Pancaldi for referencing and discussion.

[22] http://www.reuters.com/article/2014/09/25/italy-funds-idUSI6N0RA00R20140925.

[23] http://www.ecb.europa.eu/press/pr/date/2014/html/pr140605_2.en.html; https://www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html.

[24] We 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.

lifejacket. Now Italy must swim and reach the lifeboat where it can start growing with her partners. Apt and reliable signals of reform could make it easier to appeal for a less stringent austerity from the EU.

Labour market reform cannot be asymmetric. It cannot be limited to the employee's side (e.g. allowing for fewer types of contracts, easier dismissals, lower compensation allowance, unemployment pay, unilateral change in employees' duties, legal technological monitoring of employees, higher flexibility of fixed-term contracts…). It has to be extended to the employers' side. The State should stop sheltering inefficient entrepreneurs, through subsidies or other practices. Instead, it should let them fail and lower entry barriers alongside start-up costs. An asymmetric liberalization of the labour market would be dangerous and unfair. A swelling unemployment pool would be met by an inadequate, unsuccessful, ineffective productive system and it would be then impossible to absorb it. The old absorber, the public sector, is not and should not be any more feasible. Public sector overmanning is in fact one of the nodal issues to be solved. This problem could be solved without excessive tension if private sector low productivity and underproduction are tackled. The latter are tackled iff creative destruction and restructuring could take place. Effective labour market liberalization and public sector overmanning reduction go hand in hand with a dynamic view of specialization and restructuring.

The above changes would weaken and eventually break the link between special-interest organizations and the productive side. They would be bitterly resisted and require further reforms of the public sector. 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. Public expenditure should not be wasted in supporting wasteful clients. Instead, alongside institutional reform, it should assist in reducing inequality, increasing income intergenerational mobility and cutting down corruption. Corporate taxation should be brought down towards European levels. Tax assistance should be provided to allow for the replacement of obsolete capital, technologies and organizational procedures. Income taxation should be simplified with respect to its current complex fragmentation and it should introduce a higher degree of progressivity.

Such regeneration demands reforms of the Italian Constitution and electoral system. This objective should be reached without sweeping constitutional changes. The strictly necessary amount of corrections should be introduced to the existing constitutional text. A massive rewriting would be tantamount to paralyzing the reform process. This redrafting should bring in an electoral system whereby the natural bottom up process is restored and the power of political parties drastically diminished. A simplification of the legislative system is imperative since the current one in its outdated, burdensome, complex structure has highly hindered the country modernization. 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. Special-interest organizations would not relinquish easily their privileges. Selective incentives and/or extra-rational motivations (Olson, 1971, 1982; Hardin, 1982; Drazen, 2001) may provide solutions. Even more promising are the solutions to the rebel's dilemma of mobilizing collective dissent (Lichbach 1996, 1998).

We stress that policy makers cannot hope that tinkering with commonly prescribed policies could firmly put Italy on a new stable growth path. To resume a virtuous path those measures should be framed in a perspective of overcoming the CAP, dissolving the implicit contract and bringing down particracy with corporatism. 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 the ECB liquidity creation. The channelling of the TLTRO/QE resources towards the healthy fraction of the productive structure can provide a massive forward push. If those resources were wasted to rescue deadwood a huge opportunity will be missed and Italy would move closer to the abyss.

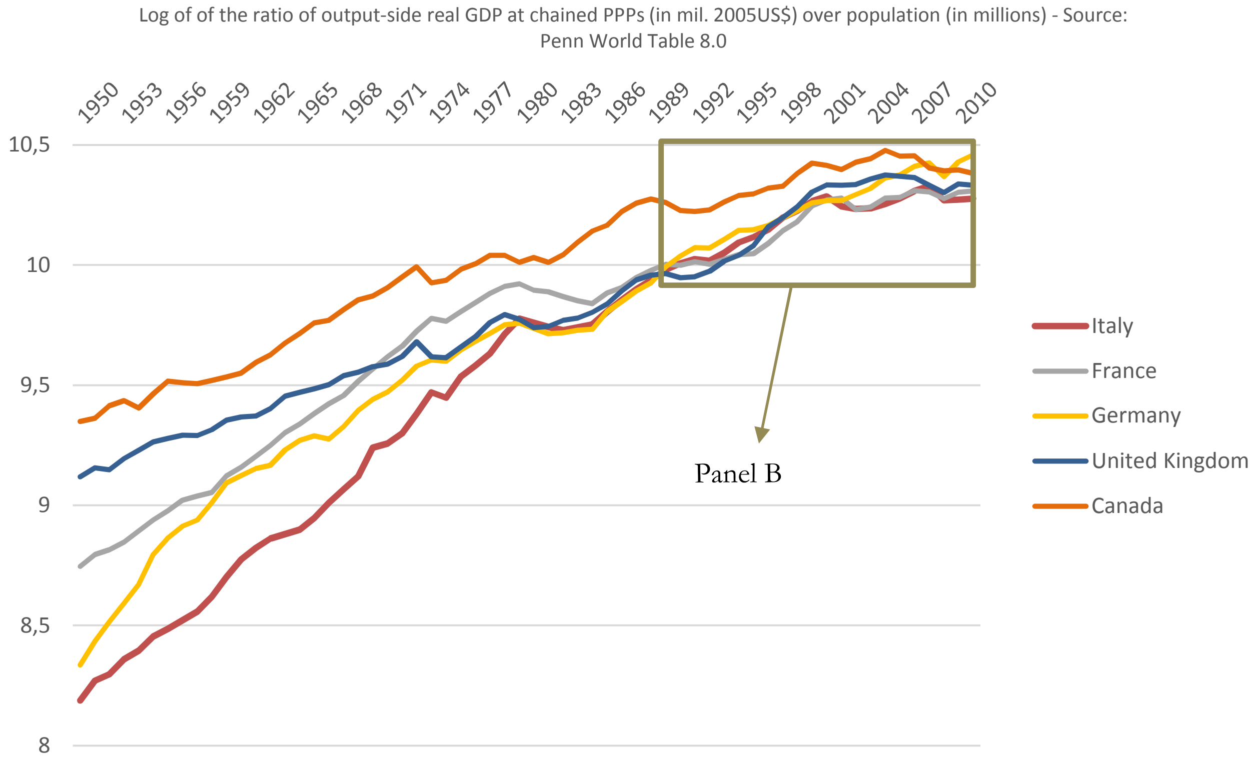
Furthermore the current crisis has weakened the interlinking between the costs-benefits structures of patrons and clients. Patrons' costs have been increasing in an unsustainable way and have not translated directly into clients' benefits. This trend may be fatal for special interest/rent seeking organizations and 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 foster their special interests.

To save itself, 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". Paraphrasing Johnson (1976), we claim that Italians should 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. Italians should understand that there is no alternative to this path towards modernization other than economic and institutional decline. In a fast changing world, Italy could survive only if she changes herself.

Figures

Figure 1

Panel A



Panel B

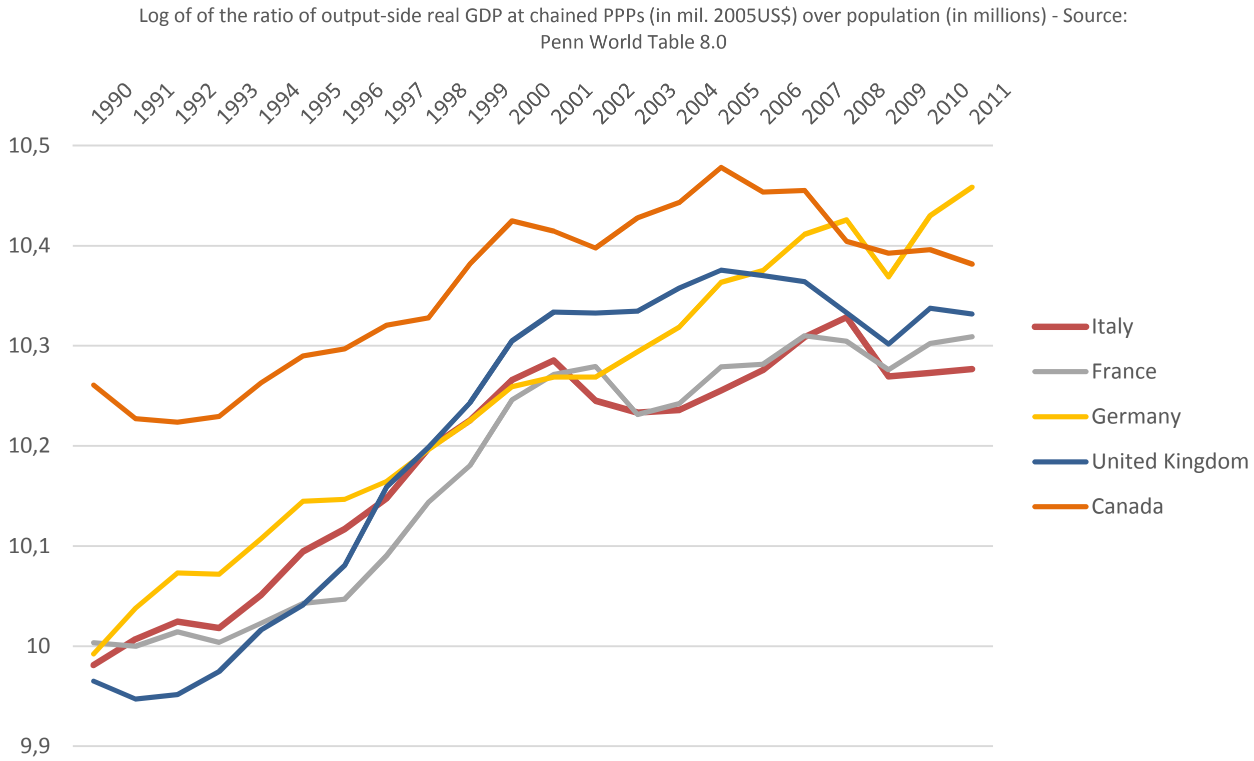


Figure 2

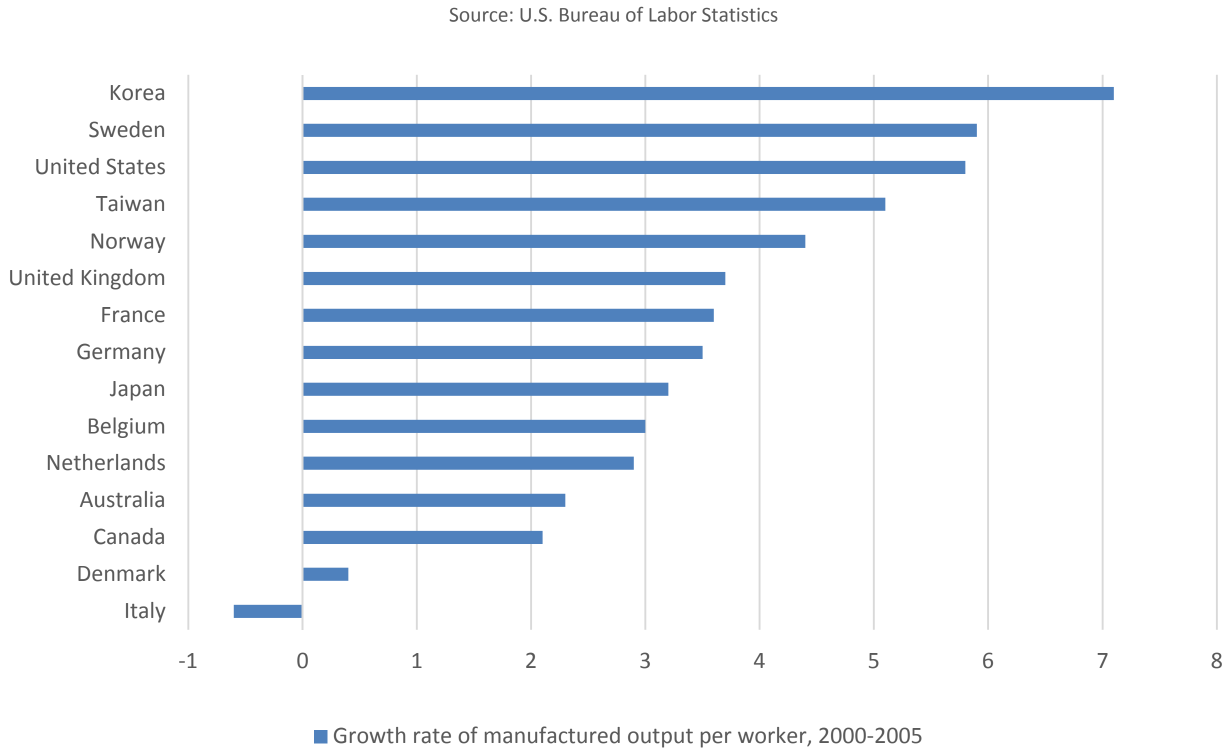


Figure 3

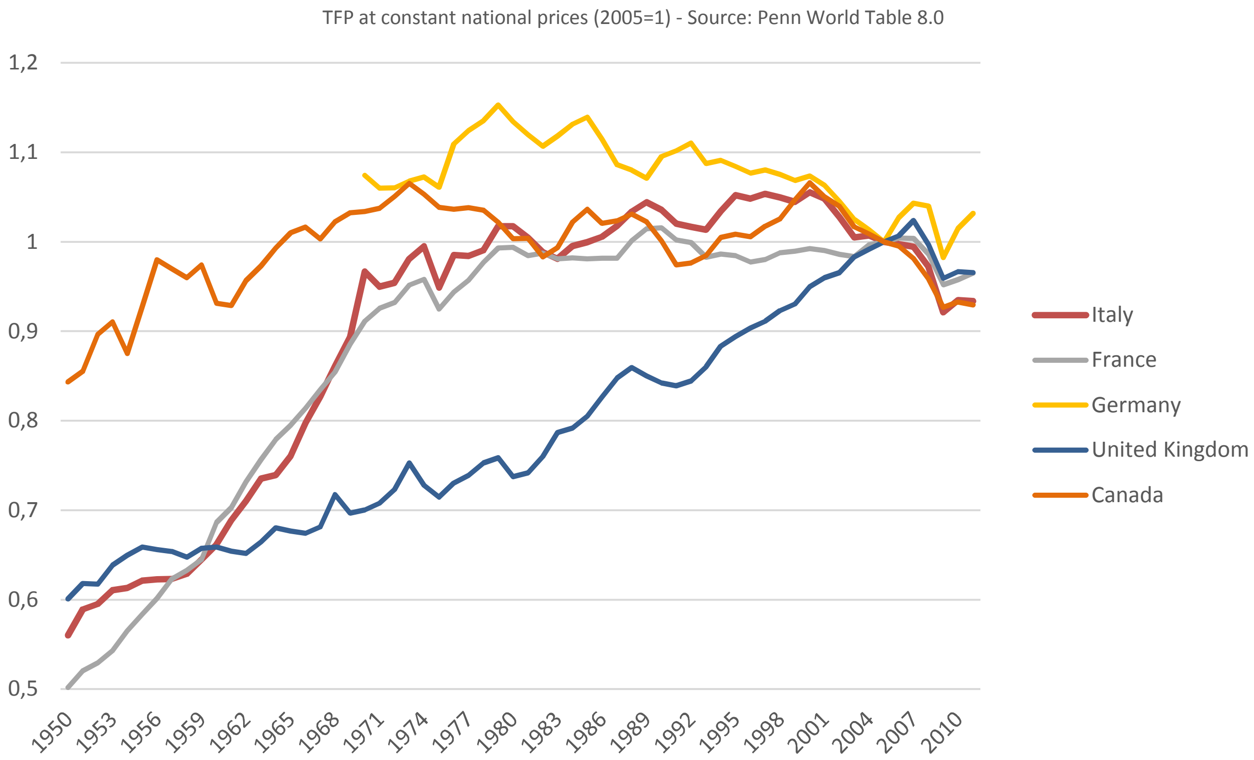


Figure 4

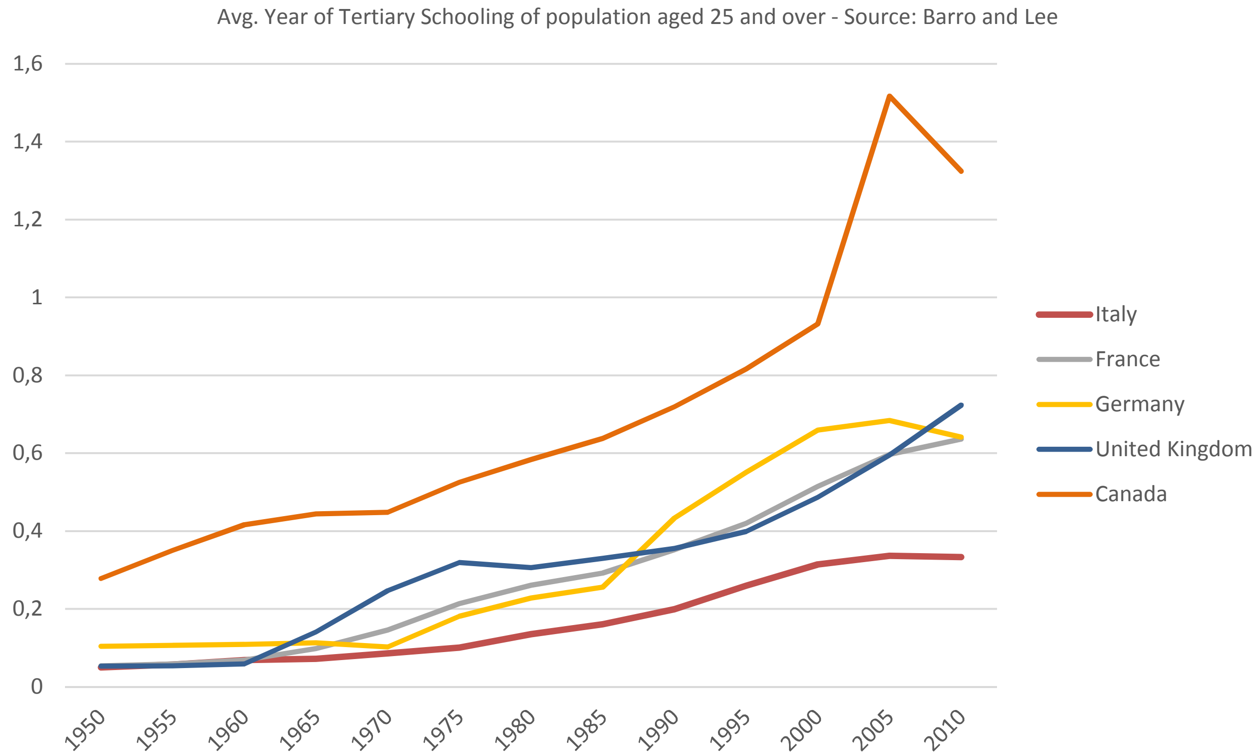


Figure 5

The Great Gatsby curve (Corak, 2012)

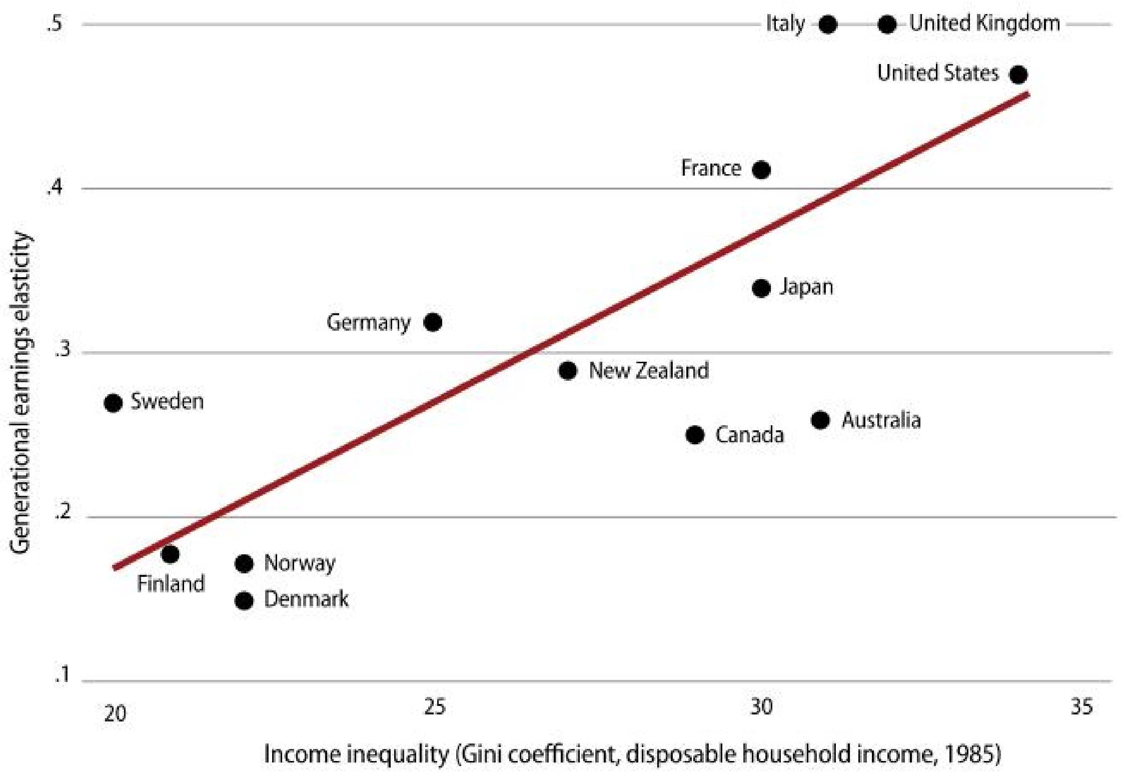
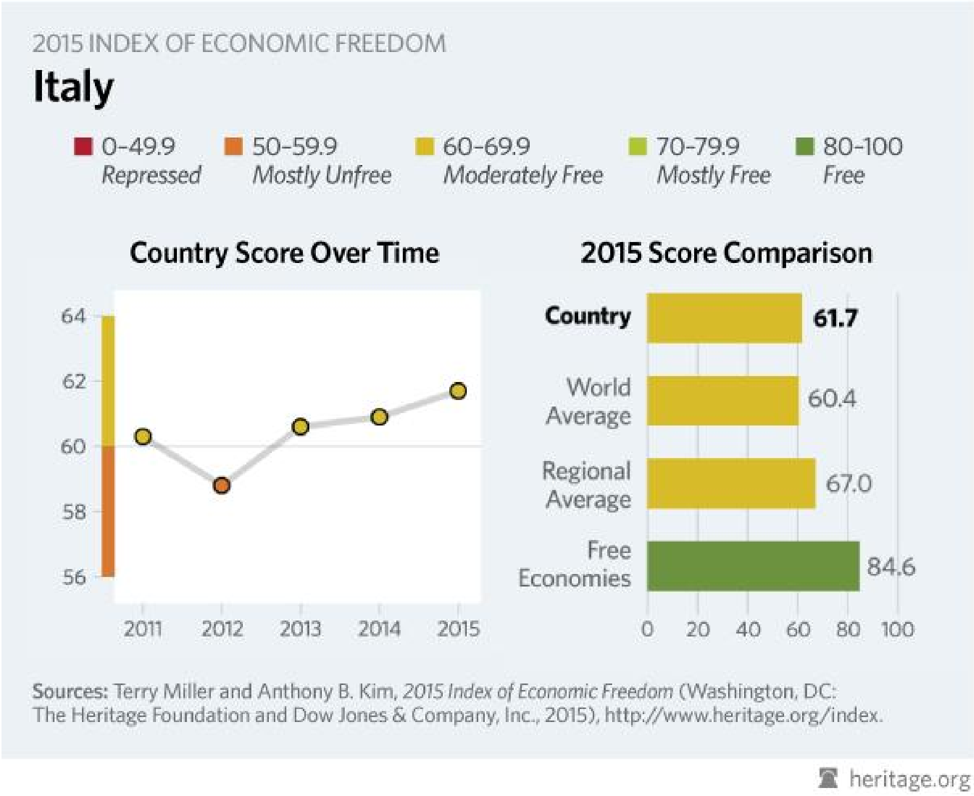


Figure 6



2015 INDEX OF ECONOMIC FREEDOM
Italy
0–49.9 Repressed
50–59.9 Mostly Unfree
60–69.9 Moderately Free
70–79.9 Mostly Free
80–100 Free
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62
60
58
56
2011
2012
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2015
2015 Score Comparison
Country
61.7
World Average
60.4
Regional Average
67.0
Free Economies
84.6
0
20
40
60
80
100
Sources: Terry Miller and Anthony B. Kim, 2015 Index of Economic Freedom (Washington, DC: The Heritage Foundation and Dow Jones & Company, Inc., 2015), http://www.heritage.org/index.
heritage.org

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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