



UNIVERSITÀ DEGLI STUDI DI MACERATA

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Income distribution, growth and financialization:  
the Italian case.

D. Tropeano

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## **Income distribution, growth and financialization: the Italian case.**

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### **Abstract**

The paper investigates whether the current decline of the Italian economy could be traced back to financialization. In principle financialization could not be so important for an economy in which many firms are not quoted in the stock exchange and for which shareholders' interests should not matter. The author argues that financialization may have deep effects in such an environment by changing the perceived financial norm and the target return on capital. The author draws on a model by Lavoie (1995) extending it to an open economy. She uses this model by looking at the effects of an appreciation, thus replicating the appreciation of the euro in the last years and its possible effects on the Italian economy. The results of such an appreciation would be a fall in the rate of growth, accumulation and in the realized rate of profit. This picture, however, does not fit in well with some stylized facts. In Italy, the rate of growth and the capital accumulation have slowed down while the rate of profit and the profit share have clearly increased. The increase concerns the average profit share and the average profit rate while indeed the profit rate is declining in the manufacturing sectors, but rising in the services sector. At this point a different interpretation is presented, which is no more based on the financialization hypothesis but rather on the increase in the degree of monopoly power in the Italian industrial sectors, given the increase in the mark-up. This process would have been favoured by the privatization process of previously public enterprises. The author shows what might have happened by using a model by Dutt (1995) with two sectors. In this model in the long-run the accumulation of capital is still governed by aggregated utilization and profitability, but the allocation of capital among sectors and their growth depends on the profit rate differential. The profit rate differential might have shifted resources to the service sectors, which would have been favoured by the privatization process. In this case, financialization would be a consequence of the increase in monopolistic competition, which in turn could be responsible for the decline.

*Domenica Tropeano*, Università degli Studi di Macerata.  
E-mail: [tropeano@unimc.it](mailto:tropeano@unimc.it).

# Introduction

The recent performance of the Italian economy has been very weak. The main stylized facts are the slow growth of output and investment, the fall in the export share, and the worsening in the distribution of income, the fall in labour productivity. Many explanations have been proposed, though mainly on the microeconomic level. In what follows I will deal the issue whether Italy's bad economic performance is related to financialization, having the country at the same time entered in a phase of deep structural changes involving both trade and financial liberalizations. In the first section I will give a brief review of the recent literature on financialization, from the macroeconomic side, to see whether this approach could be applied to the Italian case. In the second section I will show the main trends in macroeconomic aggregates and distribution of income in Italy and discuss the debate on these themes. In third section I will propose a very simple model of financialization, which could eventually apply to the Italian case. In that model, financialization would work through an increase in the target rate of return. The conclusions of that model, however, do not fit well the Italian case. In the last section I will examine another story, mainly dealing with monopoly power and classical competition among capitals. According to the last story financialization, interpreted as changed attitude of firms towards investment, share issue, dividends, might be a consequence rather being the origin of the problem. Conclusions will follow.

## 1 Financialization in macroeconomic models.

In the macroeconomic literature on the financialization there are two main settings. Either financialization is defined as a growing rate of return on financial assets relative to real assets, that is an increase in the real long term rate of interest or in the yield of financial activities. Another strand of literature, fast growing in the last year, deals with the change in the corporate governance of enterprises, the so-called shareholder value orientation. In particular it focuses on the increase in the dividends distributed, on the fall in the rate of issue of new shares and on the repurchase of their own shares by enterprises. These changes are incorporated in standard macroeconomic models and their effects on the accumulation of capital and its profitability are examined (see Stockhammer 2005-2006, Skott and Ryoo 2007, Hein and van Treeck 2007, Aglietta-Breton 2001, Boyer 2000).

In Kaleckian models the usual investment and saving functions are re-written by taking into account those changes and the usual comparative statics derivatives are calculated. They show what happens to the endogenous variables of the model with respect to a change in the shareholder orientation. Since this change affects both the investment and saving functions, the result is that an equilibrium between saving and investment at a higher level of output is possible provided that the decrease in investment is compensated by an increase in consumption out of wealth (coming from the increase in distributed dividends). If instead the propensity to consume out of wealth is low, a lower accumulation rate will prevail.

Most of the arguments used can be represented graphically by means of a diagram in the rate of profit is a function of rate of growth of saving and of investment. (see Lavoie 1995). To a certain equilibrium between saving and investment corresponds a certain equilibrium rate of profit. If the curves shift then a new equilibrium point will be reached at a higher or lower rate of growth of saving and investment and a new equilibrium rate of profit will result.

By means of this graphical representation the main supposed changes related to financialization are examined. The so-called shareholder value orientation is simply represented as a downward shift in the investment function. Other things being equal this means a lower saving-investment equilibrium and a lower rate of profit.

The other changes are an increase in the dividend rate. This is simply accounted for by assuming that dividends are a negative item in the saving function of entrepreneurs, which at least in some models are the unique figures to save. If those dividends however are used to demand more goods consumption will increase as well.

As Skott and Ryoo (2007) point out, if a change in the new issue policy and a decrease in retained earnings are the main consequences of financialization, in this type of models the only effect on the rate of accumulation and the rate of profit must be positive. In fact, all these things simply amount

to a reduction in the saving ratio. However, in models where capacity is underutilized and labour supply is elastic, a reduction in the savings ratio will increase aggregate demand and output.

If all these things happen, according to the most common definition of the investment function, the investment curve should shift upwards too. In fact the profit share rises, the ratio of price of shares to reproduction cost of capital rises too, the rate of utilization rises as well. Then in such a context investment should increase too. Empirically however this does not happen and then to reach the desired conclusions one has to assume that, though investment is a function of all these things, the relative parameters are very low and that shareholders value orientation simply means a downward exogenous shift in the investment function.

For example, in the model by Stockhammer (2005-06) it is assumed that shareholders prefer profits to growth and this is embedded in the production function. A growing weight of shareholders means that a point in the preference function of firms where higher profits and lower investment is chosen. As Skott and Ryoo (2007) write, in this case rather than explaining the stylized facts they are simply assumed as basis for the analysis. In this model the outcome of a lower growth of investment and a higher rate of profit is simply supposed to exist and introduced in the production function rather than explained by the model.

In Hein and van Treeck (2007) dividends are explicitly introduced in the saving function of the entrepreneurs and an increase in them has a depressive effect on output if the propensities to consume out of wealth are low. Hein and van Treeck (2007) consider whether the increase in dividends will be transferred to prices or not. According to different parameter values an outcome, which is compatible with the stylized facts of higher profits and lower investment, can occur. This happens when, the increase in capacity utilization notwithstanding, the firms decide not to invest given the weight of the dividends distributed. Thus capacity utilization and profits are high while investment grows at a low rate. The high capacity utilization is due to the higher demand, which stems out of wealth effects as usual. Thus both the profit rate and the rate accumulation move parallel to each other, as in all the models based on steady state growth in the Cambridge tradition. Only investment grows less, that is the rate of profit may be lower than the rate of change in the capital stock. In most models, as Skott and Ryoo (2007) point out, is not clear what happens to the prices of shares and why Tobin's  $q$  does not work, Boyer (2000) keeps it fixed and Stockhammer (2005-06) does not consider it at all.

The problem is that, if shareholder value orientation simply means a shift in the investment function, one wonders then why to have such an investment function? If, as is commonly assumed, investment is rather insensitive to increases in the share of profits, capacity utilization and the  $q$  ratio, then the next question to ask is for how long an expansion fuelled only by consumption may last. In middle-run models this question may be ignored but the same is not true in the long run.

The assumption of the shareholder value orientation is simply used as a *deus ex machina* to make the models match the empirical evidence. In practice, this amounts to denying any validity, under the present historical conditions, to the investment functions. Then why do we still use them?

Another issue is how changes in the dividend and new issue policies of corporations are introduced in the analysis. Though most of the scholars dealing with the issue of financialization refer to Lazonick's definition of the present era as one of "downsize and distribute" rather than "retain and grow", nobody asks how these increased profits to be distributed are obtained. The underlying assumption is that the share of retained profits falls as to allow a greater part of them to be distributed. The question which is not on the agenda is how the increase in the profit share and rate has been obtained. The question answered instead is what happens if a greater part of profits is not retained within the firm but distributed as dividends to the shareholders. But a sensible assumption would be that the target rate of return of enterprises has increased. Moreover if they downsize this has important implication on the composition of aggregate demand. The most common consequence is a fall in the level of wages paid. Thus opposite tendencies prevail at the top and at the bottom of the production chain. At the top concentration increases while at the bottom increased competition depresses wages (see Milberg 2006). All these things are neglected in the most used aggregate models, which are by definition one sector models.

In the rest of the paper, which refers to the present situation in Italy, the issue of financialization is dealt in an open economy context by focusing on the increase in the target rate of return of

enterprises, favoured by various circumstances, among which the change in the financial norm at the world level, the opening of the economy to foreign trade, the privatization of public enterprises, the change in the regulation of labour markets. Thus the effect of shareholder orientation on dividends, new issue etc is ignored in the first stance.

## 2 Changes in income distribution and slow growth: the case of Italy.

The present state of the Italian economy is not encouraging. The country is often described as being in a state of economic decline. There is no agreement however of what is meant by this word. The most common mentioned circumstances are the slow growth of output and capital accumulation, the fall in the productivity of labour and the fall in the share of exports. Moreover in the last decade there has been a shift in the distribution of income with a rise in the share of profits and a fall in the share of wages. All this has happened just when the Italian economy has undergone a process of financial opening, trade liberalization and internal economic reforms aiming at improving efficiency and performance. Among the latter the most important one has been the privatization of previously state owned enterprises. The introduction of the euro and its appreciation until now has contributed to the difficulties encountered by the exporting industries.

At the same time the economy has experienced a process of de-industrialization and tertiarization common to many other European countries but with some peculiar characteristics. The weight of the industrial sector calculated as percentage of its value added to the gross national product had decreased while that of various types of service sectors has increased. In the last years this process has accelerated and now the industry account for roughly 30% of GdP.

At the same time a change in the distribution of income has happened. The share of wages has fallen while that of profits has increased. The fact has been empirically ascertained by a number of recent studies (Levrero and Stirati 2005, Prezioso 2005, Torrini 2005a, Torrini 2005b, Daveri and Lasinio 2005). The methodology employed in these studies is different but this notwithstanding the results are the same. In what they differ is the interpretation of the results. Torrini (2005b) and Daveri-Lasinio estimate a neoclassical production function, which could allow for changing factor shares. Prezioso (2005) calculates that the wage share has fallen five percentages points in the last twenty years. The fact is remarkable because during the same period total employment has been rising by 21.1%. Levrero and Stirati (2005) calculate also the wage share for the same period and find a fall in it and also they calculate the rate of profit by dividing the profits by the value of capital and find a rise in it which is particularly remarkable for the services sectors.

Prezioso (2005) calculates the mark-ups for two series of prices, consumption good prices and industrial products. In the industrial sectors the mark-up over variable costs has decreased. This fall however has not benefited workers because fixed costs have increased, namely the costs of scrapping old machinery and replacing it with new one. The average time use of plants has greatly decreased. The mark-up so has not increased, though the rate of increase of prices has been higher than that of labour costs. Notably the price of exports in Italy has been higher than that of foreign competitors, even European ones. The rate of growth of industrial prices has been higher than that of the same goods in France, Germany and Spain. The conclusion that Prezioso draws is that the rise in the mark-up has contributed to the slow growth of output since the average propensity to save out of profits is usually lower than that out of wages. In Kaleckian types of models the value of the multiplier falls as the mark-up rises (for a restatement of this proposition see Vera 2006). To this it must be added that the main sources of output growth in the same period have fallen, namely state expenditure and exports. State expenditure has been cut to reduce the debt and meet European targets, exports fell because of the decline in the industrial sector. Thus aggregate expenditure has been reduced and the multiplier though the rise in mark-up too. The lower expenditure has had a smaller effect than in the past on output.

Levrero and Stirati (2005) offer the same type of empirical evidence as to the changes in distributive shares. They offer a slightly different explanation of the fall in the profit share of the industrial sector with respect to that of the services sector. They argue that to the different market structures

in the two sectors, the industrial sector operating in condition of full competition the other sector under monopolistic conditions. They argue that, if the mark-up and then the profit rate increases in one sector, whose products are used as inputs by the other sector, the profit rate in the latter must necessarily decline independently from the differences in the market structure. This would happen just because of input-output linkages. Many scholars also claim that the loss of competitiveness of the Italian exporting industries is due to the higher prices of the services employed in the production of industrial goods and thus to the inefficiency of the non traded sectors, which are not exposed to international competition. However, a closer examination of the weight of intermediate inputs from these sectors over total costs of the industrial sector cast some doubts on this explanation (see Schiattarella 2007). The same result has been reached by using a different method by Daveri and Lasinio (2005).

Another open issue is the source of higher mark-up in the services industries. Services is a wide sector where there are both traditional low productivity sectors and modern industries. The productivity of labour in those sectors has been always lower than in traded good sector and in the last years has declined further. However the mark-ups are also high in industries which have been privatized and have a high productivity of labour such as telecommunications, banking and finance and new services to enterprises. For the branches, whose productivity has fallen, the higher mark-up comes out from recharging on prices the increase in costs; for the other more efficient ones, the high mark-up comes out from the choice of not granting to labour its share of productivity improvements. This could fit well the motivation given in the financialization literature. The owners and controllers of those big firms aim at a high stock market valuation and to get it they have to show high net profit figures in their balance sheets. They need also to have high margins to be able to distribute dividends. High profit margins and high dividends are also necessary to be able to resell the firm with a capital gain after some time (see Telecom).

As a matter of fact, the return on capital has been higher in the newly privatized industries, irrespective of their belonging to the manufacturing or service sectors. Torrini (2005b) calculates the return on capital is calculated as the profits net of depreciation divided by capital value at replacement costs. He finds out that , starting from a base value of 1.00 in 1989, the rate of return on capital in the manufacturing sector has been falling throughout the period 1989-2001 reaching 0.52 in 2001, while, over the same period, it has been rising from 1.00 to 2.21, 1.65, 1.30 respectively in the three sectors energy, transportation and finance (see Torrini 2005b table 5 p.24).

In this case, though the ratio of price of shares to the cost of reproduction of capital (Tobin's  $q$ ) rises, no increase in investment occurs because the required high rate of return is possible only in high oligopolistic sectors where entry is legally regulated and requires enormous financial means. The option of setting up a new firm rather than acquiring an existing one is not available in these cases. This means that investment is replaced by mergers and acquisitions which in turn require high borrowing. Further those mergers and acquisitions boost the price of shares of the firms to be acquired. In the traded goods sector the labour saving technical progress may displace workers while in the non traded sectors the expansion of overhead labour may increase employment, though only for low skilled workers. The combination of all these changes may cause a shrinking of the labour share and a rise in the average rate of profit without an increase in the rate of growth of output.

The increase in the target rate of return in one sector according to Lavoie and Ramirez (1997) should decrease the rates of accumulation and the rates of growth in all sectors both in the short run and in the long run. The model however is a model where capital accumulation depends on the utilization of capacity and in which nominal wages are fixed. The mark-up is fixed and the paradox of costs holds. In the present environment maintaining a certain profit margin in adverse circumstances is possible if an adequate restructuring of the production is undertaken f.e. through foreign outsourcing to low wages countries. This implies to assume that both nominal wages and mark-ups are flexible. In this way a low accumulation of capital and a low growth rates may be compatible with a higher target rate of return and also a higher ex post realized rate of return at least in some sectors where the new investment is concentrated.

### 3 Financialization and the Italian case: the effects of an increase in the target rate of return

As we have seen in the preceding section, the empirical studies on the Italian economy we have cited all agree that the mark-up has increased, particularly from 1992 onwards, though with different trends in different productive sectors. Thus the main issues discussed in the macroeconomic literature on financialization, namely the consequences of different attitudes of managers towards retaining profits and new issues or the wealth effects on consumption are not relevant in the Italian case. The reason may be that most Italian firms are small, thus they are not concerned with the problems of middle and big corporations. Moreover the wealth effects on consumption have virtually vanished after the lowering of the interest rate on debt and its sale abroad while they were important in the seventies and the eighties. This notwithstanding, I am arguing that financialization may still be important in the Italian case if attention is devoted to the issue of the increase in the target rate of return, which may be the consequence of the financial opening and of a different sensitivity to this issue.

In order to explain the macroeconomic consequences of an increase in the financial norm on output growth and the rate of profit I will use an old model developed by Lavoie (1995). In particular I will draw on the so-called neo-Ricardian variation on this model. The object of Lavoie' work was the increase in the real rate of interest on the rate of profit and the growth rate of output. He uses the same model with a few variations to show the different positions on the subject of Cambridge theorists, Kalecki, neo-Ricardians and at the end he develops a variant that is called Minsky-Steindl.

In the tradition stemming from Cambridge and Kalecki a rise in the rate of interest should simply lead to a fall in the rate of growth and the rate of profit. Some neo-Ricardians following Sraffa's idea that the increase in the long run rate of interest should lead to an increase in the desired rate of profit or normal rate of profit argue like this, distinguishing however between the ex ante and the ex post rate of profit. At the end he develops a sort of Minsky-Steindl model where wealth effect are considered and entrepreneurs are allowed to save in which it is shown that an increase in the real rate of interest may have effects of different type on the rate of accumulation and the rate of profit according to the values assigned to the parameters of the model.

The claim that an increase in the financial rate of return should increase the normal rate of profit in Sraffa is not based on macroeconomic considerations. Thus it is not necessary to develop a complicated macroeconomic model to see what happens to the accumulation of capital. An increase in the financial norm could have macroeconomic effects even if all the other ingredients used by Lavoie (1995), such as the propensities to save out of profits, out of wealth and so on, were omitted from the model. The inclusion of all these ingredients obviously change the equilibrium point between saving and investment and may give rise to different results. The tendency of the normal rate to equate the changed rate of return on financial assets does not necessarily depend on the saving and investment propensities of capitalists, shareholders and bondholders. It could exist even in an economy, which is not so sophisticated from this viewpoint. Italy is a case in point. Thus in order to see the macroeconomic effects of a change in the perceived rate of return on financial assets it is not necessary to have a model in which all these different propensities to save and to invest are specified. A change in the perceived return on financial assets might have macroeconomic effects even in an economy with a much simpler financial structure. For this reason I will use the most simple model developed by Lavoie (1995) with reference to the neo-Ricardian position.

In Lavoie (1995), the Kaleckian model consists of an investment equation depending on the differential between the expected rate of profit and the interest rate and of a saving equation derived from the Cambridge equation. The demand for investment depends on the expected rate of profit and on the interest rate and on a parameter  $\gamma$  that describes the expected future sales growth.

$$g_i = \gamma + g_r (r^e - i) \quad (1)$$

Where  $r^e - i$  is the difference between expected rate of profit and the real interest rate. The saving equation will be equal to the Cambridge equation :



$$gs = sp_r \quad (2)$$

The combination of the equation 1 and 2 under the assumption that expected and realized profit rate are the same allows to get an equation for the rate of profit as a function of exogenous variables and parameters.

$$r = \frac{\gamma - gr_i}{sp - g_r} \quad (3)$$

Lavoie (1995) adds another equation, which defines the profit rate from the standpoint of costs. Thus the rate of profit defined as profit over capital is defined as follows:

$$r = \frac{\pi}{K} = \left(\frac{\pi}{Y}\right) \left(\frac{Y}{C}\right) \left(\frac{C}{K}\right) = mu \left(\frac{1}{v}\right) \quad (4)$$

Profits over capital are equal to the ratio of profits to output multiplied by the ratio of output to capacity output and to the ratio of capacity output to the stock of capital. M is the share of profits u the rate of capacity utilization and v the capital/output ratio, assumed as given.

Equation 4 can be rewritten in the following way:

$$u = \left(\frac{v}{m}\right) r \quad (5)$$

Lavoie then recalls that for a rate of profit given by the effective demand constraint of equation 3 the rate of capacity utilization u depends on the margin of profit m that is on the mark-up over costs set by the firms. The price is determined by the following equation:

$$p = (1 + \theta) w/y \quad (6)$$

Where p is the price level,  $\theta$  the mark-up w the nominal wage rate and y the average labour productivity. The mark-up and the rate of profit are related to each other in the following way:

$$m = \frac{\theta}{1 + \theta} \quad (7)$$

According to Kalecki's original thought, the mark-up should be fixed.

Lavoie (1995) reformulates this model in order to take into account the neo-Ricardian critique and the reformulation is the following. The main objection of the Neo-ricardians is that investment does not depend on the actual rate of profit and does not depend on the interest rate but rather investors when making their decisions look at the natural rate of profit or normal rate of profit. The normal rate of profit should be equal at least to the opportunity cost of alternative investments such as the real interest rate and to the normal profit of enterprise. Thus the equation for the normal rate of profit is the following:

$$rn = i + npe \quad (8)$$

This equation may be linked to the cost-plus pricing model. In fact in target return pricing the margin of profit is set to a level that provides a normal rate of profit when firms produce at the normal standard degree of capacity utilization. In terms of the previous model this implies that :

$$rn = \frac{mun}{v} \quad (9)$$

By combining the last two equations we see that :

$$m = m_0 + m_i i \quad (10)$$

We can see that the profit margin becomes a positive function of the real interest rate. We then define:

$$m_0 = (npe)v/u_n \quad (11)$$



And

$$m_i = v/u_n \quad (12)$$

The real wage would be defined by the following equation:

$$w/p = y(1 - m) \quad (13)$$

Lavoie also considers the neo-Ricardian claim that the investment function does not depend on the current rate of profit but on the normal one and replaces the investment function of the previous model with the following:

$$g_i = \gamma + g_r(r_n - i) = \gamma + g_r(npe) \quad (14)$$

In this case the  $g_i$  curve becomes a straight line (see Figure 1). Lavoie shows that in that case an increase in the normal rate of profit will cause a rotation downwards in the profit cost curve since the mark-up increases and even if the investment line does not move at all a fall in the utilization of capacity occurs. The realized ex post rate of profit would not change after the revision in the normal rate of profit.

If applied to the Italian case, this means that the increase in the financial norm has increased the mark-up on costs, thus causing a fall in the realized utilization rate. The equilibrium between saving and investment has not changed. This means that the change in the financial norm has had no effect at all on the rate of growth of output and the rate of profit. Of course this happens only under the assumption that the investment equation is a straight line. If investment had been lower, then a fall in the rate of growth of output and in the realized rate of profit would have occurred (see Figure 1 at the end of the paper).

A different picture arises if we expand the same model to an open economy. An extension of this simple model to an open economy requires that in the saving equation we take into account of the current account of the balance of payments. In an open economy the saving investment equation is replaced by an equation that has on the right side the sum of investment and the current account balance. If we assume, as usual, that the current account depends on the level of the real exchange rate we get the following equation for savings:

$$g^s = s_p r + CA(h) \quad (15)$$

The real exchange rate  $h$  is defined as the ratio of the nominal exchange rate multiplied by the foreign price level divided by the domestic price level:

$$h = \frac{eP^*}{P} \quad (16)$$

We assume as in the preceding model that mark-up is fixed and not flexible and is exogenously determined by the conditions on financial markets. Thus we do not assume that domestic firms profitability depends positively on the exchange rate. If the exchange rate appreciates domestic firms do not reduce their mark-up in order to maintain competitiveness. This contrasts with other views on the issue of mark-up and competitiveness (see Blecker 1989) but it reflects closely the behaviour of Italian exporting firms (see Bugamelli, Tedeschi 2007).

Now we see graphically the consequences of a higher target rate of return and of a nominal appreciation. We observe that the saving curve goes up thus decreasing the rate of profit ex post, while the rise in the mark-up makes the price cost margin curve PC rotate downwards (see Figure 2 at the end of the paper).

In the case, in which, the target rate of return is raised and a nominal appreciation occur, the saving curve should shift on the left because of the lower value of  $e$ , the nominal exchange rate, and the higher value of  $P$ , the price of domestic goods. This amounts to a real appreciation of the domestic currency. In a closed economy, instead, under these conditions, an increase in the target mark-up would have only led to a decrease in capacity utilization while the rate of profit ex post would have stayed constant. In fact, if we assume that the investment line does not move the higher

desired target rate of return will only affect utilization of capacity but it will not lower the realized profit rate. The effect of an appreciation would be a fall in the rate of profit (see Figure 2). The final result of a constant rate of growth and an unchanged rate of profit, though with lower utilization rate, does not fit well the current situation of the Italian economy as we have seen in the last section. In fact the rate of profit has increased while the rate of growth has decreased.

The reason why this model does not fit the Italian situation may be linked to some weakness in its main assumptions. In particular the model assumes that an increase in the target rate of return causes a rise in the rate of profit on all investment, including that made in the past, rather than on new investment only. Lavoie (1995) asserts that the normal rate has nothing to do with the realized ex post rate of profit and therefore it is used as a substitute for the mark-up that firms impose on variable costs. Once the normal rate of profit has been revised, the mark-up in the whole economy must increase and thus the real wage and the utilization rate must fall. A radical objection to this interpretation is that the normal rate of profit is the return that new investment should carry in order to be made. If firms would decide to invest more, according to their expectations of future sales or whatever else, they would require in normal conditions under normal capacity utilization a rate of return at least equal to the revised normal rate.

It is different however to argue that firms will impose a higher mark-up on costs, other things being equal, only because they have revised their normal rate upwards. A more sensible interpretation would be that firms would plan their future investment in such a way as to reach that higher rate of profit. Besides this, it is unlikely that firms raise their mark-up without experiencing losses in realized sales and then in ex post profits. Moreover, the idea of the mark-up does not mean that they may only increase prices to get a higher profit margin, they may decrease costs as well or plan to organize the production in a different way to get the same result (see Sawyer and Shapiro 2003). Prices neither are determined by costs nor determine them.

*“The prices of the firm are not given with the costs of its products, nor are they determined by the demand for them. Prices do not necessarily change with the demand for products just as they do not necessarily change with the costs, and they do not do so for the same reason: the price changes may not be in the interests of the firm.” (Sawyer and Shapiro 2003 p.358.)*

While it is likely that the revision in the normal rate of profit may affect future investment decision, it is, however, not warranted that the increase in the mark-up may be applied to current production. The Italian case shows a marked increase in the weight of the services sector in the value added. This tendency however is common to all industrialized countries and thus may not be connected to the financialization. The peculiarity of the Italian case however is the increasing weight, over the value added of the private services, of some industries. These industries, telecommunications finance transport, have been privatized and, after that, both their profits and the valuation of their shares have increased. New investment in those industries could be undertaken only because they were privatized. In order to purchase them it had been necessary to buy their shares on the market. Once acquired, the investment strategy pricing and all the other organization issues could have been decided ex novo by the new owners. Often owners and managers were the same persons. The price elasticity of demand for utilities is also not very high. Moreover the strategy of the new owners may not have been focussed on long term growth but rather on profitable re-selling after a short period (see the Telecom case). In this case the capital gain on future sales would have been higher, the higher the increase in the valuation of shares.

#### **4 An alternative story: monopoly power, classical competition and financialization.**

An alternative explanation of the changes in the distribution of income in Italy and of the evolution of the macroeconomic aggregates could be based on a model, in which mark-up pricing co-exists with classical competition (see Dutt 1995, Dutt 1997). In this model, the rate of growth of output would

depend on the rate of capital utilization (average) and on the rate of profit. Thus the accumulation of capital would depend on the utilization and profit. The allocation of a given capital among sectors would depend instead upon the profit rate differentials among sectors. The last feature would reintroduce some form of classical competition in the model. There is a mechanism, however, which ensures in the long run equalization of profit rates and convergence to the steady state rate of growth. The rate of growth is defined as follows:

$$g = (g_1 K_1 + g_2 K_2) / (K_1 + K_2) = \tau_0 + \beta_1 u + \beta_2 r \quad (17)$$

Where

$$u = (P_1/P_2)^0 u_1 k_1 + u_2 k_2 \quad (18)$$

And

$$r = r_1 k_1 + r_2 k_2 \quad (19)$$

Where

$$u_i = X_i/K_i, k_i = K_i/K_1 + K_2 \quad (20)$$

And  $(P_1/P_2)^0$  is the initial price ratio.

If the allocation of investment between sectors is governed by the profit rate differential:

$$g_1 - g_2 = \mu (r_1 - r_2) \quad (21)$$

In the short run, given the stocks of capital, the market for each good clear through output adjustments. In the long run the stocks of capital in the two sectors change. Of course if there is no possibility of free entry in the second sector the profit rates in the long run would not be equalized.

The implications of the model are the following, according Dutt (1995). The relative price both in the short run and in the long run is determined by the each sector's degree of monopoly and by technical parameters. This would be in contrast to the classical approach where prices are determined assuming equalized rates of profit, given input-output relations and distributional parameters. In this type of model the allocation of capital among sectors would depend on the relative profitability of the sectors and the movement of capital would produce in the long run the equalization of profit rates. In this case no change in the target rate of return would be necessary to explain the trends in the accumulation of capital, output growth and the distribution of income. The profit rate differential would be sufficient to cause the higher rate of growth in newly privatized sectors with respect to old industrial sectors. In this case however no equalization of profit rates would be attainable even if free capital mobility is assumed. The reason is that the sector with higher returns are monopolistic ones, this means that there are barriers to entry. The only thing that can be done is to purchase a stake in it in order to control them. The attempt to purchase them would only cause a rise in the prices of their shares and thus in the value of the value of their capital in the stock exchange. The rate of profit in some sectors could be persistently higher than in other sectors and higher than the average rate of growth.

## Conclusions

I have recalled some stylized facts regarding the Italian economy. In particular, in the last twenty years, the rate of profit and the share of profit have gone up, output growth and investment have slowed down and the export share has fallen. We have discussed whether the decline of the Italian economy could be linked to the financialization process. Usually the literature on financialization focuses on changes in the investment attitude of corporations like the increase in distributed dividends and the fall in the new issue of share. I have argued that, even in a country where all these things have happened partially and later than in the rest of the world, financialization may have deep effects by changing the perceived financial norm. If this financial norm affects the target return

on capital, macroeconomic effects may be very important even without explicitly taking into account all the other things.

By drawing on a model by Lavoie (1995), I have shown that an increase in the target rate of return would leave unchanged the rate of accumulation, the rate of growth and the realized rate of profit while decreasing the capacity utilization. If we extend the same model to an open economy and assume that an appreciation of the currency occurs, a fall in the rate of growth, accumulation and in the realized rate of profit would follow. This picture, however, does not fit in well with the stylized facts mentioned above. In Italy, the rate of growth and the capital accumulation have slowed down while the rate of profit and the profit share have clearly increased. The increase concerns the average profit share and the average profit rate while indeed that the profit rate is declining in the manufacturing sectors and is rising in the services sector. The profit rate is declining in the manufacturing sector, due to the increase in fixed costs for a more rapid replacement of the old capital stock. This decline would not depend on the utilization rate.

At this point a different interpretation is presented, which is no more based on the financialization hypothesis but rather on the increase in the degree of monopoly in the Italian industrial sectors, given the increase in the mark-up. This process would have been favoured by the privatization process of previously public enterprises. We show what might have happened by using a model by Dutt (1995) with two sectors. The stock of capital is fixed in the short run while the rate of growth depends on the total utilization of capacity and the average rate of profit. In the long run, however, while the accumulation of capital is still governed by aggregate utilization and profitability, the allocation of capital among sectors and their growth depends on the profit rate differential. In the steady state, this differential would tend to zero. In reality, if there are barriers to entry or limited possibilities of expansion in the higher profit sectors, this does not need to happen. The only thing that has happened is the attempt to purchase stakes in those industries, which in turn has increased the value of their shares, so satisfying the objectives of their managers. In this case, financialization would be a side effect of the increase in monopolistic competition.

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Figure 1: Equilibrium between saving and investment (upper part of the graph) and price cost margin equation (lower part ) in Lavoie (1995).

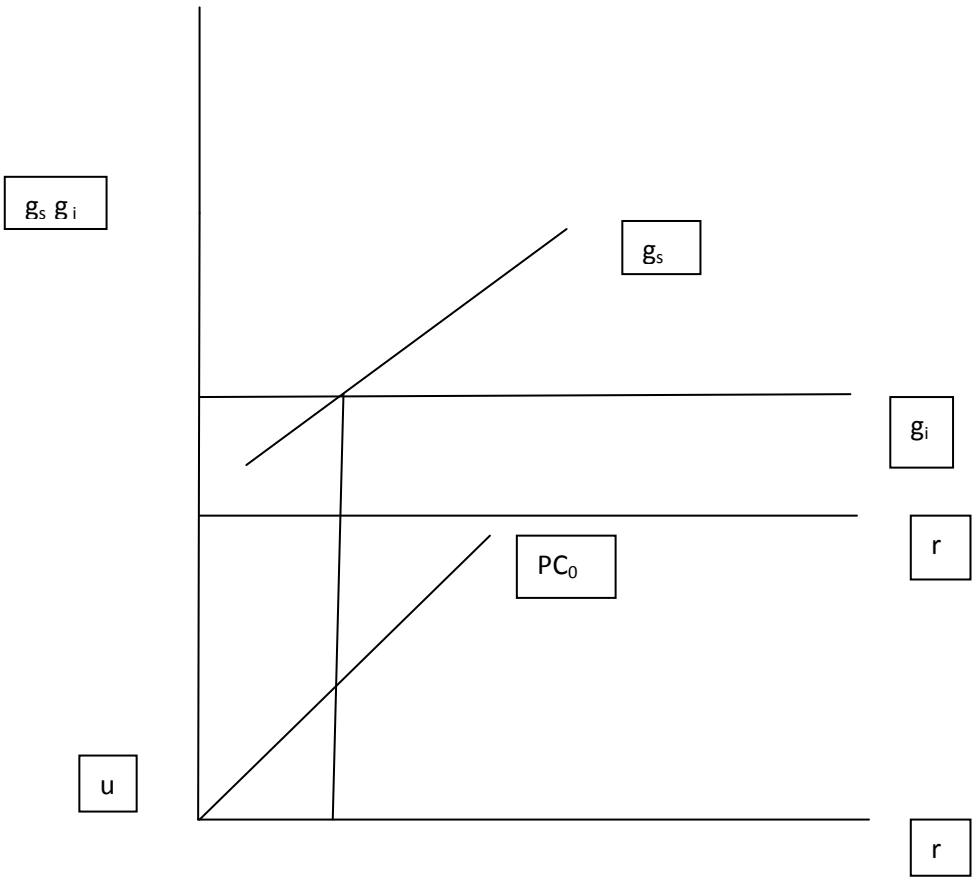


Figure 2: Equilibrium between saving and investment and price cost margin equation in an open economy after an appreciation of the currency.

