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THE STATE AS INNOVATOR OF FIRST RESORT**

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THE ITALIAN ECONOMIC DECLINE AND THE PROPOSAL OF THE STATE AS INNOVATOR OF FIRST RESORT

Guglielmo Forges Davanzati¹

Abstract

This paper deals with the Italian economic decline, proposing a massive State intervention for public investment aiming at promoting innovation. The recent history of the Italian economy shows that our firms have always tried to become more competitive in international markets by keeping wages low or by taking advantage of the devaluation of the lira. The direction of economic policy in Italy today seems to be a rehash of the old idea that “small is beautiful” – linked to the belief that small artisanal businesses are more efficient – combined essentially with the failure to position our firms in the high segments of the global value chain and thus promote innovation.

1 - Italy is not growing because labour productivity continues to fall, in a spiral lasting over twenty years that shows productivity figures almost always below the European average for the same period.

The low growth of labour productivity can be blamed on two factors: the drop in public and private investments and the continual reduction of the wage share over GDP. Let us try to understand why this has happened, starting from some considerations on the recent history of our economy.

After the ‘economic miracle’ of the ‘50s and ‘60s with its export-driven growth, in the ‘70s there was a period of massive workers’ struggle. Strikes increased, the hours worked diminished and money wages rose, leading to an inflation of the conflict and a worsening of the current account balance. In an attempt to contain worker confrontation and make prices competitive again, firms in the ‘industrial triangle’ started decentralising production, relocating to small production plants initially in the north-east of the country. As a result, trade union bargaining power was weakened and inflation – which in the previous years had been extremely high due also to the two oil crises in 1973 and 1979 – started to decline. After the peak in 1982 (14.7%), the inflation rate kept coming down throughout the Eighties, reaching 4.7% in 1987.

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This was due on the one hand to the end of the period of confrontation inside and outside the factories, and therefore to the beginning of a phase of wage moderation, and on the other, to the rise in the interest rate, designed to attract speculative capital to restore equilibrium in the balance of payments. The higher interest rate however had a negative effect on the dynamics of private investments, not compensated for by significant increases in public investments. In the 1980s, the rise in public spending was mainly due to an increase in current expenditure (which went from 35% in 1980 to 45% of GDP in 1990), designed to neutralize once and for all the remains of the conflict inherited from the previous decade. Entry to the EMS in 1979 – a fixed exchange rate system with a 6% fluctuation band – introduced further rigidities for firms, since it made competitive devaluations difficult. Agreement grew on the need to establish an ‘external constraint’, considered necessary in order to start a series of ‘modernisation’ reforms and above all to keep the public accounts² under control. The year 1992 was a turning point. Italian enterprises continued to lose market shares in foreign trade because of the increasing global competition and, now that social confrontation was definitely over, it was essential to restore the conditions for Italian firms to regain competitiveness. This was in a context marked by speculative attacks on our public debt. It was decided to adopt policies of “blood, sweat and tears”, that is, strongly restrictive fiscal measures, officially designed to reduce the public debt, but actually serving to compress domestic demand, with the resulting reduction of imports. The workers’ bargaining power was reduced as a result of the rise in the unemployment rate for the whole period from 1992 to the beginning of the 2000s, leading to wage compression.

The arrival of the 2008 crisis made all the unsolved problems from the previous decades explode, and came on top of a production structure that had become increasingly fragile, made up of small sized firms strongly dependent on bank credit, specializing in technologically mature sectors (tourism, agro-food, luxury goods).

2 - In a nutshell, the recent history of the Italian economy can be seen as the story of attempts to make our firms more price competitive, by means of fiscal measures, monetary policies and exchange agreements that have systematically enabled our businesses to compete by cutting wages.

In more recent years, no government has tried to change direction and make our production system stronger and more internationally competitive by investing in innovation. By contrast, public spending on research has been drastically cut (and

² The need for an external constraint was theorised, among others, by Guido Carli, Carlo Azeglio Ciampi and Beniamino Andreatta, who argued that Italy would be able to apply strict discipline in the management of public finance only if it was imposed by an external actor, in particular, by the European institutions.

private spending has reached ridiculously low levels). This is probably due to the extreme difficulty of making up for lost time (it is hard to re-industrialise a country after decades of de-industrialisation policies), to the belief that Italy can grow in virtue of the presumed excellence of ‘small is beautiful’ and its handmade products, to the political shortcut of refraining from interventions in the production fabric via public investments in research and infrastructures, both material and immaterial, (whose effect would be felt in the long run), and to increasing current expenses in order to gain support.

Then came 2018. The so-called government for change espoused the belief that these problems derive from European constraints, in the wake of a decade-long theoretical elaboration stating that the material standard of living of Italian citizens would improve if we could do without the euro. It was an erroneous argument which failed to grasp the real scope of the problem (economic and political). As Mario Draghi recently reminded us, the devaluations of the lira (7 cases from 1979 to 1992) were always accompanied by drops in productivity caused by the opportunity offered to firms to compete at a favourable exchange rate without innovating³. Furthermore, since in the later decades, in particular, Italian exporters were located mainly in the North, the devaluations of the lira usually caused a widening of regional disparities.

Although erroneous or at any rate highly debatable, this argument is what underpins the drawn-out negotiations with the European institutions for an increase in the deficit/GDP, which should lead (in the intentions of the government) to a radical revision of the European Treaties, if not to Italy’s unilateral abandonment of the euro⁴.

The opinion polls available – trusting that they are reliable – tell us that Italians are largely opposed to unilaterally abandoning the euro. But at the same time there is widespread support for the measures, even from intellectuals until recently close to the left. This support also comes from economists who call themselves Keynesians and who interpret it as a radical change in direction compared to the austerity measures in place up to now. This is an optical illusion, since the measures essentially reflect the interests of the Lega’s real electoral base (small firms in the North), being designed to increase the deficit mainly through tax cuts – via the flat tax – and to bolster the domestic market through money transfers – via the “citizen’s

³ The fact that there is an undeniable cause and effect link between devaluations and the reduction of productivity may be challenged, but the empirical evidence seems to demonstrate it sufficiently, at least for the second period considered, namely between the end of the 1980s and the beginning of the 1990s.

⁴ On this, there seem to emerge some affinities between what happened at the end of the 1800s between Italy and the Latin Union (an embryonic experiment in monetary unification), when Italy managed in 1878 to obtain the minting of silver coins – which today would mean the re-appropriation of monetary sovereignty – to then engage in a standoff with France which ended in the subsequent ban on minting silver money. Aside from the technical terms, Italy emerged essentially defeated and accused of “rash actions”.

income”. In this sense the budget cannot be called Keynesian, at least in the sense that a genuine Keynesian economic policy envisages increased spending first of all for public investments aimed at redistribution. The Stability Law (*Legge di stabilità*), instead, introduces elements that contribute to increasing the inequalities

In this perspective, it is not the expansive nature of the financial measures that raises concerns in Europe, but this government’s attempt to invert the logic that guides eurozone policies which correspond to the interests of big companies with a high export vocation: this involves creating favourable conditions for growth by increasing foreign sales – by means of wage moderation and keeping prices low – and reducing imports – by cutting public spending. In other words, the fundamental incompatibility between the government and the European institutions lies in the fact that the government’s aim is to expand the domestic demand to enable Italian firms to recuperate profit margins since they would not be able to do so by exporting, while the European institutions espouse an economic policy designed to attain growth through an increase in net exports. We are therefore embroiled in a typical inter-capitalistic conflict, between large and small firms, between exporters and firms operating on the internal market, which underpins the shaky internal political equilibrium and the even shakier balance in the negotiations between the government and the European institutions. Moreover, wage moderation contributed to increase public debt/GDP ratio for the operation of the following mechanism: low wages imply low consumption, low domestic demand and low rate of growth; at the same time low wages contribute to produce deflation and deflation, in turn, increases the *real* interest rate on State bonds.

The direction of the economic policy being followed in recent months in Italy seems to be essentially a re-proposal of the old argument that “small is beautiful”, linked to the belief that small artisan businesses are more efficient, combined with the failure to position the Italian economy in a high segment of the global chain of value, which would enable our firms (especially the small ones) to survive by selling on the domestic market (cf. Perri and Lampa, 2014).

On the economic policy plane, PostKeynesian scholars propose more public investment and, in the next sections, this argument will be expanded considering the role of the State in promoting innovation.

3 - The key figures of the Italian public sector and its contribution to innovations are the following. OECD 2019⁵ (Research and development (R&D) - Gross domestic spending on R&D) reports that in 2017 gross domestic spending on R&D was 1.354 on GDP while the average OECD spending was 2.368%. The Italian economy

⁵ See: OECD 2019

employed 5427 researchers per 1000 employees, while the average OECD researchers was 8287 per 1000 employees⁶. Employment by education level⁷ is lower in Italy than in the average OECD⁸. The percentage of unemployed graduates in Italy is about the double of the average of the Eurozone, and the percentage of graduated individuals is lower than in the average of OECD countries. OECD (2017) reports that employed workers in the Italian public sector are, on average, older than 55 years, while in the average of OECD countries the average age is 34. The workers employed in the Italian public sector are 13% on the total labour force, while on average OECD countries employ 18%. The average salary is lower than in other OECD countries.

The dimension of the public sector affects the performance of the private sector and, particularly, the path of labour productivity. It is well known that labour productivity in Italy is lower than most OECD and European countries and that it continuously declined starting from the early 1990s.

4 - The dominant view, in the Italian academic and political circles, is based on the conviction that the Italian public sector is inefficient. As a result, it is claimed a policy designed to incentive a managerial approach. The increase of the efficiency of public sector is conceived as a necessary condition for private firms to invest (cf. Paolazzi, 2014). A similar argument is applied to universities: it is argued that they are unable to provide students competences which are consistent with those demanded by the private sector. Accordingly, the Italian unemployment is assumed to depend on the mismatch between labour supply and labour demand.

The argument proposed here is radically different. First, unemployment depends on lack of aggregate demand, which is generated by policies of fiscal consolidation. Second, unemployment (particularly, unemployment of young high-skilled individuals) also depends on the *mismatch in the public sector*: the low demand for high-skilled workers depends on political decisions namely the political decision of reducing the dimension of the Italian public sector, via the reduction of funding and the imposition of term employment limits⁹.

⁶ The so-called Manuale Frascati states that "Researchers are professionals engaged in the conception or creation of new knowledge, products, processes, methods and systems, as well as in the management of the projects concerned". See: <https://data.oecd.org/rd/researchers.htm#indicator-chart>.

⁷ This indicator shows the employment rates of people according to their education levels: below upper secondary, upper secondary non-tertiary, or tertiary. The employment rate refers to the number of persons in employment as a percentage of the population of working age. The employed are defined as those who work for pay or profit for at least one hour a week, or who have a job but are temporarily not at work due to illness, leave or industrial action. This indicator measures the percentage of employed 25-64 year-olds among all 25-64 year-olds.

⁸ See: <https://data.oecd.org/emp/employment-by-education-level.htm#indicator-chart>.

⁹ SVIMEZ shows that the Fondo di Finanziamento Ordinario (FFO) for state universities fell from 7 billion 250 million euros in 2008 to around 6 billion 500 million in 2014, with a reduction of 14%. This measure appears functional to reducing the quality of the workforce, since Italian firms do not express a great demand for high-skilled workers. The

Some Post-Keynesian scholars suggest that no constraints on the expansion of public spending exist and that all constraints are endogenously generated by political decisions (cf. Parguez, 2008). Moreover, in the case under consideration, there is a country-specific constraint which pertains to the public funding to the public sector.

A policy of expansion of the public sector, particularly for R&D activities, would produce significant macroeconomic outcomes.

- i It would involve directly more *high-skilled* workers hired by the State in order to directly produce innovations. This would lead to an increase of the rate of growth of labour productivity, giving rise to a potential virtuous circle between increasing aggregate demand and increasing productivity.
- ii It would involve mainly and directly young workers, which, as a norm, are more productive than older workers. This effect would (at least partially) compensate the average old wage of workers employed in the Italian public sector. Arguably, its inefficiency depends more on this than on the lack of managerial attitudes.
- iii It would have a positive impact on domestic aggregate demand, not only because of the increase of the money wage bill, but also because of the higher propensity to consume on the part of young individuals.
- iv This policy prescription also aimed at creating more good jobs, contrasting the tendency of increasing propensity of private firms to use underpaid workers (often in a condition of intellectual underemployment).
- v Above all, a paradox could be dealt with: an ‘industrial reserve army’ formed also by young high-skilled workers are unemployed or underemployed, ready to emigrate and prepared to work in R&D activities cannot be hired in the public sector although the Italian public sector hires few and old workers.

Consider also that the programme of the State of innovator of last resort should not provoke a strong reaction from the capitalist class, insofar as productivity increase can benefit also the private sector, via the availability for the private sector of a stock of inventions which can be used. In this respect, one could consider that most Italian firms import high value added capital goods (Palma, 2016). Accordingly, at least in the Italian case, this programme should not necessarily compromise private firms’ competitiveness and could reduce the dependence of the Italian economy from innovation produced abroad.

outcomes are intellectual unemployment, intellectual underemployment and, above all, migration of high-skilled workers from Italy to other countries (in the absence of high-skilled workers attracted from abroad to Italy), with the consequent loss of labour productivity in Italy.

An increase of aggregate demand consequent to the increase of employment in the public sector stimulates innovations in the private sector, not only because of the operation of the Kaldor-Verdoorn Law, but also because as the employment rate increases it becomes more difficult for private firms to gain competitiveness via wage moderation (Dutt, 2012)¹⁰. This is a case for demand-pull innovation (cf. Bogliacino and Pianta, 2016).

Two main factors seem to impede the implementation of this policy. First, the short-period propensity of the political class; second, the (false) dominant conviction that private firms are always more efficient than public firms (Mazzucato, 2018).

On the theoretical ground, the argument proposed here establishes that private investment increases as public investment increases, and so does labour productivity. In formal terms:

$$\pi = f(I, Ip), f' > 0 \quad [1]$$

where π is labour productivity, I are private investment and Ip are public investment. This argument is theoretically significant insofar as it suggests that the standard Neoclassical aggregate production function is fallacious *also* on the ground that it does not consider the role of the State in a capitalist economy (cf. Mazzucato, 2017). The so-called Neo-liberalism – by contrast with the Liberal view of the 20th century - is based on the view that markets are a political artefact and that a market economy cannot function in the absence of a massive State intervention aiming at increasing income inequalities for the sake of generating economic growth. Accordingly, the aggregate production function cannot hold if public spending is not taken into consideration.

Equation [1] holds on the condition that $I = f(Ip), f' > 0$. This condition settles the crowding in effect of public investment. The magnitude of the expansion of private investment as a consequence of an increase of public investment – and hence the ‘acceleration’ factor - is likely to depend on a number of variables, such as the efficiency of the public sector and/or the increase of firms size. Of course, a time lag should be taken into consideration: an increase of Ip in time t may generate an increase of I in time $t+1$. In other words, firms can react to the increase of public investment increasing their investment both because they have more easy access to the public administration and scientific research produced by the State, and because

¹⁰ The State can not only finance R&D but also directly produce innovations, via public firms. As stressed by Proponents of the so-called National system of innovations, this could be a case where innovations spread via imitation (cf. Vertova, 2014).

they expand their dimensions (and hence their technical division of labour) as a result of an increase of demand. The increase of labour productivity may derive from the increase of capital turnover, particularly in context where firms compete producing and selling *before* their competitors (the so-called time-based competition). It may be also derived from an increase of capital utilization on the part of private firms. This effect is particularly relevant in the European peripheral countries – Italy included – where evidence shows that firms work with high levels of capital underutilization.

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