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ITALY: Escaping the high-debt and low-growth trap

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With public debt amounting to 132.1% of GDP and negative productivity growth over the last twenty years, Italy appears to be stuck in a high-debt and low-growth trap. We focus on the causes of Italy's two main economic plights and discuss how they are intimately related: a slow growth limits the budgetary margins and casts doubts on public debt sustainability; the reduced fiscal space and the tight fiscal rules in turn weighs on growth and public investment.

In the first part, we discuss the roots of the explosion of Italian public debt, the country's consolidation attempts in the 1990s and early 2000s and finally, the effects of the Great Recession and fiscal austerity. In the second part, we identify the structural weaknesses of the Italian economy. We notably emphasize the specialization bias towards low tech sectors, the "nanism" of Italian firms, the misallocation of talents and resources, the North-South divide and its related labor market consequences. We conclude with some policy recommendations for a revival of growth in Italy.

Our first proposal calls for industrial policies which foster knowledge accumulation and firm learning. The second proposal envisages a new European fiscal golden rule which would remove specific public investments from the computation of structural primary balance. Our third proposal is instead related to labor market regulation, and advocates for the introduction of a minimum wage on the one hand, and the facilitation of retraining policies on the other hand. Our fourth proposal highlights the need to complete the banking union and to solve the issue of non-performing loans in order to improve the robustness of the Italian banking sector. Lastly, we conclude that Italy's fate is inextricably related to Europe's and that Italy needs more rather than less Europe to escape its high-debt and low-growth trap.

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With a negative productivity growth over the last twenty years, Italy brings up the rear of growth in the European Union. In addition, Italy's public sector ranks as one of the most indebted in the world, with a debt amounting to 132.1% of GDP in 2018. The country which, after the second world war, became the symbol of the “economic miracle”—a period of unprecedented economic and employment growth, high productivity and real income increases—does not seem to find the way out of its doldrums. Today, the world tenth economic power conveys the image of a clay-footed colossus, prisoner of a low growth trap, a high debt burden and structural weaknesses that the Great Recession of 2008 have exacerbated further. In this Policy brief, we focus on these two main plights of Italy: high public debt burden on the one hand, sluggish GDP and productivity growth on the other hand. Both issues are intimately intertwined: the absence of growth increases the debt burden; the reduced fiscal space in turn weighs on growth and public investment, depriving the economy of one of its engines.

Our first goal is to retrace the history of the Italian public debt problem. We identify the origins of Italy's sizeable government debt, and we shed some light on the drivers affecting its evolution. We show that this evolution can be decomposed into four distinct phases. In the last phase, we document how a badly-timed fiscal consolidation policies contributed to both limiting GDP growth and raising public debt. Yet, the origins of the Italian economic decline are much more ancient. In the second part, we review some of the structural weaknesses of the Italian economy, notably a specialization bias towards low tech sectors, the “nanism” of Italian firms, the misallocation of talents and resources, the North-South divide and its related labor market issues.

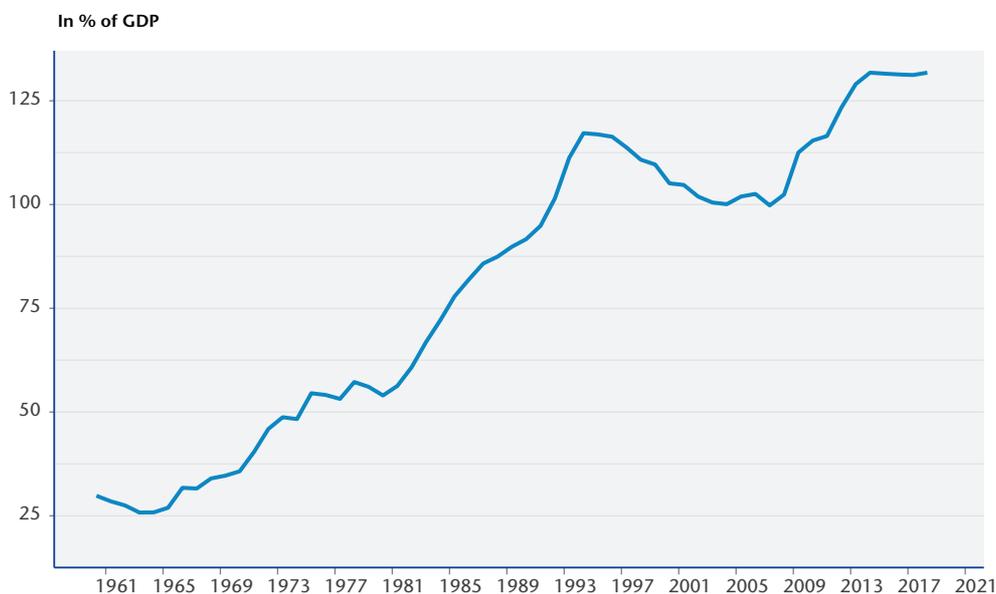
We conclude the Policy brief with four policy recommendations which could help reigniting economic growth in Italy. We advocate a revival of industrial policies that should nurture knowledge accumulation and firm learning, productivity growth being a main issue. Our suggestions also include a technical proposal—creating a new European fiscal golden rule which would remove specific public investments from the computation of structural primary balance—as well as proposals to tackle labor market issues, with the introduction of a minimum wage and the facilitation of retraining policies. We also advocate the need to complete the banking union and to solve the issue of non-performing loans in order to improve the robustness of the Italian banking sector. Last, we consider that Italy's fate is inextricably related to Europe's and that Italy needs more rather than less Europe. Therefore, the country must play its part to the full in order to help reshaping Europe.

At the roots of the explosion of public debt in Italy

Discussions about Italy's public debt issue, and its potential disruptive consequences for the stability of the European Union, have for a long time occupied a central place in political and economic arenas. Figure 1 plots the historical time-series of the government debt-to-GDP ratio in Italy starting in the 1960s. We clearly identify four distinct phases in the history of Italian public debt. A first phase, between the early 1960s and 1980, was characterized by a positive but moderate growth of debt. A second phase, unfolding through the 1980s and until 1992, saw the explosion of public debt, from 54% of GDP in 1980 to roughly 117% in 1994. The third phase, which began with the budget law of the Amato's government in 1992, coincides with a significant fiscal consolidation effort, and the public debt to GDP ratio eventually

decreasing below 100% in 2007. The stabilization effort was however interrupted by the Great Recession and by its effects on public finances in the European Union. In the fourth phase, from 2008 on, the public debt-to-GDP ratio consequently increased, reaching the current level of 132.1% in 2018.

Figure 1. Evolution of the Government Debt to GDP ratio



Source: AMECO.

Figure 2 shows how the different drivers of public debt and GDP (government primary deficit, interest expenditure as a fraction of nominal GDP, real GDP growth and inflation) contributed to the growth of the public debt-to-GDP ratio. The chart indicates that the seeds of the rapid growth of the Italian government debt observed during the 1980s must first be found in the high and persistent primary deficits that were accumulated by Italian governments since the mid-1970s, and that contributed significantly to debt growth in spite of a high real GDP growth, positive inflation and low interest rates favored by the monetary financing of public debt. As it has been noted elsewhere (see e.g. Rossi, 2007 among others), this fiscal profligacy stemmed from the inability of Italian governments to finance the increase in welfare state related government expenditures with a stable increase in tax revenues. The fragile fiscal stance of the 1970s and 1980s alone would however not solely explain the explosion in public debt. A second, and equally important contribution, came from the robust rise in interest payments starting from the 1980s.¹

The 1992 budget law by the Amato government marked a turning point in the history of Italian fiscal policy, and the beginning of a fiscal consolidation phase that lasted for more than a decade. Table 1 compares the structural primary balances² of governments in the Euro 12 from 1995 to 2018. On average, Italian governments persistently scored sizeable structural primary surpluses during the entire period considered. In addition, these surpluses were always much higher than the average in the Euro 12.

The main result of this fiscal consolidation was the reduction of the public debt-to-GDP ratio from a 117% peak (reached in 1997) to a value below 100% in 2007 (*cf.* Figure 1). Nevertheless, given the high level of outstanding debt at the beginning of the 1990s, such a reduction would have been impossible without the significant decrease in real interest rates on debt, which was observed starting from 1993 (see

Rossi, S. (2007). *La politica economica italiana, 1968-2007*, GLF Editori Laterza.

1.

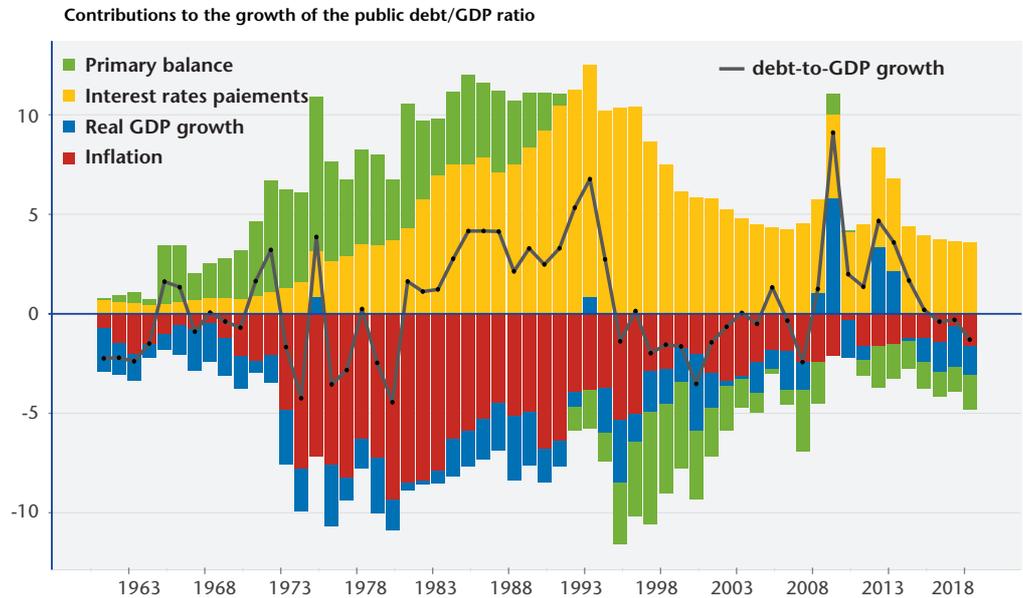
The latter stemmed from two factors. First, the practice of monetary financing of debt began to decrease in the 1980s, following the so-called “divorce” between the Bank of Italy and the Ministry of Treasury in 1981. Second, in the framework of the European Monetary System (EMS), fixed exchange rates were implemented. These policy choices aimed at disinflating the Italian economy and at pushing forward the European economic integration process. Yet they also resulted in a significant and prolonged increase in the real interest rate on public debt in Italy.

2.

The structural budget balance is indeed the primary balance, corrected for the effect of the business cycle on tax revenues and government expenditures. It thus provides a concise measure of fiscal consolidation (or its lack thereof).

Figure 2). This steady trend was the outcome of the interest rates convergence triggered by the process that ultimately led to the introduction of the euro, and it is undoubtedly one of the greatest benefits that Italy has gained from the introduction of the common currency.

Figure 2. The drivers of Italian public debt growth



Sources: AMECO, OECD, authors' calculations.

Table 1. Average net lending (+) or net borrowing (-) excluding interests of general government adjusted for the cyclical component

In % of GDP					
	1995-1999	2000-2004	2005-2009	2010-2014	2015-2018
Austria	0.230	1.147	-0.266	0.306	1.523
Belgium	5.783	5.458	1.663	0.014	1.193
Finland	3.196	5.610	2.500	-0.324	0.633
France	0.694	-0.226	-1.664	-2.150	-0.880
Germany	-0.533	0.026	0.984	1.494	2.124
Greece	2.454	-0.898	-7.976	-2.200	4.001
Ireland	4.849	0.936	-3.853	-3.931	-1.498
Italy	5.168	2.006	0.321	2.081	1.987
Luxembourg	4.364	2.375	1.453	1.824	1.618
Netherlands	2.051	0.884	0.145	-1.186	1.648
Portugal	0.242	-2.124	-3.226	-1.955	1.972
Spain	1.245	1.830	-2.489	-4.104	-0.739
Euro 12	2.479	1.419	-1.034	-0.844	1.132

Note: Adjustments based on trend GDP.
Source: AMECO database, authors' calculations.

The fiscal consolidation efforts in the 1990s and the early 2000s were completely wiped out by the 2008 Great Recession and the consequent sovereign debt crisis in Europe. The Italian public debt-to-GDP ratio rose sharply in few years from roughly 100% in 2007 to 131% in 2014, and it has been fluctuating around that value since then. It is worth noticing that: (i) this upsurge of 31 percentage points in public debt occurred in half of the time that it took to reduce the same ratio by 20 percentage points (see *supra*); (ii) the increase in the debt-to-GDP ratio occurred despite the significant structural primary fiscal surpluses accumulated by the Italian governments (see the last two columns of Table 1).

The main causes of this debt resurgence were the rise in real interest rate on debt as a consequence of the sovereign debt crisis on the 2008-2012 period (Figure 2), and the low GDP growth rates. Indeed, negative real GDP growth gave a positive contribution to debt growth during that period.

In a period of structural primary surpluses, low inflation and with central bank interest rates already close to the zero lower bound, the only way to reduce Italian public debt is an increase in real GDP growth. Unfortunately, as Figure 2 shows, real GDP growth in Italy has been weak since the 2000s and even turned negative in 2008-2009 and 2012-13, positively contributing to the growth of debt. In addition, when analyzing the contributions of aggregate demand components to real GDP growth since 1996, Antonin *et al.*, 2019 show that the positive contributions, both before and after the strains of the Great Recession, mainly came from domestic components like private consumption and investment. In contrast, the positive contribution of exports was almost always compensated by the negative contribution of imports. Hence, Italy was unable to grow *via* external demand in the period considered, despite the market integration opportunities offered by the introduction of the euro in 2000. This reveals a structural weakness of the Italian productive system, which has lost international market shares since the Great Recession of 2008 (a theme we discuss in more detail *infra*).

A second negative contribution came from government consumption, which significantly fell in relation to GDP since 2009 (see Figure 4). This is clearly the outcome of a combination between the already high debt-to-GDP ratio and the austerity efforts imposed by fiscal rules in the European Union. However, fiscal austerity did not have an impact solely on government consumption. Government investment also plummeted more than GDP since 2009 (see again Figure 3). Interestingly, Figure 4 shows also how that reduction was partly explained by the need to have more room to finance the increase in social benefits expenditure from 2008 on.³ Hence, in a regime of heavy constraints imposed on fiscal policy, Italian governments chose to substitute investment for revenue subsidies, in this way hampering the growth potential of the country. At the same time, such a “dangerous” choice was somewhat imposed both by the strains of the Great Recession (the increase in social benefits since 2008 is mostly due to the increase in unemployment benefits) and by the prolonged stagnant productivity and income growth in Italy (see also *infra*). Finally, a further negative stimulus to aggregate demand came from the tax burden, that significantly increased over GDP between 2005 and 2013.

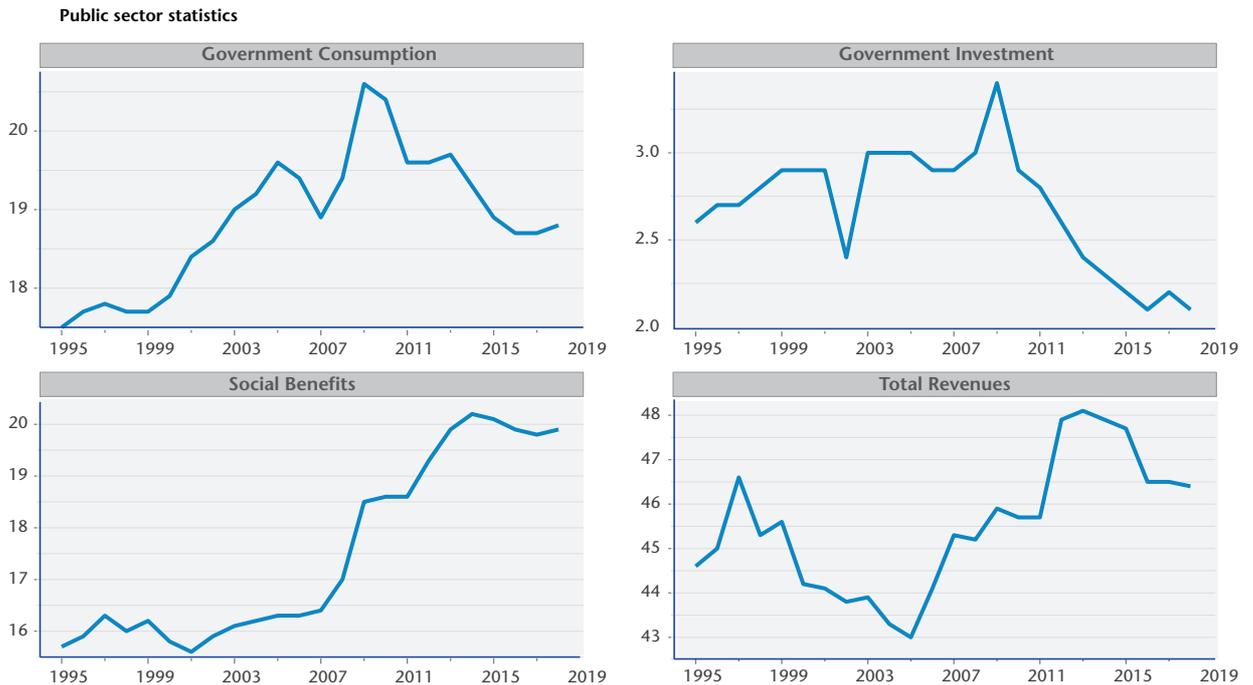
Overall, fiscal austerity aggravated the fall in aggregate private demand triggered by the Great Recession, by implying a reduction in government consumption and investment and a significant increase in the fiscal pressure in the 2009-2013 period. Sampognaro (2018) estimates that Italian consolidation efforts made from 2008 to 2017 reduced Italian GDP by 4 points, among which 3.5 points were related to national consolidation and 0.5 point was due to the fiscal consolidation of trade partners. In addition, austerity was self-defeating as it produced a rise in the ratio of public debt-to-GDP that dismantled the consolidation efforts made 10 years before.

Antonin C., Guerini M., Napolitano M. et Vona F., (2019). “Italy: escaping the high-debt and low-growth trap.” *Sciences Po OFCE Working paper*, 07/2019.

3. Another important item that we do not display here is the compensation of employees, which remained stable in relationship to GDP on the entire 1995-2017 period.

Sampognaro R., (2018). “Les effets de la politique budgétaire depuis 2008 dans six économies avancées.” *Revue de l'OFCE*. 155(1): 269–302.

Figure 3. Evolution of government expenditure components and total tax revenues in relation to nominal GDP, 1995-2018



Source: Eurostat.

Italy's chronic low-growth problem and its drivers

It would however be incomplete to attribute low growth in Italy only to a badly-timed austerity, one that in particular did not take into account the cyclical situation of the economy. Indeed, GDP growth in Italy has been significantly lower than in other countries for many years, notably before the Great Recession.

Table 2. Average real GDP annual growth rates

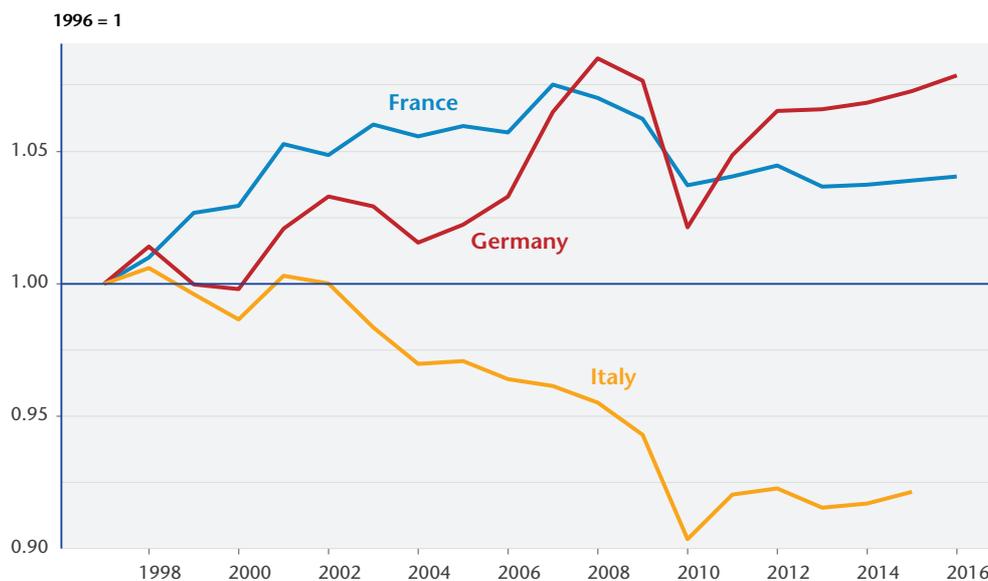
In %	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009	2010-2014
Germany	3.692	3.177	1.807	2.894	1.493	2.604
France	4.992	4.000	1.141	2.364	1.461	1.952
Italy	4.814	5.063	1.810	2.496	0.881	0.642

Source: University of Groeningen Penn World Table dataset.

As Table 2 reveals, average real GDP growth rates in Italy began to decelerate already in the 1980s (i.e. in correspondence with the explosion of the public debt, see *supra*). Nevertheless, in those days, average growth rates were still comparable to Germany's and France's. The growth trajectories of Italy and its neighbors instead became divergent in the 2000s. Italy's average real growth has indeed been below 1% since 2000 and far below Germany's and France's.

Another signal about the Italian growth decline can be grasped by looking at the evolution of productivity, which is a simple indicator of a country's structural performance, one that in particular captures the efficiency by which inputs are used to generate output. Figure 4 reveals how Italian total factor productivity (TFP) experienced

Figure 4. Dynamique de la productivité globale des facteurs (PGF)



Source : EU-KLEMS.

a cumulative decline of 7.9% over the latest 20 years.⁴ This contrasts with the efficiency gains experienced by France and Germany, where productivity increased by 4.1% and 7.9% respectively.

The Italian decline can be related to the country's specific structural factors hindering its growth potential. Some of them, like the dualism between the North and the South, have plagued the country almost since its foundation. Others, like the small size of firms and the excessive specialization in low tech sectors play a key role in explaining the weak export dynamics. We discuss each of these factors in more detail below.

Specialization bias towards low-tech sectors

Italian industrial specialization has historically been concentrated in low-tech sectors wherein the competition of low-wage countries, such as China, became particularly stronger in the 2000's. A study by Bugamelli *et al.* (2012) shows that the Italian industrial structure is indeed unbalanced towards traditional and low-value-added sectors. These sectors also have little technological content as well as a low demand for innovative technologies. This limits the extent to which newly created knowledge can be applied, e.g. through downstream and upstream linkages, to other high-value-added uses (renewable energy machineries, robotics, bio- and nano-technologies, ...). For instance, the broad textile sector (including clothing, leather and shoe sectors) accounts for around 14% of total manufacturing value-added in Italy whereas it only accounts for 5% in France and 3% in Germany. On the contrary, the sectors more prone to innovate (e.g. ICT, radio-television machineries, chemicals and pharmaceuticals) account for around 16% of manufacturing value-added in Italy, while they represent 20% and 21% in France and Germany respectively.

The "nanism" of Italian firms

Italian firms are too small on average to compete in international markets and to trigger a virtuous circle of productivity and employment growth. The small-size bias of Italian manufacturing companies compared to EU competitors is well-illustrated by

4.

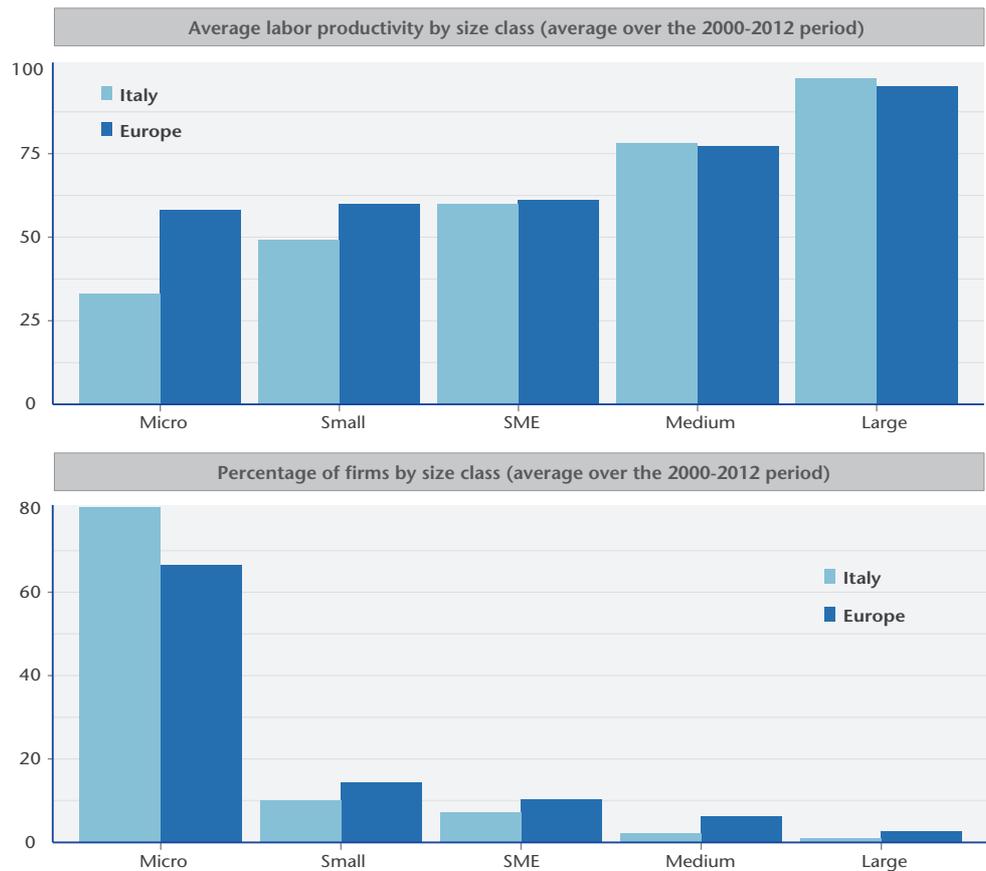
A more extensive sectoral comparison between Italy and EU economies is presented in Guerini M., Napoletano, M. & Nesta, L. (2018). "Convergence of productive structures and synchronization of industrial cycles in the European Union." *Revue de l'OFCE*, 158(4): 127-147.

Bugamelli M., Cannari L., Lotti F. & Magri, S. (2012). "Il gap innovativo del sistema produttivo italiano: radici e possibili rimedi." Banque d'Italie – Publications occasionnelles (121).

Berlingieri G., Calligaris S., Costa S. et Criscuolo C., (2018). "Sulla produttività pesa la dimensione di impresa." *www.lavoce.info*.

Figure 5, reproduced from a recent work by Berlingieri *et al.* (2018). What clearly emerges is that the share of micro-firms (below 9 employees) is much larger in Italy than in other European countries (bottom panel). In addition, small and medium Italian firms are much less productive than their European counterparts (top panel). The productivity gap disappears only for large enterprises. The net effect on aggregate productivity depends therefore upon the relative balance between small and large firms. Since the medium and large firms in Italy represent less than 3% of all the population and the micro and small firms account for around 90% of the whole population, the aggregate effect is a lower productivity with respect to the EU partners.

Figure 5. Firm size and productivity in the manufacturing sector, Italy and EU average



Source: Authors' elaboration from Berlingieri *et al.* (2019).

Three possible explanations may account for the "nanism" of Italian firms and their low productivity. First, "historical accidents" played a key role. One example is the dismantlement of the oligopolistic core in the 1990s, also as a consequence of privatization programs (see Dosi & Guarascio, 2016). Another one is the historically persistent specialization in small-scale artisanal productions (see De Cecco, 2012). Second, a recent empirical work by Dosi *et al.* (2012) suggests the co-existence of a group of dynamic firms with a generally bigger ensemble of much less technologically advanced and small firms. The latter firms nonetheless survive quite comfortably, due to the exploitation of local markets niches. However, the small size of these niches is unlikely to trigger significant firm learning and technological spillovers, thus amplifying the technological gap of Italian manufacturing with respect to other European countries. Finally, a third important explanation is credit constraints, which are on average stronger for small firms, therefore limiting their growth possibilities.

Dosi G. & Guarascio D., (2016). "Oltre la 'magia del libero mercato': il ritorno della politica industriale." *Quaderni di rassegna sindacale* 17(3): 91-103.

De Cecco M., (2012). "Una crisi lunga mezzo secolo: le cause profonde del declino italiano." *Economia italiana* 3.

Dosi G., Grazzi M., Tomasi C. & Zeli A., (2012). "Turbulence underneath the big calm? The micro-evidence behind Italian productivity dynamics." *Small Business Economics* 39(4): 1043-1067.

Talents' and resources' misallocation

Italy is characterized by a chronic problem of misallocation and underutilization of talents. This is evident from several well-known indicators, revealing extremely high levels of corruption, incidence of tax evasion and of shadow economy compared to similar countries in Europe. Distortions in the allocation of opportunities are exemplified by the high social immobility in Italy compared to other EU countries. This high social immobility is mainly explained by non-meritocratic channels such as nepotism, political patronage and family labor market networks (Raitano & Vona, 2015). The resulting perception of injustice has led a large number of Italian graduates to migrate in other countries where non-meritocratic mechanisms are weaker. Moreover, the prevalence of these channels in the Italian labor market undermines the incentives to invest in human capital, therefore creating a persistent under-supply of skills needed to increase specialization in high-tech sectors.

Raitano M. & Vona F., (2015), "Measuring the link between inter-generational occupational mobility and earnings: evidence from eight European countries." *The Journal of Economic Inequality* 13(1): 83–102.

The North vs. South divide

The above-mentioned factors hindering Italy's growth potential are stronger in Southern regions than in Northern ones. In addition, the North vs. South divide, which has characterized the country almost since its foundation has become more pronounced in the aftermath of the Great Recession. Figure 6 gives an idea of the increased North-South divergence in response to the crisis. In the 1995-2016 period, the value-added per worker (a proxy for labor productivity) in manufacturing fell by more than 20% in the South, and only by 11% in the North. This result is even more striking if one considers that the initial level of productivity was already approximately three times higher in the North (15 802 euros in 1995) than in the South (5 499 euros in 1995). Investments per worker after 2008 have also much more collapsed in the South than in the North. And with respect to the 1995 levels, the overall effect has been a 16% increase in the North and a zero gain in the South.⁵ Not surprisingly, the differential resilience to the crisis of Northern and Southern regions mapped into a wider and persistent gap in several labor market outcomes. For instance, the North-South gap in unemployment rates increased by 25% after the Great Recession. Such a gap is even larger among those younger than 24 years. Finally, we also observe a substantial worsening of the historical North-South gap in the incidence of irregular labor and in labor force participation (see Antonin *et al.*, 2019).

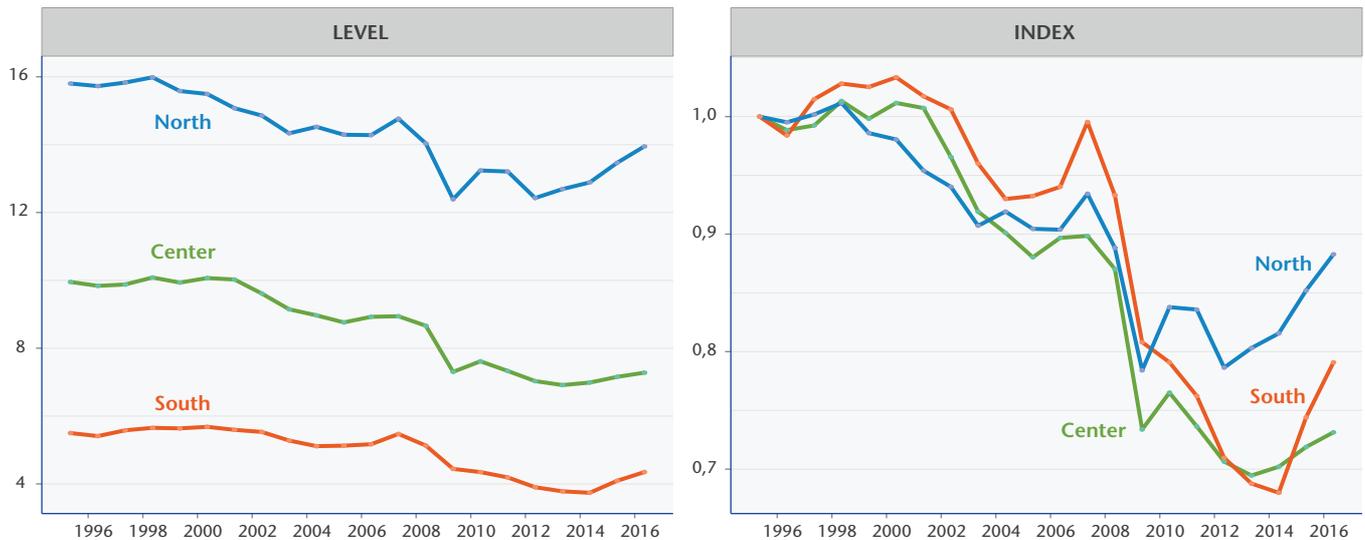
5. Furthermore, since the 1990s, public investment has been falling in the South and rising in the North, further amplifying the Italian dualism (see also the SVIMEZ 2014 report at <https://www.svimez.info>).

The ISTAT data also documents an increase in the North-South real wage gap (a 30% increase in the North, and a 5% decline in the South over 1995-2016). However, the comparison of real wage levels using a national deflator might be misleading as living costs are significantly different across Italian regions. A recent work by Boeri *et al.* (2019) corrects for this bias and shows that real wages are lower in the North than in the South. This would indicate the absence of relationship between wages and productivity (high in the North and lower in the South), that can be related to the centralized system of collective bargaining and the lack of diffusion of the two-tier wage negotiation system, mostly occurring at the local and firm levels. Boeri *et al.* (2019) show that a decentralization of the bargaining system similar to the German one would instead give a big boost to investment and employment in the South.

Antonin *et al.*, (2019). *op. cit.*
Boeri T., Ichino A., Moretti E, & Posch J., (2019). "Wage Equalization and Regional Misallocation: Evidence from Italian and German Provinces." *NBER Working Paper* n° 25612.

However, such a result rests on the strong assumption that real wages are at the market clearing level in the North. As a result, this proposal is tantamount to cutting wages in the South. Such a cut, combined with the tight constraints already existing on Italy's fiscal policy, could exacerbate the effects on growth and public debt of adverse macroeconomic shocks (like the one of the Great Recession discussed above). More generally, it is difficult to believe that wage cuts would be enough to incentivize

Figure 6. Per capita value added in the manufacturing sector, per macro-region



Source: ISTAT regional accounts.

investment in the South of Italy, whose economy seem to be stuck in a low-employment, low-productivity trap, mostly due to the strong incidence of factors like the talents' misallocation discussed above and to the complete absence of complementary production factors that makes investment worth (e.g. physical and infrastructural capital, technical skills and firm capabilities).

Policy recommendations to reignite economic growth in Italy

Escaping the high-debt low-growth trap is no easy task. The variety and the persistence of factors which are responsible for the Italian decline make it difficult to believe in recipes that address only some aspects of the problem. The recent political economy debate in Italy is characterized by a sharp division between two factions: those who attribute the causes of Italian economic decline to the straitjackets imposed by the European fiscal rules and by the common monetary policy, and those instead who stress the positive aspects of fiscal consolidations and point to the excessive rigidities of labor and product markets as the main cause of the country's low growth.

Such a polarized debate is not very fruitful. Indeed, this polarization originates from considering demand and structural factors as completely separated, which is, in our view, misleading. It is clear that Italy's low growth problem began much before the introduction of the common currency. At the same time, it is clear that some of the problems, like the regional dualism, are too profound to be solved solely by reforms targeting rigidities. They require instead active industrial policies with the essential support of government-sponsored investments (in education, research and innovation, infrastructures, etc.). In addition, one should not undermine the role that a badly-timed and self-defeating austerity played in exacerbating the impact of the Great Recession on Italy's growth, regional disparities, and public debt.

The chicken-egg problem is that, on the one hand, austerity prevents the use of fiscal levers to tackle some structural problems of the country. On the other hand, disregarding the role of structural problems may undermine the effectiveness of

expansionary fiscal policies and of public investments in particular. It follows that an approach (see also [Dosi et al., 2017](#), and [Amendola & Gaffard, 2019](#)) considering interactions between demand and structural (i.e. supply-driven) factors would be more useful in addressing the Italian low growth problem and, relatedly, its high debt one. The policy recommendations that follow are inspired by this approach.

1 Associate public investments to industrial policy and notably mission-oriented public programs

A standard critique towards additional public expenditure programs, like those that stem from the modified golden rule described below, is that they will ultimately end up in a waste of resources, especially in Italy, characterized by high levels of corruption in some areas. A similar critique is that those investment programs, like the generous fiscal expansions of the 1970s, would not result in an increase in long-term growth. To address these critiques, *public investment should be associated to industrial policies targeting the structural problems exposed in the previous section*. These industrial policies should aim at nurturing knowledge accumulation and developing capabilities in certain sectors (see [Cimoli et al. 2009](#)). They could also be implemented *via* mission-oriented programs targeting specific objectives, and should be supported by a long-term financial commitment from the public sector (see [Mazzucato, 2018](#)). An example is the green transition that had large multiplier effects at the local level in the United States (see [Vona et al., 2019](#)).

Clearly, to be effective, the above mentioned industrial policies must also be combined with a substantial improvement of the quality of Italian public administration. This is to ensure that the funds mobilized by such policies are not captured by rent-seekers, criminal firms and politically-connected incumbents. This is particularly relevant for industrial policies aimed at tackling the Italian dualism, whereby Southern companies are usually infiltrated by criminal organizations (the recent scandal of wind farms is an example). The creation of special development zones, initially isolated by the influence of local actors and with special fiscal and regulatory status, could be a solution to trigger a change in Southern regions and create a critical mass of dynamic entrepreneurs and capabilities.

2 Remove public investments from the computation of the structural primary balance that is relevant for the excessive deficit procedure

The Stability and Growth Pact (SGP) should be modified to exclude some specific forms of government investment expenditures from the computation of the excessive deficit procedure, while current expenditure should be balanced over the course of the business cycle (see [Dervis & Saraceno, 2014](#)). This modified *Golden Rule*, which is intertemporally fairer than current fiscal rules in the SGP, would allow a high debt country like Italy to use certain types of investments both as a cyclical lever to compensate the fall of aggregate demand during a recession, and as a long-term instrument to address the country's structural problems. Fiscal discipline would be enforced as current expenditures should remain balanced.

Besides the above golden rule, additional resources for investments could stem from savings on unproductive current expenditures (e.g. Cottarelli's spending review). These savings should amount to 34 billion euros in total, and could already free significant resources for investment as they would correspond to 1% of Italy's nominal GDP and to 10% of the country's current total expenditure for gross fixed capital formation.

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3 *Introduce minimum wage and reinforce retraining policies*

As of 2019, 22 out of the 28 EU countries have an official minimum wage; Italy does not. This self-exclusion of Italy from the EU standard practice, is partly justified by the fact that the Italian labor market is already characterized by a collective “tripartite” wage bargaining at the industry level between workers' unions and firms' confederations, with the government playing the referee between the two parties. Since the collective agreement is automatically extended to everybody, this should in principle guarantee an outcome close to a minimum wage. However, the tripartite bargaining sign has shown some weaknesses over the last years, with a substantial increase of non-compliance rates and the emergence of contracts signed by unions with little representation in the firms. The most vulnerable (i.e. unskilled) workers are the most penalized by the proliferation of these “atypical” labor market contracts.

Introducing a national, statutory minimum wage, determined by using the same tripartite fashion as collective agreements, is a way to solve these problems. Sector- and firm-level bargaining should be anchored to the minimum wage, which would then constitute a lower bound to all other agreements and all types of contracts. In addition, a minimum wage would sustain aggregate demand through higher wages to workers who are likely to be more credit constrained and thus with a higher marginal propensity to consume.

Finally, to be effective, the minimum wage should be combined with a convincing and well-enforced sanction mechanisms for non-compliance, and by giving an active monitoring role to unions. In addition, it should be complemented by effective retraining programs for displaced and unemployed workers. The design of training interventions should also be radically rethought, by reallocating funds to centers with better capabilities to provide good quality training such as technical schools and universities.

4 *Completing the banking union and solving the issue of non-performing loans (NPLs)*

The nanism of Italian firms can be related to financial constraints, which are particularly tight for Italian firms. This is also the result of the fragility of the Italian banking system, which stems two main factors. First, a significant Italian government bond share (20%) is held by domestic banks, which implies a high interdependence between the domestic financial system and public debt, with possible negative effects on credit supply and on real economy in case of rising bond yields. Second, non-performing loans (NPLs) represent an important share of banking assets. According to the Bank of Italy, their gross total amount represented 189 billion euros in 2018 (10,8% of GDP). A high proportion of NPLs erodes banks' net worth, it increases the risk of a bank's default, and it has negative effects on credit supply to firms as well.

In order to improve the Italian banks' robustness and resilience to shock, we defend the idea that completing the banking union should remain on top of the agenda. Two out of the three main pillars of the banking union are already effective, namely the ECB supervision of systemically important financial institutions⁶ and the orderly resolution of failing banks. Yet, the third pillar, i.e. the European deposit insurance scheme, is still far from implementation; some countries argue that the risk of bank default is still too heterogeneous in the euro area to allow deposit guarantees to be pooled. Hence, solving the issue of NPLs appears like an important step towards completing the banking Union.

6.

ECB supervision should also be improved by taking into consideration the high interconnectedness of today's financial and banking sectors, see Napoletano M. & Battiston S., (2014). “Some reflections on the ECB's Comprehensive Assessment.” *OFCE Le Blog*. December 9th.

For the time being only country-level initiatives have been implemented, for instance recapitalizations or securitization with state guarantees in Italy. The gross amount of NPLs has been cut by almost one half since then, from 360 billion euros in 2015 to 189 billion euros in 2018, while 52,7% of the NPLs have been provisioned. Apart from these solutions, the European public authorities still have a key role to play. Their levers include the definition of the regulatory and institutional framework and an extended ECB supervision (see [Antonin et al., 2018](#)).

5 Italy needs more Europe not less Europe

To reignite growth and solve its public debt problem *Italy needs more Europe not less Europe*. First, abandoning the euro, with a consequent huge devaluation of the currency, would have disastrous consequences on Italy's interest rates and on the government debt burden, which is denominated in euros. Second, and more importantly, most policies reigniting Italy's growth require the active participation and cooperation of the European Union to be effective. For instance, the introduction of a golden rule of fiscal policy needs re-discussing the entire framework of fiscal rules in the EU. The EU could also be helpful in mobilizing additional funds for Italy, *via* a common investment plan for the area (e.g. a Juncker's plan substantially rethought with stronger participation of public actors). Third, even industrial policies nurturing learning and firm capabilities seem infeasible without the explicit cooperation of European authorities in light of the existing norms constraining support to national firms. The same industrial policies would probably be more effective if they were part of a global industrial policy agenda of the entire union, rather than being the exclusive focus of single countries.

In conclusion, Italy cannot solve its economic problems without the help of Europe, but solving these problems requires an active role of Italy (which is a founding country of the union) in a process of overall reform of European policies. This process should ultimately converge towards a fully-fledged federal state in Europe, and in particular one with common fiscal policy and redistributive mechanisms across states. Indeed, a good deal of the conundrums Europe is experiencing, like those associated with migration, economic slackness and populist pressures for disintegration, originate from the incompleteness of the European construction. In this respect, it can be helpful to adapt Dani Rodrik's famous trilemma to the European Union (see [Rodrik, 2007](#)). The trilemma states the impossibility of having at the same time globalization, democracy, and the nation state. In a situation where globalization, i.e. international economic integration, seems irreversible, preserving democracy requires abandoning sovereignty and moving towards a federal state. Europe's democracies are instead stuck in a limbo between the nation state and federalism, where the solution to single countries' problems (like Italy's low growth one) now require the active cooperation among states, but where such a cooperation is difficult or absent. Yet, for federalism not to be perceived as a mere technocratic idea, the European political project must be revived. This in particular requires deepening the democratic side of Europe and binding together countries with shared European values ■

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