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ITALY FROM CRISIS TO CRISIS

Political Economy, Security, and Society in the 21st Century

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To Carol and Luigi Einaudi –
friends, mentors, and benefactors in the most literal sense

CONTENTS

3

DISEMBEDDING THE ITALIAN ECONOMY?

Four trajectories of structural reform

Jonathan Hopkin and Julia Lynch

Introduction

Southern Europe's debtor nations need far-reaching structural reforms if they are to prosper within the strictures of the single currency, runs the constant refrain of the Euro crisis.[1] Yet Italy, the target of many such recent complaints, had already transformed its economy fundamentally over the past two decades, among other reasons in order that Italy could participate successfully in the Economic and Monetary Union (EMU). The need to comply with the Maastricht convergence criteria drove major budgetary reforms in the mid- to late 1990s, as well as banking reform, privatization, decentralization, judicial reform, deregulation, and changes to the labor market and the welfare system. Europe provided a "*vincolo esterno*" or external constraint (Dyson and Featherstone 1996) that pushed Italy into accepting structural reforms which would otherwise have been resisted. Italy was "rescued by Europe" (Ferrera and Gualmini 2004).[2]

This relatively optimistic picture of Europe pushing Italy in the direction of beneficial reforms must of course be qualified in the light of the country's subsequent weak economic performance. After out-growing most other western democracies throughout the postwar period, since 1990 Italy has had the worst growth record of any OECD country. In the same period, inequality and poverty rose consistently. This suggests that the structural reform agenda has implied important social costs, while in economic terms it has at the very least not lived up to expectations, and at worst may have been counterproductive. Yet prominent economists and policymakers continue to insist that Italy and other Southern European countries must adopt the reforms recommended by the European institutions and the broader international policymaking community if they are to emerge from the current crisis. Reforms, though "painful," are necessary and beneficial in the long term.

This chapter seeks to contribute to the debate around the apparent failure of European Union-inspired structural reforms in Italy. Our approach takes as a starting point Karl Polanyi's fundamental observation that economic activities are always embedded in social and political institutions of one kind or another – and that it is the character of a market's embeddedness, rather than the market per se, that gives it its characteristic outcomes (Polanyi 1944). This contrasts with the dominant approach in much of economics and in the policy world that sees structural reform as a project of identifying the "right" policies and beseeching failing countries to implement them, with little concern as to whether these policies are indeed appropriate to their social and political contexts, and often, relative indifference to their distributional consequences.

A focus on how the economy is embedded in social relations offers useful insights into the outcome of reform processes. In economics, market dynamics are analyzed as being constrained by formal institutions but largely abstracted from other forms of social relations. Proponents of liberal markets accept the need for some basic institutions, but see most constraints on the market as undermining the efficient operation of the price mechanism and distorting the allocation of resources. Structural reform therefore consists largely of acts of "disembedding" market exchange from the constraints of inefficient social and political institutions. However, economics is less sensitive to the need to "re-embed" the market in ways that allow it to work to the benefit of society. For example, reforms that free the market by removing distorting regulations may not have the desired effect if society responds by subverting the price mechanism in new ways. "Making markets" is often as much about effective "re-regulation" or "re-embedding" as it is about deregulating and disembedding (Vogel 1996). And disembedding often involves removing protective institutions that redistribute from wealthier to poorer citizens, increasing inequality and poverty.

In this chapter we suggest that not only was Italy not "rescued by Europe," it was not rescued at all. The program of structural reforms inspired by Europe disembedded the largely successful postwar model, but for the most part failed to re-embed it in a set of appropriate institutions. We show that Italian reformers tried to use neoliberal ideas to disembed markets in response to the crisis of the political economy, because of the tight connection between the economic and political failings manifested in Italy in the 1980s and early 1990s. But this reform project was not as successful as anticipated because disembedding either removed institutions that were more effective than they appeared to be, failed to eradicate dysfunctional institutions, failed to build new institutions that could re-embed the market, or failed to build appropriate new institutions at all. We contend that this perspective contributes to explaining why reforms did not produce the desired result, and that this has important implications for the solutions to Italy's current malaise.

Italy's "First Republic" miracle: a sheltered economy or an embedded economy?

The political economy of Italy's "First Republic" – a shorthand for describing the period between the establishment of democracy after the war and the transformations of the early 1990s – has been well studied and there are many available analyses (Zamagni 1990, Salvati 2000, Rossi 2007, Sapelli 2012). It is common to draw a distinction between an initial phase of classic "catch-up" economic growth in which state-directed industrialization exploited relatively low wage costs, and a second phase in which large manufacturing companies became less important and growth was driven by the "flexible specialization" strategies of small and medium-sized firms in the "Third Italy" (Bagnasco 1988, Piore and Sabel 1984). In both phases economic performance was extraordinary: Italy grew faster than any other European economy between the end of the Second World War and 1990, a performance described as Italy's "economic miracle."

On the other hand, scholarly research into Italian politics in the same period emphasized crisis, conflict and instability, and widespread political violence (Tarrow 1977, Lange and Tarrow 1980); even the more optimistic accounts regarded Italy as a democratic anomaly (LaPalombara 1989). Weak state capacity and the chronic instability of multiparty coalition governments, added to endemic corruption and expansion of state economic intervention for clientelistic purposes, were consistently identified both in the scholarly literature and in public discourse in Italy and outside as a drag on the economy. By the 1980s, Italian governments were expanding public employment and social spending while running large budget deficits, political parties used state-owned enterprises for partisan advantage, organized crime had infiltrated political institutions both in traditionally Mafia-ridden regions and in the central government, and inflation ran persistently high, leading to periodic devaluations to maintain competitiveness. These failings were ascribed to the unstable foundations of government coalitions, which led to frequent government turnover and an inability to take authoritative decisions. In short, the consensus view was that Italy's economic performance came about in spite of its political system: it was a bumblebee, too heavy to fly, and yet somehow it managed.[3] *Eppur si muove.*

One prominent example of this diagnosis came in a major book on the Italian economy by economist Fiorella Padoa-Schioppa Kostoris, *Italy: The Sheltered Economy* (1989). Padoa-Schioppa Kostoris argued that excessive state intervention in the economy was holding Italy back and that a broad shift towards less regulation, privatization of public assets, lower levels of government spending on welfare, debt reduction, and tight monetary policy would produce better results. And yet, writing in the late 1980s, when the Italian economy was still enjoying impressive growth, Padoa-Schioppa Kostoris was forced to recognize that the country's poor institutions had not held it back too much. She argued that "the country (was) developing in spite of, and not as a result of its policymaking" (1989, 230). In an interesting analytical twist, she argued that Italy's success despite pathological institutions was due to "*l'arte di arrangiarsi*" – the Italians' "talent for improvisation" and getting around the rules – and went on to suggest that this fact was "living proof that deregulation and flexibility work" (1989). She concluded on this basis that "the Italian economy would grow even more strongly and rapidly if it were not hampered by the present policy-induced rigidities" and advocated a "slimmer and better-performing state" (1989).

Soon after Padoa-Schioppa Kostoris' book was published, a major anti-corruption investigation by Milanese prosecutors (known as the *Tangentopoli* scandals) began to lift the lid on the clientelist and corrupt way in which the Italian state ran its affairs (Della Porta 1992, Della Porta and Vannucci 1994, Hopkin 2012). It was revealed that Italian politicians at both central and local levels engaged in systematic trading of favors for money, particularly in the allocation of public contracts, to finance their political parties and careers (Della Porta and Pizzorno 1996). The scandals also showed the extent to which public employment and welfare payments were manipulated by politicians in order to generate political support. The evidence of gross and systematic misuse and waste of public money, and the distortions in the market caused by corrupt public contracting and procurement practices, called into question the legitimacy of government involvement in the economy more broadly, and gave credence to a neoliberal diagnosis of Italy's economic problems.

Although the *Tangentopoli* scandals revealed much that was indefensible about political interventions in the economy, scholars working in the economic sociology tradition presented a different take on the country's institutions. The first phase of industrial development is often attributed to the competence of the generation of state managers who coordinated the public sector of industry through the holding company, *Istituto per la Ricostruzione Industriale* or IRI, a survivor of the fascist regime (Amoroso and Olsen 1978). Similarly, the success of the small- and medium-sized manufacturing sector in the North-East revolved around the cohesiveness of clusters of producers in industrial districts, facilitated by social and political networks embedded in the institutions of local government (Bagnasco 1988, Trigilia 1986, Putnam et al. 1994, Piore and Sabel 1984). These patterns of embeddedness were not considered relevant by the neoliberal reformers following the recommendations of mainstream economics, however, and the liberalizers on the whole won the policy argument in the period after 1992.

As we argue below, the claim that Italy would benefit from liberalizing reform looks far from convincing in hindsight. Yet this diagnosis seems to have been extraordinarily influential in informing policy over the period of the "Second Republic." It was coupled, of course, with deep dissatisfaction and frustration with the failings of Italy's ruling elites, and the push for political reforms that would dislodge them and make a different policy orientation possible. Key policy actors came to see overturning the corrupt, clientelistic and apparently inefficient political system as a way to reform the Italian economy in a liberalizing direction, preparing it for full participation in the EMU agreed in 1991.

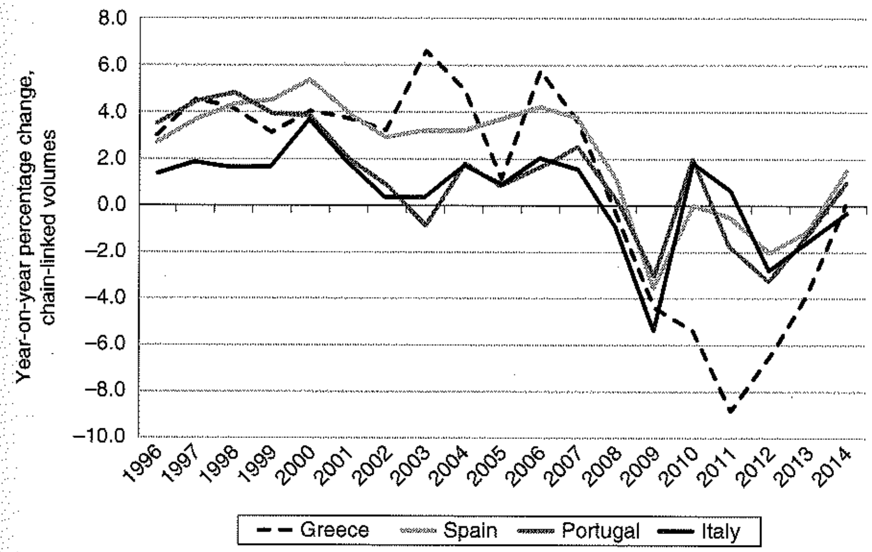
Only a few short months after the Maastricht summit, Italy entered profound political and financial crises. The dramatic emergence of the Northern League in the April 1992 elections and the *Tangentopoli* scandals at more or less the same time began a process of decomposition of the main governing parties. In July, emergency measures, including a bank levy, were taken to stave off financial collapse, but by September Italy was ejected from the European Monetary System after a run on the lira. In short, the political and economic systems reached a critical point at precisely the same time, ushering in a major turnover of political elites and a shift in economic policymaking. It was hoped that the crisis would not only clean up Italy's political system, through the prosecution of corrupt politicians and the introduction of a majoritarian electoral law to facilitate political competition, but also permit economic reforms that would keep Italy at the core of the European integration process.

The collapse of the Christian Democratic and Socialist parties in 1992–94, and their replacement by an ostensibly more pro-market party, Berlusconi's *Forza Italia*, added to the Italian Communist Party's adoption of a social democratic and in some ways liberalizing platform, pointed towards a shift in the Italian political economy. Italian business would no longer rely on favors from well-placed political supporters to make money; instead, the theory went, the retreat of government from the economy would subject them to the full force of the market. After the brief episode of Berlusconi's first government, centrist coalitions led first by central banker Lamberto Dini and then economist Romano Prodi piloted a succession of liberalizing reforms, with the help of the Maastricht convergence criteria. By 1999 Italy was in a position to qualify for the third stage of Monetary Union, with low inflation, a stable fiscal position, and now a stable exchange rate.

The rest of this chapter will argue that the program of structural reforms followed during the Second Republic were well-intentioned from the standpoint of trying to root out dysfunctional forms of market embeddedness. But because they relied on a neoliberal economic paradigm in which markets were seen not to require supporting institutions, the reforms, to the extent that they "succeeded," in fact disembedded Italy's largely successful postwar model and failed to re-embed it in a set of appropriate institutions. This disembedding meant dismantling an elaborate system of economic redistribution that had contained inequality and poverty in Italy but was perceived to be a drag on growth. Yet Italy's GDP per capita was lower in 2013 than in 1999 when it entered the euro. The reasons for this poor performance are of course far from straightforward, but we will suggest here that the changes to the Italian political economy after 1992 failed to improve the country's economic performance, while undermining the social model that had been built up over the 1970s and 1980s. We begin by outlining the evidence for Italy's economic stagnation and increasing inequality during the Second Republic.

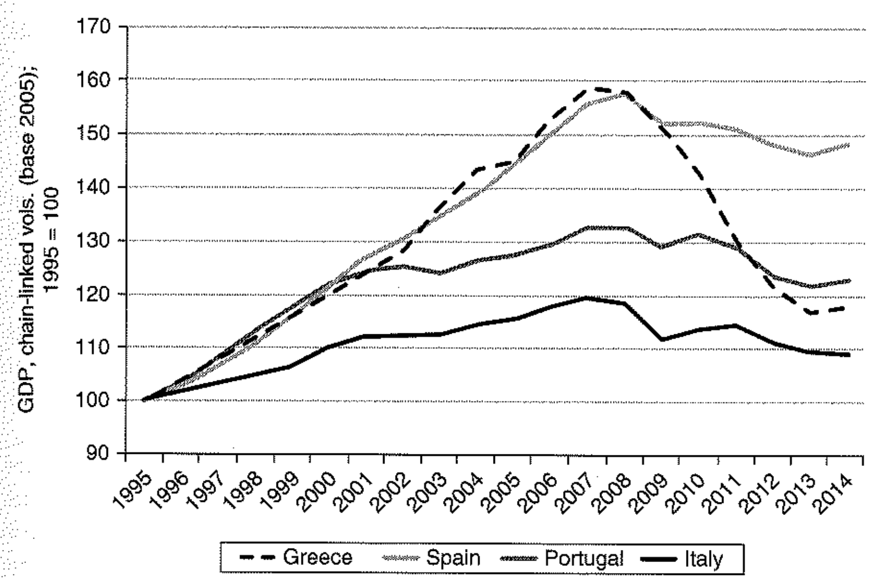
From miracle to misery: economic performance in the Second Republic

There is little dispute that Italy's economic performance over the past quarter century has been dire. From the mid-1990s through the onset of the financial crisis in 2008, real GDP growth in Italy was stagnant, averaging only around 2% per year, and considerably lower than in Spain or Greece (Figure 3.1). Following the financial crisis, growth has been negative or very slow across Southern Europe. But even taking into account the drastic shock to growth in Greece and Spain since the crisis, Spain's GDP grew almost 50% from the mid-1990s to 2014, and Portugal's and Greece's output grew close to 20%. Meanwhile in Italy the total value of goods and services produced per annum grew less than 10% since 1995 (Figure 3.2). Moreover, economic growth has been slow across Italy. While the regions of the North and Center have been more dynamic than those of the South and Islands,



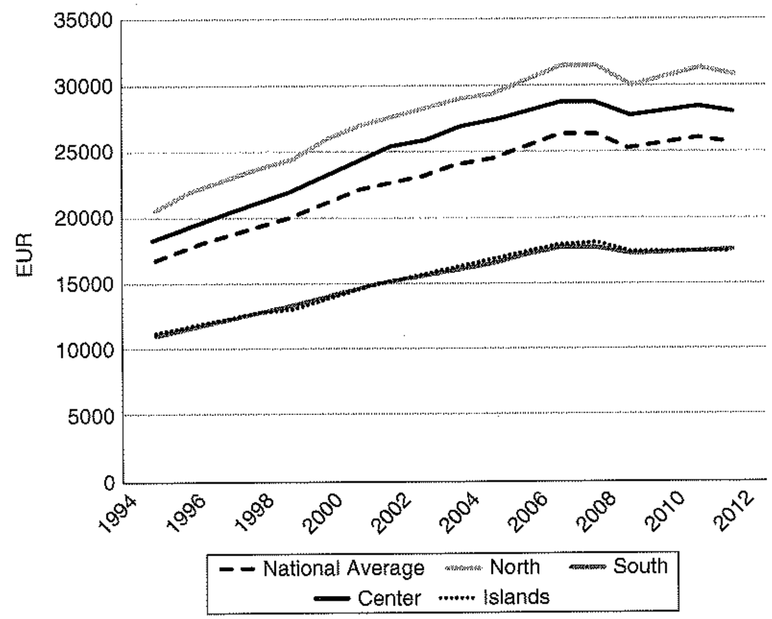
Source: Eurostat national accounts main tables, March 2015
Notes: Spain-provisional data from 1996–2014; Greece-provisional data from 2011–2013, 2014 missing; Portugal-estimated data from 2012–2014

FIGURE 3.1 Real GDP growth



Source: Eurostat National Accounts, Main Tables

FIGURE 3.2 Indexed GDP in Southern Europe, 1995–2014



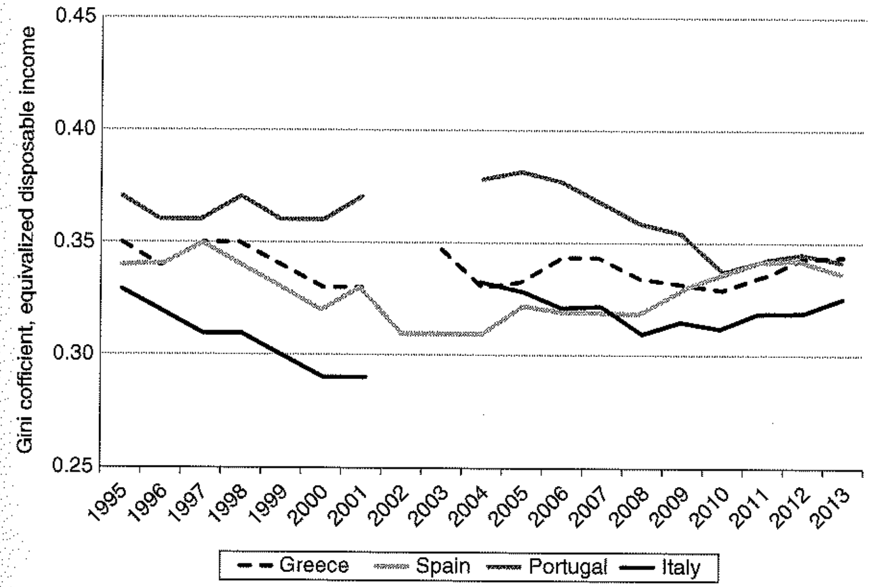
Source: Istat national accounts main tables, Nov. 2013
Note: figures calculated according to ESA 1995 methodology

FIGURE 3.3 Italian GDP per capita by geographic region, current prices

per capita GDP has grown only slightly faster in the latter than in the former since 1994 (Figure 3.3).

GDP growth rates are of course a crude indicator of economic and institutional performance, but measures capturing the distribution of economic growth tell a similar story of stasis since the mid-1990s. For example, Italy's level of income inequality, as measured by the Gini coefficient, was considerably lower than in the rest of southern Europe in 1995. However, even as income inequality has declined somewhat in the rest of southern Europe, income inequality in Italy seems to be at roughly the same level in 2013 as it was in 1995 (Figure 3.4).[4] Similarly, the share of all households in or near poverty (i.e., with an income adjusted for household size after taxes and transfers of less than 60% of the median income) has remained high and stable in Italy since 1995 (Figure 3.5), despite policy innovations meant to reduce poverty.

Poverty rates may rise even as living standards overall are improving, if the incomes of higher earners are increasing faster than those at the low end. Measures of material deprivation capture actual living standards, for example, whether a household has access to adequate heating and cooling, nutrition, transportation and the like. The best available measures show that living standards have not improved in Italy; in fact, they have worsened considerably since 2004, the earliest year for which we have data (Figure 3.6). Furthermore, while Spain and Portugal show only minor increases in



Source: Eurostat Income and living conditions main tables, Feb. 2015
Notes: Greece-2002 data missing, break in series in 2003; Spain-break in series in 2002 and 2004; Italy and Portugal-2002 and 2003 data missing, break in series in 2004

FIGURE 3.4 Income inequality

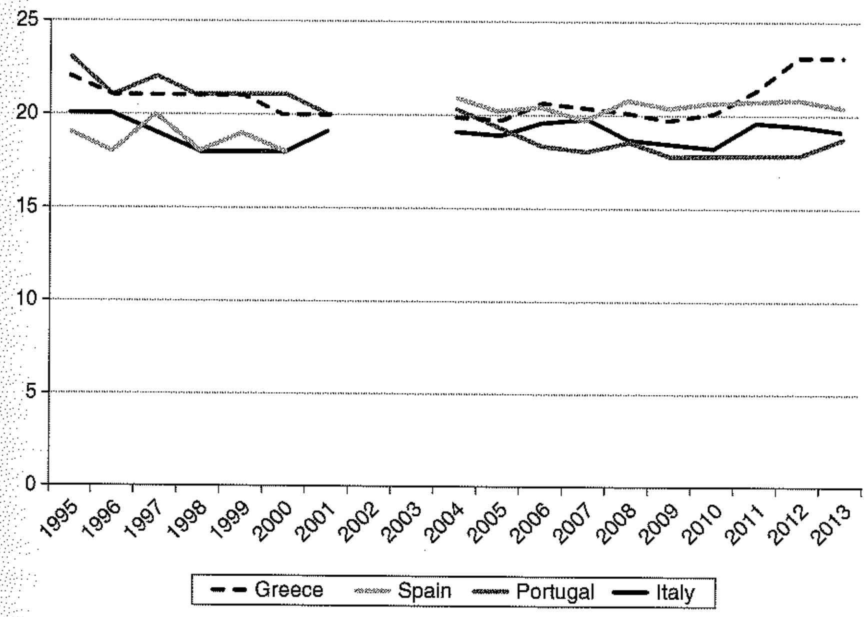


FIGURE 3.5 Households at risk of Poverty (60% of median equivalized income after social transfers), 1995–2013

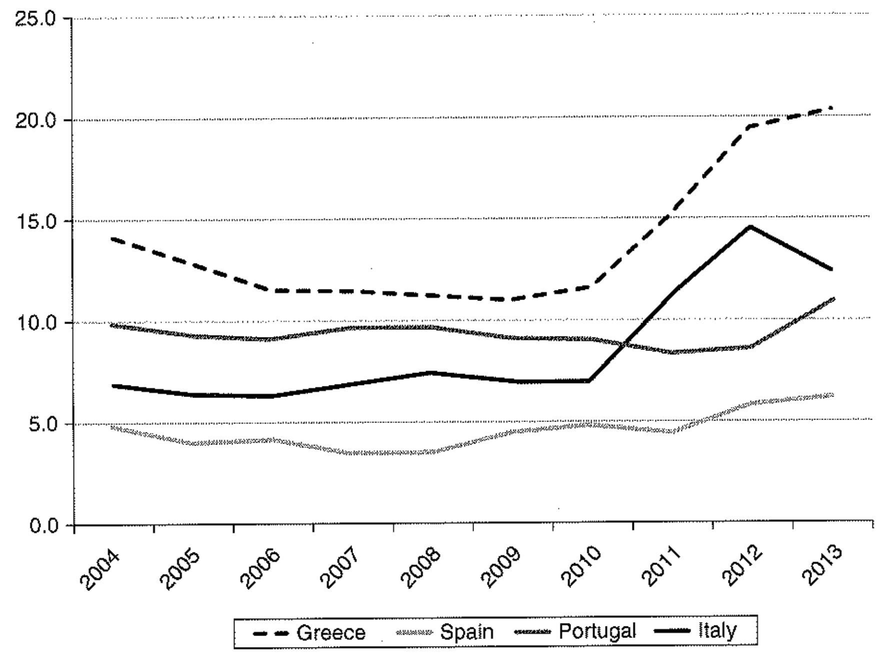


FIGURE 3.6 Percentage of population living with 4 or more indicators of material deprivation

the rate of material deprivation after the onset of the crisis, living standards worsened dramatically in Italy after 2010, and have yet to recover to Iberian levels.

The longer data series available for measuring absolute poverty – which in Italy is defined as membership in a household (hh) without adequate post-tax and transfer income to purchase a minimal basket of goods – show a significantly higher incidence of absolute poverty in the South and Islands, at least since the late 1990s. This gap reflects historical lower household earnings (including social transfers) and larger household size in the South. However, the incidence of absolute poverty has grown somewhat in all areas of Italy relative to the 1997 baseline, particularly after 2011 (Figure 3.7).

These were not the results that were expected when Italy embarked on the process of reform that transformed its party system and took the country into the European Monetary Union. The overall picture of stagnant growth and little improvement in inequality, poverty, or living standards is neither a phenomenon solely attributed to poor performance in the South of the country, nor purely a concern of the post-crisis period. Simply put, the Italian economy and society has, at least since the mid-1990s, been in the doldrums. What can explain this sustained lack of dynamism? And in particular, why have sustained reforms failed to improve Italy's economic performance? There are a number of potential explanations.

The first and perhaps most obvious hypothesis would be that Italy simply did not adopt the appropriate reforms, or failed to implement them with sufficient

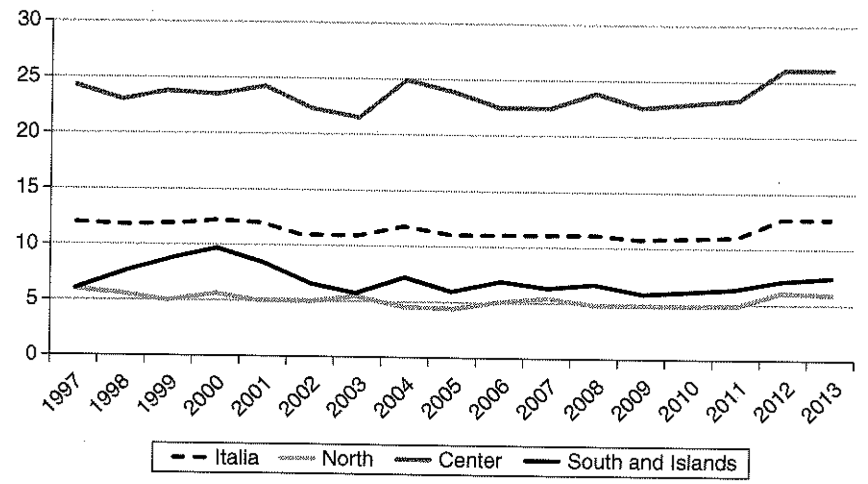


FIGURE 3.7 Absolute poverty rate (% in hh lacking disposable income needed to purchase essential basket of goods)

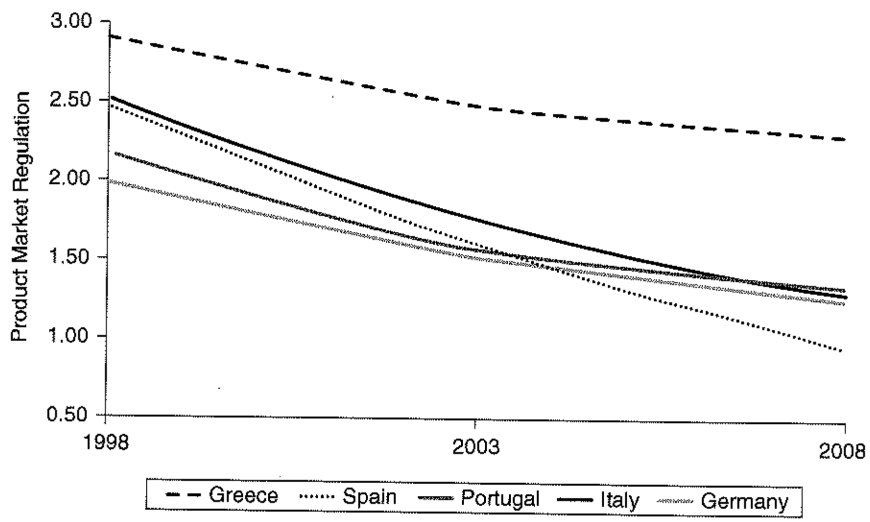


FIGURE 3.8 Product Market Regulation

intent. This is consistent with the mainstream view: because Italy did not eliminate enough of its inefficiencies and distorting policies, its economic policy regime remained inadequate to the task. Yet while many of the changes economists like Padoa-Schioppa Kostoris advocated at the time have indeed subsequently been introduced, the decline in Italy's performance has been unmistakable. Figure 3.8 shows that Italy has introduced substantial regulatory reforms in this period, converging on a level of product market regulation similar to Germany. While there is evidence that some reforms were held back by the lobby power of vested interests, it probably makes more sense to look for the causes of economic stagnation in the content and implementation of the reforms that did occur, rather than in the absence of those that did not.

A second possibility, quite consistent with the first, is that although Italy introduced the right formal reforms, these reforms did not have the desired effects because of institutional failings. For example, liberalization of markets may not have led to greater efficiency if the "meta-institutions" needed to govern them – such as anti-trust authorities, the judicial system, or the public administration – were incapable of providing the necessary regulatory and administrative infrastructure of a market economy. In this view, the reform program remained relatively superficial and formalistic, and the underlying dynamics remained inefficient. The issue, rather than poor policy choice, was a problem of governance and institutional quality.

There is some evidence to support this view. Lay and expert opinion alike, both within Italy and outside of it, tend to put the blame for stagnant growth on Italy's business and political culture. The World Bank's worldwide governance project has collected data from a variety of sources on overall government effectiveness, regulatory quality, control of corruption and rule of law that can be used to assess some of the perceived institutional and procedural barriers to economic growth in Italy. Based largely on surveys of experts and business leaders, these indicators may capture reputation more than reality. However, even taken with a grain of salt, they indicate that Italy, along with Greece, has a serious and growing problem of perception. The regulatory quality indicator shows only a slight net drop from 1996 to 2013, but sources have if anything become more concerned about the business climate in Italy during this period. Indicators tapping perceptions of government effectiveness, corruption, and rule of law have declined quite markedly in Italy and Greece over the last twenty years, while evaluations of the climate in Spain and Portugal have been more positive, and less subject to erosion (Figures 3.9a–c).

Both these points of view draw on a pro-market vision of how to improve Italy's economy: freer markets and a more consistent and transparent application of the formal rules governing the market are the key to better performance. But they limit their attention to the minimal institutions in which a theoretical market economy needs to be embedded, without considering the reality of the institutional legacies which shape how real economies work. A convincing account of Italy's economic decline requires a fuller understanding of these institutional legacies.

Marco Simoni's book *Senza alibi* (2012) offers a more sophisticated take on the reform dilemma. It draws on the Varieties of Capitalism scholarship (Hall and Soskice 2001) to argue that Italy's problem is not too much or too little reform, but that the reforms instead have created a "hybrid" model which is neither a fully liberal market economy nor a coherently coordinated one. Reforms pushed Italy in different and often contradictory directions, generating inconsistencies between institutions governing company ownership, finance, and the labor market. The result was to undermine the innovation capacity of firms, leading to economic decline. A similar view holds that liberalizing reforms were simply the wrong approach in

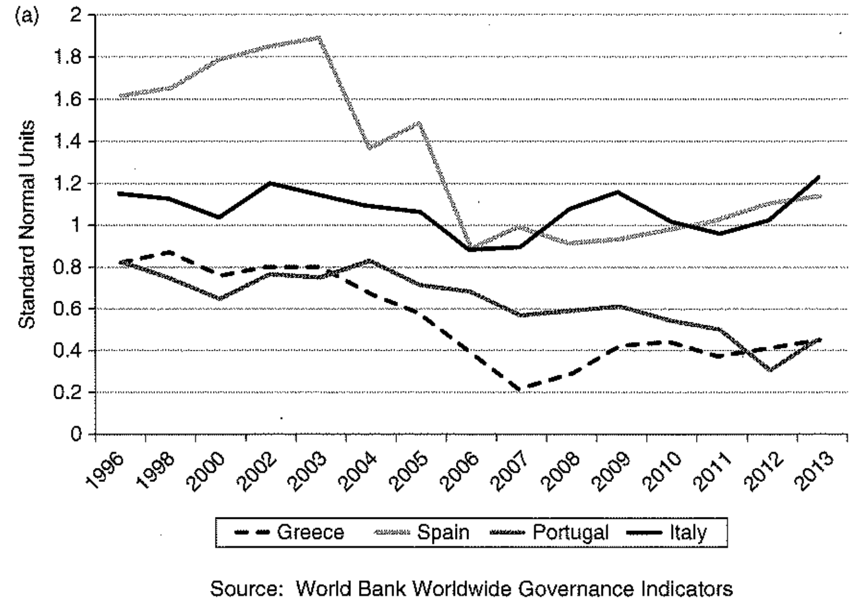


FIGURE 3.9A WGI Government Effectiveness Indicator

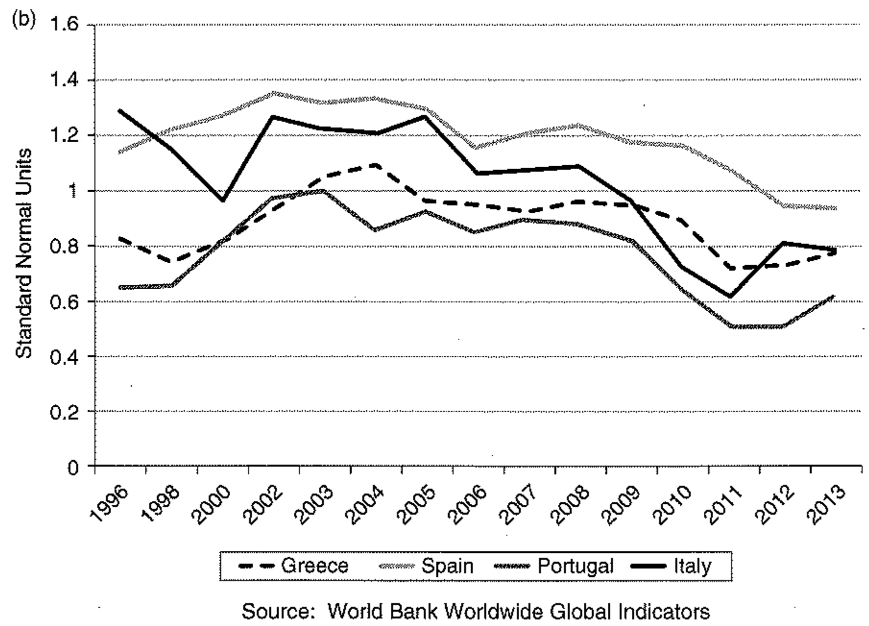


FIGURE 3.9B WGI Regulatory Quality Indicator

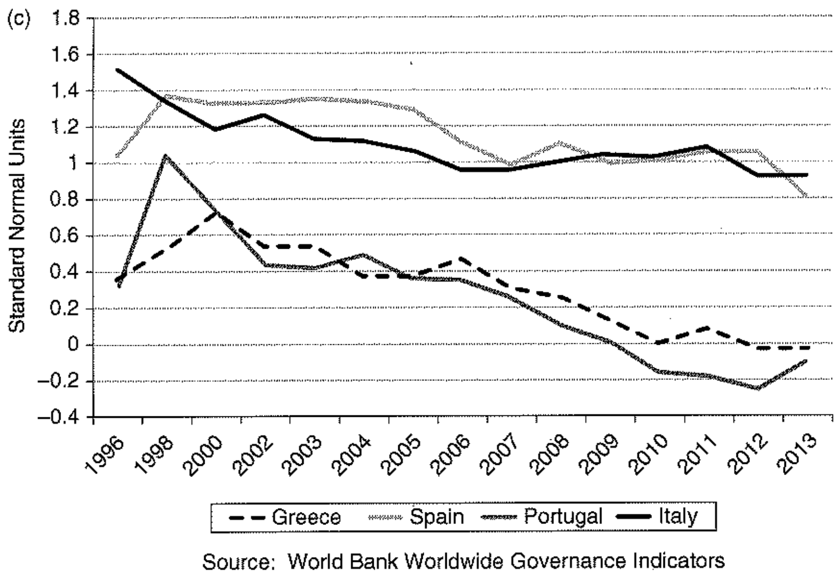


FIGURE 3.9C WGI Controlling Corruption Indicator

general. Rangone and Solari (2012) argue that the reforms simply added a greater degree of *laissez-faire* to the Italian model without addressing its real weaknesses, and that the reforms had a class bias, weakening labor without undermining the power of Italy's crony capitalist elite.

We find useful suggestions in this literature, particularly in work which stresses how the economy is embedded in a variety of institutions, formal and informal, that can illuminate the limitations of the crude structural reform agenda. Explaining Italy's poor economic performance is an undertaking far too ambitious for the scope of this chapter, since we would also need to take account of the secular trends in the global economic context which have left Italy facing an enormous challenge of adaptation because of the particular structure of its economy. Policy decisions were unable to overcome these challenges, partly because the declining competitiveness of Italy's distinctive, almost unique, mix of small exporting firms, and the fiscal crisis of the Italian state in the 1990s, required incompatible solutions (competitive devaluations for the former, participation in EMU for the latter) (de Cecco 2007). This perhaps fatalistic view would suggest that Italy's spectacular post-war performance essentially could not be sustained.

However we do argue that the analysis of institutional changes in the Italian political economy since the early 1990s can provide insights into Italy's decline. The mismatch between expectations of the results of structural reforms and the disappointing outcomes is striking enough to be worthy of more detailed investigation. In the next section we present a framework for understanding the reform process and the reasons for the often suboptimal results of specific measures.

Explaining economic decline: why do structural reforms fail?

We aim to build on the literature assessed in the previous section and understand more clearly the exact mechanisms through which liberalizing reforms affected the Italian political economy. We take our cue from Wolfgang Streeck and his work on the importance of non-market institutions in coordinated capitalism (1992; see also Streeck and Thelen 2005). Streeck's argument was mostly developed to interpret how diversified quality production functioned in Germany, but is highly relevant to Italy, and indeed a related scholarship emerged using a similar approach to explain the success of the flexible small-scale manufacturing of the "Third Italy" (Piore and Sabel 1984, Trigilia 1986). The crux of this research tradition is to emphasize the importance for industrial production of patterns of social interaction that to some degree fall outside the combination of market transactions and formal legal and administrative institutions considered by mainstream economics. Where economists tend to interpret the world in terms of rational, individualist, goal-oriented behavior within formal-legal constraints, economic sociologists and institutionalist political scientists see behavior as embedded within a range of institutions, both formal-legal and informal, such as local networks, organized political allegiances, cultural expectations, and so on.

These different conceptual and empirical approaches have consequences for policy. Economists tend to favor reforms that will enable markets to function as freely as possible in terms of price signals to which individuals respond to maximize their advantage. In practice this usually means removing institutional obstacles in the way of such market adjustment, such as rules and regulations, organized collective action, enforced consultation between representatives of different productive actors, and redistributive fiscal and expenditure measures. Applied to a deeply regulated economy such as Italy, this reasoning points in a clear liberalizing direction. The more institutional or sociological approach championed by Streeck and others instead focuses attention on the ways in which the economy is embedded in patterned social behavior, and in particular, the ways in which liberalizing reforms may have disembedded the Italian economy, and the consequences of this disembedding.

The transition to the Second Republic is generally viewed as a transformation of the political, and in particular the party system, architecture of Italian post-war politics. But the Second Republic also ushered in a period of sustained policy reform in the social and economic realms that was every bit as significant as – if ultimately less effective than – the changes in the realm of party politics. These reforms, we shall argue, aimed at breaking the connections between politics and the economy – freeing the wage-labor nexus from political control, delinking welfare state benefits from the political power of unions and the self-employed, and reforming government institutions in order to ease the functioning of impartial markets. Taken together, the reforms constituted an unusually thoroughgoing and ambitious attempt, undertaken by center-left and technocratic governments of the Second Republic as well as by the center-right, to disembed the Italian economy from its political underpinnings.

In fact, however, reforms in Italy have not been uniformly liberalizing or disembedding. In the next section, we identify four ideal-typical reform trajectories that have been undertaken more or less simultaneously in Italy during the Second Republic. A first trajectory involves reform that is inspired by a desire to liberalize, but that does not in fact disembed the regulation of markets from the political and social networks dating back to the First Republic. We argue that decentralization of central state administrative functions to the regions is an example of this trajectory. A second reform trajectory, exemplified by some of the labor market reforms of the last decades, involves true liberalization of markets, in which markets are disembedded and not re-embedded in new institutions. The third and fourth trajectories disembed and then re-embed market structures in new institutions. The third variant, exemplified by reforms to the legal system, re-embeds market regulation in new networks that are not functional or productive, in the sense that they do not result in a well-functioning economy. The fourth variant, which we see in Italy in the form of some welfare reforms undertaken during the Second Republic, comes closest to a functional re-embedding of market institutions. We do not in this chapter attempt to develop a theory of why these different reform trajectories occurred when and where they did, although this would no doubt be a useful exercise. Our core argument is simply that Italy's poor economic performance during the Second Republic can be understood as a result of the fact that "liberalization" in Italy has often followed one of the first three trajectories rather than the last.

Structural reforms in the Second Republic: four trajectories

Trajectory 1: Failed disembedding. The case of administrative reform

Administrative reforms carried out throughout the Second Republic aimed to fundamentally reshape the Italian state, thereby improving the quality and efficiency of public administration and harnessing the incentives for efficiency said by (neo) liberals to reside in decentralized governance. The Northern League's electoral successes early in the Second Republic and their key role in the center-right coalitions gave renewed impetus to the project of regionalism begun in the 1970s, but the administrative and economic ideologies of a new policy elite also played an important role. "It is becoming increasingly apparent that the Italian state's bureaucracy is a major competitive disadvantage for Italian producers of goods and services," remarked one contemporary observer in describing the motivation for the decentralizing Bassanini laws in 1997–8 (Gilbert 1998, 140).

Subsidiarity, the principle that no two layers of government should be doing the same thing, was meant to ensure efficiency. Hence the first Bassanini laws and subsequent implementing legislation gave the central state the power to delegate functions to the regions and other entities; transferred control over active labor market policy, employment centers, economic development, aid to firms, planning and infrastructure, and social and educational services to the sub-national level; transferred to the regions, provinces, and localities responsibility for policy areas vital to local and regional interests; and contained hundreds of provisions aimed at reforming specific practices of the public administration at all levels of government and streamlining bureaucratic procedures, particularly in the areas of business licensing (Gilbert 1998, 146). When the center-right returned to power, the process of decentralization deepened, with regions granted competence for any function not explicitly reserved for central government or shared between levels of government.[5] Since the crisis, constitutional reform packages have proposed further territorial reforms that would lead to cost savings (i.e., creating new metropolitan areas and eliminating the province as a level of government) and a series of reforms to Parliament and the executive branch that would further streamline Italian lawmaking and implementation.

Yet despite giving the appearance of a radical decentralization of finances, power and control, decentralization of the state administration has in reality done little to disrupt old patterns of national-local relations and political contestation. The Left and the Right in Italy have both rallied around decentralization, but for different reasons. Successive governments during the Second Republic thus proposed a series of alternative visions of decentralization, which in practice were not compatible, and which delayed decisive progress towards devolution (Lynch and Oliver forthcoming). Furthermore, the Italian legislative process in general and the decentralization process in particular contained multiple "self-decelerating mechanisms" (Lynch and Oliver forthcoming) – e.g., a need for enacting legislation, deferred decision-making, requirements for multi-level consultation, built-in delays in implementation – that slowed the pace of real reform to a crawl. By the time the full force of the financial crisis hit Italy in 2011, derailing further policy development, key components of the reform process that would have allowed regional governments to have real autonomy over their budgets (e.g., definition of the *livelli essenziali di servizi*) had still not been enacted. Substantive decentralization of policymaking in Italy has thus largely been derailed. Whether a real reform of the state administration would in any case have resulted in better economic performance remains an open question. What is clear, though, is that decentralization undertaken in the name of "liberalizing" the state did not result in meaningful disruption of old patterns of policymaking.

Trajectory 2: Liberalization without re-embedding. The case of labor market reform

A number of significant reforms meant to liberalize the labor market have been introduced in Italy since the onset of the Second Republic, reflecting what appears to be a consensus among a segment of the policy elite that both growth and equity have been hampered by labor market rigidities. Various measures to lighten regulation of the Italian labor contract were introduced in the 1990s and 2000s. The general pattern was of substantial deregulation under center-right governments, with some re-regulation under center-left governments. The first important reform of the period was the Social Pact of 1993, enacted under the first Berlusconi government, which allowed regional- or firm-level bargaining to supplement national contracts. A series of reforms to the regulation of atypical employment contracts began in 1997 with the Treu Law, named for the first Prodi government's minister of labor, Tiziano Treu. This package aimed to boost employment in the South of Italy by increasing labor market flexibility. It introduced temporary contracts and incentivized part-time work, while another 1997 law lifted the public monopoly on job placement centers.

In 2001 two legislative decrees under successive center-right governments transposed European directives on part-time work and fixed-term contracts. The 2003 Biagi reform (Law 30/2003), named for the advisor to the Berlusconi government of 2001–2006 on its labor market reforms, further deregulated "atypical" work arrangements like temp work and part-time work, and created new forms of short-term employment. In 2011 the Berlusconi government once again deregulated part-time contracts, as well as providing for flexible apprenticeship arrangements and introducing a new collective bargaining regime that allowed local- and firm-level agreements to override provisions in the national law regarding the termination of work contracts (Sacchi 2014b, 26). Some re-regulation of atypical work arrangements, including independent contracting, freelance work, and apprenticeships, occurred under the Monti government in 2012 with the Fornero law, but the law also deregulated some aspects of fixed-term contracts.

These reforms, taken together, constitute a significant deregulation of the Italian labor market. According to Sacchi (2014b, 18), "Between 1990 and 2008, Italy was the advanced capitalist country that flexibilized its labor market the most, reducing restrictions on hiring through fixed-term contracts." And despite much rhetoric to the contrary, even the labor market for workers on standard, open-ended full-time contracts is rather flexible and lightly regulated compared to other Continental European countries (Schindler 2009, 6, Sacchi 2013, 5). Labor market liberalization in Italy has succeeded in disembedding full-time labor from old forms of social protection such as Cig and protections against dismissal laid out in Article 18 of the 1970 Workers' Statute. Privatization of the job placement service has also effectively detached certain kinds of employment from old clientelist networks based on colonization of the public service. The workers "freed" from these old constraints on the liberal market have not, however, been offered much in the way of new protections, and employment has not been re-embedded into, for example, regional economies well adapted to provide employment growth. Labor market liberalization in the Second Republic has largely followed the prescriptions of orthodox neoliberalism in freeing up market forces, without the labor market subsequently being re-embedded in new forms of societal control.

Trajectory 3: Dysfunctional re-embedding. The case of judicial reform

The Second Republic's roots in *Tangentopoli* and Berlusconi's legal troubles ensured that from 1995 onward Italy saw a series of reforms (and failed reform proposals) of the judicial system. The role of prosecuting magistrates, in particular in Milan and Palermo, in uncovering the systematic corruption of Italy's political and business classes placed the judicial system at the heart of political debate. As a result, the battle over judicial reform became a barometer of the broader political battle for control over the state institutions, with far-reaching implications for the new political economy emerging in the 1990s.

The *Tangentopoli* scandals revealed that laws governing public contracting and public sector spending more generally were routinely flouted, and politicians and businesses were systematically involved in corrupt transactions, yet the judicial system had mostly failed to intervene. Moreover, the judicial system itself was affected by corruption, most notoriously in the long-running dispute over the ownership of Mondadori, in which it subsequently emerged that Silvio Berlusconi's legal team had bribed judges to emit a favorable sentence. The prosecuting magistrates investigating corruption became political actors, arguing for a more consistent application of the law to eliminate corruption (for example Colombo 2008). In opposition to this, Berlusconi's *Forza Italia* party criticized the heavy-handed regulation of economic life in Italy and the overbearing presence of the state, implicitly justifying corruption as a necessary response to administrative inefficiency (*lacci e lacciuoli*, which can be roughly translated as "red tape"). Berlusconi's position was not always articulated openly, but it combined vague appeals to reduce the regulatory burden on business with sympathy for those facing corruption charges.

Judicial reform consequently followed a rather inconsistent pattern. Berlusconi himself proposed a series of judicial reforms that, while they surely served the purpose of making his own legal troubles easier to manage, also responded to pressing problems with the Italian judiciary by reducing the powers of prosecutors. These included limiting the use of wiretaps in criminal investigations, separating the careers of prosecutors and judges and placing prosecutors under the authority of the executive, and speeding the pace of trials by setting new statutes of limitations (Dubay 2011). Berlusconi governments passed reforms in 2001 (right to damages for judicial delays), 2003 (special rules for commercial cases), 2009 (reducing length of civil proceedings), and 2010 (mandatory mediation).[6] Silvestri (2011) characterizes the reforms of this period as a privatization of the judiciary, in which the role of judges would be reduced to mediating between the will of the two opposing parties, rather than affirmatively seeking justice (Silvestri 2011, 4).

This can be seen as disembedding, to the extent that the intended effect was to hinder judicial interventions in economic life by clipping the wings of crusading prosecutors. One striking example of this was the law effectively decriminalizing false accounting, passed conveniently to relieve Berlusconi of one of the charges leveled at him by the Milanese prosecutors (Ginsborg 2004, 135). Another similar case was the restriction on use of evidence of illicit financial activity from Switzerland in Italian courts (2004, 143). However, such measures, by removing the legal safeguards against fraudulent activity, hindered the development of open and competitive capital markets in Italy, forcing a continued reliance on personal connections in investment decisions. As such it constituted a re-embedding of financial activity in often corrupt and clientelistic networks.

Other reforms introduced by the Berlusconi governments also had the effect of re-embedding the economy in a dysfunctional set of judicial arrangements. Many of the measures introduced to respond to the Prime Minister's own personal judicial problems had the effect of lengthening trials in order to allow the statute of limitations to take effect, so that the judicial system was being made slower and less efficient. For example, one reform facilitated defendants requesting their trials to be moved to different jurisdictions on the grounds of bias, which was used by Berlusconi to obstruct the investigations of the Milanese prosecutors. By undermining the rule of law, these reforms had the effect of protecting existing corrupt networks and therefore restricting the operation of arms-length relationships driven by the price mechanism.

Not all reforms in this period had the aim to reconstituting corrupt arrangements of the "First Republic." With the advent of the technical and center-left governments, some more substantive reforms were passed. Provisions in the 2013 Decreto del Fare (DL 98/2013) aimed to speed up the pace of justice, and in 2014 the Renzi government issued an urgent decree to attempt once again to bring Italy into compliance with the European Convention on Human Rights' "reasonable time" to trial requirement. The Renzi government's push for speedier trials had the goal of "transform[ing] the Italian justice system from a burden on the country's growth to a driving force to assist in resolving the nation's economic crisis" by making Italy more attractive to foreign investment (Jones Day 2014).

However, the persistence of an inflated volume of legislation that is not easily dismantled (Mattarella 2011) and the conservatism of the judicial profession make reform arduous. Disembedding has not got very far, and in many cases has amounted to an informal re-embedding of the economy in corrupt networks, a theme pursued in Fabio Armao's chapter in this volume.

Trajectory 4: Functional re-embedding. The case of welfare state reform

Italy's welfare state was built up over the 1960s–1980s by the social partners and by politicians eager to reap rewards by promising benefits to particular segments of the electorate (Lynch 2006). The result was a system of social insurance that was fragmented, costly, and insufficient to meet the needs of Italian citizens without strong connections to the labor market or to self-employment. Reforms during the Second Republic attempted, not always successfully, to disembed many key programs of the welfare state from clientelist practices and from an over-reliance on the family for economic support and care – a practice that nevertheless continues, as Adele Lebano's chapter describes, as a means of coping with the current recession. The reforms also sought to provide new forms of social protection to citizens who would otherwise be exposed to the vagaries of the market, and in so doing re-embed the economy in a more robust system of social protection.

By 1992, the expensive Italian pension system had already come under sustained scrutiny. With the Maastricht criteria looming, the Dini government passed a second significant reform in 1995. Additional reforms in 1996, 2004, 2009–10 and 2011 further tightened eligibility requirements, gradually increased the statutory retirement age, and reduced special privileges for specific segments of the workforce. Clientelist delivery of pensions through party- and union-run *patronati* was reduced, and pension policymaking, which during the First Republic had been systematically governed by clientelist practices (Maestri 1994, Lynch 2006), was substantially disembedded.

The Onofri Commission was tasked by the Prodi government with reviewing the performance of the entire welfare state in 1997. The Commission's final report recommended a citizenship-based welfare architecture to replace much of the fragmented, occupationally based system, neutral selection criteria for determining eligibility, and a greater emphasis on services in kind rather than cash transfers, among other reforms (Bosi and Dirindin et al. 2003). All of these proposals would have undermined clientelist control over welfare provision (Lynch 2006). In response to the Onofri Commission's recommendations, and satisfying a long-term desideratum of both unions and large employers that social assistance functions be separated from the contribution-based social insurance system, the Prodi government passed clearer, more transparent rules on social assistance financing.

The Monti government's 2012 labor law also made broad changes to unemployment insurance. The reform replaced the standard "ordinary unemployment benefit" (OUB) with a new "social insurance for employment" benefit (ASPI). Contribution and insurance requirements would remain the same, but the duration and age differentiation of benefits were adjusted, and coverage expanded. The reform brought Italy's previously very low unemployment benefit in line with that offered in other European countries, and expanded eligibility to include all categories of dependent employees with sufficient contribution records. This trend was extended by the Renzi government with the 2014 Jobs Act, which, as well as diluting the dualistic divide in labor protections between temporary and tenured employees, also expanded the unemployment compensation system by creating the new Aspi (NASPI) which increased coverage for unemployed temporary workers (Sacchi 2014a). Although the replacement rates of these benefits remain low by comparative standards, they constitute a step towards a more universalistic unemployment coverage system, which Italy lacked entirely until the 2000s.

Many of the reforms to the welfare state undertaken during the Second Republic were disembedding, in the sense that they rather successfully divorced the allocation and delivery of welfare state benefits from the clientelist networks of exchange in which they had been mired for most of the post-war period. Inspired by the "flexicurity" model pioneered in Denmark, reforms have sought to move beyond the emphasis on protected employment contracts, public sector expansion and tolerance of informal employment typical of the First Republic, to a more flexible market-driven model backstopped by a more universalistic welfare state. To some extent these reforms successfully re-embedded economically vulnerable citizens in new systems of support that protect their incomes from the vagaries of the market, while allowing the labor market a degree of flexibility and adaptability. However, the sparse resources available to reformers in the fiscally constrained environment of the post-crisis period limited how far this re-embedding could go. In this context it is noteworthy that while the welfare state in Italy was substantially disembedded from its formerly clientelist party linkages, its embedding in family structures remained substantially untouched.

Conclusion: political transformation and the embedded Italian economy

A broad shift in the ideological orientation of key policy-makers was a major contributing factor to the trends we have observed in this chapter, and happened partly through a process of replacement of political elites. The pressures of the Maastricht requirements, added to the decapitation of the political class after the *Tangentopoli* scandal broke, created an opportunity for pro-market reformers in Italy, notably central bank personnel, to push a reform agenda based on slimming down public spending, liberalizing markets, and disengaging the state from industrial policy. After a brief phase of concertation in the late 1990s to help in reducing inflation, trade unions were also increasingly sidelined and policy began to be dictated more by central bank and academic economists and less by social partners more actively engaged in real productive activity on the ground. The judicial offensive against corruption also contributed to breaking up established patterns of economic coordination by restricting the ability of politicians to intervene by assigning public contracts.

But the policy changes we have outlined in this chapter depend in more subtle ways, too, on the incomplete transformation of political leadership brought about by the transition from the First to the Second Republic. One reason is that the various forms of "statist" economic management, either directed by the central state or coordinated by local political institutions, that characterized Italy's post-war boom began to break down as a result of these political changes. What has been described as "relational capitalism" (*capitalismo di relazione*) relied heavily on the coordinating role of political elites with close relationships to economic actors like banks, unions, and parastatal entities. Because these relationships were often heavily personalized, they did not easily survive the elite turnover of the early 1990s. Further, to the extent that relationships were mediated by more formal institutions such as political parties, the collapse or transformation of the major Italian parties also broke up established networks. Of course, breaking some of those relationships oriented towards corrupt exchange had possible efficiency benefits too. But far less attention has been paid to the costs of disembedding the Italian economy from these political relationships.

Second, the political transition to the Second Republic was not only a change in personnel: it also brought about changes in the political institutions underlying Italian capitalism, with rather predictable consequences for the functioning of the latter. After 1994, Italy moved towards more majoritarian competition, albeit with qualifications due to the continued fragmentation of the political space that forced

the main political parties to form broad alliances. This change occurred both at the national level and at the regional and local levels. At the same time, there was a shift in the balance of power between the branches of government, as the executive, and particularly the Prime Minister, was strengthened at the expense of the Parliament. This occurred not by any constitutional change, but because the electoral system introduced leadership figures in the party electoral alliances as de facto Prime Ministerial candidates. At the local and regional levels, the introduction of elected mayors and presidents with run-off elections and majority bonuses also disrupted established patterns of elite recruitment, making local and regional leaderships more autonomous of the party structures that had traditionally connected them to other social institutions. These changes were important because proportional representation and legislative dominance are in fact functional for the patterns of cooperation typical of more coordinated capitalism, of which Italy was a variant.

Italy's institutional transformation after 1992 presents a remarkable example of policy change and structural reform in the context of a Southern European political economy, and bears important lessons for the eurozone crisis and the proposed solutions to it. Further research to clarify why the attempts to disembed economic relations and re-embed them in more functional social and political forms were more successful in some areas – for example social policy – than in others – like administrative and judicial reform – could yield useful insights for policy-makers seeking to stimulate economic transformation in other countries. Yet the Italian case is also illustrative of the complex interaction between the theory-driven recommendations of policy-makers and other observers and the peculiar social and political underpinnings of a real economic system, with the result that reforms designed to improve economic performance can in certain conditions contribute to worse outcomes. Dislodging the First Republic's political elite and its approach to the political economy implied important costs as well as the more immediately obvious benefits of beginning to disentangle the economy from its embeddedness in corrupt and criminal political networks.

The push to disembed the Italian economy in order to give greater scope to market dynamics led to positive outcomes when it both broke down existing clientelist networks and re-embedded economic life in new and functional institutions. In many cases, as the examples presented in this chapter demonstrate, this did not occur. The Italian political transformation has been incomplete, and old, dysfunctional forms of embeddedness have proved more resilient than reformers expected. But Italy's economic fortunes have also been hostage to economic ideologies that fail to recognize Polanyi's fundamental insight: for markets to work effectively, they must protect and be protected by society.

Notes

1 For a recent example, see Sentence 2016.
2 We should point out that Ferrera and Gualmini did place a question mark in the title of the book.

3 The metaphor of the Italian economy as a bumblebee (*calabrone*), which seems too heavy to fly, has often been used to represent this paradox (e.g., Beccattini 2007).

4 The break in the Italian figures from 2001–2004 is due to a change in Eurostat's source data for income inequality. From 1994 to 2001, the primary source was the European Community Household Panel (ECHP) for the EU15 countries, and national databases for others. ECHP data collection ended with 2001 and was replaced by European Statistics on Income and Living Conditions (EU-SILC). For our countries, EU-SILC was launched in 2003 (Greece) and 2004 (Spain, Portugal, and Italy).

5 Decentralization did not lead to reduced spending overall, however. "While all considered, decentralized spending of regions and local entities amount to more or less 50 percent (excluding pensions and interests), the same territorial entities are responsible for raising less than 18 percent of tax revenue. The result is a vertical fiscal gap of 32% that gives the measure of political un-accountability of the system and that has fostered an uncontrolled increase in the decentralized spending for years.... The trend in the health sector may be emblematic to this regard. From 1998 to 2008 the expenditure has increased out of control from 55.1 to 101.4 billion and the State has transferred 12.1 billion euros to recover the debts of the overspending regions. The lack of incentives is evident. The more a region spends and accumulates debt, the more the State allocated funding to it" (Valdescalici 2014, 75–76). Mussari (2013) notes persistent decision-making authority of central government and "diffuse territorial indiscipline as a reaction to the autonomy limitations imposed by the central government."

6 Some of these were later overturned, and specialists agree that these reforms had little real impact on the rule of law (Caponi 2009, Silvestri 2011). According to Silvestri, the main reasons that the reforms failed is that "the Italian legislator thought things could be improved by changing only the procedural regulations, and leaving the environment in which such regulations are supposed to work untouched" (Silvestri 2011, 3).

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