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The potentials and the dangers of the Italian economy in a renewed euro area

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Policy Brief

LUISS



September 12, 2019

1. Overcoming the political and institutional tensions that have characterized Italy in the last fourteen months opens up new prospects for economic growth and cooperative relations with the European institutions. In this regard, the recent appointment of former Italian Prime Minister Paolo Gentiloni as the European Commissioner of Economy is an important signal. However, these promising prospects will not automatically translate into actual progress. For example, the scope of the Economy portfolio assigned to Gentiloni as designated commissioner is different from the one of Economic Affairs, held in the old (and still operative) Commission by Pierre Moscovici; above all, Gentiloni's scope is more limited than that attributed to Valdis Dombrovskis as designated executive Vice-President with responsibility for one of the three crucial areas of the new Commission (that is, Economy). In this perspective, the fact that Dombrovskis has a coordinating function also – but not only – in relation to Gentiloni's range of activity shows how important it is that Italy does not force the European constraints and – at the same time – takes advantage of the many opportunities provided by the guidelines of the new Commission. These guidelines were clearly specified in the program presented by the new President of the Commission, Ursula von der Leyen, for her election by the European Parliament.

Similar and complementary considerations apply to the action of the new Italian government. To increase Italy's economic growth, the new coalition between the Five Star Movement (FSM) and the Democratic Party must: (i) overcome their latent internal conflict, thus avoiding the reappearance in new forms of the pre-existing climate of political uncertainty; (ii) launch an effective economic policy package that will encourage sustainable development in the short and medium-long term, one that is, at the same time, compatible with Italy's commitments to the European institutions and with Italy regaining its central role in the European Union (EU).

In this Policy Brief I will focus on point (ii), keeping the short-term problems separate from the medium to long-term ones, even if, in the actual way the Italian economy works, the two problems are strongly intertwined.

2. We begin with the short term, referring to the upcoming deadlines for defining, approving, and adopting the 2020 Italian Budget law.

The budget adjustments implemented in July 2019 by the FSM-League government in order to stop the European procedure for excessive disequilibria in the Italian balance sheet in terms of public debt (see the related **Budget re-balancing law**) restored the conditions necessary so that the public deficit/GDP ratio at the end of 2019 would be around the threshold of 1.9% (according to the government's assessment), or 2% (according to the assessment of the Commission). In any case, these thresholds were close to those indicated in the 2019 Italian Budget Law (approved in December 2018). The result appeared achievable even with an Italian GDP's growth rate significantly lower than 0.5%.

It is very likely that, at the end of the current year, this forecast may prove to be too conservative thanks to two factors that could not be fully included in the **Budget re-balancing law**: the use of the

two leading initiatives launched by the previous government (“Citizen's Income” and “Quota 100 retirement scheme”) is being translated into expenditure that is below the relative funds allocated in the Budget Law for 2019; the revenues coming from one-off events, mainly those from indirect taxes (VAT) due to the introduction of electronic invoicing, are increasing significantly. By mid-July 2019, the Italian Parliamentary Budget Office estimated, balancing these dynamics and the downward trend in the growth rate, that the Italian public deficit/GDP ratio could decrease to 1.8% of GDP for 2019.¹

Over the summer, expectations of lower government spending and higher government revenue increased in Italy. The most recent estimates indicate a decrease in expenditure of around EUR 5 billion and an increase in revenue of around EUR 2.5-3 billion. Moreover, these same macroeconomic adjustments, combined with the results of the European elections at the end of June 2019 and with the foreseen revival of non-conventional and expansionary European Central Bank monetary policies, already triggered reductions in the structure of the interest rates on the Italian sovereign bond during last July; this trend accelerated with the formation of the new government. It is therefore reasonable to expect that, if the European Central Bank restores the unconventional monetary policies in the terms expected by market participants, the financial burden on the service of Italian public debt at the end of 2019 will decrease by about 500 million euros compared to what was provided for by the previous Budget Law.

Unless there are major and positive breakthroughs in the Trump administration's approach to international trade and in the British government's approach to Brexit, the last months of 2019 will record a slowdown for the United States and the euro-area economies. As a consequence, also the growth rate of Italy's GDP for all of 2019 will be much lower than the forecasts of the previous government (0.1% at the most). Even in this negative scenario, previous considerations suggest that, in Italy, the public deficit/GDP ratio for 2019 could be around 1.6%.

In the **Updates to the Economic and Financial Document** (NADEF), which the new Italian government will have to submit to the European Commission by the end of September 2019, this ratio of 1.6% should comply with the commitments that Italy made towards the EU institutions for 2019. Moreover, if it was possible to assume an arrangement in which the legislation is unchanged, the consequent “carry-over effects” should ensure the implementation of the 0.6% reduction in the structural deficit/GDP ratio for 2020. Note that this reduction was the one requested by the European Commission since it would allow Italy to gradually approach its Medium-Term Objective (MTO); and that this same reduction is an important component of the new commitments made by the past Italian government to the EU in last July. Let me add that it is plausible to anticipate a further fall in interest rates on Italian sovereign bonds of various maturity and a positive – although moderate – GDP growth rate for the new year (0.4% in the forecast of the Parliamentary Budget Office). If the

¹ See: *Hearing of the President of the Parliamentary Budget Office on recent government interventions in the field of public finance balances*, 16 July 2019.

legislation is unchanged, all these elements will allow Italy to have a public deficit/GDP ratio for 2020 of about 1.2%.

3. This framework of fiscal rebalancing is, however, unrealistic. First, even if it were implemented in the terms set out above, it would be partial because it would 'forget' the problem of Italy's public debt. Furthermore, this same framework cannot be implemented because it should be based on passive and restrictive fiscal policies (full increase in VAT rates without stimulus for getting out of the current economic stagnation). Due to the current economic stagnation, these policies would have a short-term recessive impact on the Italian economy and, therefore, would not be compatible with the internal equilibria of the new government.

Hence, it is a question of redefining the outlined framework by introducing at least three additional factors:

(a) The decrease in the public deficit/GDP ratio in 2019 will not result in a corresponding fall in the Italian public debt/GDP ratio since there will be a shortfall of 18 billion euro foreseen in the Budget Law for 2019, which would have to be the result of the sale of publicly owned shares in a number of companies (17 billion) and in real estate (1 billion). Having twice experienced the launch of a procedure for excessive public debt (November 2018 and June 2019), Italy will be forced to create a credible strategy of gradual reduction of the public debt/GDP ratio in its Budget Law for 2020 without having recourse to distortionary tricks (such as the transfers of controlling shares of state companies from the Ministry of Economy and Finance to the **Cassa Depositi e Prestiti**, which is itself under this Ministry's control).

(b) Ever since the NADEF and, more importantly, in the Draft Budget Law for 2020 (to be submitted to the European Commission by mid-October 2019), the new Italian government will be required to specify the alternative funds to be used to deactivate the safeguard clauses, which, for 2020, would imply increases in VAT and in some excise duties for more than € 23 billion; one of the qualifying points of the economic program both of the old and the new government excludes, in fact (in our opinion, too stringently), the implementation, even partial, of these clauses.

(c) Although still generic, the other qualifying points of the new government's economic program outline interventions for the support of Italian economic growth (reduction of the 'tax wedge', re-launching of public investment, more robust incentives for innovation and education), as well as social cohesion (minimum wage, reduction of poverty); a prudential estimate signals that these interventions would lead to decreases in revenue and increases in public expenditure for an amount of at least 15 billion euro in 2020; it is important to note that a large part of the funds set aside for public investment was in fact used differently in the past financial years and should, therefore, be restored.

In the face of a downward trend in the public deficit/GDP ratio with the legislation unchanged (1.2% for 2020: see above), Italy is therefore in danger of facing an increased public imbalance of more than two percentage points of GDP. In 2020, as in the following years, an increase in the public deficit/GDP ratio beyond (or even around) the 3% threshold would, however, be incompatible with the agreements made with the EU institutions. Above all, this increase would have effects that are even more important for the public debt/GDP ratio: given the lack of reduction of this ratio in 2019, in the absence of ad hoc adjustments, the growing dynamic of the Italian public debt on GDP would be confirmed and aggravated in the following years. This dynamic would expose Italy to new pressures for excessive public debt (with the high risk of thwarting the reduction of the financial charges on the public debt). This would call into question the medium-term sustainability of the Italian balance sheet.

4. The realistic short-term picture is, therefore, much more problematic than that suggested by the previous unrealistic assumption of an unchanged legislation. It is therefore necessary that, without falling into the habit of indiscriminately canceling what was done by the previous government, the new Italian coalition reduce the imbalances in the public budget for 2020 and the subsequent years by adjusting, as far as possible, the more inefficient items of government expenditures or of tax cuts implemented in 2019 (“Quota 100 Retirement Scheme”; a ‘flat tax’ for a part of self-employed workers with a yearly income below a given threshold; and so on).

The problems to be addressed, however, will become even more difficult to handle if we link the short-term framework, outlined above by focusing on the presentation of the Budget Law for 2020 and its preparatory stages, to the medium-to long-term prospects.

Recent analyses confirm that the Italian economy and, in particular, the manufacturing sector can count on outstanding firms that are competitive on the international frontiers of innovation and that defend and strengthen Italy’s share in world trade. These firms, however, do not have a significant number of national imitators. Most Italian firms, therefore, remain uncompetitive also because of their very small size, poorly adapting to the combination of technical and organizational innovations imposed by the new technological trajectories. This explains why Italy’s economy is an extreme case of those innovation lags experienced in the euro area and in the EU as a whole with respect to China and the United States in the artificial intelligence and digital fields. This twofold Italian delay (compared to the non-European international areas and the EU itself) is the main cause of the stagnant trend in Italy’s average labor productivity and other forms of productivity, which has characterized the last twenty years and more, and which has created a growing gap between the limited subset of efficient and internationalized Italian firms and the backward body of the other national firms. Adding to the negative demographic dynamics (increasing population ageing), the stagnant average labor productivity implies that Italy’s lack of economic growth is a structural factor and not a cyclical one.

It is therefore essential for the new Italian government to launch, as soon as possible, a systematic and well-designed set of incentives for innovation. In this regard, the recommendation to the new government would be to efficiently allocate the limited available resources by establishing, for example, close links between the composition of the new public investments and the stimuli for the dimensional growth of very small and small private firms with innovation potential.

The opening of the Italian economy to innovation, which is an essential condition for the restart of medium to long-term growth can however accentuate, in the short and medium term, Italy's serious social vulnerabilities. Already today the Italian participation rate, that is, the active presence in the labor market of the (declining) share of the Italian population in working age, is one of the lowest among economically advanced countries. Despite this, Italy's unemployment rate, that is, the percentage of those who are actively searching for a job in the labor market but cannot find employment, is structurally above the European average (especially for vulnerable groups of workers and, in particular, for young people; and in the most marginal areas such as southern Italy). Moreover, Italian employees have skills that are poorly adapted to innovative productions because they have lower levels of education and qualification than the average of their European peers and, with the same education, have specializations that do not correspond with advanced technical skills. The result is that Italian firms try to compensate for the low quality of their labor demand and supply by reducing monetary wages, which – moreover – are burdened by a high 'tax wedge', or by resorting to short-term solutions that accentuate the structural inefficiencies of Italy's economy (temporary jobs without protection). It is not surprising that, in this situation, Italy was unable to handle the increased inequalities in income distribution that occurred in the early nineties, that is, in the years in which the core countries of the EU and the euro area began to adopt new and innovative technologies. Consequently, in the last two decades Italy has witnessed the growth of the phenomenon of 'poor' employees and the incidence of absolute and relative poverty as the result of a further polarization between the highest and the lowest income classes.

In the presence of such vulnerability, a pervasive introduction of innovative processes in the Italian economy without the corrective interventions of a social policy would have the effect of making the utilization of a significant part of the current employees even more inefficient or useless, thus aggravating the marginalization and the fall into some form of poverty of a still wider part of the population in the working age. It is therefore essential that the new Italian government increase investment in education and training, reduce the 'tax wedge', strengthen the fight against poverty, provide new safety nets for low income workers and the unemployed. If anything, the recommendation to be made is that the new Italian government should not limit itself to sporadic interventions but finance a systematic plan for the reform of the welfare state. The traditional idea that the welfare state should only intervene ex post in order to protect and re-integrate the population groups most affected by economic changes must be overcome. Instead, the government should intervene, above all ex ante, in order to prepare and/or adapt the population in advance, especially but not only the young people, to the changes taking place in innovative processes.

5. These considerations have at least two implications. Firstly, they show that, in the long term, the management of the Italian public balance sheet cannot be simple maintenance or routine. If the objective is to make Italy a competitive country characterized by sustainable growth within one of the most advanced areas of the international economy (the EU), it is necessary to provide for a radical change in the composition of public expenditure and revenue and be ready to manage the impacts of these changes on consolidated interests. Only in this way will it be possible to build a society open to economic innovation and focused on social fairness (equality of opportunities in a substantial sense). Secondly, the same considerations show that, in the short term, the problems of the Italian balance sheet cannot be tackled effectively if the already difficult combination of growth stimuli and imbalances adjustments are separated from the long-term objectives and the related medium-to-long-term interventions. Any increase in public expenditure and/or reduction of taxation must be elements of a broad structural plan that is complemented by ‘cuts’ in public expenditures that are becoming socially ineffective and economically inefficient with respect to the most innovative and fairest society that Italy intends to build in the medium to long term.

These two implications may appear visionary. However, they have at least three very concrete consequences both at national and European levels.

At the national level, it follows that Italy’s economic and social decline can be stopped only if it is admitted that, during the extraordinary period of rapid economic development after WWII (1952-1979) and – above all – in the following decade, Italy accumulated and crystallized a large number of rent-seeking positions that today are no longer sustainable in terms of public debt and social cohesion. The non-ordinary management of the public balance sheet must reduce these rent-seeking positions through the implementation of specific interventions able to overcome the many public and private inefficiencies.

The two consequences at the European level, on the other hand, are based on an easy but distorted possibility of linking short-term and long-term problems: the search for more fiscal ‘flexibility’ rather than binding contractual arrangements with respect to European rules.

The preceding analysis makes it clear that for the new Italian government it would be almost impossible to reconcile the revival of sustainable medium-to-long-term growth with gradual adjustments of Italy’s public debt without European cooperation. The latter would have to make Italy able to manage, in the short term, the financial costs arising from efficient public investment programs for the reform, for example, of Italy’s education systems or for the renewal, for example, of intangible infrastructure to facilitate the innovation of Italian firms. This cooperation may, however, lead to two alternative strategies. Firstly, the European institutions grant Italy the so-called fiscal flexibility, i.e. loosen the constraints with respect to Italy’s convergence towards its medium-term objective (MTO) and hence allow temporary increases of its public deficit/GDP, which are incompatible with the related structural adjustments. It is worth noting that this flexibility is offered

without an assessment and the centralized control of the Italian allocation of excess expenditure or reduced revenues, but also without the assumption of any commitment on the part of the European institutions to support the Italian government in managing its balance sheet in case of future difficulties. The second possibility is that Italy agrees with the European institutions on a multi-annual program of reforms and investments, and accepts periodic and centralized European controls on the gradual implementation of such a program. In exchange, Italy gets centralized funding that does not entirely account for its balance sheet, as long as the program is implemented according to the original agreements and is consistent with its explicit medium-to long-term objectives.

The first strategy, which is preferred by any national government because it does not place restrictions on its fiscal choices, is very dangerous. As has happened in Italy in the recent past, it tends to translate into a use of flexibility for short-term purposes that disregard the medium-to long-term program. The result is that, once the margins of flexibility granted by the European institutions are exhausted, the country (in this case Italy) would find itself with aggravated imbalances in its public balance sheet and, therefore, with even more binding constraints for the revival of long-term sustainable growth. The second strategy, which in the short term appears to be more politically costly because it results in a transfer (even if agreed, partial and temporary) of national sovereignty in fiscal policy to the EU, is conversely an opportunity to translate the management of the public balance sheet into a sequence of steps consistent with a long-term program at least partially supported by the European institutions.

The objection that can be made with respect to the conclusion suggested here, and which leads us to the second consequence at the European level, is that the first strategy ends up weakening the EU and the euro area's existing and distorting fiscal rules while the second strategy fully accepts and legitimizes these rules. According to this view, fiscal flexibility would have a positive impact not so much because of its short-term effects on national public balance sheets but because it would act as a lever to loosen the rules and strengthen cooperation between EU and euro-area countries in the long term.

This objection, however, is likely to have unintentional but negative and serious effects. It is true that European fiscal rules have major problems that can be significantly improved; and, in this perspective, it would be expedient to suggest changes and solutions. The presence of these rules is, however, the glue that allows for the co-existence of a centralized monetary policy and some form of institutional coordination of decentralized, that is, national, fiscal policies. A mere and systematic relaxation of fiscal rules would fully free the European institutions of any responsibility for accumulated fiscal imbalances at national levels. In this perspective, euro-area countries with high public debt would be exposed to the volatile assessment and to the short-term sanctioning of market investors without any European institutional protection.

This threat is not just theoretical; it has already progressed due to the recent reform of the European Stability Mechanism (ESM). After having long favored stricter European fiscal rules (with the tightening of the Stability and Growth Pact), the most rigorous countries of the euro area are now

moving towards granting increasing margins of fiscal flexibility to the most fragile member states. As showed by the decisions taken in the December 2018 and June 2019 meetings of the Eurogroup and Euro Summit, the 'core' countries are trying, however, to impose a quasi-automatic mechanism of sovereign debt restructuring on countries that are forced to activate European aid programs from the ESM. The new strategy of the 'core' countries is thus to place full responsibility and all the burdens arising from its recurrent fiscal imbalances on the individual member state in difficulty.