The Italian Economy: Obstacles and Recommendations for Growth
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The Italian Economy: An Overview

GDP growth in Italy has steadily declined since 1960, from about 6% to less than 1% today[1]. Looking at two time periods, 1960-1985 and 1985-2011, Italian TFP growth has slowed from 2.85% to .57%. Italy's economic growth during 1960-1985 was driven primarily by rapid TFP growth along with strong growth in capital accumulation (1.70%), allowing the Italian economy to prosper during a period where the labor force shrank at a rate of 0.35%. This growth period was highlighted in the 1960s when, with help from the Marshall Plan, the country modernized its industrial and business practices to make them more efficient.

A number of factors have contributed to the stagnation of the country's economy. The Doing Business Index indicates a difficult business environment relative to EU Peers, due largely to institutions and access to credit. On a scale of 1 to 189 in measuring the overall ease of doing business in the country, Italy ranks 65th, whereas comparable economies rank far higher. For example, the United Kingdom ranks 10th, and the EU regional average is approximately 29th. Key elements contributing to computing a country's ranking include the ease of getting construction permits, starting a business, getting credit, paying taxes, and enforcing contracts.

Italian Institutions: Judicial, Legislative and the Rule of Law

Unfortunately, many of the factors that are hindering growth in Italy today are a product of entrenched, systemic issues with the country's institutions. These are not small problems to tackle, and require tremendous political and public cooperation, will and sacrifice.

An efficient and effective judicial system which serves to enforce contracts and property rights is a crucial component of a high-performing economy, encouraging investment in the country by building faith that agreements will be honored and disputes will be settled in a predictable manner. Unfortunately, Italy's judiciary is highly inefficient. The enforcement of claims is excessively delayed. In Italy, it takes approximately 1,200 days to enforce a contract, more than twice the average of other high-income OECD economies. Italian courts take an average of eight years to escalate civil cases to their Supreme Court, compared to 788 days for the average OECD European country[2], and the country ranks 103rd in enforcing contracts in the World Bank's 2014 Doing Business rankings.

The low nominal court fees and costs to bring a case to suit coupled with multiple routes to challenge rulings encourages litigation and increases the number of new cases and appeals, which has created a tremendous backlog of pending cases. This large case volume, as well as with frequent legislative changes make legal consistency difficult, as the Italian system's focus on civil rather than common law shies away from precedence and reduces predictability of legal outcomes[3]. This hinders the productivity of the Italian economy by inhibiting entrepreneurial risk-taking and by increasing banks' reluctance to lend to businesses. Italy ranks 109th in Getting Credit in the 2014 Doing Business rankings, and its FDI inflows are 1/3 those of the average euro economy[4]. The inefficient enforcement of contracts has a detrimental impact on Italy's TFP and, in turn GDP, as positive NPV projects are not pursued or fail to secure funding.

Unfortunately, Italy's judicial system is not its only governmental branch whose structural issues impact its economic outlook. Italy's legislative branch is oversized with 945 MPs (more than twice the number in the U.S., which has a population 5x larger)[5], and gives each house equal power which leads to a systemic paralysis and stalling of bills. Italy's decentralized government, which often regionally delegates decisions, limits the central government's ability to pass legislation that has broad national impact and makes it difficult to pass sweeping reforms. In spite of this, in recent years Italy has made progress on successfully implementing policies, but most significant legislation has been issued by government decree and therefore have not been subject to parliamentary debate, scrutiny or regulatory impact assessments. When passed, Italy's legislation suffers from a lack of transparency due to unclear wording and opaque references to other statutes.[6] While Italy has had recent success with reducing its debt and launching initiatives to address its economic woes, much work, including structural reforms, are still critical issues. This lack of cohesion, and the resulting frequent changes in regulations create time consistency issues that raise doubt about the future environment and discourage investment into the country.

Weaknesses in Italy's legislative and judicial structures do not help the country's broader issues with adherence to the rule of law. Corruption is a major issue in the country, and a 2007 study organized by Italy's High Commissioner against Corruption (an office which has since been abolished), concluded that corruption is "deeply rooted" in public administration. Bribes are commonplace in Italy and are paid to obtain licenses and permits, secure public contracts, and even practice medicine. Corruption is perceived as a transaction tax that raises the cost of doing business in the country to the tune of 100 billion euros per year, which further disincentivizes investment.

Flawed Institutions Create Flawed Policies: Taxation and Labor

The ratio of debt to GDP ratio in Italy is one of the highest in the world at 132% in 2012 and has grown at an average of 4.8% per years since 2008.[7] This enormous rate of increase has contributed to high debt interest payments as a percentage of government expenditures (~5% compared to 2.1% in US and 1.8% in Germany[8]) , money that could be spent on productive government activities, subsidies and incentives. Government austerity measures introduced in 2010 have successfully begun to reduce overall government spending by reducing contributions to public sector pensions, local government spending, as well as restrictions in the hiring of, and wage increases for government workers, thus far reducing budget deficits to 3% of GDP.[9] We believe these policies and activities should continue. Italy's high deficits divert capital away from the country and drag down its credit rating, creating a vicious cycle impeding access to capital.

In addition to reducing expenditures, the government can focus on reducing its deficits by raising revenues. With tax rates in the country already high at 31.4% compared to the European average of 20.6%[10], simply raising rates is not advisable. Rather, taxation should be reformed to facilitate investment and accelerate the foundation of start-ups, especially in highly productive sectors like information technology that the country is currently weak in. The tax revenue lost due to evasion and avoidance as a percentage of GDP in Italy is 11.64%[11], reducing potential government revenues by as much as 20%, as compared other Eurozone countries like Spain, France and Germany where the figure ranges from 6.5 to 7.5%. The UK's significantly lower rate of 4.86%[12] leaves much to be strived for.

If the Italian government can collect 25% of its avoided taxation, it will collect additional tax revenues equal to 3% of GDP, and effectively close its budget deficit, freeing up resources to devote to financing GDP-accretive activities and reducing debt interest payments.[13] By reducing the difference between nominal and after-tax wages[14], updating its outdated assessment and collection of property taxes[15], and changing the criminal penalties for tax avoidance[16], Italy can begin to improve its collection rates. Across the board reductions in prevailing rates can be coupled with these initiatives, and will increase overall revenue collected, improve transparency and foster greater trust and credibility with the taxpaying population while encouraging greater investment by firms.

Rigid Labor Policies Need Overhaul to Revitalize the Economy

Italy has had inflexible and non market-oriented labor policies in place for decades. More recently, the Italian government has come under intense criticism for failing to address a number of key issues:

- *Inflexible Firing Laws:* A series of measures have been protecting employees from being dismissed, even during economic recession. Firing underperforming staff can take up to three years and garner high legal costs[17]. The judicial system tends to side against employers. This policy hurts businesses in financial distress and makes employers conservative in their hiring practices, contributing to higher unemployment rates and lower accession rates[18] leading to sub-optimal labor allocation that translates to lower productivity and lost economic growth
- *High Wages, Low Productivity:* Economic competitiveness has been low partly due to a high and inflexible wage environment driven by collective bargaining and high taxes and social charges.[19] This puts pressure on SMEs and tends to favor production shifts abroad. Meanwhile, labor productivity in Italy is declining the most

among its peers.[20] Weak education, poor training and a lack of innovation all need to be addressed to drive long-term sustainable growth

- *Skill Shortages:* There is a significant gap between skill demand and supply, particularly among the youth population in Italy, with 47% of surveyed firms reporting a significant gap; more prevalent than any other European country[21]. Skill supply that matches market need drives labor productivity. Higher education and training programs are critical to closing this gulf. A recent OECD report points to Italy's lagging PISA scores relative to its European counterparts, limited education system reform and a lack of dedicated funding[22].
- *Weak Active Labor Policies:* Weak active labor policies that fail to both equip unemployed individuals with the right skills and push them into suitable jobs tend to restrict labor supply and prevent optimal allocation of labor. This dampens the labor productivity needed for increased economic growth.[23,24]

The effect of these labor market policy weaknesses is an economy that is unable to realize its full growth potential with symptoms of high unemployment and low mobility and productivity of labor. In fact, the IMF has concluded that labor market reforms that reduce dismissal barriers, the creation of active labor policies and a simple increase in female participation in the economy could lead to a long run increase in real GDP of +1.8%.[25]

A reform package was approved in July 2012 which addressed, amongst others, the need to reduce barriers to dismissing employees and the pursuit of active labor market policy reforms for the youth while offering unemployment benefit protections.[26] These regulations have not taken on full effect and are criticized for being too watered down.[27] It is clear that significant policy changes need to be in place going forward, including:

- **Enforcement of Dismissal Flexibility**: Cut legal and cost barriers around the ability of employers to lay off employees if they are underperforming and/or during economic downturns
- **Decentralize Wage Bargaining:** Reducing wage bargaining at a firm or industry level provides flexibility, for necessary reduction in wages where labor productivity is low and uncompetitive
- **Enhance Education and Training:** Initiate educational reforms to teach young people the skills needed by current job market demand with a focus on technology to keep manufacturing competitive
- **Strong active labor policy:** Create unemployment training programs that educate worker and place the unemployed in jobs that match their skills

Small to Medium Enterprises as a Case Study

In the U.S., 11% of people work at firms with 10 or less employees. In Italy, more than 45%[28] do, and 69% work at firms of 50 or less people[29]. Historically, the pervasiveness of small-to-medium enterprises in Italy has been characterized as a strength. Today, many point to it as a byproduct of Italy's weakness in contract enforcement and corruption, leading firms to hire only those they implicitly trust. Italy's overly burdensome bureaucracy is exemplified by its ubiquitous licensing system[30], which impacts industries ranging from car dealerships to pharmacies, protecting inefficient regional operators' territories from well-managed, growing, would-be national firms that have a higher TFPs. This protectionist approach, while crafted in the name of small business, is anti-entrepreneurial: it stifles growth of successful start ups and limits potential upside. SME policy in Italy inherently favors firms that cannot invest in R&D and creates a self-reinforcing cycle whereby small firms cannot build creditworthiness to take on debt and allocate investment more efficiently.

This predilection is a proxy to barriers to entry in science-based sectors, which are typically dominated by larger firms that require scale to innovate and achieve economies of scale, whereas smaller firms that tend to produce products that are more easily substituted for. Italy's tax system plays a part in this story too, with transactions taxes twice the OECD average and a skewed approach to retained earnings that discourages scale[31].

Our recommendation to promote the growth of the Italian economy

While we've outlined a number of measures that will promote short-run economic gains, Italy must focus on making changes that increase the openness and competitiveness of its markets to promote stable, long-run growth, with the particulars hammered out through willful participation by a range of educated stakeholders from small businesses, finance and government. Italy's current disincentivization of entrepreneurship and growth in businesses stifles innovation and fosters inefficient resource allocation. These measures will signal a desire to create a more predictable business environment and spur investment.

With this goal in mind, we recommend that the government lead reform efforts of its institutions to address structural flaws in the judiciary and legislature as well as capital markets regulations.

Institutional reforms in legislature should focus on creating clarity in the language of passed bills. This standard can then be applied to relaxing Italy's burdensome approach to occupational licensing, simplifying bankruptcy proceedings and incentivizing equity investment to motivate businesses to build scale and entrepreneurs to invest in the economy by improving predictability and allowing efficient firms to drive creative destruction.

Judiciary reforms must bring weight to common law precedence, decrease the number of appellate opportunities available, and increase the cost of litigation. These changes will not only help to bring confidence in the future regulatory and policy playing field, but will unclog a judicial system, increasing its efficiency and predictability.

Endnotes

[1] Calculated from data used in Problem Set #2

[2] International Monetary Fund (IMF) Country Report No. 13/299 http://www.imf.org/external/pubs/ft/scr/2013/cr13299.pdf

[3] Ibid.

[4] Ibid.

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[11] Calculated from Trading Economics.com graph "Italy Government Budget" (Eurostat)

[12] The Guardian, *Tax evasion: how much does it cost?*, http://www.theguardian.com/news/datablog/2013/sep/27/tax-evasion-how-much-does-it-cost-a-country

[13] By dividing 3 (current deficit as % of GDP) by 11.64 (current percentage of taxes lost to evasion), we get a ratio of .2577, which is the percentage of collection above current levels required to reduce the deficit as a percentage of GDP to zero.

[14] IMF, *Italy: Technical Assistance Report—The Delega Fiscale and the Strategic Orientation of Tax Reform*, retrieved April 1, 2014, https://www.imf.org/external/pubs/ft/scr/2012/cr12280.pdf, page 11

[15] Ibid, page 22

[16] Ibid, page 23

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