The Adverse Effects of Wage Moderation and a Proposal for the State as Innovator of First Resort

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1 - Introduction

The economic policies implemented in Italy in recent years, fully consistent with European Commission recommendations and with what has been achieved in other European countries, are essentially based on two axes: fiscal consolidation and structural reforms. Fiscal consolidation is achieved by cutting public spending and increasing the tax burden, with a reduction, in particular, in social spending and welfare services and with an increase in taxation - which is becoming less and less progressive - especially to the detriment of workers. The so-called structural reforms concern the processes of privatization and liberalization and, above all, further measures of labour precarization.

The aim of this paper is (i) to account for the failure of these measures in relation to the declared objective of generating a recovery in economic growth and increasing the employment rate; (ii) to put forward the proposal for a greater public intervention aimed at making the State an employer and innovator of first resort. This is a proposal taken from the post-Keynesian theoretical tradition (Minsky, in particular) and taken up in more recent times by scholars of modern money theory. On this last aspect, a 'sympathetic' critique will be presented, based on the belief that the state, in a capitalist order, is not a 'neutral' actor with respect to the verified power relations existing in the labour market. Far from it. Economic policies are deeply affected by the capital-labour conflict (including financial rents) and inter-capitalist conflicts. In this sense, the proposal in question, rather than being criticized on a 'technical' level (possible inflationary effects, possible increase in public debt), should take into account the intrinsically class nature of economic policy choices.

The paper is organized as follows. Section 2 explains the failure of policies of fiscal consolidation and labour precarization, with special reference to the Italian situation. Section 3 discusses the idea of the state as employer and innovator of first resort and section 4 presents the conclusions.

2 – The failure of wage moderation in Italy

According to the European Commission and the successive Italian governments in recent years, the combination of austerity policies (now referred to as "fiscal consolidation") and labour precarization measures should ensure the resumption of economic growth through the increase in exports. Fiscal consolidation is pursued with the stated aim of reducing the public debt/GDP ratio, while labour precarization is implemented with the declared objective of increasing employment. The two measures - it is expected - should also improve the current account balance, through greater competitiveness of Italian exports. It is therefore thought that wage moderation resulting from lower public spending and greater job insecurity, by reducing production costs, enables Italian companies to be more competitive (i.e. able to sell at lower prices) in international markets. Tax exemption measures also fall within this logic, since lower taxes on profits are expected to mean lower costs for businesses and, therefore, greater competitiveness in international markets.

This is an approach that has proved to be a complete failure and which, unless it is expected to give its results in the very long term, should be completely reversed. The theoretical foundations on which these policies rest are extremely shaky, for the following reasons.

1) Austerity policies, especially if implemented in recessionary phases, cause not a reduction but an increase in the public debt/GDP ratio, which in actual fact has increased constantly (from 120% in 2010 to 133% in 2018). This is due to the fact that cutting public spending lowers the rate of growth by reducing the denominator of that ratio more than it reduces the numerator. This effect grows in proportion to the value of the fiscal multiplier, estimated at 1.5 by the International Monetary Fund. In this sense, fiscal consolidation, even before being a mistake in economic policy, is an error in itself, a technical miscalculation, based on the incorrect calculation of the multiplier effects of changes in public spending.

2) Labour precarization policies do not increase employment, on the contrary they tend to generate increases in the unemployment rate. This is basically for two

reasons. First, job insecurity increases the uncertainty of workers about the renewal of their contract and therefore encourages precautionary savings, compressing consumption and internal demand. Secondly, as it allows companies to regain competitiveness through wage moderation measures, precarious work discourages innovations, hence the growth rate of labour productivity and, consequently, of employment. In addition, by leading to wage moderation, job insecurity helps to generate deflation; deflation increases the real burden of servicing the public debt and makes higher taxation necessary. In a situation where companies are mobile on an international scale and banks, especially in Italy, are creditors of the State, the only taxable subjects (as they are neither mobile nor creditors) are employees (and possibly small businesses).

3)The tax exemption for corporate profits has no significant effects on investments, since these depend fundamentally on entrepreneurial expectations, which, in turn, are strongly conditioned by growth expectations (and therefore by sales expectations). Restrictive fiscal maneuvers, by squeezing internal markets (vital for most Italian companies), can, if anything, worsen expectations and therefore lead to a reduction in investments. Moreover, the tax exemption for business profits - in a situation where it is necessary to generate primary surpluses - involves higher tax on workers' incomes, or on the incomes of those who show the highest propensity to consume. This is another reason why making businesses tax-exempt means reducing their outlet markets, at least the internal ones, with a consequent reduction in profits and an increase in insolvencies. The problem arises above all for the revival of these measures in an attempt to attract investments to the South, through the recent establishment of "special economic zones". In addition, the attempt to use incentives to stimulate investments in the South does not take into account the limited dynamics of domestic demand (firms invest if they expect to be able to sell and obtain reasonable profit margins, which does not happen if demand is low and falling), along with the presence of crime and the inadequate infrastructure.

4) Wage moderation does not increase exports. The latest ISTAT Report certifies that the Italian current account balance has improved only because imports have decreased following the fall in domestic demand, and that the Italian economy is, to date, one of the least internationalized of the European economies. It is also recorded that despite a slight increase in the profit margins of our firms starting from 2014, private investments are still diminishing constantly. It is also pointed out that for a part of our exports (specifically, agri-food and luxury goods), what matters is not price competitiveness (the compression of wages is therefore

useless or counterproductive, since it compresses internal demand), but competitiveness based on quality, or on the so-called Veblen effect, which means the higher the unit price, the greater the volume of goods exported.
Moreover, these are policies that have been implemented for almost a decade now, always with unsuccessful results. The fundamental error of the latest governments lies precisely in having used the (few) resources available in the worst possible way: reductions for businesses and monetary transfers to families (think of the 80 euro measure of the Renzi government). Such measures impact neither private investment nor consumption. Probably, in a very short-term logic, they increase the approval rating, only to then return to the starting point but with fewer resources.

Schematizing to the utmost, in the internal debate in the Italian left (and excluding the options of so-called leftist sovereignty of abandoning the euro), a broadly supported position seems to emerge. It is believed that, *in the given institutional conditions*, i.e. excluding exit options from the European Monetary Union[1], it would be necessary to use the fiscal space available for greater public investments that increase domestic demand and labour productivity. The necessary resources should be found through a more equitable distribution of the tax burden, overturning the logic followed up to now of tax exemption for higher incomes. Restoring greater tax progressivity (i.e. raising tax rates on higher incomes, especially if deriving from financial or real estate rents), as well as responding to an elementary criterion of fairness, is a pre-condition for raising revenues. Added to this is a radical revision of the labour precarization measures. A variant of this measure is related to the possibility of direct public intervention in the labour market, designed to make the State an employer of last resort and innovator of first resort. This proposal will be discussed below

3 – The state as employer of last resort and innovator of first resort: the Italian case

The proposal of the state as employer and as innovator of last resort is motivated, at the factual level and in reference to Italy, by two ideas:

1) The problem of the Italian economy is essentially, and increasingly, a problem of the weakness of the production structure, which has resulted, for at least the

[1] This is not the right place to discuss the numerous reasons for this choice. See http://temi.repubblica.it/micromega-online/come-la-lega-ci-porterebbe-fuori-dall%E2%80%99euro-e-con-quali-conseguenze/ and http://temi.repubblica.it/micromega-online/i-venti-anni-dell%E2%80%99euro-un-bilancio/

past twenty years, in a dramatic fall in the growth rate of labour productivity. Italian businesses, and even more those in the South, are usually small firms, often family-run, not very innovative, with little exposure to international competition, specialized in 'mature' sectors and with low technological intensity (agri-food, luxury goods). Their labour demand is, in most cases, for a low-skilled workforce, despite the growing supply of skilled labor. Youth unemployment, which in Italy reaches 40%, and in some areas exceeds 60%, is largely intellectual unemployment - or underemployment. The successive governments in recent years have tried to counter it, unsuccessfully, by lowering the quality of the labour supply through massive cuts to the training system (see Forges Davanzati, 2018). In this scenario, the idea of expanding employment in the public sector in order first of all to absorb youth unemployment, especially the more skilled component, appears reasonable. The rationale of this proposal is to combine the vision of the state as an employer with that of the state as an innovator - that is, an entity that, in the absence of productivity increases generated in the private sector, takes on the task of producing innovations by hiring highly skilled workers.

2) Contrary to the message of popular media, the entire Italian public sector in its two different branches is in fact the most undersized in Europe. This proposal - in the acronym ELR (State as employer of last resort) - was recently revived in the wake of a reinterpretation of Minsky's thought within the theoretical framework of Modern Money Theory (MMT).

The variant developed by its supporters lends itself to two critical considerations:

a) MMT theorists believe that public spending is or can be fully monetized, assuming that the state and central bank are a 'consolidated' sector (Wray, 1998). What we firstly want to discuss here is whether, *under the given conditions*, there is reason to consider the proposal feasible. In my opinion, this is a critical point. In the MMT it is assumed that the achievement of full employment is possible since the state (seen as a macro-agent consolidated with the Central Bank) can monetize spending without any constraint of scarcity, and do so in the absence of inflationary pressures. The main criticality of this approach is that monetization encounters political constraints (specifically, in this historical phase, in the European Monetary Union), and that these constraints reflect both economic theory beliefs and material interests which cannot be ignored since they reflect existing class relations.

b) The implicit hypothesis of the MMT proposal completely disregards the power relationship between capital and labour. On this point, it is necessary to recall Kalecki's argument that a capitalist economy is incompatible with *maintaining* full employment (as this condition would maximize the bargaining power of workers both in the labour market and above all in the political arena).
The question of identifying funding channels for increased public spending is, to a large extent, a false problem. Identifying the so-called "coverage" is a purely political problem, concerning political decisions on the allocation of public resources among alternative uses. Consequently, the real problem encountered by the ELR proposal concerns the reversal of capital-labour relations: a structural problem, not a monetary one (see Kriesler, and Halevi, 2001). And, assuming its political feasibility here, in the Italian case it must be reformulated, combining the vision of the state as an *employer* and that of the state as an *innovator of first resort*.

The latest OECD survey informs us that, while in our country the public administration employs about 3,400 workers, in France and the United Kingdom, countries with a population and a per capita GDP of similar size to ours, there are 6,200 and 5,800. In the United States - a country traditionally viewed as a true market economy - the number of public employees is about 25% higher than ours. It can be added that, in Italy, employment in the public sector mainly concerns highly educated individuals. It can also be noted that, as pointed out among others by Dutt (2012), a condition of full employment favours the growth of labor productivity. This is due to the fact that firms are not put in a position to compete by compressing wages and instead are 'forced' to compete by innovating. In this sense, the ELR scheme could also - and perhaps more usefully – be designed to generate economic growth *also on the supply side* and not only to achieve full employment. To this we can add that, following the theoretical line of the proponents of the ELR scheme, public spending is *complementary* to private investment spending: it is a 'monetary complementarity', since the increase in public spending expands the outlet markets and makes it convenient to implement new private investment flows[2]. Consequently, an ELR scheme could have a positive effect on the growth rate of labour productivity, both due to the increase

[2] As shown by Forges Davanzati (2016), unlike the operation of the IS-LM model, if we accept the idea that public spending serves as an anchor to private investment, the increase in public spending - since it increases the internal funds of firms and therefore their bargaining power vis-à-vis the banks - tends to be accompanied by a *reduction* in the interest rate, which could stimulate further private investment. As Parguez (2008, p.50) observes: “a full employment policy automatically pushes for increased investment and therefore for the embodiment of more and more technology-innovations in the stock of equipment. It is tantamount to the proposition that a full employment policy sustains the growth of productivity in the long run ”.

in public investments deriving from greater public spending, and as a result of the containment of intellectual obsolescence that would arise in the other eventuality of unemployment, especially if it is long-term. A further advantage of the implementation of an ELR scheme would spring from the fact that, in conditions of full employment, it would be extremely difficult to recruit workers in the shadow economy or, even more so, in the criminal economy. This topic is particularly relevant in the Italian case, and even more in the South, since the presence of illegal work and criminal activity is much more widespread than in other Eurozone countries.

Also relevant, albeit with a stipulation, is the argument put forward by Wray (1998), that unemployment has high social as well as existential costs. Conversely, being employed should ensure better living conditions, also because of the greater self-esteem. True or plausible, but with the necessary specification that the employment guaranteed by the public sector must be rewarding, that is, the ELR scheme cannot merely identify measures to *increase* employment but also *to improve the quality of work*.

Furthermore, as shown in particular by Massimo Florio (https://www.ripensarelasinistra.it/wp-content/uploads/2014/05/florio.pdf), the ELR scheme could be useful in reversing the policy followed in Italy – *its most fervent supporter among the Eurozone states* – designed to push privatizations. Privatizations, as unequivocal empirical evidence shows, generate redistributive effects mainly due to the increase in tariffs - making real wages fall - and the exceptional increase in executives' salaries in the transition from public to private ownership. They also generate less growth since, in many cases, including Italy, privatized firms are companies oriented towards financial speculation which, as documented by many, is a significant brake on real investments.
Public sector inefficiencies, just like examples of wastefulness in the private sector, are everywhere. The rhetoric of the lazy public servant remains such, it damages the country and prevents an open debate on how public interventions in the economy can contribute to economic growth and help create jobs, especially among young people and above all of high quality. Apart from individual cases of ethically reprehensible behaviour (in the Italian media vulgate, that of so-called "crafty clock-punchers"), punishable according to current legislation, one must consider the possible macroeconomic effects that such measures are likely to produce. And it is also necessary to consider first of all that the current legislation - the so-called Brunetta decree - already contains all the necessary measures to allow the dismissal of public employees, in a regulatory framework in which the

private and public sectors have different systems for sanctioning absenteeism. In the private sector, the regulations on sick leave envisage that, for the first three days of continuous absence, the sick leave allowance is paid by the employer, with a percentage of coverage laid down by the national contract. Starting from the fourth day, INPS pays an indemnity of not less than 50 percent of the salary, while the remainder is supplemented by the employer. By contrast, in the public sector the regulations envisage the loss of all additional allowances making up the salary (about 20 per cent of the average salary) for the first ten days of continuous absence due to illness, while house calls by the medical inspector - which can be carried out over the space of seven hours a day - are almost double the number of those in the private sector.

It is no mystery that the measures that, in Italy, have been put in place to monitor the performance of public employees basically reflect the aim of 'slimming down' the public sector, which is commonly justified for two reasons: the Italian public sector is oversized and the employees it hires are not very productive. These are two arguments that do not stand up to the facts.

On the first aspect, consider that, starting from the second half of the 90s, current expenditure began to contract, falling from 896,000 billion to about 894,000 billion lire between 1993 and 1994. The overall expenditure of the public administration dropped from 51.7% to 50.8% of GDP in 1994 and, in 1995, this reduction continued, reaching 49.2% of GDP. It is interesting to note that, in the international comparison with the main OECD countries, from 1961 to 1980 (a period when public spending in Italy was growing steadily), the public resources relative to GDP that the Italian state committed were systematically lower than the average in industrialized countries: purely by way of example, in 1980, the ratio of current expenditure to GDP in Italy was 41% compared to 41.2% in Germany. In the same years, in comparison with the main Eurozone countries, Italy experienced the most significant contraction in domestic demand, mainly attributable to the cuts in public spending and, especially in recent years, to the increase in the tax burden.

As for the second aspect, INPS figures show that, in an international comparison, Italy is one of the countries marked by the lowest levels of sick leave, but with a lower incidence in the public sector. The relative inefficiency of the Italian public sector therefore does not seem to be due to its employees' low motivation to work, but rather to the very low funding allocated to its processes of production of goods and services. Purely as an indication, it can be considered that many public administrations are almost completely lacking in IT systems. It must also be taken into account that, due to the substantial freeze on staff turnover, workers employed in the public sector are, on average, over the age of forty, therefore, for many tasks, less productive than younger workers could be.

Instead, what the Italian economy needs – within the limits of financing available - is public investments in research, which activate a potentially virtuous path of growth driven by increases in demand, in the short term, and by innovations, in the long term. It should be remembered that public and private spending on research and development in Italy is the lowest in the Eurozone. And it should be remembered that, in a situation where businesses do not innovate, it is good for the state to become the innovator of first resort. In other words, as widely shown in the literature, innovations in the private sector are always (and historically have always been) preceded by innovations in the public sector: think of the computers we use every day, whose technical devices ultimately originate from public investments in the information technology sector that can be traced back to the Second World War and the huge loans granted at that stage to the war apparatus in the United States (see Mazzucato, 2014). It can be added that Italy experiences the paradox of a high number of underemployed (or emigrant) graduates, therefore with an individual and aggregate performance level among the lowest in Europe, and fewer employment opportunities in research and development activities funded by the public sector. From this perspective, the real mismatch is not between the supply and demand for work in the private sector, but in the fact that the supply of skilled labour *fails to find* a demand for skilled employees in the public sector (due to the blocking of staff turnover and the absence of a public investment strategy in the field of scientific research).

There is obviously a link between the decline in public and private investment in research and development and the increase in labour precarization, especially in the highly skilled segment of the workforce. The rise in intellectual underemployment and intellectual migration depends fundamentally on the private sector's inability to absorb a highly skilled workforce while the policy response of recent years - defunding universities to de-qualify the labour supply - appears clearly inadequate to cope with the problem (see Bellofiore and Vertova, 2018). These measures are conceivable only assuming that the public actor cannot intervene to change the production structure.

4 – Concluding comments

In this paper, it is shown that policies of fiscal consolidation combined with so-called structural reforms have been and continue to be unsuccessful in achieving their stated aims (return to growth, higher employment). It is also made clear that although the proposal to radically revise this line of economic policy – based on the idea that the state can act as employer of last resort – is in principle decidedly better than the status quo, it presents, with particular reference to Italy, some critical issues. Finally, it is shown that a scheme of the state as innovator of first resort, implemented through a significant increase in public investments in R&D combined with an intergenerational turnover in the public administration, can counteract the continuous increase in youth unemployment, especially for the more qualified.

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