

*Navigating
Economic
Change*

THE
ECONOMY 2030
INQUIRY

Lessons from Italy's economic decline

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November 2022



*Navigating Economic Change
Lessons from abroad and history*

Navigating Economic Change

As the UK is buffeted by the economic shocks and challenges of the 2020s, The Economy 2030 Inquiry, a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics (LSE), funded by the Nuffield Foundation, is publishing a series of essays examining how policy makers from a range of advanced economies, including the UK in the recent past, have managed periods of disruptive economic change. As we seek to reformulate the UK's economic strategy for new times it is vital that we learn the lessons of these comparative and historic perspectives.

Some consider the trajectory of a national economy following a major shock – for instance, Germany after unification, New Zealand after the UK joined the European Community, Estonia post-USSR and the UK during the tumultuous 1980s. Others examine the experience of particular cities – for instance a group of post-industrial 'turn-around cities' - or the adjustment of key features of a national economic system, such as Danish 'flexicurity'. Together they offer a powerful and timely set of insights on the successes and failures of economic policy makers in the face of economic shocks and structural change.

The essays are written by a range of leading economists and national experts and reflect the views of the authors rather than those of the Resolution Foundation, the LSE or The Economy 2030 Inquiry.

They have been commissioned and edited by Gavin Kelly (Chair of the Resolution Foundation and member of the Economy 2030 steering group) and Richard Davies (Professor at University of Bristol and fellow at the LSE's Centre for Economic Performance).

The Economy 2030 Inquiry

The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

Lessons from Italy's economic decline¹

Summary

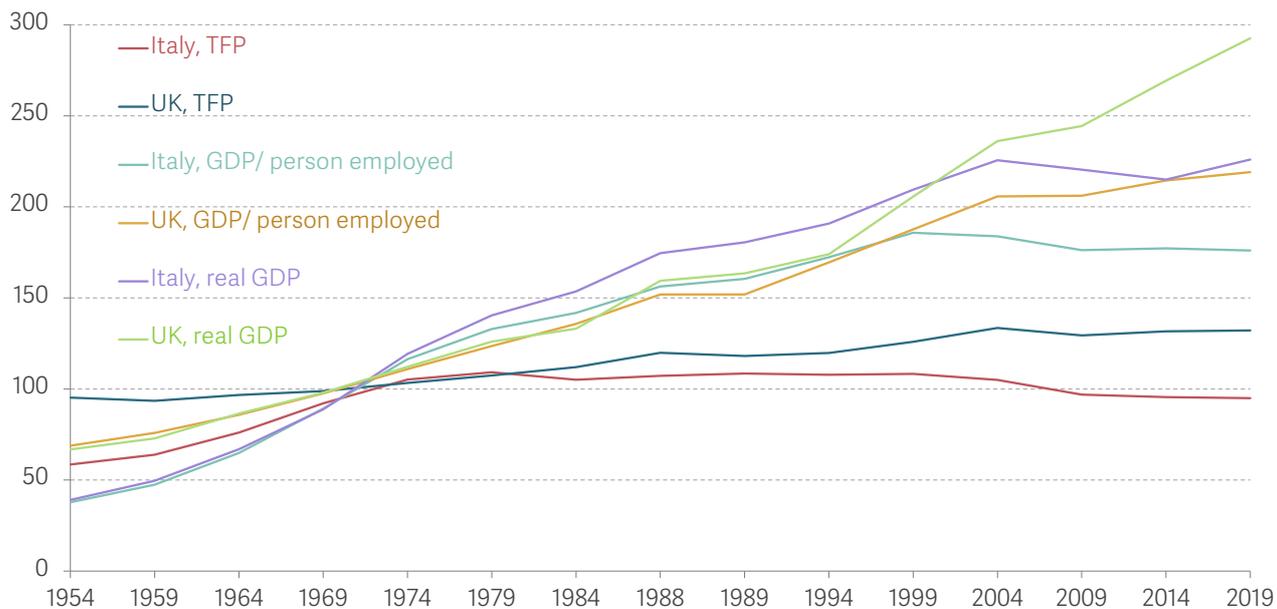
Italy has faced a series of economic crises in the past 50 years, many of them shared by the United Kingdom. There were inflation crises in the 1970s, public debt concerns in the 1980s and currency volatility in the 1990s. There were then four shocks in a row over the past fifteen years, i.e. the Global Financial Crisis (GFC), the sovereign debt crisis, the coronavirus pandemic and finally the inflation shock partly linked to the Russian invasion of Ukraine.

These crises were opportunities to reform Italy's economy. Yet, hopes have been repeatedly disappointed by the lack of policy delivery and as reforms were captured by lobbies and interest groups. This chapter first examines some stylised facts, then provides a short history of Italy's economic underperformance, before digging into the root of Italy's growth problems. Many factors are to blame: poor economic incentives, a large share of small and unproductive firms, a lack of domestic market competition, and policy capture. Some of Italy's traps may become future challenges for the UK economy.

Background: 50 years of decline

Italian productivity stalled 50 years ago, with total factor productivity (TFP) growth stalling in 1970 (Figure 1). TFP captures the growth in output that is not explained by changes in inputs—labour and capital—that are used in production. It reflects technological progress and innovation, as well as allocative efficiency. TFP is also related to the organisational efficiency of public institutions.

FIGURE 1: **Italy and the UK: TPF, real GDP and GDP per person employed (Index, 1970 = 100)**



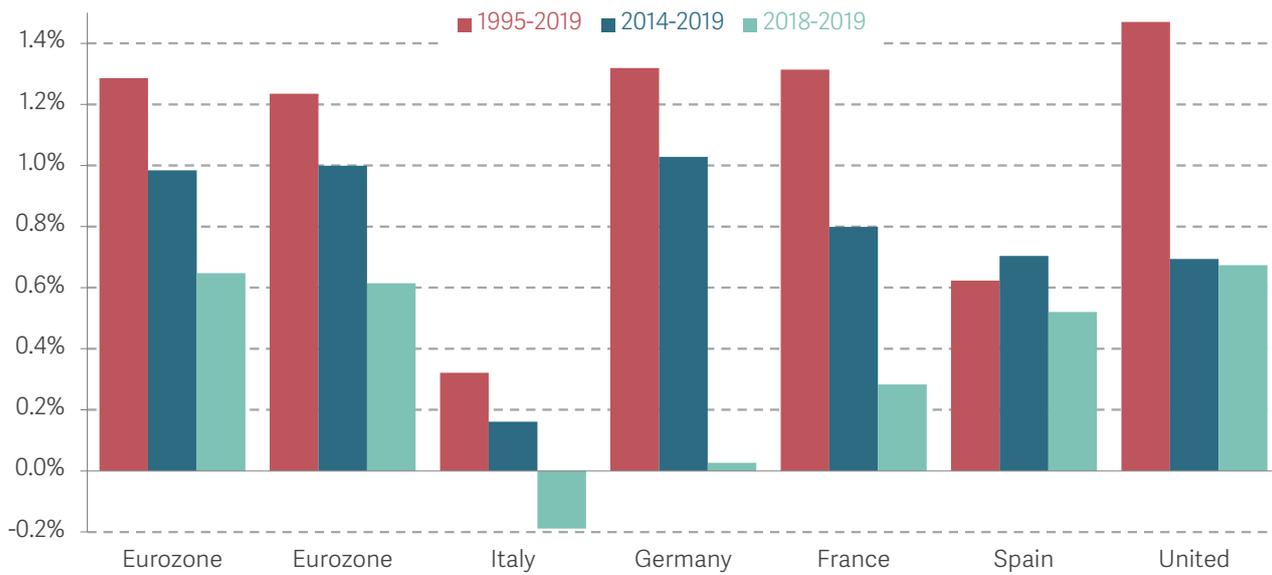
SOURCE: University of Groningen, Penn World Tables, authors' calculations.

¹ This essay draws on Chapter 2 of a forthcoming book on "Meritocracy, Growth & Lessons from Italy's Economic Decline. Lobbies (and Ideologies) Against Competition and Talent" by Lorenzo Codogno and Giampaolo Galli, Oxford University Press.

In the first three decades after WWII, Italy's TFP increased substantially, and by more than the UK's. This, the so-called 'Italian miracle', happened as Italy was catching up with more advanced countries. Starting in the 1970s TFP first stagnated and then declined. Between 1998 and 2019 it fell by a staggering 13.7 percentage points. It is as if Italy regressed in its ability to innovate, allocate resources, and organise factors of production. By contrast, TFP continued to rise in other major European countries over this period: by 15.3 percentage points in Germany, 7.6 percentage points in the UK and 4.1 percentage points in France.

Despite this TFP slowdown, GDP growth was in line with other countries in the 1970s and 1980s. Figure 1 shows a striking divergence between real GDP and TFP emerging in the 1970s, coinciding with a major oil shock in 1973. The increase in GDP was not based on innovation—this would have driven up TFP—but on short-term demand stimulus, in the form of deficit spending or currency devaluation. These were not sustainable policies and in the second half of the 1990s the expansion stalled. From 1995 to 2019, the cumulative gap in GDP growth was 32 percentage points compared with France, 24 vs Germany, almost 30 vs the average of the Eurozone, and 49 vs the United Kingdom. Similar trends can be seen when we look at the trend in labour productivity (Figure 2).

FIGURE 2: **Labour productivity in Italy, the Eurozone and the UK, average year-on-year change**



SOURCE: ISTAT, authors' calculations.

Italy's post-war economic performance can be summarised in various phases (Table 1). The first period—after WWII and until around 1974—is sometimes called the 'golden age' of the Italian economy: GDP expanded by more than 5.5 per cent per year, on average. In this period, the driving force of growth was imported innovation, as for other European countries. TFP grew at an average rate of almost 3 per cent in Italy.

TABLE 1: **The sources of growth of the Italian economy, 1955-2019**

Periods	Real GDP growth	Contribution of labour	Contribution of capital	Total factor productivity
1955-1974	5.58	0.14	2.51	2.93
1975-1995	2.37	0.71	1.48	0.18
1995-2019	0.68	0.51	0.67	-0.51
1955-2019	2.70	0.46	1.49	0.75

NOTES: Percentage changes; yearly average in periods. The first column containing real GDP growth equals the sum of the other three columns in the table.

SOURCE: University of Groningen, World Penn Table, author's calculations.

Until the mid-1990s GDP grew, but more slowly. However, the contribution of TFP was close to zero. Growth was driven mainly by capital: large flows of investment and a build-up of the capital stock occurred, partly due to the substitution of labour for capital. Behind this lay a labour market that had become rigid and inefficient.

Since 1995, GDP growth has been dismal, and the contribution of TFP has been negative. What changed was labour productivity, which ceased growing in the mid-1990s (Figure 1).² Growth of this measure in Italy was just 7 per cent—it was 29 per cent for Germany and 32 per cent for the UK. The Italian worker has fallen behind.

One hypothesis is that this could be driven by demographics: an ageing workforce, and more early retirement. The evidence does not support this view. For a start, the numbers of hours worked increased in line with Germany. This suggests that the low growth in GDP per person is not being driven by demographic changes: in particular, it does not depend on more elderly people being counted as 'capita' in GDP per capita, but no longer contributing to the productive effort of the nation. Neither does it depend on fewer working-age people actually working. The employment rate in Italy is low, but its percentage change since 1995 has been positive (10 per cent), more or less in line with France, Germany and the UK.

In fact, total employment has risen—by around 16 per cent in this period—primarily because of steadily rising female labour market participation. Finally, the labour force's median age (MEDAGE) is relatively high but no higher than in Germany. Therefore, the culprit is unlikely to be demographic change. It is stalling productivity that is driving the divergence.

² Additional comparative data are in Table 2. Since 1995, Italy's GDP (column 7) and GDP per capita (column 1) have grown by 15 per cent and 9 per cent, respectively, the slowest pace among the selected countries.

TABLE 2: **GDP per capita and its components in selected countries**

Index: 1995=100	GDP/POP	GDP/TH	TH/ POP	TH/ EMP	EMP/POP	POP	GDP	EMP	TH	MEDAGE
Italy	109	107	102	93	110	106	115	116	108	44
France	130	130	100	94	107	113	147	121	113	42
Germany	135	129	104	91	115	103	139	118	107	44
UK	141	132	107	97	110	117	164	128	124	41

NOTES: GDP= real GDP national accounts; POP=population; TH= total hours worked; EMP= employment; MEDAGE= Median age of the working force (average 2010-2019).

SOURCE: Penn World Tables; ILO.

Unsustainable growth – the political-economic doom loop

The Italian anomaly did not start in the 1990s, as is often believed. It began in the 1970s. But while TFP ceased to grow in the 1970s, the gap between Italy and other advanced countries in terms of GDP took more time to appear. Growth was propped up through continuous currency depreciation, public investment and subsidies, and both public and private consumption. The result was high inflation, price-wage spirals, and high fiscal and current-account deficits. The corporate sector experienced a creeping nationalisation and zombie firms began to emerge.³

In April 1974, Italy had to borrow from the International Monetary Fund (IMF) and was forced to pursue a restrictive monetary policy as part of the terms.⁴ It then begged for lines of credit from foreign entities, including the UK. Overall in the 1970s, the cumulated inflation was 230 per cent and the Deutsche mark appreciated against the Italian lira by 174 per cent. A misguided agreement on wage indexation made in 1975 between social partners was one of the key factors behind these dramatic inflation developments.

In Italy crises often lead to emergency coalition governments. This was the case in July 1976, when a 'national solidarity government' was formed opening a window of opportunity for Italy's parties to work together for the benefit of the country. In the 1980s, significant efforts were made to reduce inflation: these included the 'divorce' between the Treasury and the Bank of Italy and attempts to reduce the stringency of the wage indexation mechanism.

Inflation did fall, but the depreciations continued. Italy's debt-to-GDP ratio rose sharply as public spending was used to 'buy social peace'. Overall, the debt-to-GDP ratio rose from almost 56 per cent in 1980 to over 94 per cent in 1990. Inflation was still at 6.6 per cent at the end of 1990. Italy had the highest inflation and the highest debt in Europe.

By the 1990s concern turned to the lira. In September 1992, the combination of lost competitiveness and high debt caused a capital flight and made it impossible to maintain the lira inside the system of fixed-exchange rates (ERM) of which Italy was a member. This represented another window of opportunity: all political parties agreed to lower the deficit and reform the wage indexation mechanism. Another emergency government—led by the governor of the Bank of Italy, Carlo Azeglio

³ For a good account of Italy's economic history, see G Toniolo (ed.), *The Oxford Handbook of the Italian Economy since Unification*, Oxford University Press, 2013.

⁴ The UK shared a similarly unpleasant experience in 1976. For an interesting account see R Roberts, *When Britain Went Bust, The 1976 IMF Crisis*, OMFIF Press, 2016, and the IMF rescue plan.

Ciampi—was formed.⁵ This raised hopes and achieved some results, substituting the old backward-looking wage indexation mechanism with a forward-looking system based on targeted inflation.

Since the mid-1990s currency crisis, the 'Italian disease'—low productivity, an unsustainable growth model, and political instability—became increasingly evident. In 1995, another former central banker, Lamberto Dini, was called on to become Prime Minister following the collapse of the first Berlusconi government. The Dini government achieved important results in stabilising the lira's value and starting to reform an unsustainable pension system. The steps taken by Ciampi and Dini were crucial, but were not sufficient to address Italy's deep-rooted structural issues.

Growth stalled from the mid-1990s. Rent-seeking had come to dominate the economy and there was little reward for merit. The labour market remained rigid. The new century brought new challenges. With the entry of Italy into the Eurozone monetary union, interest rates converged towards German levels. Structural issues became even more apparent when China entered the World Trade Organization (WTO), globalisation deepened and significant technological advances left Italy on the side-lines.

Two major—and connected—policy mistakes played a role. The first was a wage increase incompatible with the new monetary regime. The European Central Bank (ECB) had the mandate to keep inflation low. Neither the government nor trades unions—or companies—fully understood the implications of the new system. Wage growth was moderate but still high relative to stalled productivity—this caused a dramatic loss in price competitiveness versus Germany and most other European countries.

The second mistake was equally crucial. The inheritance of a large primary surplus accumulated by Prodi and Ciampi in the run-up to the single currency was squandered by subsequent governments. The primary surplus was over 6 per cent per cent in 1997 and fell almost to zero by 2005. As the cost of servicing debt stood at 9 per cent of GDP in 1997 (although it declined to below 5 per cent by 2005), and nominal GDP had started to slow, maintaining a large primary surplus was essential to preserve debt sustainability.

The 2008-2009 GFC was particularly damaging for Italy. Global trade saw an unprecedented collapse, hitting Italian exporters. An expansionary fiscal policy was adopted to support economic activity, in line with most other countries. However, Italy's fiscal position was weak, and in 2011 the country found itself fully immersed in the European sovereign debt crisis.

By comparison, the UK engaged in more supply side reform during this period. This ran through Margaret Thatcher's policies, continued under John Major and then took a new form with the Labour governments that followed. Efforts to change the supply side of the economy gradually bore fruit. Sterling went through a major devaluation in 1992, at the same time as the Italian lira. Yet the UK economy managed to recover more quickly, courtesy of enhanced flexibility.

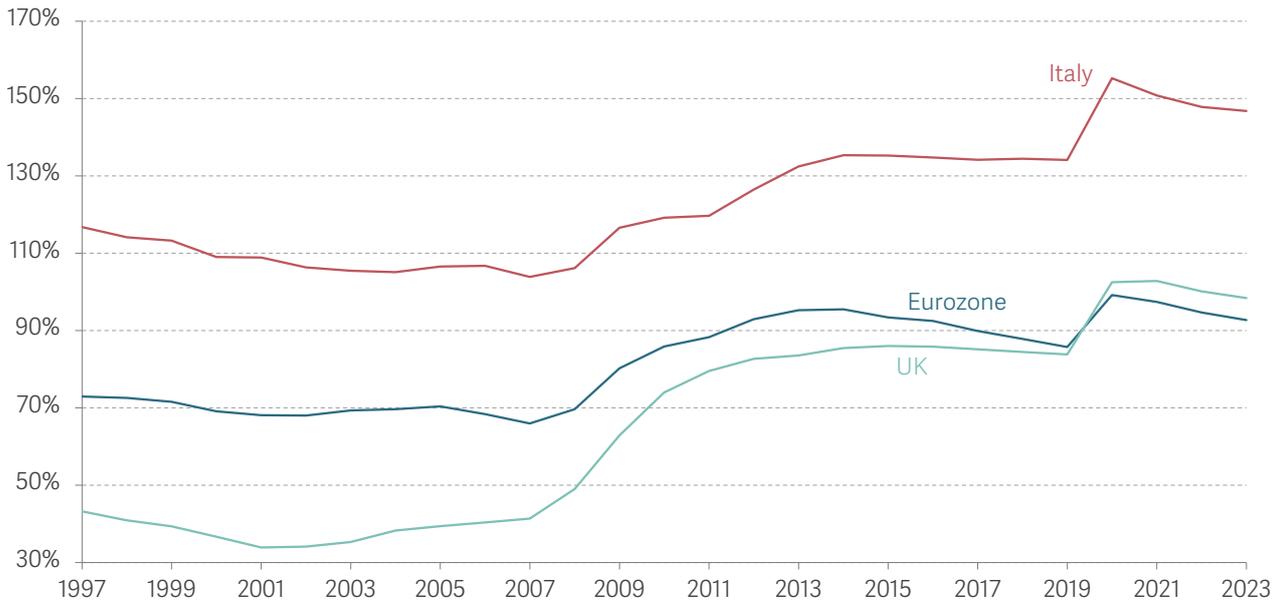
The Global Financial Crisis

The GFC crisis hit the two countries in 2008-2009. The UK was more exposed to the near-term impact due to its oversized financial services sector. Yet Italy was more vulnerable in the longer run, as the financial turmoil eventually led to a Eurozone-specific sovereign debt crisis in 2010-2011. With more underlying fragility and still-underdeveloped policy tools within the Eurozone to combat the crisis,

⁵ The crisis was due to scandals linked to illegal financing of political parties.

the impact on so-called peripheral countries (such as Italy) was sizeable. By 2014, the Eurozone economy was still 0.2 percentage points below its 2007 real GDP levels, while the UK economy was 5.4 percentage points above and the US was 8.2 percentage points above. There was considerable variation within the Eurozone, with real GDP levels rising by 6.3 percentage points for Germany and 3.3 percentage points for France, but falling by 6.5 percentage points for Spain and 8.5 percentage points for Italy.

FIGURE 3: **Debt to GDP ratios in Italy, the Eurozone and the UK**



SOURCE: European Commission, Refinitiv (Datastream), Commission forecasts for 2022-23, authors' calculations.

Italy's fiscal consolidation undertaken in 2011-2012 is still a controversial topic. According to many observers, fiscal tightening caused a deep recession in 2012, with GDP falling by 3 per cent. It also resulted in a substantial rise in the debt ratio from 104 in 2007 to over 135 per cent in 2014. This was called the 'doom loop'—the self-reinforcing negative feedback between Italy's fragile fiscal and financial positions. The 10-year government bond yield spread shot up from about 150 basis points in early 2011, to 300 points in the summer, and above 550 points in late 2011. As a result, bank loan growth declined rapidly and then turned negative in the final part of 2011 and 2012. The credit crunch deepened Italy's recession.

At the time it felt like there was no alternative to fiscal consolidation. Absent austerity measures, Italy could have ended up like Greece, losing access to financial markets. Nor could much support be expected from the rest of the Eurozone or the ECB due to weakness in the Eurozone financial architecture and the prevailing view that Italy's problems were essentially self-inflicted. Indeed, only

after Italy pursued fiscal consolidation was the ECB, with the backing of the European Council, willing to announce that it would have done 'whatever it takes' to save the euro and thus Italy in 2012.

The crisis caused considerable suffering and, again, led to major political change. By the fourth quarter of 2013, GDP was a remarkable 9.5 percentage points lower than in the first quarter of 2008. This is one of the reasons for the Five Star Movement's success in the political elections held in February 2013. It was also one of the main reasons why the governments in the 2013–2018 legislature were all very cautious about public finance consolidation.⁶

Between 2014 and 2016, the government, led by Matteo Renzi, tried to implement important reforms in many different fields: education, banking, and the labour market. It had mixed results, and Renzi's term in office ended prematurely after he proposed to change the constitution in 2015, with the aim of improving political stability and policymaking. However, this attempt was defeated in a referendum held in 2016, after which Renzi had to resign. It was another missed opportunity.⁷

Populist parties have thrived in the aftermath of these crises. In March 2018, two leading groups, the Five Star Movement and the League, won the general elections. They cut the retirement age and added fiscal pressure via a new basic income subsidy. Luckily, this coalition did not manage to break from the euro, block inward migration or introduce any of the other radical proposals of the two parties' electoral platforms. With Italy's high debt levels, the new rulers quickly came to terms with the need to deal cautiously with financial markets. In August 2019, that government came to an end as Matteo Salvini, the League's leader, withdrew his support. Yet, this troubled period left behind economic damage.

As Covid-19 hit Italy, the country faced health and economic emergencies. In 2020, the pandemic caused a 9 per cent fall in GDP, forcing the government to approve 108 billion in support measures (6.5 per cent of GDP). Public debt surged from 134 per cent of GDP in 2019 to over 155 per cent in 2020.

Once again, an emergency government was formed. In January 2021, the government lost its majority and Italy's President asked Mario Draghi, the former head of the ECB, to form a 'high-profile government' to tackle the health, economic, and social crises related to the pandemic. The Draghi government included a range of politicians and independent technocrats, and was supported by a large majority in parliament, including the Five Star Movement, the League, Forza Italia (Berlusconi's party), the Democratic Party, the centrist Italia Viva (Matteo Renzi's start-up), and a far-left party called Article One.

Root causes

What does this history tell us about the root causes of Italian stagnation? What explains low growth? And why did a relatively thriving and affluent European economy fall so far behind its peers?

Italy's productivity dynamics differ substantially by region and sector. Since 2010, there have been efficiency improvements within the manufacturing sector, but not in the non-financial services sector.

⁶ These government were led by (led by Enrico Letta in 2013, Matteo Renzi until 2016, and Paolo Gentiloni until 2018) and followed what Finance Minister Pier Carlo Padoan labelled 'the narrow path', meaning consolidation had to be done gradually to avoid damaging the economy. See P Padoan, *Il Sentiero Stretto ... e Oltre* {The Narrow Path... and Beyond}. il Mulino, 2019.

⁷ Another constitutional reform, with the stated aim of reducing political instability, had also been attempted by the Berlusconi government and was defeated in a popular referendum in 2006.

The heterogeneity within each industry is even greater than that between industries, with productivity differences depending on companies' size, market orientation and geographical region.

Small firms form a vital part of Italian industry. In terms of GDP and employment, the backbone of Italy's economy is a large number of small and micro-enterprises. Historically, they were perceived as an asset due to the flexibility and effectiveness of the so-called 'economic district' model, but soon they demonstrated their drawbacks.

In terms of business demographics, Italy is polarised. Micro and small enterprises are generally old, rarely innovate, they are less inclined to adopt technological change, and are not involved in international markets. Many firms show poor managerial capacity and a weak financial structure. This is why these companies suffered enormously from globalisation and the credit crunch that followed the sovereign debt crisis. Empirical studies show that Italian micro-companies are, on average, less productive and dynamic than similar-size European counterparts.

Medium and large enterprises (MLEs) are less affected by these problems. In particular, the performance of a smaller set of medium- and large-size manufacturing companies is comparable to, if not better than, their most successful European competitors. They innovate, are technologically advanced, and show a strong attitude towards exporting. They have also opened up their capital structure and are well managed, despite all the headwinds and difficulties of the Italian business environment.

As a result, MLEs strong productivity supports Italy's growth. However, their average size and share in value-added is comparatively smaller than in other countries. The labour and TFP productivity gap of micro-firms relative to large firms has widened from 55 per cent to almost 65 per cent over 2000-2015. Thus, an unfavourable composition effect—too many SMEs, and too few MLEs—explains a large part of Italy's productivity problems. These trends are particularly strong in construction and professional services.

Why, then, are Italy's strong performing companies not able to grow? One view is that managers in continental Europe are under intense pressure to stabilise employment and forego projects that would be profit-maximising but add risk.⁸ They also tend to deplete capital instead of downsizing when facing falling demand. In essence, managers are considered successful when they respond to public opinion and political pressures: increase employment and never decrease it, undertake new investment and never shrink or reallocate, pursue wider social goals. And these pressures are particularly acute after a major crisis.

This tendency – to respond to public and political pressures - is compounded in Italy because of general hostility towards large companies. The public perception is that big businesses exploit workers, damage the environment and evade taxes. However, the opposite is more typically true: working conditions are better, and more attention is paid to environmental standards in large companies than small ones. As for taxes, the bulk of tax evasion in Italy comes from very small companies. A company above a certain 'visibility threshold' receives attention from public opinion, the media, environmental campaigners, and from tax authorities and magistrates. By contrast, small

⁸ J M Roe, Political determinants of corporate governance, Harvard Law School Discussion Paper, no. 451, 2003.

companies can get away with a degree of tax evasion and only partial respect for the environment, worker rights and irregular workers. Moreover, these are also structural reasons why merit is not highly considered even in the corporate world.⁹

Italy's innovation and technology gap versus countries at the frontier is a crucial determinant of its poor performance over several years. It is partly based on underinvestment: Italy's net capital stock growth has been at the bottom of the league table for advanced economies over the past decade. Since the 2008-2009 crisis, public and private investment has fallen, and the capital stock has also shrunk (Figure 4).

FIGURE 4: **Net capital stock growth**



SOURCE: Refinitiv (Datastream), AMECO European Commission, authors' calculations.

Italy also under-invests in human capital.¹⁰ This creates a Catch-22 problem: companies find it challenging to find qualified workers, but the return on education has remained low as rigidities in the labour market prevent companies from rewarding merit and productivity. Thus, there is reduced incentive for Italian workers to build their own human capital through higher education and vocational training. This shortfall of human capital in the private sector is a drag on growth. In the public sector, a large body of research suggests human capital deficiencies can impede a country's development.¹¹

In Italy, merit is disregarded in many fields of society. The egalitarian anti-meritocratic ideology that has prevailed in Italy—especially since the 1970s—has produced the opposite of equal opportunities. Merit is not adequately rewarded and has been impeded. For instance, national labour contracts fix wages for large groups of workers meaning that reforms to introduce evaluation and merit in public institutions have failed.

⁹ See L Codogno & G Galli, *Meritocracy, Growth, and Lessons from Italy's Economic Decline Lobbies (and Ideologies) Against Competition and Talent*, Oxford University Press, 2022.

¹⁰ See E Phelps, *Mass Flourishing*, Princeton University Press, 2015. Also, F Schivardi & Roberto Torrini, *Cambiamenti strutturali e capitale umano nel sistema produttivo italiano* {Structural changes and human capital in the Italian productive system}, Bank of Italy Occasional Papers, no. 108, 2011.

¹¹ See the landmark book of Daron Acemoglu and Robinson A. James. 2012. "Why Nations Fail: The Origins of Power, Prosperity, and Poverty", New York: Crown Publishers.

At the same time, many firms are managed by founding families. Even when they cede direct control, family owners tend to prefer faith over qualifications when selecting managers. Evidence suggests that this leads to weak management practices, inefficiency and a lower rate of innovation and exporting. The fact that seniority is so often based on family ties rather than merit disincentivises investment in education.

The structure of finance holds back Italy's economy. Italian firms are more reliant on banks than businesses in other advanced economies. A lack of alternative forms of finance, such as venture capital and private equity, means start-ups and innovative firms can struggle to raise funds. Capital markets are underdeveloped. Insolvency procedures, poor enforcement of the rule of law, and the inefficiency of civil justice all hold back productivity and innovation. The result is that measures of business dynamism—the rate at which firms are founded, grow and decline—are concerning in Italy. The enterprise churn rate has steadily declined across manufacturing and services sectors. The rate of entry has shown a widespread decrease since 2008.

These factors—underinvestment in capital of all types, incentive problems, and financial frictions—explain why Italy found it hard to switch from growth based on innovation, to the innovation that is needed when a country is at the technological frontier. From the 1970s onward the country could no longer grow by imitation; it faced greater international competition due to China's WTO entry, the enlarged EU, and the creation of the euro. By the 1990s it became clear that Italy could no longer rely on the short-term demand stimulus that currency devaluation and public spending had provided. Italy has found itself in a semi-permanent state of crisis ever since. By contrast, countries that have prioritised research, innovation and good governance, including South Korea, have successfully transitioned from imitation-led growth to innovation-based growth.¹²

Italy's growth and then decline has been accompanied by flagging prosperity (Table 3).¹³ The Legatum Institute's Prosperity Index covers many measures, including social capital, governance, and education, providing a broader lens on a country's economy and society.¹⁴ These indicators provide additional evidence on why Italy essentially stopped growing in the past quarter of a century.

¹² Phelps et al., have thoroughly analysed and made compelling the core technical argument, see Phelps et al., *Dynamism*, Cambridge, MA: Harvard University Press, 2020. They show that in the three decades after WWII, most European countries grew by imitation, i.e. importing technological innovation from the USA. The USA was, and still is, the world's technological leader. In this context, Italy did not stand out as a major centre of what they call 'indigenous innovation', i.e. innovation produced within the country. Still, it managed to adopt American innovation quickly. In the succeeding four decades, productivity growth fell almost anywhere, including Germany, France, and the UK, but Italy's decline was particularly severe. Italy failed in substituting imported with indigenous innovation.

¹³ Legatum Institute, [The Legatum Prosperity Index Methodology Report](#), November 2021.

¹⁴ It has a vast number of indicators (294 in the 2020 edition) taken from all the best available sources. It has about seventy different sources, although most indicators are taken from international organisations such as the United Nations (and its satellite entities Unicef, Unhcr, Unctad), the World Bank, the IMF, and others. In addition, survey evidence, typically when hard data are not available, is taken from the international Gallup Polls, some of which are produced for various United Nations Reports and the WEF's Competitiveness Report.

TABLE 3: Ranking of Italy and the UK relative to the 34 advanced countries

Pillar	Italy	UK	Top Country
Social Capital	25	10	Denmark
Economic Quality*	32	15	Switzerland
Natural Environment	27	21	Sweden
Investment Environment	32	6	Singapore
Governance	33	12	Finland
Education	30	15	Singapore
Enterprise Conditions	26	11	Singapore
Living Conditions	28	10	Denmark
Market Access & Infrastructure	21	6	Singapore
Personal Freedom	21	17	Norway
Safety and Security	20	18	Switzerland
Health	9	22	Singapore
Overall ranking	26	11	Denmark

NOTES: summarises the main headings (called 'pillars' in the Prosperity Index), but it focuses only on 34 advanced countries instead of the whole sample of 167. The ranking is perhaps more meaningful since it compares countries similar to Italy or the UK. Italy's position is relatively low in the entire set of 167 countries considered in the index and close to the bottom in the 34 advanced nation group.

SOURCE: Legatum Institute, and authors' calculations.

Before the pandemic struck, Italy ranked 31st in this prosperity index, while the UK was 13th. Denmark, Norway, and Switzerland were the top three countries, with the United States in 18th position.¹⁵ Over time Italy has rarely been in the top-30—with most advanced countries and some emerging ones ranked better. Moreover, this performance has not changed much over the past thirteen years since the index's inception—most problems are longstanding. The UK is much better positioned in this regard, but with scope for improvement.

Reasons for optimism and policy lessons

There are, however, recent chinks of light amid this gloom. There is some evidence of industrial strength, with several hundred 'small multinationals' that show productivity growth far above the rest of the economy. Exporters have done well: in the last decade, Italy has been one of the few advanced countries that have managed to maintain its export share in world trade despite the rising role of China and other emerging economies. Studies show that exporters adopt good management practices and reward merit. The private sector has a high saving rate and low debt. These factors have contributed to an improvement in Italy's current account surplus. As a result, the net financial position of the country has reached balance after having been negative for many years.¹⁶

¹⁵ Italy's ranking in the Prosperity Index is not very different from those indicated by the World Bank, the UN Human Development Report, or the WEF.

¹⁶ Recently, a current account deficit has emerged due to sharp rises in the price of imported energy.

These signs point to potential. To realise it policymakers should address Italy's structural weaknesses: its rigid and inefficient business environment that dulls business dynamism and target its human capital shortfall by enhancing skills in the workforce. The shortfall in human capital investment is closely intertwined with a lack of meritocracy and the misguided incentive structure in the economy.

A kind of "zombie congestion" is pervasive. A lack of business dynamism prevents resources from being funnelled to more productive firms, especially new ones. The existence of inefficient incumbents is a hurdle for the economy's allocative efficiency and creative destruction process. Steps to improve the allocation of capital and labour towards the most productive firms are needed. Newly established firms need to be able to grow or exit early. Inefficient firms too, should be wound down, freeing up valuable resources.¹⁷

Political instability has played a role too. Italy has suffered a negative loop in which economic problems have led to policy instability and in turn undermined economic reforms needed to improve the economy. Reforms have been rolled back rather than accelerated. Here the signs are concerning: many political parties are still in denial about Italy's deep-rooted issues. This does not bode well for the future.

In this way, Italy's struggles are a warning sign for Britain. While the UK's performance has been comparatively strong, there are deep concerns over productivity and business dynamism. Moreover, the post-Brexit economy will require efforts to improve the underlying supply-side drivers of economic growth. Politically, the UK faces similar risks of denial and lack of reform that have deepened Italy's problems in the past.

¹⁷ M Bugamelli & F Lotti (eds), Productivity growth in Italy: a tale of a slow-motion change, *Questioni di economia e finanza*, Bank of Italy, no. 422, 2018.

Navigating economic change: lessons from abroad and history

As the UK is buffeted by the economic shocks and challenges of the 2020s, The Economy 2030 Inquiry, a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics (LSE), funded by the Nuffield Foundation, is publishing a series of essays examining how policy makers from a range of advanced economies, including the UK in the recent past, have managed periods of disruptive economic change. As we seek to reformulate the UK's economic strategy for new times it is vital that we learn the lessons of these comparative and historic perspectives.

Some consider the trajectory of a national economy following a major shock – for instance, Germany after unification, New Zealand after the UK joined the European Community, Estonia post-USSR and the UK during the tumultuous 1980s. Others examine the experience of particular cities – for instance a group of post-industrial 'turn-around cities' - or the adjustment of key features of a national economic system, such as Danish 'flexicurity'. Together they offer a powerful and timely set of insights on the successes and failures of economic policy makers in the face of economic shocks and structural change.

The essays are written by a range of leading economists and national experts and reflect the views of the authors rather than those of the Resolution Foundation, the LSE or The Economy 2030 Inquiry.

They have been commissioned and edited by Gavin Kelly (Chair of the Resolution Foundation and member of the Economy 2030 steering group) and Richard Davies (Professor at University of Bristol and fellow at the LSE's Centre for Economic Performance).