Flexibility, Job Creation and Globalization: The Case of Italy

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1. Introduction

The Italian economy lacks robustness and vitality. It is losing ground in the international economic race. Unemployment is high, employment growth is low, and its competitive position in world trade is weak in areas of high technology, such as computers, communication technology, and biotechnology.

Italy's poor competitive position in high technology is a symptom of two interrelated factors. First, weak incentives to invest in skill (human capital) and venture capital, produced by the current level of regulation, taxation and bureaucratization. Second, the inability of the Italian system to respond to change rapidly. The new economy of the twenty-first century is characterized by variability and the need for flexible responses. This variability creates opportunity, but only for those able to respond quickly and with efficiency. It creates a demand for highly skilled labor and venture capital to respond to the new opportunities. The social system in Italy impedes rapid responses and hence thwarts the Italian economy from making use of the opportunities created by the new economy.

To understand the problems that beset the Italian economy and the possible solution to these problems, it is important to understand the causes of these problems more clearly and to distinguish the short-run from the long-run problems. In my view, it is the incentives in place that have long run consequences that are the most worrisome because they affect the way Italy will perform in the next generation. Large growth rates produce large wealth levels for future generations while low growth rates produce low wealth levels. Italians should be worried about these rates, although most political discussions focus only on the short run targets.

One immediate problem facing Italy and much of Europe is that of high unemployment rates although recently this problem has begun to lessen. European and Italian unemployment has increased to extraordinarily high levels over the past 20 years. Something has changed and that something is not specific to Italy, but is common to many countries in Europe. Understanding that common factor, or set of factors, is the topic of a lot of recent research in economics.

Despite appearances to the contrary, there is more agreement among economists than might first meet the eye. Contrary to public perception, professional economists who study European unemployment and the Italian economy agree on the basic forces underlying the high persistent unemployment in Italy and much of Europe.

There is a substantial body of empirical evidence pointing to the fact that incentives matter and that firms, individuals, and nations respond to them. Disincentives imposed on firms such as minimum wages, union-imposed wage floors, or entry regulations have substantial effects especially when the minimums are binding. Studies from France, Latin America and Puerto Rico, where minimum wages are often a substantial fraction of average wages, have shown substantial disemployment effects of wage floors. Yet in the public discussion of employment creation these disemployment effects are minimized or ignored entirely.

Incentives motivate economic life. It is important to understand how the modern welfare state affects these incentives in order to understand why welfare states perform the way they do.

When the American economy is compared to the Italian and other European economies, it is not hard to reach the conclusion that it is something about incentives in the regulatory welfare state that gives rise to the differential performance of these two types of economies. This paper is about those incentives, how they affect economic performance, and how incentives might be changed to improve that performance. I want to consider the economic consequences of these incentives in both the short and the long run. Elections are won on short-term performance, so politicians focus on short-run problems. However, as a detached scholar, I want to direct attention to the long-run issues: Nations prosper or founder on their long-run performance.

I make four main points and present empirical evidence to back them up, using references listed at the end of the chapter.

1. The incentives in European and Italian welfare states distort resource allocation and impair efficiency. The best estimates of the welfare cost of government activity—what economists call deadweight burden—is 40% of each Euro raised by government activity, and some would place the cost even higher. These costs arise from the distortions in economic activity induced by the fiscal system. Much more than the direct cost of taxation is involved.

Centralized bargaining and regulation of business entry, banking practices, and employment all contribute to the burden. The levels of these disincentives are higher in Europe than in America, and this contributes to higher unemployment, lower employment growth, and a lower level of effort in the society. Such disincentive effects are much discussed in academic circles but they seem never to make their way into popular discussions of policy issues. The Italian system of Cassa Integrazione is especially inefficient relative to general European systems. It does not provide universal insurance for all workers like a properly functioning unemployment insurance might do. It only protects workers in larger firms that qualify. It is not a wage subsidy so it does not promote work or employment. It has the effect of protecting a few insiders in larger protected firms at the expense at the expense of revenues collected from workers at all firms. In addition to being unfair, it props up inefficient firms and plants of firms and reduces productivity.

The benefit of the current system is alleged to be the social insurance it provides. According to this argument, the efficiency cost of taxation and regulation is to be set against the benefit of greater equity and security (Agell, 1999). A closer look at how the system works in Italy and many other European countries shows that it produces security and even wage gains for protected insiders at the cost of inequity, job loss, and income losses for outsiders who are only partially protected by social insurance. Far from promoting social justice at the price of efficiency, it provides security for some at the cost of exclusion for others.

2. The inefficiency and distortions created by the modern welfare state cannot explain the growth in European and Italian unemployment over the past 20 years. The edifice of the welfare state was in place 30 years ago, and arguably the incentives then were less favorable employment at that time than they are now (Ljungquist and Sargent, 1998; Blanchard and Wolfers, 2000). A vast empirical literature over the past 25 years has documented the distortions created by the welfare state. Many European governments reduced the worst of those incentive features in response to this literature but typically only by modest amounts. The reforms in Europe and Italy only partly close the incentive gap with America.

What is it then that accounts for the rise in European unemployment? This is the second major topic of this paper. A growing body of evidence points to the fact that the world economy is more variable and less predictable today than it was 30 years ago when the modern European welfare state with its high levels of taxation and regulation was established. This variability is associated with the entry of many countries into world trade; with the creation of new financial markets and markets for goods; and with the explosion in technology, especially in computers, information technology, and biotechnology. This variability is associated with the onset of skill-biased technical change proceeding at an uneven and unpredictable pace that is still transforming the workplace and making traditional methods of production and management obsolete. Many empirical studies have shown that skill-biased technology is at work in advanced countries as well as Third World economies. These developments contribute to enormous increases in productivity in many industries and create new trading opportunities. At the same time, they lead to more variability and unpredictability in economic life. This variability is a source of wealth for those who can adapt to it. Figure 1 contrasts the distribution of outcomes in the less variable old economy with the distribution of outcomes in the new world economy.

The manifestations of the new variability are legion: rising wage inequality in markets favoring skilled workers in freely functioning labor markets, the large scale increase in merger activity, and patenting that occurred in the early 1980s at the time of the rising wage inequality and the growth in volatility in trade and in some financial markets. The world has become more open and more fluid and at the same time many traditional methods and organizations have become obsolete.

We live in an era of creative destruction. The new order grows out of the old by destroying the old ways of producing goods and trading. This is an era of greater risk and greater return. The modern welfare state even at its newly “reformed” level is maladapted to this new world economy because it discourages risk taking and efficient adaptation by providing “social insurance” like CIG and employment protection laws to preserve the status quo at precisely the time when many old economic practices are no longer productive. This explains why so many of the piecemeal reforms implemented in many welfare states around the world have apparently failed and have been associated with rising unemployment. These reforms would have promoted employment and reduced unemployment in a former era. In this modern era of change they do not go nearly far enough to make the reformed economies flexible enough to respond to the new and changing world economy. The world has been changing too fast for European politicians and policy makers keep up, and Europe will now have to run to keep in place.

An economic order that was well adapted to the more stable and predictable economic environment of the 1950s and 1960s has become dysfunctional in the late twentieth and early twenty-first centuries. The problem of unemployment in Italy is not due solely to the fact that the cost of labor is too high, although that is a problem (Bertola, 2000). It is also due to the inability of the economy to adapt to change and to exploit the opportunities and challenges of the new economy. The opportunity cost of security and preservation of the status quo—whether it is the status quo technology, the status quo trading partner, or the status quo job—has risen greatly in recent times.

3. The opening up of world trade and the increased competitiveness that flows from it means that now, more than ever before, uniformity in the prices of traded goods dictates labor market outcomes. Benefits given to workers are costs to firms and must be paid for in terms of lower wages or less employment. Something has to give in costs because market prices are set internationally and, increasingly, capital markets are uniform around the world. Thus nonwage mandates to workers nominally paid by firms must be borne by the workers themselves. Higher wages achieved by unions or by minimum wage statutes must lead to substitution against labor—fewer jobs—if firms are to remain competitive.

4. Hallmark features of the new economy are diversity, heterogeneity of opportunities, and value of local knowledge. One feature of the dynamics of the new order is that many idiosyncratic opportunities arise as potential trading partners and potential production partners seek each other out.

The old economics focused on stable technologies where broad aggregates such as capital and labor were assumed to be homogeneous. The economics of the modern era focuses on models of matching and sorting of heterogeneous individuals into trading and production units in the face of uncertainty about the suitability of any particular trading or production arrangement. This is a new model of the economy that features the unique and the relation specific. It is a model of marriage that emphasizes the value of partners that know each other in making the decisions to produce or trade and the value of divorce when circumstances change.

It is a model of the gains to trade among idiosyncratic individuals. The new model emphasizes the value of local knowledge and the benefit of exploiting local knowledge about particular possibilities and circumstances that are not widely known. The new economy emphasizes that one person's gain is not another person's loss and that economic efficiency is enhanced by allowing those equipped with local knowledge to act on it.

A striking example of the benefits of local knowledge is the reform of British unionism. When the locus of bargaining was shifted from the national and industry level to the firm level, the face of British unionism changed for the better (Pencavel, 2000). Firms and workers in Britain are now allowed to respond to the local opportunities and conditions that characterize their particular situation and can more freely adapt to those conditions than they could when national wage setting arrangements were in place. National or industry bargaining diverted the attention of workers away from the economic realities of their own productive situation and toward the redistributive possibilities that flow from the application of uniform rules across diverse industrial or national units. Not only does the implementation of local bargaining exploit local information and hence promote productivity but it also inhibits the application of monopoly and rent seeking that occurs when bargaining units become more expansive. Unionism per se is not a cause of inefficiency. Rather it is monopoly unionism using its power to redistribute resources and divert productive activity that leads to great harm.

In the case of Italy, national wage setting norms applied to the Mezzogiorno are a source of low employment in that region. There are strong parallels between the German experience with its East and Italian experience with its South. Rather than let wages adapt to local economic realities, and promote growth, current union policy stifles development of the region. At the same time, the chance of a higher wage in the South and the subsidies to housing reduce the incentives to migrate to the labor-starved North. A policy of uniformity suppresses the possibility of exploiting regional diversity for the benefit of all.

In addressing these issues, I distinguish between long- and short-run problems and separate long-run solutions from short-run solutions that may be of no value, or even harmful, in the long-run.

2. Italian Employment, Unemployment and Wages

The facts about Italian unemployment are well known. Unemployment is high and has been rising over the past 20 years (Bertola, 2001; Bean, 1994; Nickell, 1997). Lower than American employment 30 years ago, it is now much higher. See Figures 2, a and b, which compare OECD Europe with North American overall unemployment rates. Figure 3 charts the temporal evolution of the Italian unemployment rate, which has been in the middle of the OECD pack. Italian unemployment, like most European unemployment, is largely made up of individuals suffering long spells. The unemployed are essentially removed from the labor market (see Figure 4). American unemployment is typically of much shorter duration and is associated with people changing jobs as opportunities appear and dissolve.

The rise in the unemployment rate in Italy is not due to an increase in employment or labor force participation rates. Prime age male employment rates are similar in the United States and in much of the rest of Western Europe. Overall employment rates in Europe and especially Italy are lower, a topic to which I return later. Unemployment rates are very high among Italian youth (see Figure 5).

European unemployment is structural, not cyclical (Bertola, 2001) (see Figure 6). By this I mean that European—and Italian—employment is not amenable to the classical demand management policies of macroeconomics, although a few diehard Keynesians still push that line. The factors at work that produce higher levels of Italian unemployment are due to the economic fundamentals of incentives, technology, and labor supply.

When technology and opportunities become available, as they did in Eastern Europe or in Argentina when it opened its markets to the new economy, it is the younger, more-educated, and more-able workers who benefit from the transition and the older, less-able, and less-educated workers who suffer the most. In Argentina before the recent collapse, educated workers who would have been company presidents under the old regime were unemployed under the new one. The economic fundamentals suggest lower wages for such workers. A more humane social policy would pay them higher wages but subsidize firms for employing them. Economic policy must recognize the problem of the transition as an important feature of modern economies undergoing change.

The same forces are at work in all economies although in a less dramatic fashion. In the face of changes in technology and trading opportunities, it is the younger, the more educated, and the more able who benefit the most. The middle-aged and the older workers are at a disadvantage. Unless their wages adjust, they become unemployable.

This observation serves to explain why unemployment in Europe has increased across education and skill categories, especially among more experienced workers. As a consequence of rigidity in wages across the skill categories, these workers have become less employable. Economic policy should promote wage flexibility if it seeks to improve the employability of these workers. It should also reduce incentives to be unemployed from high-income replacement rates. Wage subsidies for the cohorts of workers caught up in the transition represent one option for improving their employment without reducing their standard of living (Snower, 1994; Phelps, 1997). Italians and other Europeans abhor the route of wage flexibility followed by the American economy, arguing that equity or social justice is as important, if not more important, than economic efficiency.

Recently, unemployment in Italy has begun to decline (see Figure 6B). This dramatic decline has been linked to the 1998 reforms. The use of temporary contracts has promoted employment, especially for marginal workers.

I do not want to argue that European values placed on equality are inappropriate. However, I cannot help but note that the popular emphasis on “equity” and “social justice” is usually made in a factual void about the true costs of redistribution, which groups are targeted for social justice and which groups are excluded. It is certainly true that there is less inequality in earnings among workers in Italy and Europe than in the United States and in other economies with less rigid markets (see Table 1). At the same time, it is important to recognize that these statistics exclude the long-term unemployed, who constitute more than half of the unemployed in Italy. Accordingly, comparisons of income inequality between the United States and Italy exclude people with zero earnings and bias the comparisons, although this does not eliminate the gap in U.S.-Italian inequality. The long-term unemployed and the long-term dropouts are excluded from the accounting system of "social justice." A recent study by Flinn (2002) compares the Italian labor market with the U.S. in terms of *lifetime* inequality. While at a point in time U.S. inequality is higher, over the lifetime of people, it is *lower*. There is greater mobility and opportunity in the U.S. economy. The rigidity of Italian labor markets pegs people for life. The recent wide scale introduction of short term contracts improves employment in the short run but creates a two-tier labor market and does not encourage the training or formation of skill among the short term employed. It promotes inequality in the long run and is not a substitute for genuine labor market reform.

Implicit in many popular discussions of income inequality is the belief that one person's gain is another person's loss, that is, that the economic problem is a matter of dividing a fixed pie. In fact, the welfare state, at the level it currently operates in Italy with its substantial tax wedge, reduces the total social pie by discouraging production. It makes the size of the pie for the next generation smaller than it would otherwise be by discouraging investment in skills, technology, and knowledge. It discourages venture capital by taxing the proceeds of good investments and by regulating capital markets.

Going back to Figure 1, we see that the welfare state reduces the dispersion of social outcomes by reducing the level of social outcomes. How sizable is the cost in lost output? This is the crucial empirical question that is never asked or answered in public discussions. How much of the rise in Italian unemployment and the slow growth in output is due to institutions of the welfare state?

3. The Causes of Joblessness

In order to answer the question of what causes joblessness, it is useful to review the sharp contrast in the institutional features of Italian (and European) labor and product markets with those of American and other less regulated markets. The familiar picture that emerges is that European markets are much more regulated, wage setting is much more centralized and less adaptable to local conditions, and the replacement rate (the percentage of earnings an unemployed worker can claim) is much higher in Europe than in the United States. This latter factor plays little role in Italy, however, although it is a major factor in explaining European unemployment. (See Figures 7, 8, and 9, respectively). The level of payroll taxation is substantially higher in Europe than in the United States (see Table 2). The tax wedge between what a firm pays per unit labor and what the worker receives is much greater in Europe than in the United States, and it is especially high in Italy.

A large body of evidence suggests that at the current levels of incentives, the Italian welfare state reduces employment, raises unemployment, retards flexibility and creates a two-tier system, with a protected enclave surrounded by a partially protected group of unskilled, uneducated, and marginal workers.

The high level of centralized wage bargaining thwarts the ability of workers and firms to act on local conditions and to bargain flexibly. Pencavel (1996) documents that the application of three principles—(1) decentralization of bargaining to the enterprise level; (2) removal of government intervention from the bargaining process; (3) local determination of the terms over which to bargain—promotes productivity and links payments to productivity in the workplace and not to politics. Studies of reforms of union systems in Great Britain, New Zealand, and Chile reveal that application of these principles to previously centralized wage-setting environments promoted productivity and raised wages in the aggregate.[1]

Detailed econometric studies by Nickell et al. (1992), Gregg et al. (1993), and Machin and Stewart (1996) demonstrate that substantial productivity growth occurred after decentralized unionism began to govern economic relations. The issue on the table

[1] While wage inequality rose in Great Britain during this period, so did real wages, and at a much faster rate than in the United States.

is not about getting rid of unions; substantial productivity gains were registered at union plants when decentralized unionism was introduced. The issue is about making wage setting responsive to local conditions and to adapt to opportunities that appear. It has been shown that locally responsive unions facilitate plant-wide response to technical change (Levine, 1995). Decentralization improves adaptability, and the new economy places a premium on adaptability.

It is sometimes argued that centralized bargaining is beneficial and that unions can act in an enlightened way to correct any spillovers created by the action of local wage agreements. In theory, this is possible and experience with recent Dutch wage setting, until recently, illustrates that in a small country with few unions, it may be possible to make centralized bargaining work. However, as Pencavel demonstrates, the monopoly power created by centralization is too tempting not to use and the track record on centralized bargaining is poor, especially in large economies such as that of Italy.

Italy does not have a governmentally mandated minimum wage although union wage floors effectively operate as wage minimums. One measure of the effectiveness of a minimum wage is the ratio of the minimum to the average wage. This ratio is much higher in Italy, and continental Europe more generally, than it is in the United States or Great Britain (see Table 3). The higher this ratio, the more binding these minimums are on the operations of firms.

The French ratio is below that of Italy but much higher than that of the United States or Great Britain. A series of important papers by John Abowd (e.g., Abowd et al., 1997, 1999) and various co-authors documents the substantial disemployment effects of French minimum wages. Minimum wage effects are weak only when minimum wages do not bind. A widely cited study by Card and Krueger (1995) that claimed to find no disemployment effects of minimum wages has been challenged in the professional journals. Even if correct for the small wage changes studied in the United States, this study is irrelevant for Europe, which has much higher effective—and binding—minimums. Machin et al. (2000) demonstrates how New Deal minimum-wage increases reduced employment in the home care sector in England.

Italian levels of labor market regulation are high compared to those in the United States. Employment protection laws protect the status quo and make it difficult for firms to respond flexibly to changing market conditions and to improved technologies. Thus it is no accident that the unemployment–GDP growth relationship is weak in Italy compared to that of countries with more flexible labor markets. Figure 10 compares the change in the unemployment rate in response to GDP growth across a variety of countries. In economies where it is costly to fire workers, job growth in response to GDP growth is diminished since firms account for the possibility that the economy might turn sour in the future and employment protection laws make it difficult to fire redundant labor. (Italy is at the bottom of the graph in Figure 1 although it is not shown there.) Hence, they hire fewer workers to avoid having to pay the costs of possibly having to fire them. The other side of the coin, however, is that employment protection laws make slowdowns in GDP growth less costly in terms of unemployment. It protects the insiders against job loss.

The United States has a very flexible labor market compared to Italy. Nonetheless, substantial changes have recently been made to the "employment at will" doctrine that gave freedom to the employer to fire employees without any cost. This has moved the American system of severance pay closer to that of Europe. Union work rules impose some restrictions on U.S. firms, and the portion of the costs of unemployment insurance borne by the firm make work force reduction costly.

In the 1980s, many state judiciaries in the United States adopted "wrongful termination" doctrines. These doctrines impose substantial costs of employment termination on employers that are similar in character to severance cost payments in the Italian system. In what appears to be a natural experiment, it is possible to examine the consequences of these doctrines on employment. The effectiveness and comprehensive nature of the law vary from state to state.

While the direct legal costs of the new doctrines are relatively low, on average the whole process adds uncertainty to the employment process and some settlements are high ($177,000 in U.S. 1998 dollars). Firms now play a lottery with the court system. Despite small average costs, the response of firms to the potential of experiencing a very visible wrongful termination case has been dramatic. Elaborate procedures have been established at all stages of the hiring and discharge process. Firms now institute more elaborate screening and review procedures when hiring and firing workers.

These costs have a potent negative effect on employment in states that adopt "wrongful termination" laws. Dertouzos and Karoly (1991) examine the employment consequences of these costs. The most severe systems, which in my view are lower bounds for the Italian case, suggest that employment declines by 5 percent in states with the most comprehensive employment protection legislation.

Employment protection laws in theory need not have any adverse effects on employment. The argument is that if a firm were mandated to offer a benefit such as job security to its workers, the latter would be willing to accept lower wages to obtain the benefit. The composition of the pay package would be affected even if the total level of compensation is not. For this argument to have any practical significance, wages have to be downward flexible. Yet Table 3 suggests that they are not. Binding minimum wages, whether imposed by national laws as in France or by union minimums as in Italy, prevent the necessary wage adjustments.

Evidence of the impact of employment protection legislation on employment and wage inequality suggests the following. Countries with more severe employment regulation legislation have lower employment rates (Figure 11) and less wage inequality among workers (Figure 12). Those who keep jobs stay at them longer (Figure 13). There is little effect of this legislation on the employment of prime age males (Figure 14).

The picture that emerges from this evidence is that the employment protection laws (EPL) create a protected enclave of insiders who experience less unemployment and wage fluctuations than the excluded outsiders. Social justice applies to this enclave but not to the entire society. The introduction of short term contracts in the labor market perpetuates the two-tier system in a different form. Given that the long-term unemployed are excluded from the statistics on income inequality, international comparisons of income inequality such as those in Table 1 dramatically understate the inequality inherent in the European welfare state.

4. Incentives To Acquire Skills and Undertake Job Training

Human capital is a major ingredient in fostering economic growth and reducing inequality. The incentives to acquire human capital, both in the form of schooling and job training, are weak compared to many other major countries. (See table 4). The introduction of short term contracts does not promote on the job training and runs the risk of creating a low-skill class of temporary workers who never rise above their starting skill levels. The incentives for excellence in Italian education are also weak. Tenure is rewarded to service and not academic productivity. Salaries are low. Small wonder that many of the best Italian scientists, doctors and economists are living abroad. This reduces Italian advantage in the crucial task of knowledge creation required to keep economies competitive. These factors lead to a lower level of educational attainment in Italy and a corresponding lower productivity of the workforce. The available evidence also suggests that incentives to invest in on-the-job training are weak as well.

5. Restrictions in Other Markets

When considering Italy's employment problems, the natural first impulse is to look at the institutions governing the labor market. Yet economists since the time of Alfred Marshall have recognized that the structure of the product and the capital markets affect the performance of the labor market.

The Italian product market is highly regulated, although it is far from the most regulated product market in Europe (see Figure 16). Product market regulation goes hand in glove with labor market regulation (see Figure 17) (Nicoletti and Scarpetta, 2001; Scarpetta, 1998). Inducing competition in the product market is one way of curbing excess union power. Price-taking firms offer smaller opportunities for rent seeking unions.

Regulation of the product market retards the responsiveness of the Italian economy to new trade and technology opportunities and inhibits job creation (Djankov et al., 2000). Table 5 compares the regulatory environment in Italy with that of the rest of the world. Compared to the United States, Italian firms are required to go through more procedures (nine vs. four) and take a longer time (121 vs. 7 days), and the process costs roughly ten times more in Italy than in the United States. See Figure 18. Italy leads the developed world in terms of its regulatory burdens, especially those placed on setting up new firms. By inhibiting entry and retarding flexibility, product market regulation reduces the demand for labor and the growth of jobs. This unfriendly regulatory environment also retards investment and risk taking. It inhibits Italian adaptation to the new economy. As an example, consider the relationship between Internet usage and EPL (see Figure 19). The more stringent the employment protection or business regulation laws, the less the use of the Internet (see Samaniego, 2001), which accounts for the lesser use of the internet in Italy (see Figure 20). These restrictions and the low investment in human capital make Italy a retard in e-commerce, patenting, employment in high tech sectors and research and development (R & D). (see Figure 21) These restrictions and the low level of skills in the Italian economy are major contributors to the laggard performance of productivity (see Figure 22).

This unfriendly environment also helps to explain why, in recent years, the share of foreign direct investment in Italy has been so low (see Figure 23) and why Italian investment in venture capital is low (see Figure 24). It also accounts for why Italians have found investment abroad so attractive.

Reforms in the product market and in capital markets will promote flexibility and will facilitate reforms in the labor market. That is a lesson learned during many successful economic reforms around the world.

6. The Long-Run Consequences of Regulation and the Welfare State for Italy

Product market and labor market regulation not only impede the flexibility of the Italian economy but also threaten its future vitality. These long-run effects are rarely debated in public because they operate in a subtle fashion and do not show up on the front pages of newspapers.

Trade is a major engine of Italian economic power. Italy retains its strong competitive position in certain types of low tech industries. It does not have comparative advantage in the cutting edge technologies of computers, information technology, and biotechnology (see Figure 25). The technology intensity of Italian exports is low by international standards (see Figure 26). The highly regulated capital markets have prevented Italian venture capital from flowing into these cutting-edge areas of world trade and technology. The high tax rates inherent in the Italian system and the rigidity of the educational system discourage skill formation. Since knowledge is created by educated people, the failure of Italian institutions of higher learning to produce more students and to develop flexible arrangements with industry bodes ill for the future of the Italian economy.

7. Summing Up

The Italy economy labors under the burden of heavy regulation and weak incentives. The Italian welfare state has succeeded in raising the wages and benefits of protected insiders but at the cost of low employment growth, low productivity growth in the manufacturing sector, and higher cost of unit labor (see Figures 27). These factors threaten the long-term competitive position of Italian industry in world trade and inhibit Italy from investing in the technologies of the future.

In analyzing Italian employment problems, I have stressed the importance of distinguishing long-run from short-run problems and long-run from short-run solutions. Italian unemployment is a structural problem. A substantial portion of Italian unemployment is a symptom of the deeper problem that incentives to innovate, to acquire skills, and to take risks have been thwarted by the welfare state and regulation. The costs of preserving the status quo have increased in the new world economy that is characterized by many new opportunities in technology and trade. The winners in world trade in the next generation will be those countries that can respond flexibly with educated work forces.

In pursuit of social justice—which in actuality is a defense of a protected enclave of workers and firms—Italy has muted incentives to invest in ideas, skills, and new technology. These muted incentives portend a second-rate Italian economy of the future.

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