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Law, firms' governance and economic performance in post-1945 Italy

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1. Introduction

The existence of a positive relationship between sound "rules of the game" and economic performance has been widely accepted by economic and business historians since, at least, North's seminal contribution of the 1970s and 1980s (North 1978; North 1981). This perspective was enlarged by of a series of path breaking studies conducted by Acemoglu and his colleagues. On the one hand, they provided elaborations and formalisations of ideas already expressed by North, specifically: institutions are fundamental determinants of economic growth. On the other hand, they defined original ideas on the pattern of evolution of institutions and on their relation with long-term economic performance (Acemoglu, Johnson et al. 2001; Acemoglu, Johnson 2005). Recently, a literature often referred to as the "law and growth" approach has stressed again the relevance of the connection between legal institutions, firms' performance, and economic growth by stressing the relevance of country's legal origin (Laporta, Lopez-de-Silanes, and Shleifer 2008).

From this point of view Italy since 1945 appears a remarkable paradox: on the one hand after the war up and to the early 1970s the country grew at fantastic rates while, on the other, scholars often complained about the poor conditions of Italian laws and institutions more in general (Ciocca 2003; de Cecco 2001).

A way out of this apparent cul-de-sac is to consider two further elements of the story. Firstly, Italian growth slowed down remarkably since the "second economic miracle" of the 1980s and serious doubts are surfacing about the long-term perspective of the economy of the country (Ciocca 2007). Secondly, if we move away from the mere perspective of economic growth and we embraced the wider topic of power and income distribution, it is easy to realize that problems are even bigger. For example Italy has a remarkable level of tax evasion which strongly impacts on the sustainability and efficiency of the welfare system, as well as a gap between the north and the south of the country which shows no sign of improvement (Felice 2007).

One possible interpretation of these phenomena, the one we suggest in this paper, is that Italian capitalism has a predatory nature by which the advantages of economic performance are distributed extremely unequally. Key to this argument is the idea of Italian capitalists as "stock-holders" rather than "stake-holders" in firms. What we mean is that apart from very few exceptions, Italian firms never developed into free-standing institutions able to grow and consolidate, without suffering from undue influence from their own owners, including “tunnelling” of resources. In other words Italian firms never got close to the image provided by authors such as Coase or Williamson (Coase 1937; Williamson 1981). The second pillar of our argument is that the predatory nature of Italian capitalism is the result of poor rules of the game. However, rather than formal rules, it is the way in which they were bent, by-passed, or poorly enforced that matters. To use North’s words, the problem is in the informal institutions, not in the formal ones (North 1990).

The paper is organised as follows. In section 2 we provide a general overview of the style of firms’ governance predominant in Italy and we describe the role plaid by business consultants. In section 3 we describe the sources this paper is based upon. Sections 4 and 5 analyse in details various devices used by the owners of Italian firms to use their companies for personal purposes and, potentially, at detriment of the firms themselves and with costs for the Italian economy. Section 6 provides some tentative conclusions.

2. Black boxes and empty boxes

In the 1980s the economist Nathan Rosenberg coined the famous expression “black box” to define the limitations of neo classical economics to analyse the nature and functioning of firms (Rosenberg 1982). Borrowing from this, we argue that if the exercise is done to look inside the black boxes that are Italian firms, the boxes look empty. As a matter of facts, a closer look reveal that firms are mainly tools in the hands of the owner for him to pursue at least three different types of personal interests. Firstly they are the sources of undue extraction of financial resources. Secondly they are used as a protection against economic risks. Thirdly they constitute a shield against legal problems.

In the following sections of the article we will analyse each of these aspect individually, but before that, it is worthwhile to provide a general overview of the tactics used to turn business into the tools described above and of the incentives which makes these tactics viable and sustainable.

To understand how firms’ owners can dispose of firms at their own convenience we need to discuss the role that in small and medium enterprises, the typical form of Italian capitalism (for recent works on this issue, see Giannetti and Vasta 2006; Colli and Vasta 2010), is played by business consultants. Likewise British chartered accountants, Italian *dottori commercialisti* are a selected group of business consultants and members of a professional guild the access to which is regulated by the guild itself. The *commercialista* is a vital figure in SME because the extreme fuzziness and complexity of the laws concerning issues such as taxation and human resources management require specific competences which would be too expensive for a relatively-small firm to develop internally. However, once the business consultant is hired to deal with these specific problems, firms face a small and declining marginal cost in using the *commercialista*'s competence (and personal connection) to deal with a wider number of aspects of the business management, including the choice of financial instruments. Thus the *commercialista* rapidly becomes a "shadow" general manager of the firm and, strategically, the link between businesses and financial institutions. Given the nature of the Italian credit market this means, in most cases, various local banks (Conti 2000; Spadavecchia 2005). Because of the key role plaid by the consultant, progressively the conditions and costs for firms to obtain financial support become less and less dependent on the reputation of the business itself, and more and more the effect of the ability of the *commercialista* to keep its own reputation intact and to spend it on behalf of the firm.

Thus, what we see inside Italian SME is a constant transfer of key knowledge and information from the owner of the business to the consultant who becomes more and more embedded with the firm itself. What might look like a natural process of separation between ownership and control, however, in Italian firms acquire some peculiar features. First of all, in case of small firms the process of transfer of information and knowledge is potentially reversible given the relatively-simple nature of the business and, in theory, with some level of effort the consultant could be easily put back at his original place. However as long as the consultant manages to guarantee a flow of resources from the firm to the owner, he/she has no incentives to question the conduct of the consultant or the scope of his role. The owner becomes a prisoner in his own cage, but as long as the cage is a golden one nobody complains. Thus rule number one of a quiet relationship commercialist/owner is to extract resources form the firm and "tunnel" them towards the owner himself. We will see in the next section of the paper how this might occur. On the other hand, owners do not deal directly with the issues they leave the consultant in charge of, also because of the relative cost of generating internal resources with the same capabilities, experience, and connection of the consultant himself. However being able to cope with fiscal, labour or financial issues has a huge fix cost (for example establishing and maintaining an internal team of legal advisors), but a relatively small marginal one. This means that such costs are largely independent from the firm's size, with the implication that are relatively higher for smaller firms. This implies that the smaller the firm, the lower is the chance that it could deal with such costs, and the more central is the figure of the consultant. This means that *commercialisti* have a double incentive to divert resources form firms to owners: on the one hand they make the owner happy; on the other they reduce the chance of seeing the firm growing and, potentially, becoming redundant. The result, however, is dramatic for firms themselves and it goes against the expected outcome of the separation between ownership and control. As a matter of facts, when managers are independent from ownership, they have the incentives to make the firms as big and successful as possible in order to consolidate their position by avoiding take-over, and to maximize their prestige and remuneration. In other words the result of separation between ownership and control is to create consistency between the aim of the managers and the one of firm, at least in the short-term. In the Italian case, to the contrary, we can see a peculiar alliance between ownership and control to the detriment of the firm itself.

To use a schematic image we can think of two models of firms that we will define the "Coesian" and the "Italian" one. The former is a free-standing institution which contains the assets (including goodwill), the liabilities, the technical capabilities and the reputation. It is run by professional managers and owners only posses a partnership or shares of this entity. In the latter, the firm itself is predominantly a "veil", a legal entity responsible for the liabilities; the goodwill and assets are solidly in the hands of the owner, while the consultant embodies the reputation.

Up to this point we have focussed our attention on SME, but a legitimate question emerges on whether the analysis can be expanded to Italian firms more in general. Although a systemic analysis of the differences in the governance of small and big firms in Italy would require a bigger scope than the one of this article, some impressionistic evidence suggests that the picture we are painting for SME could easily fit bigger business as well. Let us look, for instance, to the famous case study of *Parmalat*. *Parmalat* is an Italy-based multinational Italian operating in the dairy and more general food, industry which became the leading global company in the production of UHT milk. In 2003 the firm collapsed leaving 14 Billion Euro unpaid debt in one of the biggest insolvency case ever appeared in Europe. At the moment of the insolvency the legal enquiries into the case showed the overwhelming influence of the business consultant Fausto Tonna who operated in a manner very similar to the one described above. Also the enquiry reveal a constant activity of tunnelling of resources from the firm to the owner (the Tanzi family), who accumulated what with some emphasis was defined a “treasure” which included various masterpieces of modern and contemporary art. Although the case of *Parmalat* might certainly be idiosyncratic and not necessarily representative of Italian big firms, still the ex-post analysis of the actual governance of one of the biggest Italian companies revels a structure extremely similar to the one we believe characterizes small and medium concerns.

3. Sources and methodologies

The internal agreements between owners and consultants which shape the informal style of governance of Italian firms take place, by definition, behind closed door and leave no formal record. Thus while firms are operating normally, such agreements are de facto unobservable. However, in case of bankruptcy of the firm enquiries are conducted to unveil the nature of the problems behind it and, in case of alleged irregular behaviour, penal procedures can be activated as well. It is in this case that the nature and functioning of the rules of the game can be analysed and the features of governance analysed.

In order to conduct such an analysis we use a source which has been so far neglected by Italian business historians: the minutes of legal proceedings. Our methodology consists in collecting minutes of cases discussed in the Italian highest court (*Corte di Cassazione*), the one which has the last word in both civil and penal cases. The choice of focussing on the *Corte di Cassazione* is motivated on various grounds. Firstly, it is a national court which expresses its opinion on cases taking place all over the country, thus its records guarantee a proper national coverage. Secondly, the recourse to the *Corte di Cassazione* is expensive, thus worthwhile only in case of severe crimes or very controversial cases. In this way this sources is biased towards the most significant and revealing legal cases.

We selected minutes of cases whose nature can best reveal the types of attitudes of owners towards their own firms which we described above and, potentially, the support offered by consultants. Specifically, we consider both ordinary case of bankruptcy and penal ones. Among the former we selected cases dealing with issues such as: existence of informal business, hidden partners, extra-judicial agreements previous to insolvency, but also accuracy in the assessment of the liabilities, and role of the receivers. The first three cases might reveal an actual structure and functioning of the firm different from the one which appeared to creditors and to the state. Similarly the attempt (successful or non-successful) to reach an agreement with some creditors prior to the actual bankruptcy can be the spy of the existence of non-transparent relationship between the firm (or its owner) and some specific creditors. As far as the role of the receivers, it is important to stress that in Italy official receivers in bankruptcy cases are selected among members of the guild of the *dottori commercialisti*. In other words it might happen that in case of bankruptcy, the firm's consultant (or a close colleague) can also play the role of the receiver, with a clear conflict of interest. Observing directly how this conflict of interest interferes with the functioning of the procedure can provide an accurate ex-post perspective on the role of business consultants inside firms.

Civil-law cases such as the ones described above are very useful to get an insider view into the nature of firms governance but, by definition, can only reveal behaviours and attitudes which for however detrimental of the firms, remain in within the formal border of legality. However the *Corte di Cassazione* also dealt with penal cases that can also reveal whether or not, and to what extent, the informal style of governance also has an illegal dimension. To investigate these issues we mainly look at cases of *bancarotta fraudolenta*, a special procedure to deal with cases of fraudulent insolvency. Typically, cases of fraudulent bankruptcy are characterised by undue transfer of the firms' assets and/or the owner's properties (in case of unlimited liability companies) into hands where cannot be reached and distributed among creditors. This mechanism, however, can be activated in various ways. For example assets can be physically moved and stored in secret locations, but also books can be manipulated to artificially reduce the value of the assets. On the other hand liabilities can be artificially increased and fake creditors made-up in order to distribute parts of the proceedings of the liquidation to friendly middlemen. In our search we selected minutes relative to various penal cases where evidence of such behaviour might emerge.

4. Protection against the economic risk

The process of extraction of resources from the firm has the direct consequence of keeping businesses artificially small, as proven by recent studies showing that the firm dimension in Italy is lower than in the other advanced economies (Federico 2006). As we have seen in the first paragraph, rather than being an unintentional consequence of the perverse alliance between owners and consultants this feature is, in fact, part of an explicit policy aiming at cementing the interests of the two parts.

Businesses whose size is smaller than it should naturally be, however, are particularly exposed to certain problems. Any economic and entrepreneurial activity is open to risk, either because of the risk intrinsic to the business itself and/or because of the potential impact of macroeconomic fluctuations. This risk, however, is much higher for small-dimensioned businesses or for the ones at the early stage of their life, something that makes Italian firms (and their owners) more prone to insolvency.

The need to deal with the consequences of economic risk for entrepreneurs, creditors and partners is the rationale for the existence of bankruptcy laws. Since the 1880s reforms, all over Europe law-makers devised alternative solutions for worthy and sound businesses trapped in illiquidity problems, and unviable and potentially-fraudulent debtors whose firms happed to be in structural insolvency (Sgard 2006). This way worthy entrepreneurs and firms would find an ex-post compensation for the ex-ante risk they run.

Although with some lag, the law was only passed in 1903, Italy introduced a form of pre-bankruptcy agreement (*concordato preventivo*) and, in 1942, a specific legal device (*amministrazione controllata)* conceived to offer illiquid firms a moratorium. From a formal point of view the Italian law thus looked perfectly in line with the one of other European economy and potentially able to protect worthy debtors and firms from the full impact of macroeconomic fluctuation and entrepreneurial risk. In practice, however, things worked-out very differently. A detailed analysis of the use of pre-bankruptcy agreement shows how few companies managed to obtained it in comparison to French or British counterparts; complications in the procedures, lack of attention for the firms' features, inability to constraint minority creditors, all conjured to make this institution almost useless. On the other hand, the *amministrazione controllata* was conceived for relatively big business with a clear separation between ownership and control and was simply impossible to use by the vast majority of firms in trouble (Di Martino and Vasta 2010).

Because of these problems entrepreneurs and firms' owners were *de facto* deprived of a fundamental device to protect themselves against economic risk. As a result informal mechanisms were used instead, in particular early friendly liquidations of firms. What happened in Italy was that owners of businesses in potential trouble preferred to liquidate early and informally, rather than running the risk of facing the complications and limits of the official procedures. Firms were thus constantly sold in piecemeal and re-formed, often with the same ownership and with the support of the same consults who, as suggested earlier in the paper, spent their reputation to guarantee the viability of the new business-in-the making. The continuous recourse to these types of procedures further contributes to keep Italian firms small and also short-lived. This, in turn, makes them more exposed to macroeconomic shocks and increased their probability to run into bankruptcy again. In other words Italian firms can be seen as the victims of a vicious circle by which the extraction of resources keep them small, fragile and prone to bankruptcy which is addressed using informal mechanisms which worsen their ability to survive.

Evidence of the existence of these types of mechanisms have been provided by Di Martino and Vasta (2010). For example it has been showed that in 1924 in the province of Milan (where about one third of all Italian joint-stock companies were registered) only twelve cases of insolvency had been officially declared while one hundred and sixteen firms exit the market. Even taking into account mergers, acquisitions, and firms which simply reached the end of their life, still it is clear that informal liquidation was the standard method for business to deal with illiquidity.

However, from the point of view of the firm it makes an enormous difference whether in case of insolvency the owner decides to go via the official procedure or the informal liquidation, because official procedures could allow firms to be kept as ongoing concerns. On the contrary, informal liquidation leads to the re-starting of the business only if it escapes to run into bankruptcy, something that was much more the rule than the exception (Di Martino and Vasta 2010).

The bottom-line is that deprived from sounds official rules of the game to deal with issues of insolvency, the owners of Italian firms used their businesses as a shield and sacrificed them to save their own reputation.

5. Protection against legal issues

The excessive exposure to economic risk due to the small size and high turnover of Italian firms also increases the risk for owners of having to deal with legal issues. As we argued earlier in the paper, it is often as a consequence of inquiries run during bankruptcy and insolvency procedures that legal responsibilities (both of civil and penal nature) might emerge. As a consequence, the higher the chance of bankruptcy, the higher is the risk of some irregular or illegal operations to be exposed.

As a general principle, the limited-liability form of governance protects stock-holders by limiting their responsibility to the share of capital they own. However, civil and penal responsibilities still affect administrators and managers which in the case of small firms it often means the owners. In order to protect themselves from such risks Italian firms owners have devised a series of ingenious mechanisms spotting the grey areas of laws.

The first one is the use an existing firm as a formal window to cover the fact that the economic activity is run via another one. This type of business is what in the Italian legal jargon is defined as *impresa schermo*, broadly translatable into “mirror company”. In other words, one company formally appears in contracts and agreement, all liabilities are endorsed to this firm, but this is only an empty box. The actual firm exists behind it and it is made of a formal or informal agreement between various partners (what in Italian is called *impresa di fatto*). In this structure it is clear how the firm is nothing more than a veil totally subject to the needs of the owner, a situation which in the Italian legal jargon is defined as “tyrannical” ownership, to stress the ancillary role of the company itself.

The use of formal business to hide the actual economic relationship and activity is the standard method used by Italian firms owner to use them as a shield against the cost and impact of legal and economic problems. However, this basic structure can be further complicated to perfect its functioning. One way of doing it is simply do not appear either in the formal or the informal business, instead keeping the links with other partners via private contracts. This way the so-called “silent partner” is a full-time member of the company but risks nothing in terms of involvement in legal problems or bankruptcy.

A further device that was able to trace in the minutes of the legal proceedings is the ad hoc use of the limited-liability form of governance. In theory the use of the limited-liability has higher cost that the recourse to the partnership, largely because of the minimum amount of capital required and the impact of registration fees. Thus for small partnerships or sole ownership it would have been too expensive to adopt the limited-liability form, leave alone in the joint-stock version. However, it was often the case that inquiries into the failure of joint-stock companies revealed how there firms were originally unlimited-liabilities partnerships or sole-ownership, only turned into the limited-liability form right before the declaration of bankruptcy.

Combining all these mechanisms together it is possible to imagine various combinations of “tyrannical ownerships”: for example a structure where a window limited-liability company is accountable for the legal and economic risk, but it is the facto in the hands of another informal business extracting the profits, or an unlimited-liability partnership is formally owned by middlemen but run by silent partners, and so on.

In all these cases, however, firms are far from being independent free-standing institutions to invest on and to let grow, but simple tools in the hands of their owners.

6. Conclusions

Behind the façade of rapid growth during the golden age, Italy hides substantial problems of long-term economic performance and structural issues of income distribution between social groups, geographic areas, and generational groups.

We argue that the meta cause of these problems is the inability of firms to grow and consolidate and their tendency to remain devices in the hands of owners for them to pursue their own interests.

The consequences are many, from high level of tax complacence to the wide use of illegal workers, from the inability to maintain a presence in high technology sectors to the specialization in labor-intensive products.

Although no specific study of Italy in this tradition still exists, the ample literature on the law and growth view would simply go as far as arguing that this is the expected results of inefficient formal rules developed I within the French tradition. On the one hand, we agree that the main problem is in the rules of the game but, on the other, we suggest that this is not necessarily the consequence of poor formal laws and norms. More likely problems are in the mismatch between the structure of the economic system and the features of laws and, in the ability to bend and by-pass these rules.

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