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Italy's Choice: Reform or Stagnation

MICHAEL CALINGAERT

Italy is one of the great success stories of the post–World War II era. Indeed, a massive transformation of the country's economy and society has taken place over the past 60 years. By the end of the twentieth century, a nation that in 1958 was the least developed of the six founding members of the European Community had achieved an economic miracle based on a distinctive brand of entrepreneurial development. It had become one of the world's leading industrial countries. Its reputation for fashion, food, and flair was second to none. It is today a member of the elite Group of Eight industrialized nations.

Yet, even as the outside world's image of Italy has improved over the years, a number of fundamental problems have remained persistent features of the national landscape. Italians have always been inclined to self-criticism and self-doubt. But increasingly outsiders, too, have experienced exasperation at the country's shortcomings, real and imagined. The fall of Romano Prodi's 20-month-old government in January, after the prime minister lost a vote of confidence in the Senate, was only the latest example of political dysfunction. Today, Italy faces a range of acute and pressing challenges. Many Italians fear that these pose a threat to their country's prosperity and wellbeing. The citizens also question their political leadership's capacity to address the challenges, which stem largely from ongoing political, economic, and demographic trends.

DELIBERATELY WEAK

Political instability and fragmentation have been constants of the Italian scene through most of the postwar period. Until recently governments changed with bewildering frequency—Italy has had over 60 governments since the end of World War II—though often the leadership of the political parties did not change, and the same parties and individuals often reappeared in successive governments. Significant changes have taken place in the political landscape over the past decade. Yet fragmentation and instability continue to reign, albeit in a somewhat different way, and broad coalitions of both the center-right and the center-left find it difficult, for a variety of reasons, to carry out a coherent program of government.

Italy's political system is inherently weak for institutional reasons. The country's 1946 constitution quite deliberately provided for a weak system of government, which was deemed necessary to prevent the recurrence of a strong—and pernicious—government such as Italy had experienced under Benito Mussolini. The constitution, for example, established two coequal houses of parliament, both of which have to approve identical texts of a bill for it to be enacted into law. Yet the houses deliberate on legislation in total independence of each other—that is, without a mechanism for negotiation (as exists in the United States in the form of congressional conference committees). Thus, proposed legislation must pass back and forth from one house to the other until the two have agreed on identical versions.

Further contributing to the cumbersomeness of the legislative process is the size of parliament. With 315 senators and 630 deputies, the parliament is almost twice as large as the US Congress, though it represents a population about one-fifth as large as that of the United States. In addition, the position of prime minister is relatively weak. The prime minister does not have the power to dissolve parliament, as is the case in many other countries, whereas parliament can, as it did in January, vote the prime minister out of office through a no-confidence vote.

Another key factor in Italy's political instability is the voting system. Until the mid-1990s members of parliament were elected under a system of

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proportional representation. On one hand, that enabled party leaders to exercise control over the selection of candidates and their rank order on candidate lists (the higher on the list, the greater the chance of election). On the other hand, it resulted in many small parties' gaining seats in parliament. Because proportional representation encourages coalition governments, the small parties have often exercised influence and power disproportionate to their numbers in parliament and the electorate as a whole.

A major change was made in the electoral system in the 1990s following two referenda in which the public strongly supported eliminating proportional representation. For three-quarters of the seats, the new system provided for election by plurality in single-member constituencies, while the remainder were left under proportional representation. But this reform was subsequently diluted by a return to a larger role for proportional representation. Then, weeks before the electoral mandate of Prime Minister Silvio Berlusconi's government was to end in early 2006, his government pushed through another change. The new electoral system, based exclusively on proportional representation, ensures that a coalition of parties winning a plurality of the popular vote will gain a majority of seats.

Many immigrants are viewed as threats—to existing jobs, to public order, and to the established homogeneity of Italian society.

This system, intended to ensure the electoral success of the Berlusconi coalition, was adopted over the vociferous objections of the opposition. Never before had an electoral change been implemented in the absence of general consensus across the political spectrum. However, since such changes can be made by a simple act of parliament, succeeding governments may also attempt to alter the electoral system for their own benefit. In fact, the possibility of further modifying the electoral system remains a key subject of political debate today.

THE TWO-LEGGED STOOL

While the institutional background was changing, so was the political constellation. The 1990s saw the implosion of Italy's three major traditional parties—the Christian Democrats, the Socialists, and the Communists—and the disappearance of most of the country's political old guard. The Christian Democrats, buffeted by far-reaching corruption scandals and the collapse of the Soviet threat, split into center-right and center-left parties (the parts adding up to considerably less than the former whole); the Socialists in effect went out of business; and the bulk of the former Communists moved to embrace democratic socialism, first as the Democratic Socialist Party and then as the Democrats of the Left—though a sizable minority refused to give up their communist ideology and broke off from the rest of the party. The new player in Italian politics was Forza Italia ("Go Italy!", the national football cheer), a center-right party formed in 1993 by Berlusconi, a political neophyte but Italy's richest man.

Since the mid-1990s Italian politics has been dominated by two broad coalitions that have held power alternately. A center-right coalition, called the House of Freedoms, is led by Forza Italia and dominated by Berlusconi, who has exercised power unlike any other political figure in Italy's recent past. The other main members of his coalition are the National Alliance (conservative, descendents of the Fascist Party, proponents of a strong role for the state, and concentrated in the less-developed south); the Northern League (centered in northern Italy, extremely critical of the north's financial contribution to supporting southern Italy, xenophobic, and strongly supported by small business); and the Union of Christian and Center Democrats (that portion of the former Christian Democratic Party that opted to join the right).

These parties represent different interests and philosophies and, not surprisingly, they quarreled often during their time in office from 2001 to 2006. While Berlusconi served as prime minister during that entire period—a record for political longevity in postwar Italy—he had to contend with squabbling coalition partners (usually the National Alliance and Northern League) and opposition to legislative proposals from one or another partner, which threatened to bring down the government. Berlusconi was able to keep the coalition together, in part through his power and prestige, and also because recalcitrant politicians and parties recognized that they were better off in government than out of it. Nonetheless, disunity within the coalition limited the prime minister's ability to achieve—or willingness to fight for—important parts of his legislative program.

The center-left coalition, officially called the Union, which held power from April 2006 to January 2008, is even more disparate. It includes nine parties, ranging from the far left (Communists, the harder-line Refoundation Communists, and the Greens) to the more "centrist" and larger parties (Democrats of the Left, mostly former Communists; and Daisy, mostly former Christian Democrats), plus a handful of small parties. Not only is this coalition broader than the center-right, but its leadership is weaker. Prime Minister Prodi, who headed the coalition until the recent collapse of the government, owed his position essentially to the fact that he was the most unifying figure among several power bases and individuals in the coalition. But he had no significant political base and thus had to negotiate constantly among the various forces and factions. An indication of the coalition's weakness is the fact that, in order to satisfy the many interests, Prodi headed a government with more than 100 ministers and deputy ministers.

The government's precariousness during its time in power also arose from the results of the 2006 election. The center-left coalition gained a solid majority in the Chamber of Deputies, where its slight edge in votes earned it a premium of seats under the new electoral law. However, for constitutional reasons, a different electoral system applied to the Senate, where the coalition ended up with a margin of just one seat. As a result, the government had to struggle to avoid defeats in the Senate—at the hands of one or more of its nominal supporters—on a series of issues ranging from economic reforms to the stationing of Italian troops abroad. The government remained in power as long as it did only because, on a number of occasions, it received the support of most of the seven senators appointed for life.

RACE TO THE CENTER?

One can see certain parallels between the center-right and center-left coalitions. Their electoral strength is rather evenly balanced, each is internally weak and thus vulnerable to internal tensions, and smaller parties hold the power to influence and ultimately defeat either one. As a result, there is little stomach for—and great risk involved in—trying to bring about important, but necessarily controversial, legislation to address the problems facing Italy. Most Italian politicians focus on the short term.

A further manifestation of political instability is the beginning of a process of internal reorganization and leadership change in the two coalitions. Each is seeking to consolidate its constituent parts, to move toward the political center, and to bring about generational change in coalition leadership.

On the center-left this process is more advanced than on the center-right. The center-left's two main coalition partners, the Democrats of the Left and Daisy, agreed in late 2007 to merge into a single Democratic Party. In an effort to gain popular support and buttress its democratic credentials, the new party organized a national election for party leader. The victor was the establishment candidate, Walter Veltroni, a popular and effective mayor of Rome who started his political career, as did most of the party's members, as a communist. With the fall of Prodi's government, Veltroni has become the new face of the center-left. Veltroni, however, has not been tested as a national leader. His strong suit has been achieving consensus; his willingness and ability to enforce discipline remain to be seen.

The intention of the Democratic Party's founders is to remove from the coalition's neck the albatross of the far left parties and to form a more centrist coalition that includes some elements of the center-right. Such a coalition might develop—certainly, parts of the Berlusconi coalition are restive—but it is no foregone conclusion.

The situation on the center-right is even less clear-cut. Relations among the coalition partners are often tense. Parties and politicians have been looking to the post-Berlusconi era and trying to position themselves to gain advantage. Some sympathy exists for establishing a centrist coalition; the likeliest scenario is that the former Christian Democrats in the center-right might join a center bloc. Some elements of Forza Italia and the National Alliance who are dissatisfied with Berlusconi's leadership style also support the idea.

However, the collapse of the Prodi government has changed the dynamics of the situation. It had been widely believed that Berlusconi had reached the end of his political career after dominating the scene for almost 15 years. Yet there is no credible heir apparent on the center-right. Indeed, Berlusconi is running again for prime minister, this time against the Democratic Party leader, Veltroni, who has resigned as Rome's mayor to focus on the campaign. Elections are scheduled for April.

FROM LEADER TO LAGGARD

Italy's economic challenges are as pressing today as its political challenges. This was not always so. The Italian economic miracle began in the early postwar years. Led by industrial growth, particularly in the north, the economy grew at a brisk pace. By the mid-1980s, Italy's per capita gross domestic product (GDP) exceeded that of the United Kingdom (though not for long). While government-controlled enterprises were prominent in this growth, the bedrock of the Italian economy—and a major reason for its success—was the prevalence of small, mostly family-owned firms. Italian companies on average are the smallest in Western Europe; over four-fifths of them employ fewer than 10 people. Small businesses prospered by developing niche specializations, primarily in consumer goods, and their success was attributable in large part to imagination, innovation, and adaptability.

A key ingredient was also the prevalence of "industrial districts"—clusters of firms located near one another, engaged in different aspects of producing the same or related products, and involving elements of both cooperation and competition. In many sectors Italy gained a substantial share of the world market, and it maintained its export competitiveness by devaluing the lira when circumstances required it.

A shrinking workforce will be called on to support a growing corps of retirees.

By the 1990s and into the 2000s, however, Italy had become more of an economic laggard than a leader. GDP growth had fallen toward the bottom of the European scale. Average annual growth was 1.4 percent over the decade from 1995 to 2005, and it hovered close to zero from 2002 to 2005. Delivering a sharp blow to Italian national pride, the Organization for Economic Cooperation and Development (OECD) determined at the end of 2007 that Spain's per capita GDP had overtaken that of Italy. Unemployment in Italy exceeded 10 percent from 1996 to 2000, and although it dropped sharply by 2006, unemployment among youth, at 23 percent, remained the highest in Europe. During this period, Italian exports have faced intense competition, particularly from Asia, in an increasingly open trading system. Between 1993 and 2006, Italy's exports of goods and services lost over one-third of their share of the world market.

LOSING ITS EDGE

The economic difficulties facing Italy are not new; many have existed for years. Italy did not rise on a smooth trajectory to an economic high point only to plummet, equally smoothly, to subpar performance. The country's economy has always had its strong points and weak points. The problem is that efforts to address the weaknesses have been insufficient.

For the past two decades Italy has struggled to bring its public finances under control. Starting in the 1980s the budget deficit rose sharply, exceeding 10 percent of GDP in that decade. As a result, Italy's public debt soared, jumping from about 30 percent of GDP in the mid-1960s to over 120 percent of GDP in the mid-1990s, and remaining over 100 percent since then.

Controlling public spending has been a continuing problem. Italy's social expenditures are high, and they are weighted toward protecting working people as opposed to helping job seekers and others in need. Pressures for increased spending are strong, and governments have looked more to increased revenue than to spending reductions to manage the government's finances. But revenue collection has long suffered from widespread underreporting of income, particularly by professionals and small businesses. A further problem has been the devolution of public spending in certain categories (such as health care) to regional governments, which are not accountable to the central government that provides the funds.

Italy, meanwhile, has lost some of its competitive edge. Labor productivity growth, following reasonably strong results from 1985 to 1995, dropped to under 1 percent annually between 1995 and 2000, and productivity actually declined from 2001 to 2006. The International Monetary Fund calls Italy's current productivity gap with France and Germany "striking." At the same time, Italy has been slow to shift resources that are now concentrated in sectors sensitive to low-cost competition into areas that are less so, such as high-tech goods and services. This shift is impeded in part by the relatively low skill base in Italy. The OECD calls the widespread lack of formal qualifications beyond compulsory schooling "a major weakness for Italy."

To a significant degree, Italy's economic difficulties also stem from overregulation and insufficient competition in labor and product markets. On the labor side, the legal regime for protecting workers' rights permits little flexibility in the hiring, firing, and movement of workers, creating a disincentive to hiring additional staff. The World

Bank's 2008 "Doing Business" survey lists Italy well below the OECD average in indices covering difficulty of hiring, difficulty of firing, and rigidity of employment.

On the product side, heavy regulation is the norm. According to the World Bank survey, which assesses 178 countries, Italy ranks 53rd in ease of doing business, 65th in ease of starting a business, and 155th in ease of enforcing contracts. In many businesses and professions, the government sets barriers to new entrants and imposes other restrictions to competition. This also holds true for the retail sector.

A SPOTTY FISCAL RECORD

Italy's political leaders have long been aware of these problems and, beginning in the early 1990s, have sought to address at least some of them. The most far-reaching of these efforts was the successful campaign for Italy to be among the founder-members of the EU's Economic and Monetary Union (EMU). The EMU, which came into effect in 1999, is the common monetary regime for member countries (originally 12, now 15) that includes a single currency (the euro), the European Central Bank, and the Growth and Stability Pact, which imposes limits on member states' budgetary deficits and public debt.

While Italy thus lost its ability to devalue the lira to keep exports competitive—a significant policy tool—membership in the EMU has brought distinct benefits. Inflation in Italy has declined to levels below the average for the Eurozone. High interest rates, reflecting exchange rate risk, dropped sharply once the lira was replaced by the euro, thus reducing the heavy cost of servicing the national debt. Furthermore, provisions of the Growth and Stability Pact created new pressures on the government to exercise fiscal restraint.

Nonetheless, Italy's record on fiscal restraint and debt reduction has been spotty, as governments have struggled to keep the budget deficit below the prescribed limit of 3 percent of GDP and to place public debt on a steady downward path. Good progress was made during the run-up to EMU membership from 1992 to 1997. However, Italy's performance has been less stellar since then, reflecting in particular political pressures on spending. The country exceeded the EMU's budget deficit limit from 2003 to 2006 before returning, with a significant drop in the deficit, to compliance in 2007.

A more recent improvement has been a sharp increase in public revenues, partly the result of remarkable progress in combating tax evasion. However, the government can be criticized for devoting to public debt reduction an insufficient portion of the increased revenue and of the savings that have been realized from lower interest servicing payments. Today Italy remains one of the most indebted countries in the EU.

A major component of government expenditures is pensions. Italy has the highest ratio of pension expenditures to GDP among EU countries. Amounting to 14 percent in 2006, outlays are forecast to rise to 17 percent of GDP by 2035 if adjustments are not made for increasing life expectancy. Since the early 1990s governments have grappled with this issue, which arouses understandably strong emotions. The labor unions have fought efforts to reduce current benefits. Their slogan, "Don't touch pensions," is a powerful and popular rallying cry.

Nevertheless, a series of laws—enacted starting in 1992 and continuing through 2004—have brought about significant reforms to the pension regime. Most important, 1995 legislation began transforming public pensions from a defined-benefit to a defined-contribution system (that is, tying pensioners' benefits more closely to their contributions). The 2004 law established a timetable for raising the age for pension eligibility. Further progress was not made under the Prodi government, however, because of strong pressure from its left wing and from labor unions.

REFORM EFFORTS

Significant changes have taken place in labor markets as a result of legislation enacted under Prodi (in 1997, during his first term as prime minister) and under Berlusconi (in 2003). These measures ended the public monopoly on job placement (which required that firms of a minimum size hire new employees through a public agency) and eased the conditions under which temporary work is permitted. The introduction of these measures coincided with a significant drop in unemployment—from over 10 percent in 2000 to under 7 percent in 2006. It is estimated that the majority of new hires during this period were made under "flexible employment" contracts and that such contracts reduced labor costs by about 20 percent. Not surprisingly, the labor unions and the coalition's left wing have criticized liberalization in the labor market and pressed for steps to make employment more "stable" and less "precarious."

Efforts to reduce the myriad restrictions affecting the business sector have been sporadic and, on the whole, of limited effectiveness, though progress was made under the Berlusconi government in easing start-up procedures and reducing the time required to launch new businesses. More significantly, the Prodi government introduced an extensive regulatory liberalization program. Contained in two packages, the reforms included provisions deregulating the issuance of taxi licenses, permitting the sale of over-the-counter drugs outside of pharmacies, abolishing minimum fees for lawyers and notaries, and facilitating the portability of bank accounts. Though consumers welcomed the reforms, many aspects of them met with strong opposition from affected interests—which, unlike consumers, are well represented in parliament—and the government was forced to dilute some parts of the initiative.

Starting in 1992 Italy undertook a far-reaching privatization program. Fifteen years ago, 12 of Italy's largest 20 firms were state-owned. These firms were concentrated in industry, utilities, telecommunications, and banking. Functioning as legal monopolies and enjoying exclusive concessions, the vast majority of state-owned enterprises were unprofitable. However, 80 major privatizations representing about 125 billion euros in assets were carried out between 1992 and 2005 (at which point privatization virtually ended). In some cases the state withdrew completely; in others it reduced its role to a minority stake, albeit at times retaining control through a "golden share" (allowing it to outvote other shareholders in specified circumstances).

Today's Italy is characterized by a search for short-term fixes and by a fierce defense of the privileges enjoyed by individuals, families, organizations, and groups.

In the short term, the proceeds of public asset sales contributed significantly to reducing the budget deficit and government debt. The longer-term significance is less clear, however, because liberalization of these sectors has not occurred with the same intensity as privatization. As a result, increases in market competition and economic efficiency have not been as marked as they might have been.

One bright spot has been the banking sector. Over the past decade, Italy's traditionally underdeveloped and inefficient banking system has seen significant improvement, particularly because of widespread consolidation and privatization. The process was accelerated two years ago with the appointment of a new Central Bank governor, Mario Draghi, who has promoted competition and openness in the sector, notably by dropping the central bank's previous objections to takeovers of Italian banks by foreign institutions.

LIVE LONG—BUT PROSPER?

In addition to the political and economic weaknesses already described, Italy also faces serious, long-term demographic challenges. A low birth rate and high life expectancy have combined to create a declining and aging population. This means that a progressively smaller number of people in the workforce are called on to fund a rising pension obligation. Exacerbating this problem is Italians' relatively low level of participation in the workforce.

Italy's birth rate is one of the lowest in Europe. The reproduction rate is far below that which would produce an increase in population. In fact, it is estimated that Italy's population, now about 58 million, will decline to 45 million by 2050. The US Census Bureau estimates that Italy's working population will fall 12 percent by 2030, compared to a Western European average decline of 8 percent and a rise in the United States of 10 percent. Meanwhile, life expectancy in Italy is among the highest in Europe, and the country has one of the continent's oldest populations.

Overall workforce participation of working-age Italians is estimated at 63 percent—among the lowest in Europe and considerably less than the EU average of 71 percent. This applies particularly to women, 50 percent of whom are represented in the workforce (compared to an EU average of 63 percent). The OECD reports that 30 percent of Italian women over 50 years old are employed in a workplace, compared to 65 percent in the United States.

In addition, Italians leave the workforce at a relatively early age. According to data from the International Labor Organization, only about 45 percent of Italians who are 55 to 59 years old work. This figure drops to under 20 percent for Italians between 60 and 64 years old. (The comparable figures for the United States are 75 percent and 50 percent.) The early retirement trend reflects in part a relatively generous pension regime. But it also reflects disincentives in the tax and pension systems. According to one estimate, the "implicit tax" on continuing to work into one's late 50s in Italy (through foregone pension payments and additional pension taxes) is almost 50 percent.

Whatever the causes of the problem, the financial implications are stark. A shrinking workforce will be called on to support a growing corps of retirees. The OECD forecasts that, if present trends continue, the ratio of non-working to working Italians, now about 135:100, will rise to over 200:100, the highest level among OECD nations.

A further factor affecting economic output is the average number of hours that people work. According to OECD statistics, Italian employees work about 200 fewer hours annually than their American counterparts (though more than the French or the Germans). In 1960 the figures were approximately equal.

Although these trends point to increasing financial problems that cannot be readily overcome, one potential short- to medium-term remedy is immigration—a phenomenon that has become increasingly significant in Italy. Historically, Italy has been a land from which people emigrated, particularly in the nineteenth and early twentieth centuries. However, Italy's growing prosperity—combined with its relatively unprotected sea borders and an increasing ease of travel for people from less developed countries seeking economic betterment—has attracted rising numbers of immigrants. Some are legal and some are not.

According to one estimate, non-Italians living in Italy number over 3.5 million, a figure that includes about 1 million Muslims. This is a relatively small number relative to Italy's population of 58 million (or compared to immigrant populations in some other European countries), but the influx of immigrants has created tensions. Italians are traditionally a hospitable and compassionate people, and thus many immigrants were initially welcomed, or at least tolerated. As the numbers have increased, however, a backlash has developed. Many immigrants are viewed as threats—to existing jobs, to public order, and to the established homogeneity of Italian society. In fact, the Italians' negative attitude toward immigration is the most intense among the 47 countries recently polled by the Pew Global Attitudes Project. These developments have political ramifications, and Italy is trying to balance the economic benefits (if not imperatives) of welcoming immigrants and integrating them into Italian society with an effort to weed out uncongenial elements.

NO GUARANTEES

Pundits in recent years have written off Italy as moribund, declining, or worse. Yet Italy continues to confound, showing resilience, adaptability, and—in many respects—success in the face of significant challenges. Categorical judgments about Italy are often misplaced. Certainly, one should avoid the temptation to assume the worst: in this case, that Italy is doomed to lose out, gradually or otherwise, in a fast-changing world.

Nevertheless, the severity of Italy's ongoing problems should not be underestimated. Like other countries in a globalizing world, Italy is less protected from outside forces than at any time in the recent past, and the willingness and ability of its political and economic actors to address the nation's challenges have proved in many cases inadequate. Today's Italy is unfortunately characterized by a search for short-term fixes and by a fierce defense of the privileges enjoyed by individuals, families, organizations, and groups. This does not bode well for the country's future.

Probably the best hope for Italy is that a way will be found in the coming years, if not months, to bring about a reorientation of the political landscape, in which the center-right and center-left coalitions shed some of their more troublesome supporters and move toward the center, whether together or not. If this happens, prospects for Italy's making progress in addressing its economic problems will be significantly enhanced. Otherwise, continued political stalemate threatens to condemn Italy to stagnation, if not decline. ■