# Italy's Economic Half-Miracle



**Italy has worked hard to modernize its economy, but it still lags in reforming labor markets, financial systems, and education. Will the nation push ahead, or hang on to the status quo?**

by Richard H.K. Vietor

Illustration by Dave Plunkert

**When Italians want to watch AC Milan, one of the country's best** professional soccer clubs, they tune in to the channel of Mediaset, a major TV network. It's only natural that the team appears on Mediaset: both are owned by Silvio Berlusconi — media magnate, sportsman, and politician. While AC Milan was scoring goals on Mediaset in the spring of 2000, Mr. Berlusconi had the pleasure of watching Forza Italia, the conservative political party he created, defeat the center-left coalition of Prime Minister Massimo D'Alema in regional elections. The victory was an early indication that Mr. Berlusconi had an excellent chance of being elected prime minister the following year. Indeed, as events unfolded last winter, all signs indicated that by spring 2001, Mr. Berlusconi would be prime minister. (As *s+b* went to press, the election was scheduled for May 13.)

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Mr. Berlusconi held that position in the mid-1990s until the collapse of his coalition led him to resign. He was prime minister during a period when Italy made laudable strides toward modernizing its economy, as the government reduced budget deficits and inflation, eliminated trade deficits, and shrank the public sector through privatization.

But much work remained, and prior to the 2001 vote, Mr. Berlusconi believed he could finish the job of modernizing Italy before the pincers of globalization and Italy's aging population crushed its economy and social systems. His agenda focused on addressing rigid labor markets, high structural unemployment, large and bureaucratic government, and the high public spending and taxation that choked off productivity and investment, as well as the immense regional differences that separated northern from southern regions. Mr. Berlusconi realized that Italy's capital markets remained underdeveloped and its banking system, dated. Heavy industry was still struggling to adjust, after decades of reliance on the state. And small business, in some ways Italy's sparkling competitive advantage, badly needed to modernize its undercapitalized, family-owned structure.

Mr. Berlusconi believed that a strong center-right coalition could lead Italy through the next stage of European integration. Referring to Polo per le Liberta, his Freedom Pole coalition, which includes Forza Italia, he affirmed in an interview in Rome, "We need a government of Polo that, on the foundation of its own liberal principles, puts into effect in Italy the recipes adopted by Reagan in the U.S., by Thatcher in the United Kingdom, and by Anzar in Spain."

Mr. Berlusconi is seeking to resolve a tension between the private sector and the state that roils economies across Europe. The struggle to combine social security with economic dynamism exists from Spain to Germany to points beyond. His questions — will these reforms be politically feasible? And will they be enough to stimulate the growth of the national economy? — concern reformers globally. If he is elected and then manages to resolve the public–private conflict, Mr. Berlusconi will set an example for Italy's neighbors and other countries that want to reshape their economies.

Like Italy, other countries must adjust or find themselves lagging far behind the leaders of the global economy. There is no "third way" that can maintain both affluent lifestyles and an equitable welfare state without making rigorous changes in labor markets, financial systems, and competitiveness.

Can Italy make the hard choices that have paid off elsewhere with economic growth? That depends on the influence of factors that have led Italy to this historic point (see "Nine Challenges to Italy's Economic Future," page 9) and whether the new prime minister can garner political support for the next phase of the so-called Italian miracle. Most critically, it depends on the resolve of the Italian people to overturn many facets of their comfortable — but unsustainable — society. This miracle will take more than prayers.

## After the War

In 1946, Italy held its first popular referendum. Affirming the regional split that has always marked the country, the south voted for monarchy and the north-central region voted for a democratic republic, the form adopted in a new constitution early in 1948. The constitution established separate legislative, executive, and judicial branches. The two houses of Parliament shared power equally. Members of the Parliament were initially elected by

Exhibit 1: **Recent Italian Prime Ministers**

| Prime Minister | Coalition (major parties) | Political Alignment | Begin | End |
|---|---|---|---|---|
| Giulio Andreotti | DC, PSI, PSDI, PLI | center-left | July 1989 | March 1991 |
| Giulio Andreotti | DC, PSI, PSDI, PLI | center-left | April 1991 | April 1992 |
| Giuliano Amato | PSI, PSDI, PLI | tecnici | June 1992 | April 1993 |
| Carlo Azeglio Ciampi | PSI, PSDI, PLI | tecnici | April 1993 | April 1994 |
| Silvio Berlusconi | Polo per le Liberta: Forza Italia, Lega Nord, AN, CCD | center-right | May 1994 | Dec. 1994 |
| Lamberto Dini | PDS, PPI, AD, Lega Nord, Verdi | tecnici, center-left | Jan. 1995 | Jan. 1996 |
| Romano Prodi | Ulivo: PDS, PRC, PPI, Verdi, Rinnovamento Italiano | center-left | May 1996 | Oct. 1998 |
| Massimo D'Alema | Ulivo: PDS, PPI, UDR, PDCI | center-left | Oct. 1998 | Dec. 1999 |
| Massimo D'Alema | Ulivo: PDS, PPI, Democratici per l'Ulivo | center-left | Dec. 1999 | April 2000 |
| Giuliano Amato | PDS, PPI, PDCI, PSDI, Verdi, Democratici per l'Ulivo | center-left | April 2000 | 2001 |

proportional representation. The resulting multiparty system led to constantly shifting alliances and contributed to revolving-door governments (58 in 56 years before the spring election). Exhibit 1 exemplifies the pattern over the past decade.

Also in the 1940s, the labor movement split into three trade federations: the Italian General Confederation of Labor, representing many Communists and Socialists; the Italian Confederation of Workers' Unions, composed mostly of Christian Democrats; and the Italian Union of Labor, representing Republicans and Social Democrats. By aligning themselves with major political parties, these organizations gained power during the 1950s and 1960s.

After World War II, the Partito della Democrazia Cristiana (Christian Democratic Party, abbreviated "DC" in Italian) rose to political dominance with the tacit approval of the Roman Catholic Church. The Church's goal of equitable distribution of wealth strongly influenced the policies of the DC.

Meanwhile, a second important political force was the Partito Comunista Italiano (Italian Communist Party, or PCI), the most powerful Communist party in the West. Labor unions split their support between the PCI and the Partito Socialista Italiano (Italian Socialist Party, or PSI) — both of which shared the Church's commitment to income equity. The PCI enjoyed the financial support of the Soviet Union until the late 1980s, when the Soviet Union's collapse and withdrawal of financial support from the PCI contributed to the demise of the old political order.

The DC's anti-Communist and pro-NATO policies won it the support of a third political force, the United States. Backed by the American government (so long as it did not allow the PCI into any coalition), the Christian Democratic Party held steady amid Italy's shifting political coalitions for almost 50 years. Thus, while governments rose and fell annually, the DC provided the fulcrum for each new ruling coalition.

### The First Economic Miracle

The 1950s gave birth to the "Italian miracle," an industrial boom that brought prosperity to the country's northern and central regions. Family-owned firms developed capital-intensive steel, automobile, tire, and chemical industries, among others. Entrepreneurs focused on textiles, machinery, and food processing, and the state built the infrastructure of transportation and energy. Despite the Cassa per il Mezzogiorno (Funds for the Development of the South, a program to build the south's infrastructure and economy), jobs and skilled workers migrated northward, leaving the southern economy in poor shape.

As the miracle continued into the 1960s, the DC used the Istituto per la Ricostruzione Industriale (Institute for Industrial Reconstruction, or IRI), a state-owned holding company, to buy shares of steel, chemical, automobile, and bank companies. Increasingly, state-owned monopolies, controlled by IRI, came to dominate the Italian economic landscape. "The positive results of state-owned enterprises were the building up of high-tech know-how and improvement of the south's infrastructure," explains Fernando Napolitano, vice president of Booz-Allen & Hamilton Italia. "However, the negative results included the establishment of artificial, rather than market-driven, jobs and a lack of focus on Western management styles."

By the early 1970s, both inflation rates and social tensions were escalating. Violent protests erupted as trade unions and university students demanded more benefits from the political establishment. "Some of the world's most advanced social legislation" was enacted during this period, wrote historian Mario Mignone, author of *Italy Today: At the Crossroads of the New Millennium* and director of the Center for Italian Studies at the State University of New York at Stony Brook. Social insurance was nearly universal, pensions were generous, and retirement ages were unusually low (e.g., 60 for men, 55 for women). While costly, the policies maintained political peace, and they remain in effect.

The Italian economy foundered in the wake of the first oil shock in 1973. Eighty-five percent of the country's petroleum was imported. Inflation drove up wages; slower growth led to high unemployment and increased corruption. Organized crime and political terror added the final grim elements of these *anni di piombo* — years of lead. In 1978, the radical political group Red

**To maintain pension benefits at current levels, Italy must immediately cut government spending by 49 percent, or raise income taxes 28 percent. These are not palatable solutions.**

Brigades kidnapped, and then killed, former prime minister Aldo Moro.

Despite unrest at home, Italy continued to integrate into the pan-European economy. A founding member of the European Community in 1957, Italy was one of the eight states that formed the European Monetary System in 1979. This new system of "fixed but adjustable" exchange rates helped lower inflation and protected intra-European trade from the effects of floating exchange rates. In 1986, Italy took another important step when it enthusiastically signed the Single European Act, committing 12 countries to liberalize the internal movement of goods, services, and people by removing hundreds of barriers and regulations by the end of 1992.

### The Second Economic Miracle

During the 1980s, Italy enjoyed its second "economic miracle." Under Prime Minister Bettino Craxi, a DC-led coalition controlled inflation and revitalized Italy's export-driven economy. Small- and medium-sized companies, producing clothing, leather products, shoes, furniture, textiles, jewelry, and machine tools for export, led the boom.

This second tier of Italy's economy was made up of clusters of small, family-owned enterprises. These *distretti*, or industrial districts, have been described by the *Economist* as "geographic concentrations of interconnected firms, specialized suppliers, service providers, firms in related industries, and associated institutions …[that] all contribute to a system that produces the goods characteristic of the district." Clusters include ceramic tiles in Sassuolo, silk in Como, leather in Florence, and packaging machinery in Bologna.

What was true about distretti in the 1980s remains valid today. These small firms thrive in an economy in which 98 percent of all manufacturing firms have fewer than 50 workers. Several characteristics seem essential to the development of a strong cluster: geographic concentration, close family ties, domestic rivalry, specialization, and cooperation and knowledge transfer between firms and suppliers. In *The Competitive Advantage of Nations* (The Free Press, 1990), Michael Porter explains that in Italy, "constant competitive advantage was present due to sophisticated and demanding local buyers, strong and unique distribution channels, and intense rivalry among local firms." The real uniqueness in Italy, writes Mr. Porter, derives from "highly specialized knowledge and skills, passed within families, from generation to generation."

For example, near Bologna, a cluster of 20 medium-sized firms provides specialized packaging machinery for the world market. One such firm, Industria Macchine Automatiche SpA (IMA), relies on a network of more than 200 suppliers to provide parts for its tea-bagging and pharmaceutical machinery. As these suppliers pick up techniques or cost reductions and product improvements from one another or from customers, they diffuse the knowledge throughout the region's supply chain, benefiting IMA. Additionally, IMA and the rest of the Bologna cluster are supported by industry associations, state-funded agencies, local banks, and cooperative programs. In Bologna, for instance, the Istituti Aldini-Valeriani trains mechanical engineers and other students for jobs specifically in the packaging cluster.

To date, these distretti have been a driving force in Italy's international competitiveness. However, they are vulnerable to competition themselves because of their small size, insularity, limited financing opportunities, transferable technologies, and easily copied products.

With these sorts of networks, Italy had built the world's sixth largest economy by the late 1980s. GDP per capita ($23,100 in 1990) surpassed that of the United Kingdom by 9 percent. The nation appeared to be on the right track.

**Behind the Prosperity**

But all was not well. The Italian economy presented a paradox. On the surface, it was booming, thanks to increased productivity and surging exports. But this façade of prosperity hid the truth of a sick macroeconomy. Unsustainable fiscal deficits drove the growth. Inflation and labor costs thus soared; unemployment and welfare payments were too high, maintained by the corruption of the political system. Debt was startling.

By 1992, Italy's performance numbers all looked lousy — especially compared with those of other European countries, such as Germany, France, Belgium, and the Netherlands. With unemployment at 11.5 percent, the budget deficit had reached 9.6 percent of the GDP, driving public sector debt to 124.9 percent of GDP. Both the trade balance and the current account were in deficit, and growth had slowed to 0.6 percent. Inflation was running 7.7 percent. As far as the European Union was concerned, Italy looked more like Greece and Spain than like one of the leaders.

In the midst of these unsustainable circumstances a nationwide corruption scandal erupted. An investigation known as *Mani Pulite* — Operation Clean Hands — uncovered an immense web of graft and corruption connecting national political leaders, local authorities, and major corporations. On some level, people had always suspected this web's existence. Italian magistrates now revealed the specifics of an institutionalized system of bribes through which profits from state-owned enterprises had flowed to political officials. With the majority of Italy's ruling political class under investigation, paralysis spread throughout the country. The rot infected the body politic at all levels — from local officials to corporate executives and cabinet ministers.

Mani Pulite led to the death of the First Republic — the half-century of DC centrist rule. The DC-dominated coalition collapsed, replaced by a *tecnici* government — that is, one staffed by nonparty academics, managers, and senior civil servants. (Tecnici governments take office when Italy's fragmented political system cannot deliver a majority coalition.) Giuliano Amato, a former treasury

Exhibit 2: **Major Privatizations, 1993–1999**

| Company | Industry | Year |
|---|---|---|
| Credito Italiano | Banking | 1993 |
| Banca Commerciale Italiana | Banking | 1994 |
| IMI* | Banking | 1994–1996 |
| Istituto Nazionale delle Assicurazioni (INA)* | Insurance | 1994–1996 |
| SME* | Supermarkets and Catering | 1994–1996 |
| Ilva Laminati Piani | Steel | 1995 |
| Italtel | Telecommunications Equipment | 1995 |
| Ente Nazionale Idrocarburi (ENI)* | Energy | 1995–1998 |
| Nuova Tirrena | Insurance | 1996 |
| Aeroporto di Roma | Infrastructure | 1997 |
| Telecom Italia | Telecommunications | 1997 |
| Banca Nazionale del Lavoro | Banking | 1998 |
| ENEL | Electricity | 1999 |
| Mediocredito Centrale | Banking | 1999 |

* Company sold in tranches

Sources: Banca d'Italia, *Annual Report 1995, 1996,* and *1997;* Ministero del Tesoro, *Documento di Programmazione Economico-Finanziaria 2000–2003*; BAH research minister, became prime minister in an atmosphere of national disgust with the prevailing political and economic systems. Mani Pulite gave the government a clean-slate mandate to reform Italy's economy. Since 1992, several tecnici governments have provided leadership and reform, under Carlo Azeglio Ciampi (1993-94), Romano Prodi (1996-98), and Giuliano Amato again (2000-2001).

**From Scandal to Economic Reform**

Meanwhile, market integration in Europe had progressed so well that European leaders were convinced to take the next step of forming a currency union. In December 1991, in Maastricht, the Netherlands, 12 prime ministers signed an agreement to form a single central bank (in Frankfurt) and to lock their currencies together forever, beginning on January 1, 1999. To be eligible, each country would have to meet targets for inflation, interest rates, budget deficits, public debt, and exchange rates.

Mr. Amato's tecnici government quickly passed Italy's most austere postwar budget. It reduced expenditures by ending support for universal health care, initiated pension reforms by extending the retirement age to 65 years, and raised income and excise taxes. Labor and business negotiated a historic accord to abolish the inflationary system of wage indexation.

To control the budget and extend the reform process into the microeconomy, Mr. Amato converted the four largest state holding companies — IRI, Ente Nazionale Idrocarburi (ENI), Istituto Nazionale delle Assicurazioni (INA), and Ente Nazionale per l'Energia Elettrica (ENEL) — into joint-stock companies under the control of the treasury. The ministry for state-owned participating enterprises was abolished, and Mr. Amato began selling the state holding companies.

Finally, the Amato government dealt with Italy's grossly overvalued currency, which had weakened the country's ability to trade. In September 1992, the lira was devalued by almost 30 percent. This immediately boosted Italian exports, producing a huge trade and current account surplus, but it also drove up Italy's import prices. Together with tight monetary policy, the devaluation led to a recession that Labor immediately blamed on Mr. Amato's rigid programs. After a mere 11 months, he was forced to resign as prime minister, giving way to the caretaker government of Carlo Azeglio Ciampi, the governor of the central bank.

Mr. Ciampi's government extended Mr. Amato's privatization initiative to commercial banking (Credito Italiano and Banca Commerciale Italiana), food processing, and chemicals. (See Exhibit 2.) But after just less than a year, new elections were held in May 1994. Silvio Berlusconi, a powerful businessman who owned television networks, newspapers, supermarket chains, and insurance companies, formed a new conservative party named Forza Italia. In an alliance with two other right-of-center parties — Lega Nord (the Northern League) and Alleanza Nazionale (National Alliance, or AN) — Forza Italia won the election, and Mr. Berlusconi became prime minister.

Mr. Berlusconi's short-lived government continued to reduce public sector spending and benefited from economic recovery. But Mani Pulite investigators attacked Mr. Berlusconi with accusations of bribery and corruption. Opponents alleged that he had entered politics to rescue his financial holding company, Fininvest, with its debt of 6 trillion lira, or $3 billion. The charges have never been proved, although Mr. Berlusconi's detractors continue to raise the issue of conflicts of interest. In

## Nine Challenges to Italy's Economic Future

To understand how Italy stalled after achieving half an economic miracle, it's vital to consider the web of systemic difficulties that entangles the economy and society. Here is a primer:

**1 Bureaucracy.** Business leaders complain that Italy's huge public administration and pervasive regulations continue to hinder business development. The bureaucracy makes it difficult to finance growth, so many companies choose to remain small. "One of the real tragedies of business life in Italy," says Franco Tato, the CEO of ENEL (the national electric company), "is that the authorities' procedure for doing anything is unbelievable." As a partial solution, the government has announced that this year it will reduce the number of ministries from 22 to 12.

**2 Unions.** The structure and power of trade unions led to Italy's labor-market rigidity, according to employers. The 1992 Concertazione agreements between unions, government, and business gave labor more negotiating power, which unions translated into market protections. Thus, it is virtually impossible to fire employees. "The firing restriction is very frustrating," explains one CEO. "If you fire an employee, you end up in court, where the judge can send him back to work. They can oblige you to rehire a fired employee."

**3 Unemployment.** Italy has the second highest unemployment rate among the EU countries. In 1998, Italy's unemployment rate was 2.2 percent higher than the average rate for the EU 15. New and younger workers, women, and the aged are the hard core of the unemployed. In 1998, unemployment was 9.4 percent for men, 16.8 percent for women, and 33.2 percent for people under the age of 25. Despite differences in labor supply, wages remained the same throughout Italy — a result of national wage contracts.

**4 Underground Economy.** Especially in the south, Italy maintains a sizeable underground, or "black," economy. Workers in the black economy receive lower wages and no unemployment benefits, but they also pay no taxes. An article last year in *World Economics* by Jim Thomas, a Reader at the London School of Economics, estimated the size of Italy's black economy as 27 to 30 percent of GNP — higher than that of any other country in the Organization for Economic Cooperation and Development (OECD) save Greece. "The system is too generous," asserts Guido Vitale, an investment banker. "It is easy to stay on the unemployment list, get your subsidy, and work on the black market. That way people can get two salaries, and they are very happy."

**5 Taxation.** The black economy has a major negative impact on tax revenues. "My theory," says Mr. Vitale, "is that the amount of public debt is equal to the tax evasion of the last 10 years. I would say that we lose about L250 trillion [about $125 billion] in tax evasion each year. If people paid taxes, we would have a surplus." At 14 percent of GDP, income taxes are as high as those in the United States. Corporate taxes, at just under 15





December 1994, when his coalition collapsed on the issue of pension reform, Mr. Berlusconi resigned and Lamberto Dini's tecnici government took office.

In May 1996, a new left-of-center coalition, called Ulivo (Olive Tree), won the general election. Romano Prodi, an economics professor who had founded Ulivo, became prime minister of this new tecnici government.

### The Perfect Collaboration

For the first time since the war, a left-of-center coalition with many former Communists ruled Italy. Among the coalition partners were the Partito Democratico della Sinistra (Democratic Party of the Left, or PDS), the Partito Populare Italiano (Italian Popular Party, or PPI, formerly the Christian Democrats), Federazione dei Verdi (the Italian Green Party), and the Partito della Rifondazione Comunista (the Communist Refoundation Party, PRC). Mr. Prodi, moreover, served for two-and-a-half years — an unusually long tenure by Italian standards, especially for a tecnici government.

This government, it turned out, was the perfect political/intellectual collaboration for Italy: an economist who understood what Italy needed combined with a center-left coalition necessary to get it done. As Mr. Prodi recently observed in an interview in Brussels, "the 'compassionate left' (like Clinton's Democrats) succeeded where Mr. Berlusconi failed because the right can't do reform against the left." Mr. Prodi got his countrymen to believe that vigorous participation in the European Union was vital if Italy wanted to reap the benefits of globalization. He also percent of GDP, are the second highest in the OECD, after Sweden. On large corporations, corporate taxes (including payroll taxes) range from 46 percent to 54 percent. These high corporate taxes dampen investment and perpetuate the smallness of firms, since those with fewer than 15 employees enjoy both tax and labor-law advantages.

**6 Financial Markets.** Capital markets in Italy remain underdeveloped and inefficient. Despite privatization, firms like Mediobanca still exercise disproportionate power and control. "In Italy," observes economist Marco Spinedi, "our banking system is a disaster. It is public, oligopolistic, and there are very high rates." The equity markets are likewise underdeveloped, and the government still controls significant portions of several public companies.

**7 Foreign Investment.** Throughout the 1990s, outward direct investment substantially exceeded inward direct investment. In fact, Italy's inward-flowing investment level was considerably below that of other EU nations. Inward-flowing investments have been only $2 billion to $4 billion annually, compared to net outflows of as much as $10 billion (in 1998). Poor infrastructure, low labor productivity, and fears of organized crime discourage investment.

"People do not invest in Italy because of its negative image," explains Elio Catania, CEO of IBM Italia. "Italy is considered to be a closed country." Renato Ruggiero, the former head of the World Trade Organization, observes that "the culture sees foreign investment as a threat to the existing system, because people will have to apply the market economy and work harder."

**8 Education.** In 1998, only 34 percent of adults (ages 25 to 64) had obtained high school diplomas or any sort of advanced degree. Investment in education remains low, and there is actually a shortage of schools in Italy's southern region. Italian universities focus on trade-specific skills with little attention to management practices. There are few undergraduate business programs.

**9 Privatization.** In six years, Italy has privatized dozens of firms valued at more than $22 billion. In 1999, the government sold one-third of the electric utility ENEL and the large bank Mediocredito Centrale, and was preparing to offer airports, highways, and more banking properties. Although these sales were difficult for the south, where they led to unemployment and diminished government revenues, they were meant to enhance the country's long-term competitiveness. In fact, Italy's growth rate stepped up to 2.4 percent in 2000.

But privatization on its own does not lead smoothly to competitive markets. Privatized companies in the utility, energy, and telecom sectors especially have retained the powers and profit levels of monopolists. They face limited, although growing, competition from other European companies. As the *Financial Times* has noted, "When it comes to the liberalization of markets — exposing public and private utilities to competition — the pace of change in Italy has been modest at best."





argued that to remain a major EU partner, Italy had to make serious economic adjustments.

Mr. Prodi passed tight budgetary measures to prepare Italy for the Maastricht Treaty. He further opened Italy to competition by reducing the State's holdings in ENI (the national oil company) and privatizing Telecom Italia. As fiscal deficits dropped to 3.7 percent, public debt began to fall and interest rates started falling sharply. In May 1998, Italy was accepted into the European Monetary Union. On January 1, 1999, two months after Mr. Prodi left office, the euro was introduced under direct monetary control of the European Central Bank. (Mr. Prodi now serves as president of the European Commission.)

Although Italy has cleared up its public finances, reduced inflation and interest rates, and reasserted its international competitiveness, it continues to grow disappointingly slowly — less than 1.2 percent annually between 1992 and 1999, 2.4 percent in 2000 — in a painful contrast to the rest of Europe. A slowdown of world markets, especially in south Asia and Japan, decreased Italian exports and further undermined growth. While some of these problems are certainly short-term, deeply rooted institutional and performance problems threaten Italy's long-term prospects. The situation becomes even more complex in light of the demographic crisis faced by the country.

### The Demographic Time Bomb

In a recent edition of his *World Economic Trends* newsletter, MIT economist Rudi Dornbusch devoted a

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segment to reinventing Italy. "Italy is living a brief moment of quiet, in between the fiscal crisis just overcome and the next one," he wrote. "The demographic trends that lie ahead bring about another crisis a decade or two ahead. This is far off, it would seem, but unless the issue is addressed soon it will be an altogether formidable crisis."

Italy's national statistical institute predicts that by 2010, the size of the population aged 57 and above will be equal to 61 percent of the working-age population (that is, the number of people 20 to 56). The comparable figure for the United States is 20.4 percent. A recent study published by economists Laurence Kotlikoff, of Boston University, and Bernd Raffelhuschen, of Albert-Lundwigs-Universität in Freiburg, Germany, "Generational Accounting Around the Globe," outlines the challenge Italy faces. To maintain the current level of pension benefits for this approaching demographic profile, Italy must cut government expenditures by 49 percent immediately, or raise income taxes 28 percent immediately. Of course, these are not palatable solutions; not surprisingly, the Italian government has yet to take either of these routes.

Faced with such demographic pressures and global competition, what can Italy expect? Mr. Berlusconi plans to stimulate the economy with a major tax cut. Under his plan, personal and corporate taxes would not exceed 33 percent of national income. This, he believes, would stimulate the economy in two ways — macroeconomically, by encouraging consumption and employment, and microeconomically, by fostering investment, productivity, and competitiveness.

To balance the loss of tax revenue, Mr. Berlusconi is committed to reforming the state by modernizing public administration, eliminating excessive laws, deregulating the economy, pushing privatization even further, reforming pensions by raising the retirement age, and making labor markets more flexible.

Many doubt Mr. Berlusconi's ability to pass these proposals given the political environment, and their workability if they're adopted. "Mr. Berlusconi will never be able to do what Margaret Thatcher did because he won't have the support," says economist Marco Spinedi of Nomisma, an Italian research institution. Mr. Berlusconi's political rival Romano Prodi agrees. A tax cut as large as Mr. Berlusconi's "will run huge deficits, which is not possible given the limits imposed by the EU's Stability and Growth Act," Mr. Prodi says. His analysis is supported by the fiscal impact of the tax cuts made by the Amato government in the spring of 2000. The *Economist* is already projecting that Italy will miss its deficit reduction targets for 2001 and 2002. Mr. Prodi adds, "There is a difference between a 'virtuous circle,' [which Mr. Prodi believes he started] and 'making miracles,' which Mr. Berlusconi has proposed."

### Italy's Future

As Western economies began integrating, essentially after the first oil shock, Italy did not adjust to the emerging, partially unified market in Europe. This became obvious in the early 1990s when the Single European Act integrated continental Europe, north of the Alps. While northern Europe struggled to grow and reduce inflation, Italy continued to wallow in deficits, inflation, and debt. Together, the Mani Pulite investigation and the Maastricht Treaty gave Italy a final push to adjust — and it did begin to adjust by strengthening its macroeconomy, at least. Between 1992 and 1999, Italy dramatically improved the economic indicators required by the Maastrich Treaty for EU membership.

But the second stage of competitive adjustment — retooling Italy's microeconomy into a modern, competitive, and profitable growth machine — has only recently begun. Institutional rigidities have slowed the nation's involvement in the digital economy. A creaky infrastructure has hampered the development of e-commerce, while a state-owned, regulated banking system has stymied the venture-capital markets that could nurture digital entrepreneurs.

The microeconomic adjustment continues to be impeded by political instability, a problem that will confront the new prime minister. Mr. Berlusconi leads a fragile coalition of fractious parties. If he wins, that fragility could be a particular challenge as he tackles issues associated with European integration.

The processes of integration and globalization are now moving quite rapidly, so the new government must act swiftly lest Italy fall further behind. The United States and the United Kingdom lead in creating open and efficient markets (especially financial markets), with Germany moving rapidly to adjust. However, the process is proving tougher elsewhere; for example, Japan's failure to make the necessary institutional changes has produced stagnation even worse than Italy's.

Conflicts between the north and south also fester. Although economic recovery by 1998 eased unemployment in the north-central regions, unemployment in the south was nearly 23 percent, and more than 30 percent for women. Organized crime, while weakened by resolute government actions, remains a burden on the south. Groups in the north continue to advocate greater regional autonomy.

Finally, the demographic crisis described by Mr. Dornbusch complicates the challenge of becoming more competitive; this is a crisis that demands immediate attention if Italy is to avoid burdening its youth with untenable financial obligations or greatly reducing benefits for the elderly in a decade or two. Yet the options for attacking this crisis are unpalatable.

To this observer, the problems are daunting, and Italy lacks the political system or the social consensus necessary to embrace the needed reforms. On the other hand, the country possesses an impressive economic dynamism — seen in telecommunications technology, mobility, hard work, commitment to product quality, price competitiveness, and global sales.

The next prime minister will have to convince Italians that the benefits of full European integration will require major cultural and structural changes. "If we do not pursue a policy of liberalism," says Mr. Berlusconi, "we run the risk that the policy will remain behind with respect to the advancement of globalization and the technological revolution, and even that the policy will begin to oppose them."

Despite the long-term benefits, adoption of an American-style economic model will prove difficult in a nation so culturally different from the United States as Italy. And adoption of even part of a liberal agenda will be impossible without strong, widespread public support. The new social values will take root only if the leadership avoids short-run dislocations and sustains a supportive political coalition.

Perhaps an earlier generation of Romans had the best perspective on the task ahead: *Ad astra per aspera* — "To the stars through difficulties."+

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