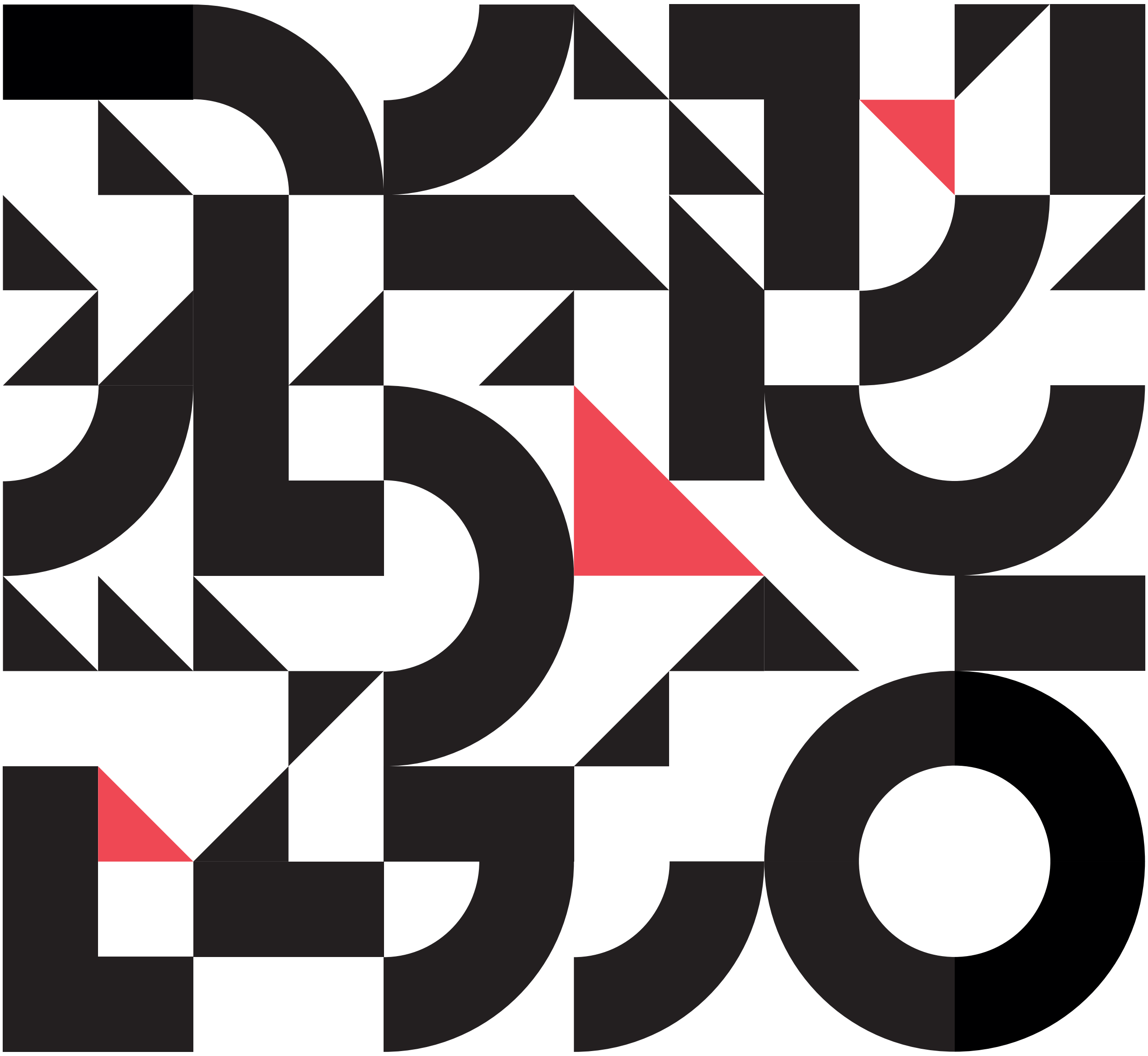
Italy and Europe will rise or fall together



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Italy and Europe will rise or fall together

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Italy and Europe will rise or fall together

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The Italian peninsula is usually described as a boot. Picture it as a pillar instead, a column that rises from the sea and holds the other lands of Charlemagne's domain above water. Should it crumble, Europe would sink.

This, in one word, is the argument I shall try to make: Italy's resistible decline is both a threat to the survival of the European Union, and an opportunity for it to mature into an organization capable of satisfying the demands of its citizens. Italy's affairs are matters of common concern, consequently, on which others should intervene.

I shall first discuss the threat and the opportunity, then Italy's decline, and finally Europe's role. I sketched the first point in a recent piece[1] for the Financial Times, and the second is the focus of my research.[2] The third, admittedly, is less analysis than pleading.

A currency without a state

The euro, one of its architects wrote, is a 'currency without a state'[3] . That 'original sin' lies at the root of the asymmetries of the monetary union, the most evident of which is the disjuncture between a centralized monetary policy and a multiplicity of national fiscal ones, coordinated through an inevitably imperfect rules-based system.

The debate on the causes of the sovereign debt crisis is not settled. But few would deny that those asymmetries left the eurozone vulnerable to self-fulfilling crises of confidence: namely, instances in which investors' doubts on the sustainability of a nation's debt lead to sales of its bonds, which in turn corroborate those concerns, provoke further sales, and set off a spiral that, in the absence of a credible lender of last resort, can lead to default. This dynamic

1 — Andrea Lorenzo Capussela, *The EU's future hinges on Italy's recovery fund reforms*, Financial Times, April 21 2021.

2 — The results are published in a longer book (*The Political Economy of Italy's Decline*, Oxford, Oxford University Press, 2018; translated into Italian as *Declino. Una storia Italiana,* Rome, Luiss University Press, 2019) and a shorter one (*Declino Italia*, Turin, Einaudi, 2021).

3 — T. Padoa-Schioppa, *The Euro and its Central Bank: Getting United after the Union*, Cambridge Mass., MIT Press, 2004, p. 35.

was manifest between the spring of 2010 and the autumn of 2011, as contagion spread from Greece onto Ireland, Portugal, Spain, and eventually Italy. Rome's hurried change of government and budget adjustment held up the crisis, but the turning point was the speech[4] that the president of the European Central Bank (ECB), Mario Draghi, delivered on 26 July 2012. 'Within our mandate,' he said, 'the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.'

The critical words – 'whatever it takes' – rested on a wide political consensus, and proved enough. More interesting here is the definition of the aim: 'preserv[ing] the euro'. At that juncture, in fact, Italy's public debt exceeded 120 per cent of GDP and was, in nominal value, the second largest in the eurozone. At stake, therefore, was not Italy's solvability but the survival of the common currency. For the magnitude of the country's debt, and the deep, long-sedimented interconnectedness of its economy with the rest of the eurozone were such that the monetary union would hardly have withstood the sequence, in rapid succession, of Italy's default, abrupt exit, and massive devaluation. If so, however, the survival of the Union itself was at risk: because the break-up of the euro would have thrown trade, financial, and political relations – especially among France, Germany, and Italy – under such tensions that the single market too could have dissolved. Behind the consensus that allowed Draghi to pronounce those words, and then enact the extraordinary monetary policies that they foreshadowed, must have lain also the assessment that an Italian default could have destroyed the European integration project.

Yet the reforms that followed were disappointing. Sovereigns were supplied with a lender of last resort, and progress was made in the banking sector, but the institutional asymmetry between monetary and fiscal policy remained, nor were the constraints that it entails for governments' ability to counter recessions offset by the creation of a common fiscal capacity for macroeconomic stabilization. This delayed the eurozone's recovery, arguably, and left the Union exposed to the same risks that had threatened it in late 2011.

The Union's response to the pandemic, and its opportunity

The founding text of the European project, the Schuman declaration of 9 May 1950, places solidarity at its heart[5]. The worst effect of the Union's response to the crises of the past decade was to fracture it, raising mistrust between North and South.

The response to the pandemic was different. The magnitude of the funds that NextGenerationEU[6] mobilises is unprecedented, as is the manner of their financing: common bonds, issued on behalf of the Union, backed by common resources. Both speak of solidarity.

'For the first time, a common budgetary instrument at European level can be used to complement fiscal stabilisers at national level, even if it is currently only temporary.' It is with these carefully chosen words that, last September,

4 — ECB, Speech by Mario Draghi, President of the European Central Bankat the Global Investment Conference in London, 26 July 2012.

5 — The Schuman Declaration – 9 May 1950.

6 — European Commission, *Recovery plan for Europe*.

ECB President Christine Lagarde described[7] the Recovery and Resilience Facility to a joint body of the French and German parliaments. Making it permanent would create a fiscal union, which is the critical component of any prospect for further integration: for a common budget large enough to serve a macroeconomic stabilization mandate, or indeed fund other common public goods, would require, for both raising and spending it, far greater democratic legitimacy than the current institutional arrangements can supply. Any form of fiscal union demands equivalent progress in political integration, in effect, and any advance there could revive the Union's performance also in other sectors. On the global stage, for example, the Union's influence is as large in trade policy, where integration is maximal, as it is negligible in foreign policy, where integration is minimal.

Of course, that budgetary instrument is an ad hoc response to an extraordinary crisis. But the European project was largely forged in crises, as its founders foresaw, and the solution that this one has received does emphatically point towards deeper integration. This is Draghi's own reading, notably, who called for a fiscal union both as a private citizen, last September[8], and as Italy's Prime Minister, in March[9].

In this, however, the outcome of the recovery plan will be decisive. Should it succeed, the arguments for fiscal and political union would be greatly strengthened by the demonstration effect. Should it fail that prospect could dissolve, as another solution exists for redressing the currency-without-a-state asymmetry: a decentralizing one, in which national responsibilities would grow larger and the rules governing them stricter.

In turn, the success or failure of the plan will primarily depend on Italy. Less because the country was hit particularly hard by the pandemic, or because it will receive the largest allocation of grants and loans, than because its weakness makes it a latent, ever-present threat to the survival of the Union.
Italy's singular decline

During the first decade of this century Italy's real growth rate was the lowest among those that could accurately be recorded in the world. Its 2008-14 double recession was the worst since the nation's unification, in 1861. Between then and the pandemic growth was less than half the eurozone average. In 2019 real GDP was still a few percentage points below its 2007 peak, in fact, and GDP per capita had fallen from about 10 per cent above the eurozone average, in the mid 1990s, to 10 per cent below.

Last year GDP dropped by 8.9 per cent, compared to an EU average of 6.2 per cent, and public debt reached 155.6 per cent of GDP. This is 35 percentage points above the level at which it stood when, in 2011, Italy threatened to break up the monetary union: without the recovery plan, and notwithstanding the ECB's extraordinary policies, last autumn a similar crisis might well have overwhelmed both the country and the Union.

Italy's low growth stems primarily from low productivity. And the problem

7 — ECB, Introductory remarks by Christine Lagarde, President of the ECB, at the Franco-German Parliamentary Assembly, 21 September 2020.

8 — Incertezza e responsabilità, l'intervento di Mario Draghi al 41° Meeting, 18 Agosto 2020.

9 — Conferenza stampa del Presidente Draghi e del Ministro Speranza 26 March, 2021.

chiefly lies in that component of an economy's overall productivity, which derives from technological and organizational progress: from innovation, in one word, which generates efficiency. The variable that measures it – 'total factor productivity' – rarely turns negative, because economies seldom suffer regressions in their overall level of efficiency: in Italy, conversely, the government estimates that between 2001 and 2019 it declined by 6.2 per cent[10]. That variable is imprecise, and errors of measurement may be involved, but Italy manifestly has an innovation problem.

Innovation can either be imported or endogenously created. While it was far from the technological frontier, during the first decades after the last war, Italy grew very rapidly, like Germany and Japan, because it proved remarkably capable of adapting superior foreign technologies to its own conditions, and shifted vast amounts of labour and capital in the sectors that could best employ them. But as it approached the frontier, around the 1980s, it was slower than its peers in switching to a growth model based more on endogenous innovation. This did not happen by accident, because innovation tends to dissipate elites' power and rents.

Italy's reversible equilibrium

Innovation-led growth is a process of 'creative destruction'[11], in fact, in which new innovations continuously displace old ones. At any of its stages, therefore, this process threatens the extant economic elites, who typically are the innovators of the preceding growth phase, and might be tempted to bridle it. Greek theogony, as J.-P. Vernant narrated it[12], offers a close parallel. Both primordial gods, Uranus and Cronus, sought to prevent the birth of their offspring precisely because they feared the emergence of a challenger: Cronus eventually removed his father Uranus, in fact, and was in turn dethroned by his son Zeus (who established the order that persists to this day).

Italy's economic elites proved better at defending themselves, compared to their homologues in the country's peers, and left less space to innovation and creative destruction. This, I think, is the immediate cause of Italy's economic malaise. Its deeper roots are the comparative weakness of the rule of law and of political accountability, which magnified the imbalance of power between elites and their challengers. Its clearest sign is that Italy is a gerontocracy, in effect, which smothers social mobility and dissipates its youth.[13]

The past three decades did see impressive reform efforts. The new laws were generally well conceived, often following European models, and widely praised. But their effects were dampened by the fact that rules tend to be respected less than in comparable democracies, as well as by collusion between political and economic elites.

Unfair and inefficient though it is, a social equilibrium characterised by weak rule of law, feeble political accountability, and low growth can nonetheless

10 — *Piano nazionale di ripresa e resilienza*, Rome, 5 May 2021, p. 4.

11 — Nicolas Da Silva, *Le pouvoir de la destruction créatrice : de l'intégration de la critique au dépassement du néolibéralisme ?*, Le Grand Continent, 29 Avril 2021.

12 — Jean-Pierre Vernant, *L'Univers, les Dieux, les Hommes. Récits grecs des origines*.

13 — The share of 15–29 year-old citizens who are engaged neither in education, employment, nor training is the highest in the Union: *ibidem*.

persist, because it tends to generate defensive responses that consolidate it. This logic is reversible, naturally, but to overcome it ordinary citizens and firms face a collective action problem.

To illustrate it I take the example of tax evasion, a mass phenomenon. The gap[14] between theoretical and actual VAT revenue, for instance, is between 6 and 8.6 per cent in France, Germany, and Spain: in Italy it is 24.5 per cent.

The gap in VAT collection between the theoretical and actual amounts within the European Union (%)

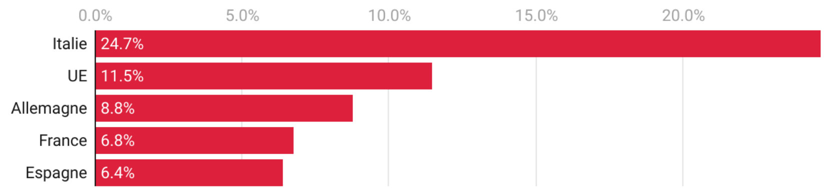


Chart: Le Grand Continent •
Source: European Commission, Study and Reports on the VAT Gap in the EU-28 Member States, Final Report 2020, 10 September 2020

Mass tax evasion harms public services, trust in the state, and, indirectly, also political accountability. Few firms and citizens that evade taxes can reap benefits greater than the costs of living under such conditions, however: the vast majority would prefer a country where tax compliance is greater, public services better, political accountability stronger, public policies more responsive. In a referendum, most would vote for the high-compliance equilibrium.

But once the low-compliance equilibrium sets in tax evasion becomes an individually rational strategy. For in that context paying all of one's taxes means subsidising delinquents, while receiving less public services than one's tax bill would justify. If they can, many will respond by evading some taxes themselves. They know that the higher equilibrium is preferable, and that their defensive strategy entrenches the lower one, but are unwilling to make the first step. Neither their culture, history, or special perfidy explains Italians' propensity to evade taxes. It's the simple rationality of that cost-benefit calculus, coupled with the expectation that much of society will follow the same logic. This explains also the singular diffusion of corruption and organised crime, as well as the comparatively low reliability of firms' accounts; and each of these phenomena, in turn, contributes to depressing productivity, chiefly through their effects on firms' size and capitalization.

To change those equilibria citizens must understand their logic, and receive credible signals that they can and will change: credible enough to lead many to make the first step, expecting others to act likewise. An inflection in expectations, leading to a change of behaviour, will suffice. For the dynamic can quickly become self-sustaining, just as the current equilibrium is self-reinforcing, and any progress could rapidly yield a marked acceleration in growth, as the potential efficiency gains created by a quarter of a century of decline are large. The country suffers primarily because its political system failed to offer citizens either an explanation for the roots of their malaise, or a vision credible and attractive enough to lead them to break out of those equilibria.

Italy's underwhelming plan

14 — European Commission, *Study and reports on the VAT gap in the EU-28 Member States 2020 final report*, 10.09.2020.

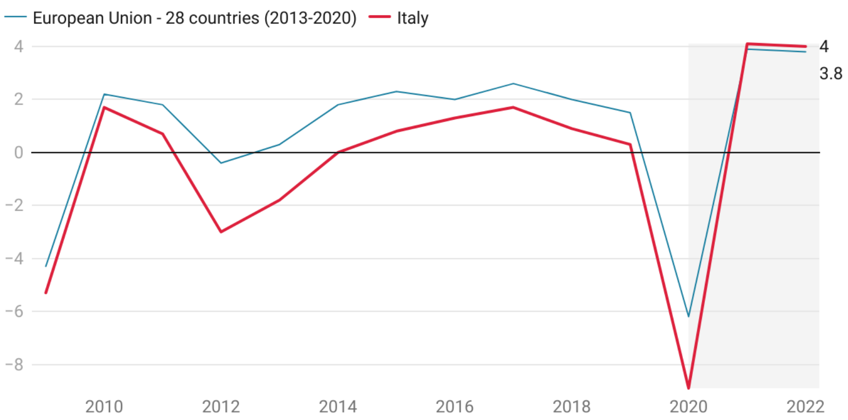
No such vision springs out of Italy's recovery plan[15], upon a first reading at least. Less because the prose is seldom inspiring, often obscure, and occasionally atrocious, than because the investments and reforms it unrolls seem neither to stem from, nor to compose, a distinct idea[16] for the future of the country.

This, admittedly, could not be expected of a cabinet supported by a coalition of adversaries, formed eleven weeks before the deadline for submitting the plan to the Commission. The same reasons can explain, and partly justify, why the plan was neither the object of wide consultation nor explained to society. But this makes the plan unfit to lead citizens out of those equilibria.

Those defects are remediable, probably. Lacking a marked imprint, in fact, the stuff which the plan is made of must be still malleable, and could be moulded into a more unitary shape if a clearer vision were imposed upon it. The question, rather, is whether Italy's political system will be able to conceive one, forged in public debate, and persuade society to embrace it.

The necessity of such a vision is evident from the plan itself. Over the next five years, it is projected to bring some 183 billion euros in additional public expenditure, equivalent to about 11 per cent of the 2020 GDP. The government outlines three scenarios as to the impact on growth: in the higher one the plan will increase the 2026 growth rate by 3.6 percentage points, in the medium one by 2.7 points, in the lower one by 1.8. Within this range, the government explains, the path that the country will take depends primarily on the effect of the reforms that will accompany these investments.[17]

Italy's real GDP growth rate (%)



GDP at constant prices; the data for 2021-2022 are estimates (OECD Economic Outlook,March 2021 Interim Report)

Chart: Le Grand Continent • Source: Eurostat

The critical ones are four horizontal reforms: those of the public administration, the justice system, the regulatory system, and the promotion of competition. Each of them, however, has one or more comparable predecessors, similarly ambitious, in the past three decades: they were generally well conceived, as I said, but the country's decline proceeded unperturbed. If the equilibria I

15 — *Piano Nazionale di Ripresa e Resilienza*, 5 March 2021.

16 — Forum Disuguaglianze diversità, *What do we think about the national recovery and resilience plan sent to the eu and "what can we do now?"* 17 May, 2021.

17 — *Ibidem*, p. 244–47.

described could subdue those reforms, therefore, in the absence of a convincing vision to support their present successors, which alone could change society's expectations, it seems hard to expect significantly better results.

This does not necessarily imply that by the end of the plan the growth rate will have risen of a mere 1.5-2 points, if anything because the government's projections might turn out to have been pessimistic: the pandemic produced 'innovations that led to gains in efficiency', O. Blanchard and J. Pisani-Ferry have recently argued[18], which will yield 'an inevitable increase in productivity' over the medium term. But should Italy miss the higher growth path, the plan will have failed: the opportunity for agreeing any form of fiscal union would dissolve, most probably, and the Union would again face the threat of crises similar to that of late 2011.

How Europe can help

It would be better, perhaps, if Italy did not exist. Italiam non sponte sequor: Aeneas himself did not want to go there, as Fate had decreed, to give it a fresh political organization.[19] Giving up on Italy, however, would strike me as unpardonably unimaginative. For a mere inflection in the country's trajectory would be enough to dissolve that threat and realize that opportunity: an inflection that would flow directly from a change in society's expectations, if the political system could secrete ideas capable of persuading it that a shift to a higher equilibrium is a realistic possibility, and would exploit the vast efficiency gains that are available, in plain sight. For this to happen, however, pressure is needed.
Economic suffering is widespread, electoral volatility high, and the party system fluctuating: everything suggests that the space for fresh ideas is vast, and the demand bubbling. Society showed unexpected discipline and civic engagement during the pandemic, moreover, and might have grown more demanding of its political elites than it previously was. Pressure on the political system could rise, therefore. But my point is that pressure ought to come also from outside, in the form of both criticism – of the plan, the government, its coalition, its opposition – and ideas. Public pressure, naturally, not private advice or silent reproaches: criticism and ideas supplied openly, so as to stimulate the domestic sources of pressure and allow public opinion to see how the political system responds.

European parties should not balk at this. For if my analysis holds, Italy's main choices are a matter of their own concern, especially if they aspire to greater integration. In Europe's newspapers and drawing rooms, after all, it has become customary to comment on the German Constitutional Court's deliberations on monetary policy: the aphasia of Italian parties on productivity, innovation, social mobility, and the predicament of the youth is no less important for the Union's future. And if European public opinions will take this approach, they might press also their governments to take bolder stances on Italy.

This would not be interference but the reflection of interdependence, and could contribute to the formation of a genuine European public sphere. It may not work: but missing this opportunity because of a reluctance to treat Italy's affairs as common ones would seem, as I said, unimaginative.

18 — Olivier Blanchard, Jean Pisani-Ferry, *A Contingent Economic Strategy for the Next Phase*, Groupee d'études géopolitiques, May 6, 2021

19 — Virgil, *Aeneid*, IV.361.