

REINVENTING ITALY

Rudi Dornbusch
Massachusetts Institute of Technology

Whatever the progress at stabilization over the past few years, in large part the benefit of EMU participation, Italy economy remains bad news. In fact, unaffordably bad.

In Between Two Crises

Italy is living a brief moment of quiet, in between the fiscal crisis just overcome and the next one that lies ahead. The formation of the European Monetary Union brought down Italian interest rates radically and, in that way, avoided what otherwise would surely in time have become an unsolvable public debt problem. As a result of lower interest rates, and the Waigel Pact's limitations on budget deficits, public finance just now is not much of an issue. The warriors of past budget wards seemingly can take a rest and claim an area of budgets without pain.

Not so! The demographic trends that lie ahead bring about another crisis a decade or two ahead. That is far off, it would seem, but unless the issue is addressed soon it will be an altogether formidable crisis. Its dimensions can be judged from research reported recently in the *American Economic Review*. The researchers conclude, in the case of Italy, that intertemporal equity – leaving future generations with the same burdens of taxes or benefits of public spending as the current generation—requires any of the following: an immediate 49 percent cut in government purchases, or a 13 percent cut in government transfers, an 11 percent hike in all taxes or a 28 percent rise in income taxes.

These are formidable adjustments to occur immediately and, of course, they won't happen. But the conclusion is that future generations will have to make them, and more! Italy is plainly shifting vast burdens to the young. Moreover, those who have to pay the extra are the same young who are currently unemployed or making time unproductively in the universities. Of course, at a minimum, policy might focus on how to raise economic growth and, in that way, contain the rapidly rising future costs of demographic transition and present profligacy. But here there is bad news too: Italy's growth performance is getting worse.

Bad News on the Supply Side

Unlike the US or other economies that have espoused supply side reform and harvested economic booms in return, Italy's supply side is bringing down growth far below the levels of past decades and increasingly so. By all accounts Italy is a bad place to do business and that means little chance for jobs, investment, productivity growth – all the things that raise standards of living while reducing fiscal burdens and intertemporal inequity.

Just how bad are things? A survey by the IMD research institute reports that Italy is ranked #30 among a large group of countries. Not among the top 5 in the world, not the top 20, #30. That means mediocre or worse. The Davos World Economic Forum rates Italy #35 in competitiveness, -- in between Costa Rica and the Philippines on one side and Peru/Indonesia on the other. No ambiguity here; in its economic institutions, Italy ranks among third-tier economies. That is not nice to say, but more important, it would be a deep mistake to ignore it. The gap to leading industrial countries is so formidable that it would be amazing if it did not show in performance. Not surprisingly, Italy is by now the worst growth performer in Europe. The bad supply side has caught up.

More detailed analysis of Italy's bad supply side comes from a major survey conducted by the OECD. In this wide ranging investigation of regulation and intrusive state presence in goods and labor markets the results are unambiguous: Italy is the worst performer in Europe with a score far more devastating than any single other country! Italy has more obstacles to entrepreneurship, less reform in labor markets, more state presence throughout the economy; whatever criterion of over-regulation, inflexibility or statism we pick, Italy is there as the worst economy. Indeed, Italy is the very incarnation of "old economy". To round the story out, a report by UNICE, a European business research group, notes that Italy ranks near-worst on a lot of criteria relevant to business formation and in obstacles to entrepreneurship.

No surprise then that Italy is doing very poorly. Moreover, since there is little sign of change there is also no prospect of better performance and, with that, Italy is heading straight for the next crisis. This one much bigger and politically more divisive than the last one. Minor adjustments to the status quo will not be enough; Italy needs radical change of the kind the UK or the US have undergone in the past 2 decades

Reinventing Italy

The Italian status quo is an unaffordable luxury of the immediate beneficiaries—the labor aristocracy, inefficient business, the governing class and the bureaucracy. We hear forever about crises but it is amazing how they have been able to keep the consensus going, keep the corporatist model afloat. Italy is misgoverned by this consensus and it is in need of a counter culture that vigorously embraces economic reform. Italy needs to reinvent itself so that everybody can work, that government stops handing out favors at its discretion, limits competition at its discretion, sustains inefficiency and rigidity in the name of equality or just plain convenience. Italy needs to cut back on its bureaucracy that spends much of its time stopping people from motivation, creativity or just plain work.

It is not right to say that overregulation is not an issue, that black markets get around these things. Of 3 firms that are unprofitable in the formal economy, one might make it but the other two will not. And that means fewer jobs, lower tax collection and a lower tax collection and a lower standard of living. The black market culture also means that cheating becomes part of normality, a bit here, a bit there and a bit everywhere. That is a self-inflicted disgrace society should not accept. It is also a major detriment to foreign investment and to cross border business opportunities more generally.

No country has the luxury to escape these changes, not Japan and not Italy; no country can afford to borrow forever to keep up present equality at the expense of future generations. Italy needs sweeping change to reverse the current decline. The talent and creativity are there but kept from contributing and so is the potential for dynamism coming from Italy's youth. What is needed now is a pervasive recognition and consciousness that regulation, statism, absurdly privileged labor contracts, intrusive bureaucracy, complacent equalizing and sweeping government discretion must go. Politicians need to receive a loud message from the public: we are fat up! The referendum is one step in that direction but it is just a beginning; a much deeper counter culture must build from there.