Italia: Chronicle of a crisis foretold

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1. Introduction

Italy has not been hit directly by the financial crisis, but the ensuing global recession has taken a heavy toll on the real economy, much higher than in other European countries. The poor shape of the Italian economy at the outbreak of the crisis provides a good part of the explanation. This chapter sums up the main points of the analysis provided in Simonazzi et al. (2009) (Section 1) and considers the effects of the crisis on the major economic variables (Section 2). It argues that the crisis hit the Italian economy at a delicate time, in the midst of a process of restructuring. Given the high debt/GDP ratio, the drop in growth increased Italy’s financial vulnerability. When the second round of the financial crisis hit the peripheral European countries of the Euro area, the Italian government, burdened with a huge public debt, was left helpless to resist speculative attacks and to avert contagion. The many weaknesses in the construction of the Economic and Monetary Union (EMU) and the dithering of European political leaders fuelled uncertainty, which wrecked the periphery and eventually engulfed Italy. Lacking any timely coordinated effort, austerity was the only option open to the periphery. By increasing taxes and cutting social spending and financial transfers to local authorities, and therefore services provision, fiscal austerity reached deep in the pockets of the usual ‘ordinary people’. The chapter concludes with an assessment of an alternative – national and European – policy for growth.

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2. Before the crisis (and beyond)

Italy is characterised by multifarious dualisms: a dual production system, a dual labour market, familistic and unequal welfare and a north–south divide. On top of this, in the past two decades the Italian economy has recorded an extremely low rate of growth, which gave support to the hypothesis of a long-run economic decline.

Decline story. The decline story maintains that firms’ size and industrial specialisation resulted in a lack of product and process innovation leading, in turn, to a loss of competitiveness, as evidenced – inter alia – by the decline in Italy’s export share. This lack of innovation came together with the deregulation of the labour market and a long period of wage moderation, which made newly hired labour extremely cheap and disposable. This, according to the common view, explains growthless job creation and the very low productivity growth which, in turn, justifies – ex post – the low wage levels.

This interpretation, which enjoyed increasing popularity and became the consensus view,¹ had come up for reconsideration in the very years preceding the crisis. The recantation was led by the Bank of Italy, previously a champion of the decline story. Distinguishing between internal and cross-sectoral reallocation, Bugamelli et al. (2009a) found evidence of a reallocation of activity within rather than across sectors since the adoption of the euro: productivity growth has been relatively stronger in those sectors that once relied more on competitive devaluations to regain price competitiveness. Firm-level evidence from Italian manufacturing confirmed that low-tech businesses, which arguably benefited most from devaluations, had been restructuring more since the adoption of the euro. Restructuring entailed a shift of business focus from production to upstream and downstream activities, such as product design, advertising, marketing and distribution, and a corresponding reduction in the share of blue-collar workers. This evidence cut the nexus which had linked the data on ‘frozen specialisation’ with the hypothesis of a lack of innovation and restructuring.

Restructuring had been accompanied by outsourcing. Breda and Cappariello (2010) assess the extent of internationalisation of production of Italian and German firms between 1995 and 2006. The growth in offshoring had been substantial between 1995 and 2000 in both economies (it had been stronger in Germany, which had started from a lower level in manufacturing industry). After a phase of stagnation during the first years of the past decade, offshoring resumed its growth at a rapid pace in 2004–2006 and especially in Italy. This evidence seems to confirm that a change in strategies and a reorganisation of production was occurring among Italian firms. The new challenges posed by globalisation, the diffusion of information and communication technologies (ICT) and the adoption of the euro were inducing the most dynamic among Italian firms to rethink their organisation and their degree of vertical specialisation.

The ongoing process of restructuring was finally acknowledged by Rossi (2011) who, quoting the results of a huge study of Italian industry carried out by the Bank of Italy just before the financial crisis (Brandolini and Bugamelli 2009), noted that ‘just before the outbreak of the crisis we observed the start, although belated, of a process of restructuring in parts of the Italian productive system, with extensive adoption of new ICT, product and process innovation, internationalisation’. The process of change had been led by medium-sized firms, firmly rooted in district economies (Coltorti 2007). Thus we seem to have reached a new consensus: the crisis struck Italian medium-sized firms just as they were crossing the ford.

**The dualistic labour market.** Two decades of deregulation exacerbated the segmentation of the labour market. There has been an increase in employment (growthless job creation) but mostly based on atypical contracts. Young people entered the labour market on temporary contracts and with lower pay. Between 1992 and 2002, entry-level pay decreased by more than 11 per cent (from 1,200 euros per month to less than 1,100 euros) for young people aged 21–22 years of age (presumably with a “diploma”) and by 8 per cent for young people aged 25–26, possibly with a degree (from 1,300 to 1,200 euros per month). For both these groups the entry wage in 2002 had reverted to the level of 20 years previously (Rosolia and Torrini 2007). As argued in Simonazzi and Villa (2010) the difficulty finding a secure job at a decent pay led to an extremely high rate of young people co-habiting with their parents, delays in forming a family and an extremely low fertility rate. Due to the female younger cohorts’ greater labour market attachment and despite
the lack of policies to favour reconciliation, the female employment rate increased, although it remained firmly at the bottom among EU countries (46 per cent), followed only by Malta.

*(Financing) the welfare state.* The enactment of several reforms in the 1970s (employment and pension schemes, health and education) resulted in a rise in public spending (from 37 to 43 per cent of GDP, net of interest, between 1980 and 1985) without a corresponding increase in tax revenue. The financing of the ‘southern welfare model’, which was still far from ensuring universal coverage, was thus provided by borrowing. The middle classes (and the ‘third Italy’ in the north-east and elsewhere) managed to avoid paying taxes and turned their tax notices into bonds, underwriting the loans required to finance the deficit (Barba 2011) (Figure 1).

**Figure 1** Debt/GDP ratio, Italy, 1970-2010

![Debt/GDP ratio, Italy, 1970-2010](image)

The policy of fixed exchange rates (EMS) in the 1980s, at a period of worldwide disinflation and high real interest rates, brought real interest rates to levels never seen before, further fuelling the debt. By 1992 the tax/GDP ratio had increased\(^2\) (fluctuating between 45 and 47 per cent thereafter), but the 10 percentage point increase of the 1980s went to

\(^2\) At 34 per cent, the ratio of fiscal receipts to GDP at the beginning of the 1980s was 12 percentage points below the figure for France and Germany, but reached the value of the German ratio by 1992.
service the debt: between 1990 and 1997 interest payments stayed constantly above 10 per cent of GDP.

Lower taxes for all! In the two decades of predominantly centre-right government a series of tax reforms have been passed. Fiscal amnesties (several waves since 1994) and no-prosecution for those returning illegally exported capital (fiscal shield 2010), elimination of the inheritance tax (2001) (reintroduced by the centre-left government in 2006 for the very largest properties), abolition of the local tax on first homes (2008) (which represented local authorities' most important source of revenue) on the one hand, and introduction of a social card for families below the poverty level, extension of the no-tax area and increased allowances for lower income families (minimum pensions, one-off allowance for the first baby) on the other, are the main pillars of fiscal and social policy.

But even lower to some. Toso, Baldini and Morciano (2007) have assessed the distributive effects of the fiscal reforms of the Berlusconi II government (2001–2005): they estimate that 2 per cent of the total fiscal advantages accrued to the 10 per cent at the bottom of the income distribution, while 20 per cent have gone to the 10 per cent at the top. All in all, more than half of the total fiscal benefits have gone to the top 40 per cent.

Lower taxes demand spending cuts to keep the deficit within limits. Social spending – education, research, social services and so on – have been at the forefront of any financial law aimed at coping with the umpteenth financial crisis; in fact, badly needed social reforms did not even take off: no support to families for child care and long-term care for dependent people, no policies for young people, no minimum income for the needy and no equal rights to protection. Of the much trumpeted flexicurity, only the first part was implemented, with gusto. Personal services have continued to rely almost solely on the family and the (irregular) market. This was made the government’s official policy in the White Book of the Minister of Labour, Health and Social Policy (Ministero del Lavoro 2009), which has put the family firmly at the centre of welfare.

Italy is now at the bottom among OECD countries (together with the United States, Portugal, Poland and Turkey) for income equality (as measured by the Gini coefficient). With poverty in the south of the
country four times the level in the north, the persistent wide north–south divide is one important factor. There is a widespread perception of a sharp increase in families’ impoverishment and precariousness that is not to be found in the statistics. In fact, since its drastic drop in early 1990s, the aggregate poverty index has remained fairly constant. This suggests that a change in the horizontal distribution of income among social classes (or functional income groups) may have occurred: self-employed, managers and pensioners have improved their position relative to employees (blue- and white-collars alike). The income distribution has become, if possible, even more fragmented and unequal also within wage earners, with enormous and increasing wage gaps between young and older workers and a soaring share for top incomes. Thus, a composition effect is concealed behind the stagnation of the average wage: a slight increase in the wage of regular workers on open-ended contracts in fairly protected sectors, compensated by an increase in low-paid irregular jobs and in sectors paying lower wages (Birindelli 2011).

To conclude, through tax evasion, tax elusion and tax cuts fiscal policy had three main effects: perverse redistribution, erosion of the basis for financing social policies and the unleashing of a political race that made tax reduction a bipartisan policy objective.

3. The crisis: reinforcing the features of the model?

Production. Following a long period of low growth, the sudden collapse of industrial production caused by the global recession dealt firms a terrible blow. Italy recorded the most precipitous fall of the Euro area index and the weakest rebound: the cumulative loss of GDP from peak to trough 2008–2009 wiped out the small progress of a decade, taking Italy’s GDP back to its level in the fourth quarter of 2000 (Bugamelli et al. 2009b). The blow has been particularly severe for those sectors that had been at the core of the process of restructuring: in the engineering industry, one of the most dynamic export sectors, exports fell by 19 per

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3. Between 1993 and 2004 the income of the top 0.1 per cent grew by 40 per cent; the income of the top 0.01 per cent grew by 75 per cent; 40 per cent of earners in the top 0.01 per cent are employees (top managers and superstars).
cent, and value added at constant prices by almost 30 per cent relative to 2007. The high correlation with the German industrial recession shows how deep the integration between the two economies has grown. While orders abruptly vanished, firms endeavoured not to let their skilled workforce go, resorting massively to the Cassa Integrazione (an institution aimed at providing income assistance for temporarily suspended employees, in essence a system of subsidised labour hoarding). Paradoxically, the credit crunch that followed the financial and banking crisis hit first and foremost those firms that had started a process of restructuring, and, in the brief season of growth that just preceded the crisis, had committed themselves to a programme of investment (Bigarelli and Russo 2011).

Following the German and world recovery, Italian exports have rebounded (by 15.8 per cent in 2010), but less than imports (23.4 per cent). Also, the index of industrial production has bounced back, but less than the index of sales (De Nardis 2011). These data suggest that the crisis may have inflicted heavy damage on the industrial fabric. Vanishing orders and the credit crunch have strained long-tested, trust-based inter-firm relations: previously outsourced production had been internalised again to ease the fall in production, and delocalisation had been speeded up to reduce costs. Plant closures resulted in the hollowing out of the value chain. Restoring trust within the subcontractors’ chain, mending the holes in the chain, restoring relations with old and new customers, finding a place within the new division of labour that Germany is devising, between competition and complementarity within the German area of influence, the near (European) East and the Far East, are the new challenges facing Italian firms.

Employment and unemployment. Unemployment did not increase dramatically thanks to wide use of the ‘Cassa integrazione guadagni’. Employment reduction hit temporary workers first but, with no clear signs of an upturn, it is now denting open ended contracts as well. Female employment was relatively shielded at first, but the new phase of the financial crisis, raiding the sovereign debt of the Eurozone

4. Italy’s world market share fell to 3 per cent in 2010, down from 3.3 per cent in 2009, while import penetration in manufacturing increased by 3.3 percentage points to reach 33.3 per cent (Istat 2011b).
countries, shattering confidence in the public debt and forcing government after government to implement austerity measures, is taking a toll on female employment. Thus, although women fared better during the financial and real crises, they are now succumbing to the effects of the fiscal crisis and the various, desperate attempts at fiscal consolidation. Young people are the gravest casualty, however. Italy is ‘no country for young men’ (to turn Yeats on his head): they are mostly employed on atypical contracts and they were the first to drop out of the labour market. In 2009, the reduction in temporary employment (by 11 per cent) accounted for the whole of the employment reduction (by 1 per cent). From a low of 20 per cent in 2007, the unemployment rate of young people aged 15–24 climbed to almost 30 per cent (against an average unemployment rate slightly below 10 per cent). This figure conceals large underlying inequalities: in the south the employment rate of young people aged 15–34 is 31.7 per cent as against 56.5 per cent in the rest of the country; two out of three youngsters are out of work, 30 per cent of young people under 34 with a university degree do not work nor study (Svimez 2011). A pervasive underground, irregular and illegal economy, made worse by a flow of irregular migrants, undermines local labour markets, erodes tax revenues and undercuts regular workers and businesses.

New industrial relations. Recent years have seen several attempts aimed at weakening the trade unions, by isolating CGIL, the main left-wing trade union confederation. On 22 January 2009 a ‘separate’ agreement between two of the three main trade union confederations (not signed by CGIL) and Confindustria (the Confederation of Italian Industry), with the backing of the government, refreshed the 1993 agreement and introduced new rules for wage indexation at the national level, while leaving to the second level (firm level) the distribution of productivity gains. In a round of negotiations at the plant level, Fiat imposed a new contract that introduced elements that departed from the national contract. The bargaining for the new rules took place under emergency conditions and under threat of relocation (to Poland and Serbia). Once again the agreement was not signed by CGIL. In the heated debate that accompanied and followed the negotiations, Fiat opted out of the collective agreement through the establishment of a new company: New Fiat. The question is whether, under pressure of the global crisis, the new model of industrial relations successfully imported into Italy from the United States by Mr Marchionne – Fiat’s
CEO – is likely to spread. On 28 June 2011 a new inter-confederal agreement, regulating the conditions under which the firm-level agreement can derogate from the national contract, was signed by the three main trade union confederations. Although fiercely contested from within CGIL, this agreement might mark an end to CGIL’s isolation.

From welfare to ‘bankfare’: financial crisis and fiscal consolidation. Although, in contrast to other countries, no expansionary fiscal measures were implemented to counteract the effects of the crisis, the collapse of GDP has inflated the debt/income ratio. The new financial environment, disrupted by uncertainty and speculation, destabilised by a huge public debt, the legacy of past profligacy and fiscal irresponsibility, makes fiscal sustainability difficult. Tax increases are not politically and economically feasible: the sheer size of tax evasion means a very high tax rate for those who pay, and one of the highest tax wedges in the EU. The combination of tax evasion and the need for fiscal consolidation has made it impossible to finance any scheme of income support in the crisis, while leaving further cuts in services as the only remaining option. The financial law of December 2010 and the Austerity Budget passed in July 2011, after a speculative attack on government bonds sent the spread over the Bund beyond the threshold of 300 basis points, were made up mostly of spending cuts: reduction in transfers to regions and local authorities, cuts in social expenditure (the national fund for social policy has been decimated and the fund for people unable to look after themselves [‘non-self-sufficient’] cancelled, to name only a couple), with the regions made to bear all the cuts. Under the unremitting attack of the financial markets, the ECB pressured Italy’s recalcitrant government into another austerity package: this time the bill, passed in September 2011, was based mostly on strongly regressive tax increases.

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5. Labour market changes in the direction of greater flexibility are among the measures set out in the letter sent by the ECB in August 2011 and that the Italian government must take as a condition for the ECB’s support of the Italian bond market.

6. Another important aspect of the agreement concerned the issue of representation.

7. It has been estimated that tax evasion deprives the Treasury of 120 billion euros in revenue each year. When taking tax evasion into account the effective tax rate (tax plus social contributions) borne by those who pay soars to 51.4 per cent (Mobill and Pesole 2011).

8. However, a large part of these cuts, and especially those cutting cronyism and the privileges of the political class, were postponed to 2013, after the elections!
Without resumption of growth, the stabilisation of the debt/income ratio will require further cuts in public spending (on current and capital accounts). However, with no growth, no work opportunities for young people, cuts in public services, stealthy increases in taxes and fees, speculative rides on bonds that shave their values, the proverbial wealth saved by Italian families over the years (often mentioned as acting as collateral for sovereign debt) is rapidly dwindling. The Bank of Italy is warning of increasing financial stress amongst Italian households, while the national statistical office (Istat 2011a) reports that 11 per cent of households are in relative poverty and 4.6 per cent in absolute poverty (23 per cent and 6.7 per cent, respectively, in the south). The north and the south of the country are drifting apart: while the north is toiling to restore its ties with Continental Europe (read: Germany), the south is adrift in the Mediterranean. Although the financial crisis seems to have frozen, for the time being, the implementation of federal reform, no concrete measures are being put forward to halt the slide.

4. What is to be done? The PIIGS and Europe

Macroeconomic effects of EMU. We can now see that, given the enormous distance separating the economic and political institutions of the Nordic-Continental countries from those of the European South, it was a mistake for the Mediterranean countries to enter a monetary union without a fiscal and political union. Survival of the weak in a currency union requires solidarity,9 something that has never abounded within the European Community and a very perishable quality indeed. It is now fashionable to say that economists have warned, since the very beginning, of the very demanding conditions required for a currency area to work properly. It is fair to say, however, that for a long time mainstream economists and politicians alike have let themselves be carried away by the ‘convergence play’, seriously underestimating the risks and costs inherent in wage and price flexibility as a pre-requisite for convergence.10

Is it still possible to save the common currency? This begs two questions. First, is there a common interest linking surplus and deficit countries and capable of supporting a commonality of policies? Can we conceive of and create a political entity to take care of Europe? Second, are there reforms that the southern countries should implement on their own in order to make the common currency a viable policy for them, besides reforms/policies that require a common design? Let us start with the latter.

**Italy: delayed reforms and (misguided) policies.** Let us try to sum up the main drawbacks dealt with separately in previous sections. An increasingly unequal income distribution, no longer mitigated by redistribution through the public budget, which on the contrary is working perversely. Cronyism, corruption and bureaucratic inefficiencies holding back growth. A fiscal consolidation policy attained by cutting social and capital expenditure and regressive taxation, undoing the modest welfare state that had been constructed. The lack of any industrial policy capable of assisting firms in their process of restructuring, and a policy of industrial relations aimed at driving a wedge between the trade union confederations (that only recently seems to have been toned down). Finally, a political stalemate, with a divided majority held together only by the desire to remain in office, and a left locked-in by its perceived impossibility to advance solutions that demand a redistribution of income and bold reforms to clean out cronyism and corruption.

This is not an exhaustive list, nor is there a lack of alternative explanations for the Italian malaise. While there is agreement on some fundamental points – the dysfunctional role of the bureaucracy, the deterrent effect of high taxes (for those who pay them), the existence, within the public budget, of large pockets of privilege and waste – the main difference, and not a small one, concerns the idea that it will suffice to unletter entrepreneurship to restart growth. The corollary is: the sooner, the better. No need for a gradual approach to debt reduction, no need to worry about the deflationary effects of balancing the budget (Perotti and Zingales 2011).

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11. *The New York Times* (Alderman 2011), *The Economist* (various issues) and economists in the financial newspaper *Il Sole 24 Ore* (for example, Perotti and Zingales 2011) have offered their own explanations and suggestions.
An alternative policy must be based on the tenet that aggregate demand must increase in order to create new job opportunities, and public (physical and human) infrastructure needs to be part of it. The tax base must be more equally spread and service provision must improve. This calls for a solution to the quandary of public employment and bureaucratic inefficiency. The concept of taxes must be connected again with the concept of services: people need to relearn that what they pay is for their health, education, kindergartens and elderly care. We need an industrial policy to identify the direction of development, guide investment, endeavour to ensure that the increase in demand does not leak out in imports (learning from the ‘bad practices’ of the green energy policy and the measures in support of car scrapping12) and devise means to support the upgrading of value chains. New industrial relations and the revision of labour market deregulation are also needed. One good thing that this crisis might have produced is to convince Italians that the country is at present on a road to ruin and that there is no external (European or German) nor individual (devolution, Lega Nord) salvation.

Only once we have done our homework can we seek, and demand, Europe’s help.

Too little, too late. In the midst of the ‘tsunami’ that wrecked the financial markets, creating a panic among savers and inundating the sovereign debt and banking systems of half of the Euro area countries, ‘a controlled process of successive, agreed steps’ was deemed the right answer. For too long the EU leaders, led by Angela Merkel, refused to acknowledge how interwoven national financial institutions had become. The leadership vacuum, lack of statesmanship and conflicting national interests have systematically prevented the timely adoption of those measures that were later forced upon them by a new, ever deeper crisis. Although the plan agreed upon at the end of July to ‘insulate’ the Greek crisis represented a big step towards greater risk sharing, it was not enough to prevent a much bigger crisis from breaking out. And again, when in September 2011, after excruciating negotiations, the German Parliament eventually

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12. In 2010, imports of electronic components jumped by 211.2 per cent, largely as a consequence of the energy saving incentives on the demand for solar panels (Istat, 2011b). In fact, these incentives were not linked to a policy supporting the firms active in the sector.
approved expansion of the Eurozone bailout fund (the European Financial Stability Facility), it had already been overtaken by events. Meanwhile, austerity is killing growth throughout Europe and European leaders’ lack of vision and resolve is scaring the world. It is possible that, when enough damage has been inflicted on the Eurozone economies and the European institutions’ credibility, more coordinated efforts – whether it be the idea of ‘Blue Bonds’ or a European Marshall plan, hacks by all the euro economies – will be forced onto the agenda. But if conditions keep deteriorating, a point may be reached at which not even a willing Germany would be able to pay the bill for everyone.

Even if the debt crisis can be overcome, the fundamental question of how to ensure convergence of economies that are still so different and far apart remains open. How long, in fact, will the southern countries be able to endure the deflationary policies that are required to restore competitiveness (even if we assume that they will be able to attain equal productivity growth), if low German inflation demands negative changes in their wages and prices? Besides negatively affecting growth, declining wages and prices will exacerbate the problem of the public debt. History teaches us that the consequences of a general deflation can be disastrous.\(^\text{13}\)

Europe must resume growth if the countries of the periphery are to have a chance to grow out of their debt. This inevitably calls into question Germany’s policies. For German voters, their country’s post-war economic miracle was built on a hard currency, prudent finances and strong exports. It is hard for German voters to fathom that these very virtues are at the heart of the current crisis (Knight 2011). As noted by Gordon Brown, ‘There is some truth in the argument that Germany will only agree to become a bigger part of the solution when faced with the evidence that it is also a big part of the problem’ (Brown 2011). Emergency intervention needs to pave the way for long-term construction: a growth strategy that would mean easing up on austerity for Greece and the other weakened countries and enacting stimulus measures in surplus countries, as well as new rules that prevent the formation of the very disequilibria that led to the present predicament.

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\(^{13}\) The economic and social costs involved in having to adjust (downward) the level of prices and wages to fit an (overvalued) fixed exchange rate have been illustrated by the UK experience of the return to gold at pre-war parity in 1925–31.
References


