CEPS COMMENTARY

Thinking ahead for Europe

What is holding Italy back?

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Italy's economy has clearly underperformed since it joined the eurozone, both relative to its peers and relative to the previous decade. Italy's growth rate averaged only a little more than 1% per annum during the boom years preceding the crisis. Then GDP plunged by 5% and instead of rebounding, it now again grows only at around 1%. At this rate Italy's public debt at 120% of GDP becomes an existential threat for the entire euro area. Understanding and curing Italy's growth problems is thus vital for the survival of the euro.

The key point of this contribution is that if one wants to explain the deteriorating growth performance of Italy, one cannot just point to the well-known weaknesses that have held back Italy for ages. Instead, one has to search for growth factors that have clearly deteriorated since about 1999-2000. This is not easy. The three most important measurable growth factors actually improved in both absolute and relative terms:

- Investment in physical and human capital (the former is high and the latter is improving rapidly);
- Structural indicators in terms of product and labour market regulation (all improving absolutely and relative to Germany, according to OECD indicators) and
- Investment in R&D (improving).

The only factors that have deteriorated absolutely and relative to the core of the euro area are indicators of governance, such as corruption and rule of law. Reversing this political decline will take years of national commitment – of which there is little sign yet.

1. Italy's relative underperformance cannot be due to a shortage of either physical or human capital.

In almost every year over the past decade, Italy has invested close to 20% of its GDP, a higher percentage than Germany (and the same is the case for investment in plant and equipment; see Figure 1). But despite this effort, GDP is now barely higher than it was ten years ago.1 This implies that the efficiency of this investment has been abysmal. Between

[1] GDP per capita in real terms in 2009 was lower than in 1999; no other country in the EU-27 had such a bad performance.

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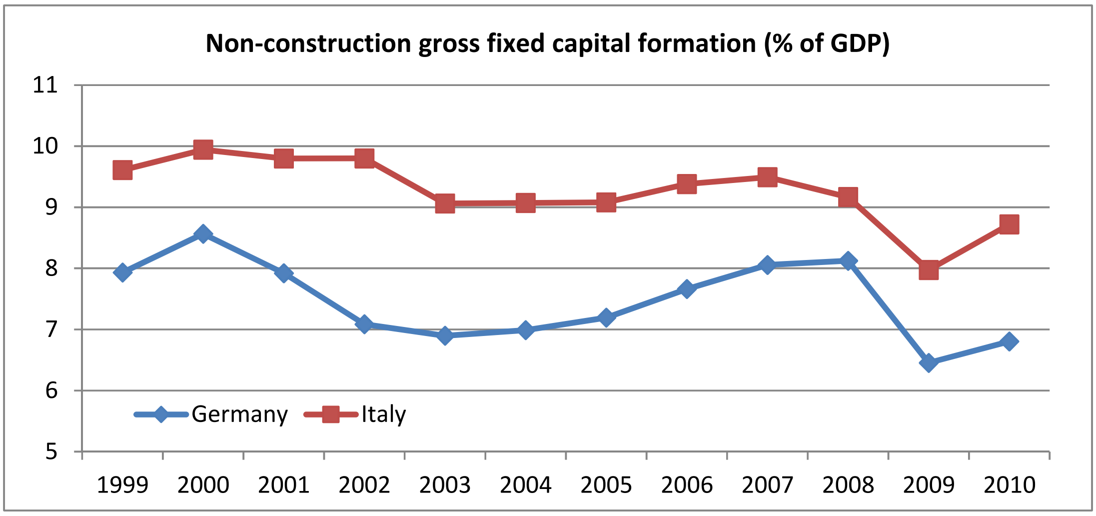
1999 and 2009, the economy-wide (net) capital stock of Italy increased by 19%; but real GDP increased only by 5%. By contrast, Germany's capital stock increased by less (about 13%), but its GDP increased by much more (almost 9%). More investment is thus unlikely to provide a solution to the growth problem.

Figure 1. Investment in plant and equipment (% of GDP)

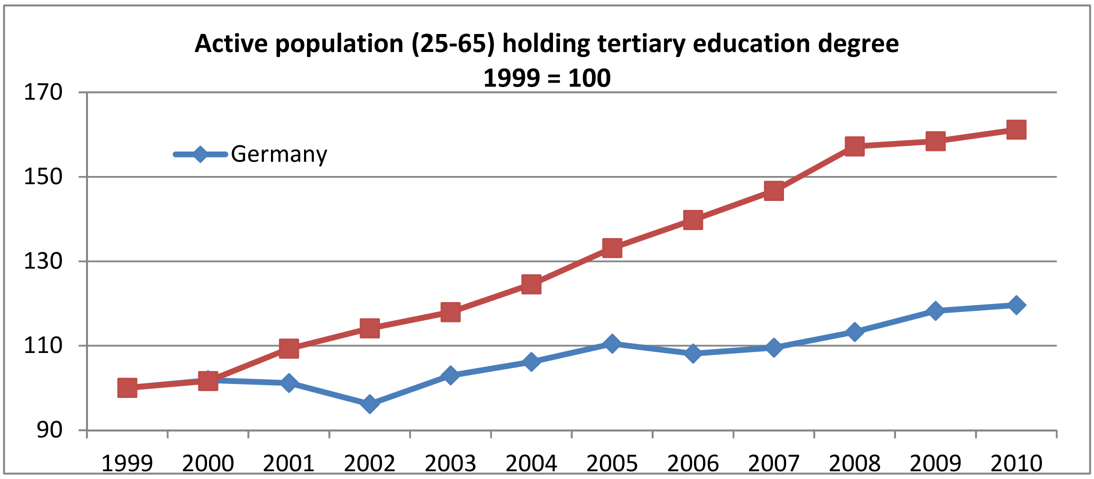


Source: AMECO dataset, European Commission (DG ECFIN).

Infrastructure investment by the government is often cited as another reason for low growth. But it has actually fluctuated around 2.5% of GDP over the last 20 years, which is in line with the EU average (and again higher than in Germany). More infrastructure investment is thus also unlikely to unlock higher growth.

The same observation applies to human capital: the Italian workforce is today actually better educated than it was ten years ago. Figure 2 shows for Germany and Italy the evolution of the population with a tertiary degree, setting the level of 1999 equal to 100.

Figure 2. Active population (25-64) holding a tertiary education degree



Source: Eurostat, Labour Force Survey.

The percentage of those with a tertiary degree has increased from 13 to 18% of the working age population (and the percentage of those with only primary education has fallen). While the share of tertiary education graduates in the active population is still lower than in partner countries, it progressed faster in the last decade. It is apparent that Italy has made much more progress than Germany. In terms of human capital Italy has thus considerably narrowed the difference with Germany.

2. Structural reforms?

How about the most common prescription for Italy, which is 'structural reforms'? Here again the evidence indicates a relative and absolute improvement. For example, the OECD indices on labour market and product market actually show a substantial improvement if one compares more recent values to the readings of about ten years ago. Moreover, Italy seems to have reached about the same level of (formal) employment protection and product market regulation as Germany.

Table 1. OECD structural reform indicators

		1998	2008 (latest available)	Change 2008-1998
IT	PRM	2.59	1.38	1.22
	EPL	3.06	2.58	0.48
DE	PRM	2.06	1.33	0.73
	EPL	2.57	2.63	-0.06

Notes: PRM= Product market; EPL = employment protection legislation.
Source: OECD,

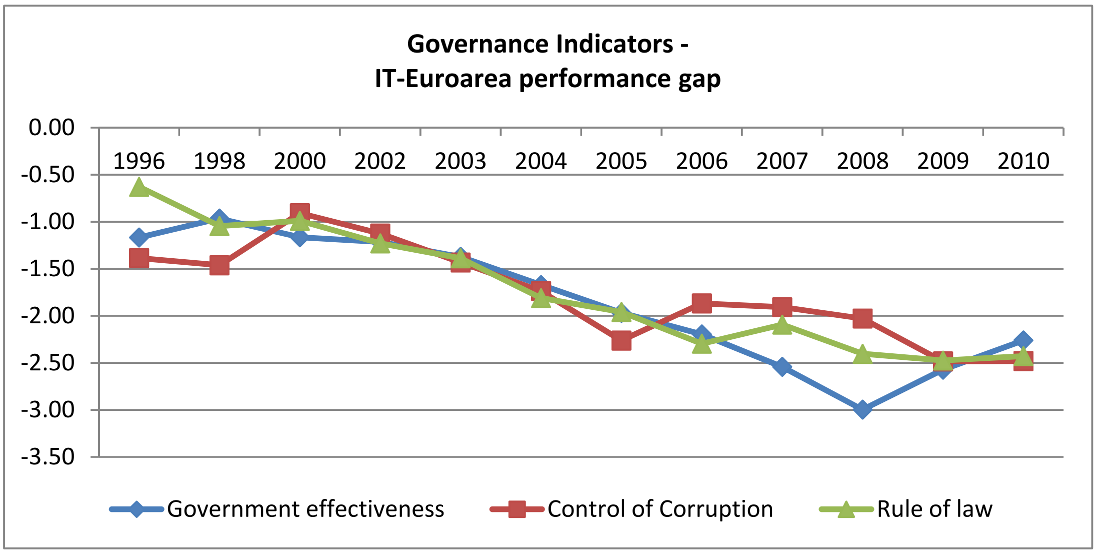
3. Innovation?

Another growth inhibiting factor often cited is the low level of investment in R&D in Italy. The level of R&D spending as a proportion of GDP is low in Italy, at 1.27% of GDP, corresponding to 62% of the euro area average. But in Italy, the share of R&D in GDP has actually increased by about one-fourth over the last decade, proportionally about the same as in Germany, and much more than in the rest of the euro area. It is difficult to explain a slowdown of growth with low R&D spending when it has actually increased relative to most of Italy's peers.

4. So: What factors have deteriorated and could thus explain the worsening of growth?

There is only one set of indicators on which the performance of Italy has clearly declined: the governance of the country. This can be measured by the Worldwide Governance Indicators (WGI) from the World Bank. The three most important indicators for the economy are: the rule of law, government effectiveness in general and control of corruption. Italy's performance on all three indicators has deteriorated dramatically over the last decade.

Figure 3. Governance indicators: Performance gap Italy versus core euro area



Notes:

Control of corruption: Captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as 'capture' of the state by elites and private interests.

Rule of law: Captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.

Government effectiveness: Captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

Source: WGI 2011, World Bank.

Moreover, for all these measures Italy now ranks lower than any other Euro area country (including Greece!). The difference between Italy and the core euro area is now over two standard deviations below the core euro area average.

Table 2. Standardised performance gap in governance indicators: Italy versus the core euro area

	Control of Corruption		**Rue of Law**		**Government Effectiveness**	
	2000	2010	2000	2010	2000	2010
Eurozone core	1.33	1.15	1.25	1.28	1.41	1.28
Italy	0.76	-0.04	0.8	0.38	0.8	0.52
Standardised distance	0.91	2.48	0.99	2.43	1.16	2.26

Note: See definitions of indicators above under Figure 3.
Source: WGI 2011, World Bank.

5. Conclusions

Growth in modern industrialised economies is a complex process. Italy stands out among its peers as having experienced a 'lost decade', although most of the normal growth factors have improved. Until 2008, the macroeconomic environment was also not especially challenging, at least not more so than for other euro area countries. The only area where there has been a clear deterioration is in the governance of the country. The available indicators in this respect point to a significant deterioration over the last ten years. This is one area where a reversal of the trend appears most difficult and it is also an area where external pressure cannot make much difference. Unfortunately the importance of better governance has not yet been fully grasped in the country (or in the European institutions) and receives little attention in the national political debate. This implies that it will be difficult to organise a sustained effort to combat corruption, foster adherence to the rule of law and improve the efficiency of the administration in general. In the end, however, progress on these fronts might be more important for growth than the reforms now being imposed by the EU.