Italy's latest legislation on accounting fraud highlights the country's difficulty in pursuing real economic and political reform

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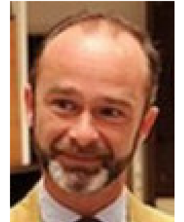


Italy has a longstanding corruption problem which the Italian Prime Minister, Matteo Renzi, has pledged to address. **Andrea Lorenzo Capussela** *and* **Vito Intini** *write on a recent piece of legislation introduced in June which alters the rules on accounting fraud. They argue that the legislation has opened up a significant loophole and is indicative of the Italian political system's inability to produce meaningful political and economic reforms.*

Applying a law that had entered into force one day earlier, on 16 June Italy's highest court, the Court of Cassation, acquitted a person who had been sentenced to roughly seven years for bankruptcy (by an appeals court, applying the previous law). The reason for the acquittal is that the new law no longer punishes valuation fraud: namely, it no longer punishes the deliberate inclusion of incorrect valuations of assets or liabilities into a company's financial statements.

This episode may seem trivial. We would argue, conversely, that it offers a good illustration of some of Italy's main politico-economic problems. The reasoning for the judgment has not yet been published. Without it, as some government officials have correctly remarked, it is impossible to assess with precision the effects of the new law: for example, the deliberate making of grossly incorrect valuations might still be a crime.

Nonetheless, if we assume that the Court of Cassation has not misread the new provision – which seems a reasonable enough assumption, for this court has the final word in interpreting laws – we can already conclude that a significant loophole has been opened. Henceforth, only the crudest form of accounting fraud – e.g. when a company says that it owns an asset it knows it does not own – will certainly fall foul of the law, whereas if a company values a ten-year old car at little less than the purchase price there may well be no crime: because the question concerns the valuation of the asset, not its existence.

Only civil remedies would remain for such forms of accounting fraud: damages, if any, and the rectification of the company's accounts. These remedies are largely toothless, however, because they are in the hands of agents – creditors and shareholders – that typically lack the necessary information to use them, and do not have the prosecutors' means to obtain the necessary evidence (controlling shareholders in non-listed companies do generally have the necessary information, of course, but they often lack the incentive to use it: as they typically either directly manage the company or closely supervise the managers, accounting fraud can hardly happen without their consent).

This is precisely why there are also criminal sanctions to repress accounting fraud. And what such sanctions are intended to protect is not just the interests of creditors and shareholders, but also an important public interest, for accounting fraud can distort both the product markets and the market for capital.

Yet, any Italian company that chooses to falsify its accounts – to support the market price of its shares, for example, or to obtain better financing terms, reassure banks and long-term suppliers, avoid a recapitalisation, evade taxes, create slush funds (from which bribes are typically drawn), etc. – now might have a safe and very versatile instrument at its disposal: valuation fraud. Only those companies that are so unsophisticated, or desperate, as to engage in the bluntest forms of accounting fraud might be caught by the new law.

The context and history of this loophole make it even more perplexing. It is often reported that a significant weakness of the Italian economy is the small average size of its businesses, which seem ill prepared to compete effectively in increasingly globalised markets. Indeed, as Table 1 shows, around 95 per cent of Italian businesses are micro enterprises (1–9 employees), employing almost 46 per cent of the occupied labour force and producing about 30 per cent of value added.

Table 1: Size of Italian enterprises (click to enlarge)

	Number of enterprises			Number of employees			Value added		
	Italy		EU-28	Italy		EU-28	Italy		EU-28
	Number	Proportion	*Proportion*	Number	Proportion	*Proportion*	Billion €	Proportion	*Proportion*
Micro	3 527 452	94.8%	*92.4%*	6 629 987	45.8%	*29.1%*	201	30.4%	*21.6%*
Small	171 658	4.6%	*6.4%*	3 049 375	21.1%	*20.6%*	141	21.3%	*18.2%*
Medium-sized	19 126	0.5%	*1.0%*	1 837 003	12.7%	*17.2%*	118	17.8%	*18.3%*
SMEs	**3 718 236**	**99.9%**	***99.8%***	**11 516 365**	**79.6%**	***66.9%***	**459**	**69.5%**	***58.1%***
Large	3 139	0.1%	*0.2%*	2 960 003	20.4%	*33.1%*	201	30.5%	*41.9%*
Total	**3 721 375**	**100.0%**	***100.0%***	**14 476 368**	**100.0%**	***100.0%***	**661**	**100.0%**	***100.0%***

Source: SBA Europe factsheet, 2014

The problem, however, lies less in the static picture – too many small companies – than in the dynamics: too few small companies grow to medium size, and too few medium-sized businesses mature into large ones. As Table 2 illustrates, in fact, over the past decade 'downsizers' were relatively more common in Italy than either firms that remained in the same class size, or firms that were able to upsize.

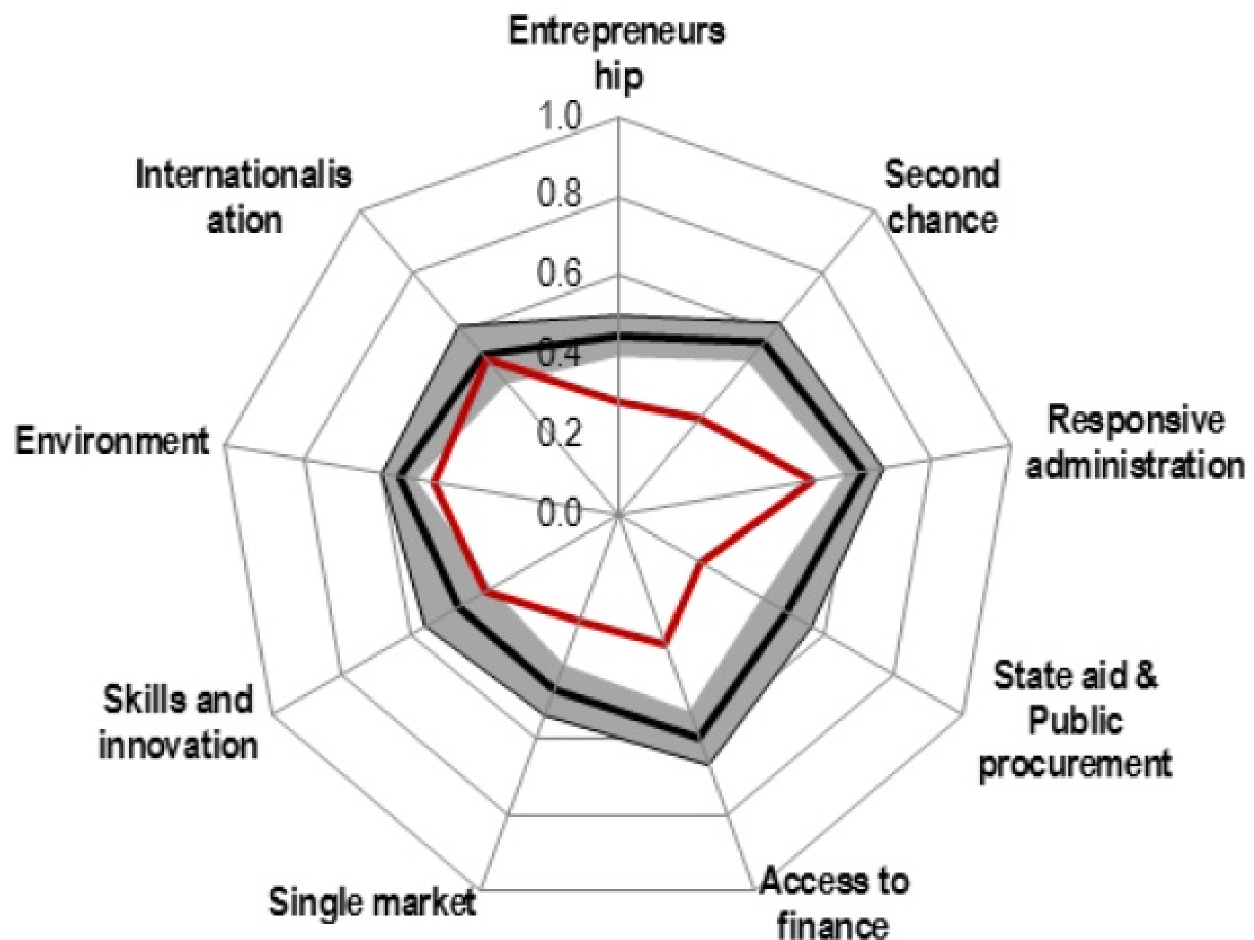
Table 2: Growth dynamics of Italian enterprises in the period 2001-2008 (click to enlarge)

	France			*Spain*			*Italy*		
Size class in 2001	*Downsizers*	*Same Class*	*Upsizers*	*Downsizers*	*Same Class*	*Upsizers*	*Downsizers*	*Same Class*	*Upsizers*
1	0.00	36.20	63.80	0.00	5.83	94.17	0.00	12.72	87.28
2	22.22	47.22	30.56	6.32	28.74	64.94	17.02	28.37	54.61
3	24.68	41.14	34.18	21.32	22.79	55.88	45.00	23.75	31.25
4	43.52	29.63	26.85	25.73	21.64	52.63	63.80	11.66	24.54
5	50.71	28.57	20.71	33.15	25.84	41.01	52.41	17.93	29.66
6	46.48	30.28	23.24	36.69	25.44	37.87	59.87	13.16	26.97
7	31.29	44.90	23.81	37.59	30.50	31.91	53.02	18.12	28.86
8	27.27	50.76	21.97	38.73	36.99	24.28	36.67	41.33	22.00
9	34.04	60.99	4.96	33.94	52.73	13.33	54.55	37.66	7.79
10	15.11	84.89	0.00	9.82	90.18	0.00	19.87	80.13	0.00
Total	**28.71**	**45.54**	**25.74**	**23.69**	**33.41**	**42.90**	**39.99**	**28.15**	**31.86**

Source: Navaretti et al., 2012, with data from Amadeus and Efige

According to the European Commission's periodic review, shown in Figure 1 below, Italy's 'SME context' remains below the EU average, with weaknesses reported in areas such as access to finance, red tape, SME access to public procurement, and the insolvency framework.

Figure 1: Italy's SME context



Source: **SBA Europe fact sheet, 2014**

One important – and equally well-established (see, for instance indicators 1.17–1.21 in this report by the World Economic Forum) – reason for these dynamics is that Italy's corporate governance standards seem less conducive to growth than those of comparable economies. And one part of the problem is precisely the relative unreliability of corporate financial statements. This is itself partly an effect of other corporate governance inefficiencies, such as the weakness of minority shareholders' protections (the World Economic Forum report ranks Italy in position 127 out of 144, between Nepal and Iran) and of the strength of auditing and reporting standards (Italy's rank is 99, between Lebanon and Moldova).

The causal link seems rather clear, and would appear to proceed primarily through the market for capital, as Table 3 and Figures 2-6 below suggest. It is also because they trust their accounts less, that outside investors – i.e. investors not connected to the controlling shareholders – are less inclined to provide long-term capital to Italy's SMEs, and demand a higher premium than in comparable economies. So, Italian SMEs grow less, on average, than their French or English peers also because they face comparatively higher costs for acquiring both equity capital and long-term debt financing, which are crucial for growth.

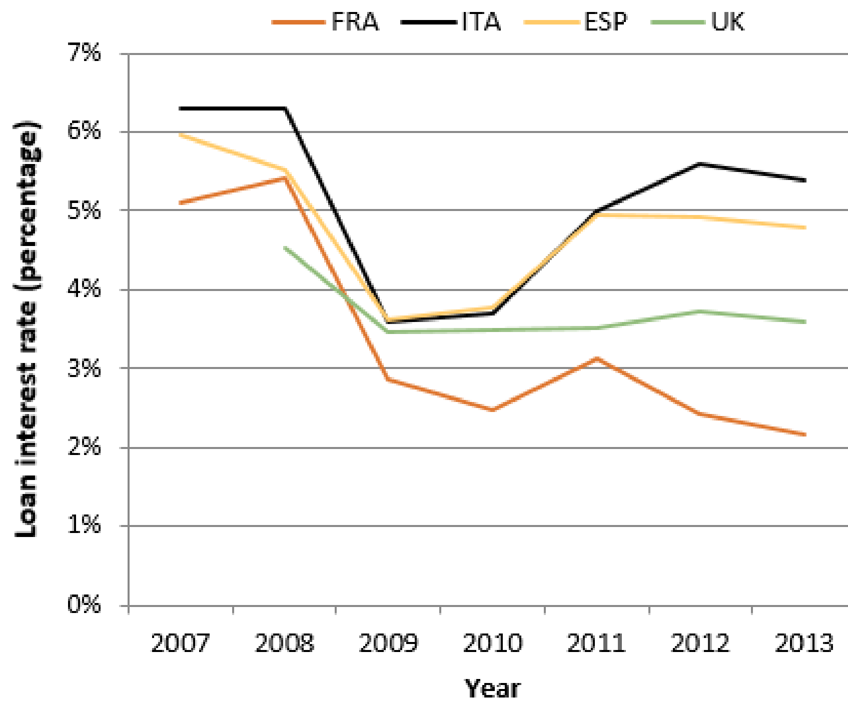
Table 3: Percentage share of SME loans in total business loans (2007-13)

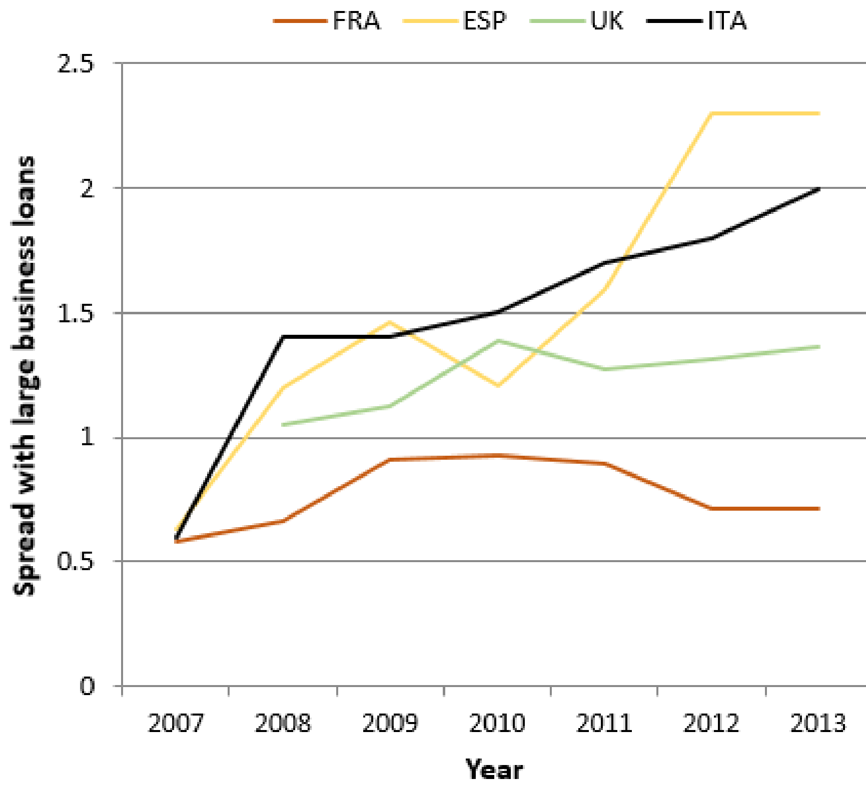
	2007	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
United States	30.9	28.4	28.4	29	26.5	23.7	22.2
United Kingdom	19.8	18.1	20	21.4	21.1	21.5	22.1
France	20.7	20.3	20.2	20.5	20.7	21.2	21.1
Italy	*18.8*	*17.9*	*18.3*	*19*	*18.3*	*18.4*	*18.7*
OECD Average	**41.5**	**39.4**	**39.6**	**41.6**	**40.9**	**40.0**	**43.9**

Source: **OECD, 2015**

Figure 2: Trends in SME loan interest rate and spread with large business loans

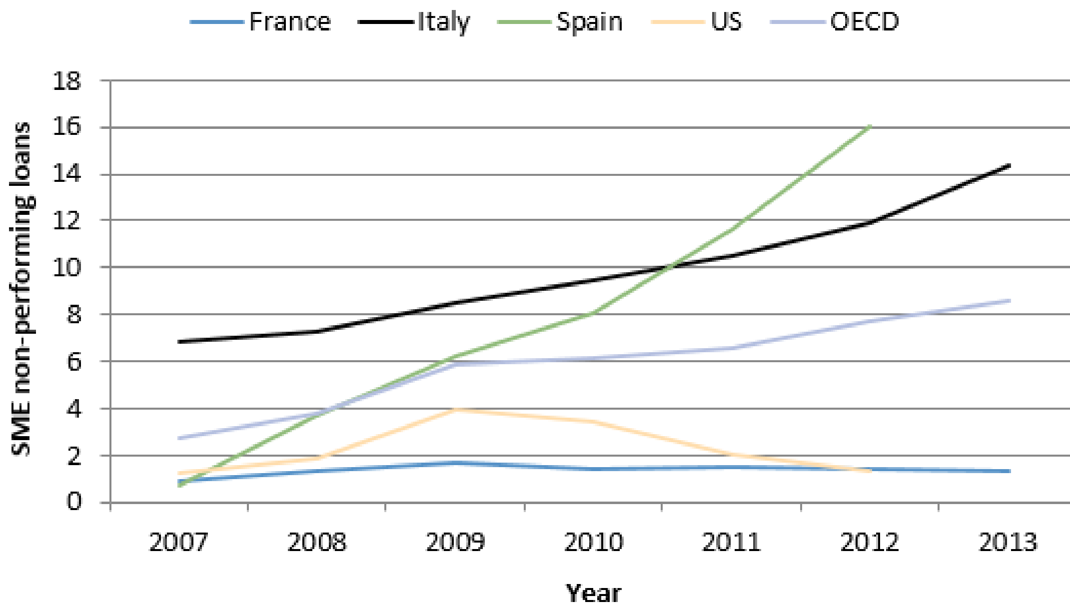
- Loan interest rate
- Business loans





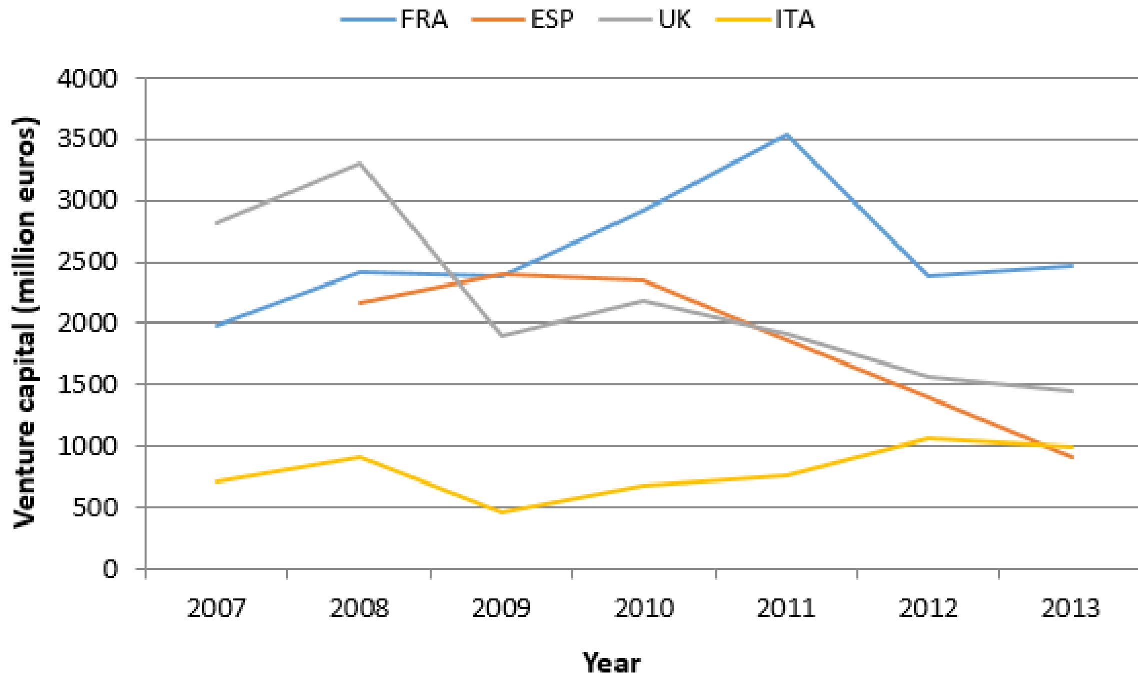
Source: **OECD, 2015**

Figure 3: Trends in SME non-performing loans



Source: **OECD, 2015**

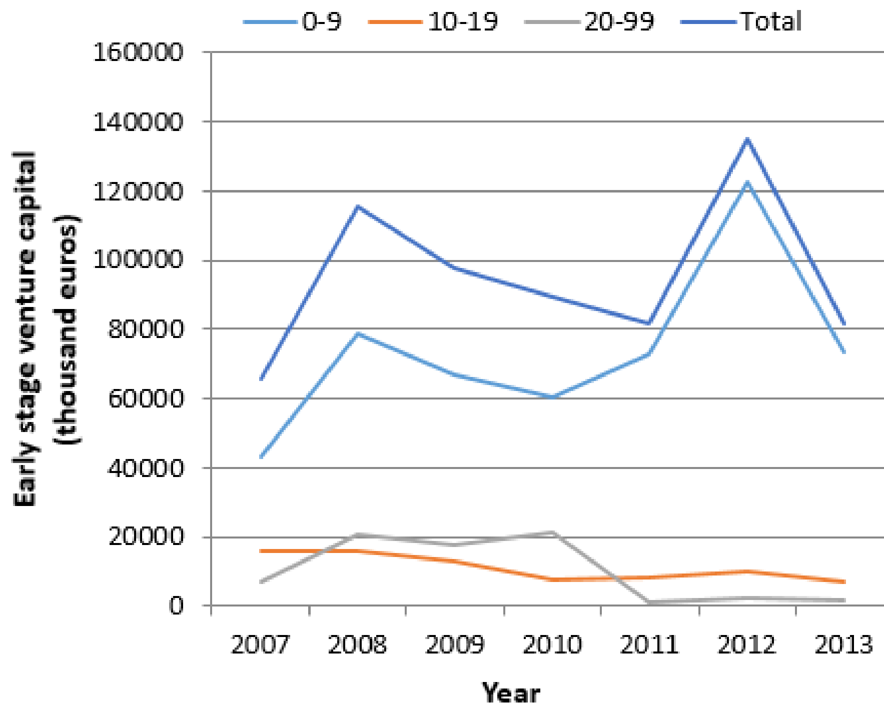
Figure 4: Venture capital in selected EU economies (million euros)

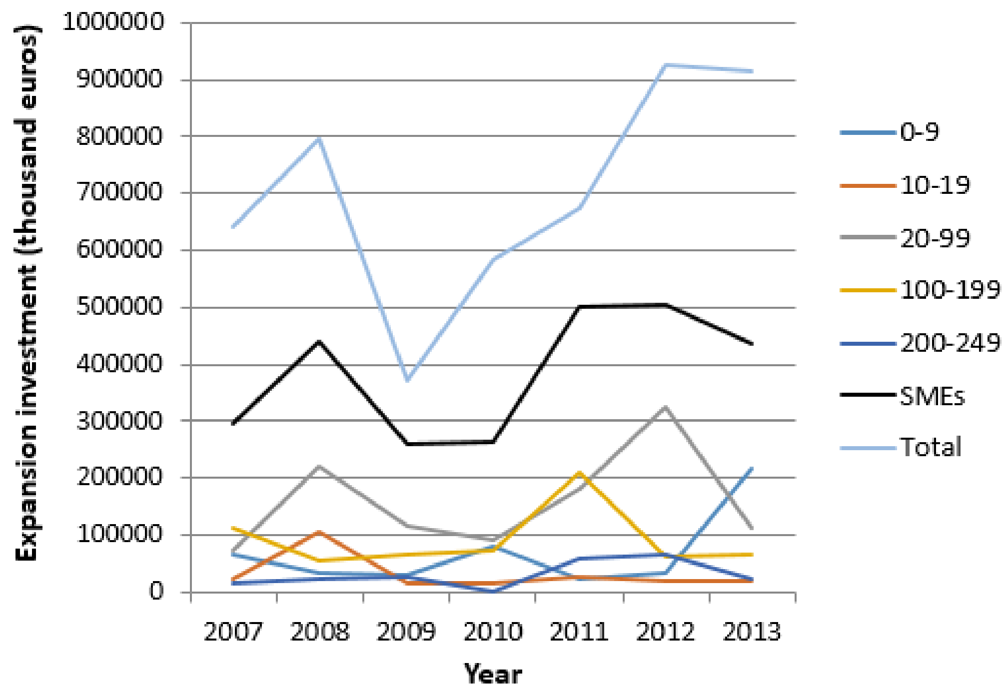


Source: **OECD, 2015**

Figure 5: Early-stage venture capital and expansion investment to Italian SMEs by number of employees (in thousand euros)

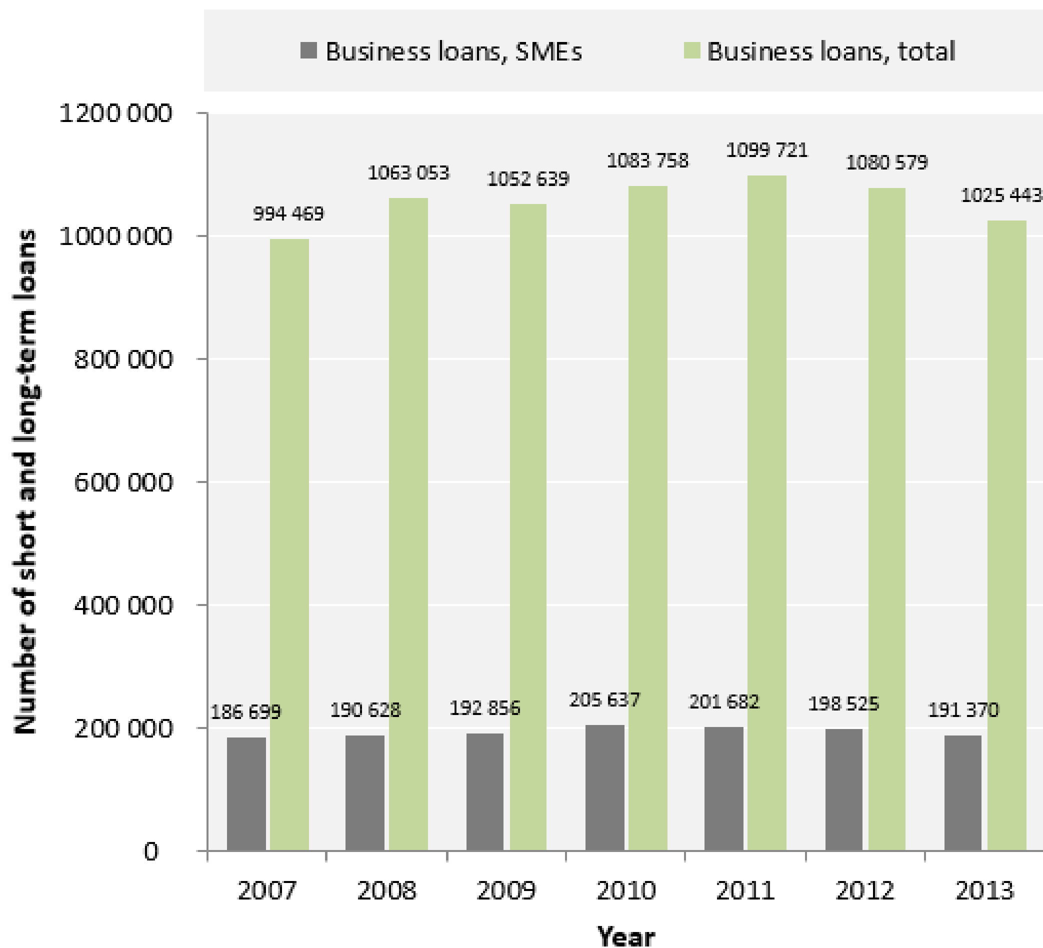
- Loan interest rate
- Business loans





Source: **OECD, 2015**

Figure 6: Number of short-term and long-term loans to Italian SMEs



Source: **OECD, 2015**

This is the background against which the political history of the loophole should be viewed. Before turning to it, however, it might be useful to recall that between the 1994 and the 2013 general elections Italy has been run by a roughly bi-polar political system, in which two broad coalitions of the centre-right and centre-left generally alternated with each other in government.

One of the many peculiarities of this political system is that during these two decades, criminal investigations and the criminal laws were often very prominent in public debate: not just because the rule of law is weak in Italy, and corruption and organised crime widespread, but also because ever since his first accession to power, in 1994, the leader of the centre-right coalition – Silvio Berlusconi – was targeted by numerous investigations for corruption and other crimes, including accounting fraud (in 2013 he was convicted for tax fraud). As such the events described below unfolded under closer scrutiny from the media and public opinion than one would expect in other nations.

In 2002, the centre-right effectively decriminalised accounting fraud, except for listed companies. It drastically shortened the jail term and statute of limitations for this crime, and made it punishable only upon the denunciation of either the shareholders or the creditors – who typically either cannot or won't denounce it, as we noted above – and only if the amount of the falsification exceeded either 5 per cent of the company's net income or 1 per cent of its net assets. This last limitation applied to listed companies too, however, opening a rather wide space for accounting fraud also in the higher echelons of the Italian economy.

The 2002 law was widely criticised, most vociferously by the opposition. And the main charge was that the centre-right coalition had passed it in order to favour their leader, who was in fact acquitted in his false accounting trials

precisely because of the limitations brought by the new law. In the 2006 elections, the centre-right was narrowly defeated by a very heterogeneous centre-left alliance. Despite electoral promises, however, the centre-left did not repeal those limitations. That alliance collapsed in the spring of 2008, leading to early elections that the centre-right won decisively.

In late 2011, when Italy seemed close to a debt crisis, the centre-right ceded power to a technocratic cabinet, supported also by the centre-left, which governed Italy until early 2013. This government did pass an anti-corruption law – not a very effective one, as we have argued – but it acknowledged that restoring effective criminal sanctions for accounting fraud was beyond its capabilities. The elections held in early 2013 produced a grand coalition government, which lasted until the spring of 2014. This government too failed to reform the 2002 law.

That government resigned shortly after Italy's main progressive party – the Democratic Party, which in 2013 obtained 55 per cent of the seats in the lower chamber, but remained a few seats short of a majority in the senate – elected a new leader, Matteo Renzi, who became prime minister in February 2014 and still governs Italy, in coalition with a small segment of the former centre-right coalition.

It is under this cabinet that the new law was adopted in June. It formed part of the government's wide and ambitious reform programme, and was hailed by several politicians and commentators (e.g. here). This law does indeed repeal each of the limitations brought in 2002. The jail term for accounting fraud is now the longest in Europe (eight years); the statute of limitations has been correspondingly lengthened; the crime is again punishable *ex officio*; and there are no thresholds. Yet this law has removed four words – '*ancorché oggetto di valutazione*' – from the clause describing the crime: those that refer to valuation fraud. This is what has opened the loophole discussed above, which could make the rest of the law largely illusory.

The amendment deleting those four words was brought rather late in the legislative process, in March, and was a government-sponsored amendment. The press noted this choice and explained its probable effect. But the government and its parliamentary majority neither responded to this criticism nor explained the amendment, which was rapidly approved by the parliament. It is also interesting to note that three months earlier, in January, the government took the position that the thresholds adopted in 2002 should be maintained. This position was widely criticised, however, and the government withdrew it.

For the reasons we discussed above the deletion of those four words might harm long-term business-induced growth. Yet the rationale that underpins this choice remains somewhat unclear (not least because neither the media nor public opinion showed much interest in this matter). A hint emerged during the debate on the thresholds in January, when the justice minister explained that it was the business sector – he named the confederation of Italian industry, *Confindustria*, and similar organisations of the agricultural and craftsmanship businesses – that had advised the government to retain them.

Indeed, *Confindustria* never criticised the 2002 law; and the head of Italy's anti-corruption agency, a respected former magistrate, has recently argued that it was passed in response also to a 'request from *Confindustria*'. (In fairness, on 28 May, addressing the organisations' national assembly, its president said that the new law is 'absurd' and 'specifically studied against business': but as he spoke before the recent judgment it is unclear whether he referred to the repeal of the 2002 limitations, to the opening of the new loophole, or to the combination of the two).

This suggests that an influential segment of the business sector might assign greater value to the benefits that accounting fraud can offer than to the prospect of acquiring better access to long-term capital. Rather than the virtuous route to growth and profits they seem to prefer other routes, which carry Italy's companies to less distant destinations, no doubt, but are easier to walk.

One lesson that could be drawn from this episode is fairly obvious, if often forgotten in the discourse about structural reforms: details matter. The 2002 law was a structural reform, and an important one, but it went in the opposite direction of what the country needed. The 2015 law was a structural reform too, because it undid that previous one:

except that it didn't.

But this story also corroborates the conclusions of our earlier post for this blog, on corruption: that Italy's political system seems still unable, alone, to reform the country's economic (and political) institutions. In short, the problem seems to be that without greater pressure from the electorate, reforms shall neither be deep enough, nor seriously implemented; and yet such pressure is not forthcoming because citizens face severe collective action problems, display growing dissatisfaction with the political system, and seem increasingly inclined to respond to its inefficiency by opting for 'exit' rather than for 'voice'. Electoral turnout is in decline, and according to a reputable report trust in the 'political authorities' taken as a whole – from the EU down to municipalities, and including both executive and legislative authorities – has dropped from 41 to 21 per cent over the past decade.

Tenacious and skilful though they are, even the current government's efforts to inject confidence in the nation do not appear to have reversed that trend yet. Indeed, according to the same report – which is based on observations taken during 2014, and was published at the end of the year – as few as 7 and 3 per cent of citizens now trust the parliament and political parties: down from 13 and 8 per cent in 2010, respectively.

Thus a vicious circle might have set in, in which political parties will rely ever more on their loyal constituencies – including sometimes patronage networks – for electoral support, and will become ever more distant from the electorate. And as no events or political forces that could break this cycle and lead citizens to a more active stance seem visible on the horizon, one wonders for how long that inefficiency/exit equilibrium can hold.

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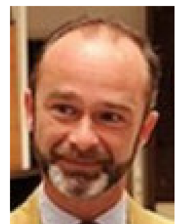

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