

Divisive integration

The triumph of failed ideas in Europe – revisited

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Edited by
Steffen Lehndorff

etui.

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A German version of this book was published by vsa (Hamburg) in 2014, with the title *Spaltende Integration. Der Triumph gescheiterter Ideen in Europa – revisited. Zehn Länderstudien*. Please visit www.vsa-verlag.de. Some chapters and data of the English version have been updated by the authors.

We are grateful to James Patterson for translation of the chapters written by Steffen Lehndorff, András Tóth and Hans-Jürgen Urban and for his careful language-editing of the book as a whole.

Brussels, 2015

© Publisher: ETUI aisbl, Brussels

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Print: ETUI Printshop, Brussels

D/2015/10.574/01

ISBN: 978-2-87452-332-8

The ETUI is financially supported by the European Union.

The European Union is not responsible for any use made of the information contained in this publication.

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Italy's long stagnation

Annamaria Simonazzi

Bare virtue can't make Nations live
In Splendour. They that would revive
A Golden Age, must be as free,
for Acorns, as for Honesty.
Mandeville, *The Fable of the Bees* (1705)

1. To have and have not

Italy is trudging through a horrendous sixth year of recession. The dismal results of the first half of 2014 only confirm the severity of the depression, the worsening of the 'fundamentals' and the ineptness of the policies implemented in these years. As a result of a continuous, severe downturn, only briefly interrupted by an almost imperceptible recovery, Italy's GDP reverted to the level of 2000, 9 per cent below the level of 2008. Despite continuing fiscal austerity, the loss in output had swollen the debt/GDP ratio to 135 per cent by August 2014. Italy's predicament is shared by the other countries on the European periphery, which are struggling with negative growth rates (see Figure 1 in the introductory chapter of the present book), record high unemployment and increasing (private and public) debts. As of March 2014 sovereign debt to GDP was 124 per cent in Ireland, 132.9 per cent in Portugal, 96.8 per cent in Spain and 174.1 per cent in Greece.

Things are different in Germany. Its GDP has reverted to – and surpassed – the pre-crisis level. Its labour market is humming: employment has risen by 3 million in the past decade and unemployment has fallen to 5.2 per cent, a post-reunification low and the second-lowest level in the EU28. Its current-account surplus has averaged nearly 7 per cent of GDP since 2006, reaching a new peak of 7.5 per cent in 2013: the surplus with other euro members fell from 4.5 per cent of GDP in 2007 to 2.1 per cent in 2013 because of their negative growth, but high-investing emerging markets have filled the void. Public finances have been flourishing, buoyed by healthy tax revenues, ultra-low long-term interest rates – in part due to Germany's status as a haven during the euro crisis – and fiscal restraint. In 2013, for the first time since 1950, the public debt fell

by 1.5 per cent and the federal government expects its debt as a percentage of GDP to fall from nearly 80 per cent to under 70 per cent in the next three years. These economic and fiscal successes continue to make Germany a bastion of strength in the fragile euro zone. No wonder that, according to a recent Eurobarometer poll, 84 per cent of Germans are satisfied with the state of their economy (Economist 2014).

Such radically diverging fortunes within the euro zone are astounding and hardly sustainable. How did we get here and where are we going? This chapter offers an interpretation of Italy's vicissitudes, starting with a brief overview of the Italian economy before the outbreak of the crisis (Section 2). It then surveys the policies implemented in the crisis and their effects on the productive and social fabric (Sections 3 and 4). The chapter concludes with an assessment of the – national and European – alternative policies for recovery.

2. Two decades of slow growth

Reforms: not far enough?

The currency crisis of September 1992 and the ensuing severe recession marked a watershed between two different economic policy scenarios. With the decision to enter the Economic and Monetary Union (EMU), the European Monetary System (EMS) first and the EMU afterwards provided the legitimacy – on the grounds of external constraint – for unpopular policy measures aimed at coping with structural disequilibria. Major supply-side reforms were implemented in the aftermath of the 1992 crisis in the areas of the labour market and industrial relations, privatisation and corporate governance, administrative decentralisation, pensions and social protection.¹ They shared the common principle of 'letting the market work'. However, while the *pars destruens* was fully or partly implemented, the *pars construens* was constantly delayed: due partly to budget and external constraints, proposals fell by the wayside during the many phases of legislative proposals, parliamentary debates, legislation and implementation, until a new government changed the agenda. Thus, labour market reforms to implement 'flexibility' were not accompanied by reform of the so-called 'shock absorber' systems (for

1. See Simonazzi (2014) for a brief analysis of the various reforms.

instance, truly universal unemployment benefit schemes or income support policies); reforms of the goods market have been limited to privatisation and unaccompanied by true liberalisation; social expenditure has remained limited to monetary transfers, with ever lower social investment; and social care has been left entirely to the family (and to religious or voluntary organisations) and, increasingly, to the (irregular) market. The result has been a set of partial, incomplete and incoherent reforms that have not changed the main features of the Italian welfare state, but have rather accentuated its segmentation and lack of universality.

Despite these far-reaching reforms, since the late 1990s growth has fallen below the EU average. This lack of growth has puzzled the (mainstream) economic community, which has sought a scapegoat by claiming that the reforms were not far-reaching enough.² A 'divided society ... less based on (declining) ideologies and more on the gradual proliferation of many consolidated interest groups, each one seeking to gain rents at the expense of others' (Crafts and Magnani 2011: 20) and the veto power of the opposing actors were offered to explain why reforms fell short of what was required to tackle the challenge of a radically changed economic environment (allegedly because of technical change and globalisation).³

Decline?

The extremely low rate of growth gave support to the hypothesis of a long-term economic decline. The decline story maintains that firms' size and industrial specialisation resulted in a lack of product and process innovation leading, in turn, to a loss of competitiveness, as evidenced by, among other things, the decline in Italy's export share. Labour reforms and the deregulation of the labour and product markets were deemed necessary to resume growth.

This interpretation, which enjoyed increasing popularity to become the consensus view, had come up for reconsideration in the very years

-
2. For instance, Crafts and Magnani (2011: 20) argue that 'supply-side reform did not go far enough especially given the context of joining the Eurozone. In several respects, including the legal system, competition policy, regulation and privatization, reforms were either incomplete or inadequately implemented.
 3. 'The general story is not that regulation has become more stringent but rather that existing regulation became more costly in the context of a new technological era' (Crafts and Magnani 2011).

preceding the crisis. Firm-level evidence from Italian manufacturing confirmed that low-tech businesses, which arguably benefited most from currency devaluation, had been restructuring more since the adoption of the euro. Restructuring entailed a shift of business focus from production to upstream and downstream activities, such as product design, advertising, marketing and distribution, and a corresponding reduction in the blue-collar workforce. The process of change had been led by medium-sized firms, firmly rooted in district economies (Coltorti 2007), and had been accompanied by outsourcing (Breda and Cappariello 2010). The new challenges posed by globalisation, the diffusion of information and communication technologies (ICT) and the adoption of the euro induced the most dynamic Italian firms to rethink their organisation and degree of vertical specialisation. The conclusion was that, since the adoption of the euro, a reallocation of activity had occurred within rather than across sectors, supporting the productivity growth in those sectors that had once relied more on competitive devaluations to regain price competitiveness (Bugamelli *et al.* 2009). While this evidence cut the link between the data on 'frozen specialisation' and the hypothesis of a lack of innovation and restructuring, it also made evident that the crisis had hit Italian medium-sized firms just as they were crossing the ford.

There are three main weaknesses in this rejuvenation process:

- (i) Restructuring has not been supported by an adequate expansion of the domestic market. The labour market reforms of the late 1980s and 1990s resulted in an increasing share of precarious, badly paid jobs and stagnating real wages. Two major consequences followed: on one hand, the stagnation in consumption accounted for the limited expansion of the productive capacity; innovative firms focussed more on the efficient exploitation of existing capacity than on the expansion of new capacity, making a productive base too small to absorb the entire labour force at fair wages; on the other hand, the creation of an ample reservoir of cheap labour allowed the survival of marginal firms.
- (ii) Widening of the north/south divide: from the mid-1990s the gap in per capita income had started to increase again. In 1992 the Cassa per il Mezzogiorno was dissolved, ending active industrialisation policy. However, southern Italian industry was too fragile to stand up to the harsh competition of a monetary union unaided: it is more dependent on domestic demand; the incompleteness of its value chains makes it dependent on external inputs, so

that the leak of imports from the centre-north weakens the correlation between the expansion of industrial production and the growth of the chain;⁴ finally a much higher share of firms in the southern value chains are in a weaker contractual position than their northern counterparts. Since the inception of the common currency the gap between the south and the centre-north of Italy has widened again (and has got worse in the crisis).⁵

- (iii) Micro-led restructuring, without a macro framework. The process of restructuring has occurred in a void of national coordination and guidance and the crisis has accelerated the trend, inducing even more fragmentation.

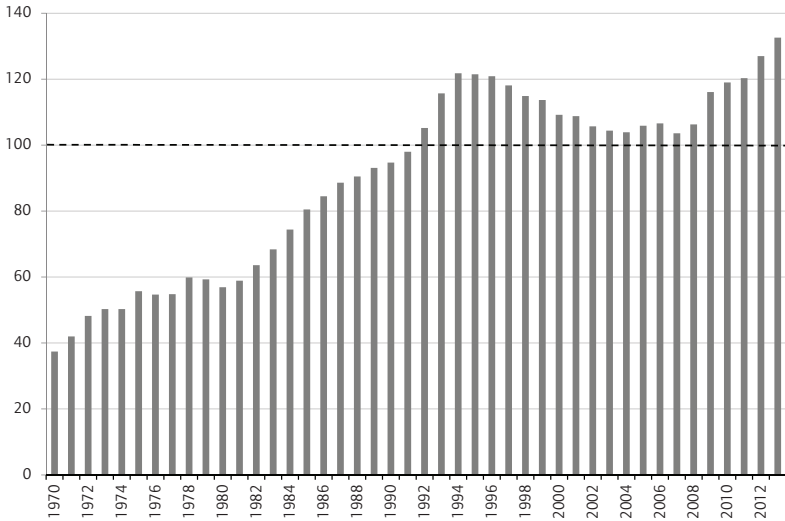
There was – and remains – little awareness on the part of the economic mainstream of the inadequacy of supply-side reforms to encourage the adaptation of a relatively still backward economy to the new context. Aggregate demand had no explicatory role in the interpretation of the slow growth of the Italian economy: the effects of these reforms, and of the macroeconomic policies implemented in the period, on income distribution and domestic demand were simply neglected. Thus, the long, painful period of cutbacks that started in the 1990s had no corresponding results in terms of improved public finances.

Public debt

The build-up of public debt occurred in different steps, sustained by various causes (Figure 1). The implementation of several social reforms in the 1970s (employment and pension schemes, health care and education) had resulted in a rise in public spending without a corresponding increase in tax revenues. The financing of the 'southern welfare model', which was still far from ensuring universal coverage, was thus provided by borrowing. The need to support the restructuring of Italian industry in the difficult decade of the 1970s provided a further exacerbation of public deficits.

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4. Bronzini *et al.* (2013) have estimated the degree of completeness of the value chains, showing that the linkages (measured in terms of additional workers) activated in the south are seldom greater than half the number observed in the centre-north.
 5. As observed by Faini (2003), if southern Italy had grown at the rate (2.9 per cent) achieved by the 'Cohesion countries' in the 1990s Italy's rate of growth would have been half a percentage point higher and there would never have been a debate on economic decline.

Figure 1 Debt as a percentage of GDP, Italy, 1970–2013



Source: European Commission, General Government Data.

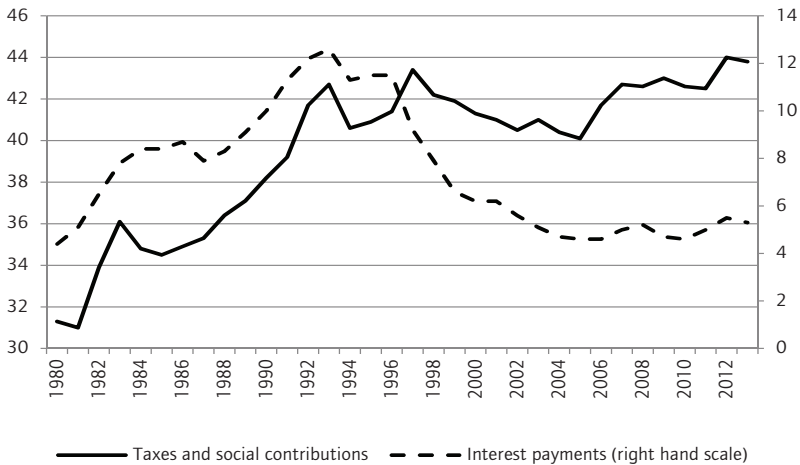
The policy of fixed exchange rates (EMS) in the 1980s, in a period of worldwide disinflation and high real interest rates, brought real interest rates to levels never seen previously. In combination with the prohibition on monetising the debt, introduced in 1981, this further fuelled the debt. By 1992 the tax/GDP ratio had increased⁶ (remaining above 40 per cent since 1991 and rising to 44 per cent in 2012), but the 10 percentage point increase of the 1980s went to service the debt: between 1990 and 1996 interest payments stayed constantly above 10 per cent of GDP (Figure 2).

Lower taxes for all!

In the two decades of predominantly centre-right government a series of tax reforms have been passed: fiscal amnesties (several waves since

6. At 34 per cent, the ratio of fiscal receipts to GDP at the beginning of the 1980s was 12 percentage points below the level of France and Germany, but reached the value of the German ratio by 1992.

Figure 2 Fiscal revenue and interest payments as a percentage of GDP, Italy, 1980–2013



Source: Bank of Italy.

1994) and no-prosecution for those returning illegally exported capital (fiscal shield 2009); elimination of inheritance tax (2001) (reintroduced by the centre-left government in 2006 for the very largest properties); and abolition of the local tax on first homes (2008) (which represented local authorities' most important source of revenue). The reduction in the tax burden from the peak reached in the late 1990s – to qualify for admission to the EMU – did not benefit everyone in the same proportion. Toso, Baldini and Morciano (2007) have assessed the distributive effects of the fiscal reforms of the Berlusconi II government (2001–2005): they estimate that 2 per cent of the total fiscal advantages accrued to the 10 per cent at the bottom of the income distribution, while 20 per cent have gone to the 10 per cent at the top. All in all, more than half of the total fiscal benefits have gone to the top 40 per cent.

Lower taxes demand spending cuts to keep the deficit from exploding. Social spending – education, research, social services and so on – have been at the forefront of any financial law aimed at coping with the umpteenth financial crisis; in fact, badly needed social reforms did not even take off: no support to families for child care and long-term care for de-

pendent people, no policies for young people, no minimum income for the needy and no equal rights to protection.⁷ Personal services have continued to rely almost solely on the family⁸ and the (irregular) market. Of the much trumpeted flexicurity, only the first part was implemented.

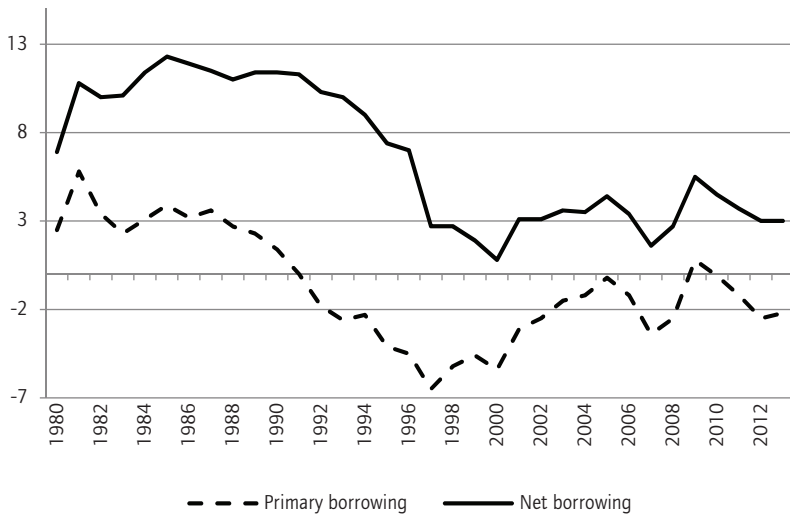
To conclude, since the 1980s the economic scene has been dominated by public debt. The debt/GDP ratio reached a peak of 120 per cent in the aftermath of the 1992 currency crisis; fiscal austerity in the second half of the 1990s and declining interest rates in the first years of the EMU lowered it to 103 per cent of GDP in 2007, just before the outbreak of the crisis. The service of the debt fell from its peak of the mid-1990s, but hovered around 5 per cent of GDP for most of the following decade (Figure 2). The debt and its servicing have represented the main, perverse channel of income redistribution, eating away the primary surpluses which have had to be squeezed out of the economy ever since 1992 (Figure 3). The middle classes (and the ‘third Italy’ in the north-east and elsewhere) managed to avoid paying taxes and turned their tax notices into bonds, underwriting the loans required to finance the deficit (Barba 2011). Through tax evasion, tax avoidance and tax cuts fiscal policy had three main effects: perverse redistribution, erosion of the basis for financing social policies and the unleashing of a political race that made tax reduction a bipartisan policy objective.

3. The crisis: reinforcing the features of the model?

At the outset of the crisis,⁹ the weakness of the public budget made it difficult to counteract its effects with an expansionary fiscal policy: according to IMF estimates, Italy’s fiscal stimulus over 2008–2010 amounted to 0.3 per cent of GDP, compared with an average of 3.4 per cent for the main advanced economies, and it was achieved mainly by changing the composition of the budget, leaving the balance unchanged. Nonetheless, the depth of the economic crisis took a heavy toll on the public finances:

-
7. The introduction of a social card for families below the poverty level, extension of the no-tax area and increased allowances for lower income families (minimum pensions, one-off allowance for the first baby) were the main pillars of fiscal and social policy.
 8. This was made the government’s official policy in the White Book of the Minister of Labour, Health and Social Policy (Ministero del Lavoro 2009), which has put the family firmly at the centre of welfare.
 9. This section draws from Simonazzi (2014).

Figure 3 Primary and total net borrowing as percentage of GDP, Italy, 1980–2013



Source: Bank of Italy.

in two years the debt/GDP ratio increased by 13 percentage points (from 103 per cent in 2007 to 116 per cent in 2009). Thus, when in 2010 the worst seemed to be over, the efforts aimed at reducing the deficit were resumed, mainly through cuts in expenditure.

Once again, the fiscal austerity measures implemented in the crisis lacked coherence and good design. This can be explained by a combination of the usual factors:

- the alternation in government of political forces with different political and philosophical orientations, mid-way between neo-liberalism and populism on the part of the centre-right, biased in favour of so-called ‘market efficiency’ as a path to sustainability, and social inclusion on the part of the centre-left;
- the lack of vision of the centre-left parties, divided between the assumed necessity for fiscal consolidation and the means to achieve it, on one hand, and the political race to implement tax reductions, on the other;

- the weakness of the trade unions, victims of their own divisive policies and their inability to represent the interests of marginalised workers and, especially, young people; and
- perverse redistribution and reduced tolerance for inequality, which has taken the form of demands for the reduction of ‘privileges’ but not for the extension of rights (universalism).

The result has been:

- further reduction of social investment;
- privatisation of parts of social expenditure and individualisation of risks, with the ‘exit’ option encroaching on health, education and personal services;
- institutional fragmentation; and
- geographical polarisation.

The commitment to reducing the debt/GDP ratio, undertaken in the Fiscal Compact, and the inclusion in the Constitution of the obligation to balance the budget will continue to impose restraint on fiscal policy in a period of persistent deep economic recession.

Austerity packages

The sovereign debt crisis, which started in July 2011 with a sharp increase in the interest rates on Italian government bonds (the yields on Italy’s 10-year bonds increased by 200 basis points, from around 5 per cent in early July 2011 to around 7 per cent in November 2011) forced (or, according to some, was instrumental in) the pursuit of fiscal consolidation. Three austerity packages were approved over a short period of time. The first two were presented by the Berlusconi centre-right government in August and November 2011. The last and tightest one was approved in December 2011 by the coalition government led by Mario Monti.

The policies implemented responded primarily to the commitment to fiscal consolidation. Budgetary measures (tax increases and spending cuts), sale of public assets and structural reforms (labour, pensions, liberalisation of strategic sectors) have been variously announced, implemented and amended by the ensuing governments.

Spending cuts consisted mainly of draconian reductions in financial transfers to local authorities and public spending for health care and education. The freezes in labour turnover and wages introduced by the Berlusconi governments since 2008 were extended in 2013 and 2014: recruitment of new permanent staff was frozen until 2015 and limited to replacing only part of the turnover thereafter. Due to these measures, since 2006 public employment decreased by 8 per cent (280,000 people), of which 70 per cent was in education (Banca d'Italia 2013). The Health Fund was repeatedly cut, endangering adequate health care.

A new wave of reforms

At the peak of the financial crisis, the new Monti government hastily passed reforms aimed at arresting the financial meltdown by reducing expenditure (pension reform) and by sending a strong signal to other countries and creditors (the labour market reform).¹⁰ These measures, rashly prepared and hastily passed in a vote of confidence, have produced unintended short and long-term effects that the following governments are still striving to put right.

Pension reform

The Fornero-Monti reform (2011) increased the minimum retirement age to 66 years, eliminating all forms of flexibility. With pension benefits strictly linked to contributions, it introduced an unnecessary rigidity in the retirement age. Precipitously and rigidly applied to respond to the urgent need to cut spending and appease the financial markets (as well as EU and German authorities), this reform left several short- and long-term problems open. While the Italian pension system has become the most rigorous among the EU systems (Banca d'Italia 2014), it is also the least adequate in terms of pension income and the most ineffectual with respect to the broader objectives of productivity, growth and employment (Pizzuti 2013). Two main trade-offs, which derive from the interrelation between the pension system, the labour market and the welfare state, threaten its long-term sustainability. By extending the working life

10. Changes in the labour market in the direction of still greater flexibility were among the conditions set out in the letter sent by the ECB in August 2011 to the Italian government spelling out the basis for its support to the Italian bond market.

of older workers, this reform ends up by keeping young people out of the labour market (and forcing down their wages), with negative long-term effects on productivity and growth, given, as is usually maintained, that young workers are more attuned to new technologies. It has also made reconciliation more difficult, especially due to the simultaneous cuts in social expenditure. The combination of an intermittent working career (due to maternity and care duties) and a pension system strictly based on contributions is likely to make economic self-sufficiency in old age more and more difficult for older women to achieve. Nor is it likely that the second, private pillar can be relied upon to complement meagre future pensions. Finally, pension reform and action by the subsequent government have failed to achieve more equity among current pension recipients. Pension benefits are very unequally distributed: the 33.5 per cent of men and 53.5 per cent of women who receive a pension below 1,000 euros per month account for 12.3 per cent and 28.2 per cent, respectively, of total pension expenditure; while the 8.4 per cent of men and 2.3 per cent of women who receive a pension above 3,000 euros account for 23.6 per cent and 8.5 per cent, respectively, of total expenditure (Istat 2013). The unfairness at the basis of the institutions of social protection has not only failed to prevent the fall into poverty of a large number of families but it has even contributed to an increase in inequality.¹¹ While the backbone of the pension reform is unlikely to be reversed, the following governments' willingness to amend some of its shortcomings – such as the elimination of the fixed age of retirement in favour of a flexible range and the problem of pension rights below the poverty line because of precarious and discontinued careers – has been stalled since these adjustments are deemed too costly for the time being (Giovannini 2013).

Labour market

Labour market policies have pursued three goals: increase flexibility; lower labour costs; and favour the employment of vulnerable categories via tax credits and subsidies.

11. It has been estimated that '21.4 per cent of expenditure goes to close the gap between the pension computed on an actuarial basis and the minimum pension (so-called 'integrazioni al minimo', 495.43 euros a month in 2013) and 13.1 per cent of social pensions, amounting to 2.8 billion euros, go to families in the highest deciles (8, 9 and 10) of the income distribution, as determined according to the new ISEE (*Indicatore della Situazione Economica Equivalente*, an indicator of the household's economic condition), with an average equivalent disposable income at or above 210,000 euros per year' (Baldini *et al.* 2013).

Calls for further liberalisation of the labour market have come from many quarters, including the ECB, the European Commission and the financial industry. Inspired by various European 'best practices' – from Danish flexicurity to the German apprenticeship model – the labour reform passed in 2012 had ambitious goals: on one hand, it aimed at reducing precariousness by re-regulating atypical contracts and extending the coverage of social protection,¹² and on the other, it was intended to make redundancies easier. The reform pleased no one: it met with criticism from firms for making atypical labour more expensive; it raised strong opposition from the trade unions for its attack on labour protection; and it frustrated the aspirations of the weakest segments of labour – women, young people, precarious workers – for its failure to tackle existing inequalities in labour rights. The part of the law targeting precariousness was soon substantially overhauled by legislation.¹³

An important corollary of the flexibility approach – and one that meets with the general support of government, trade unions and firms – is the need to reduce labour costs to increase employment. The Monti government's effort to improve access to jobs for women, young people and vulnerable categories of workers relied basically on a series of employment subsidies: tax deductions for firms (for example, IRAP¹⁴) and reductions of employers' social contributions with regard to newly hired 'weak' categories of workers or conversion of temporary contracts into open-ended contracts for women and young people. These measures were continued by the Letta government, despite doubts concerning their cost efficiency, especially as regards their efficacy in creating additional jobs.¹⁵

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12. It introduced a new system of unemployment insurance (*Assicurazione sociale per l'impiego*, ASpI) aimed at extending coverage to contractual typologies previously excluded. In fact, the reform fell far short of providing a universal measure of income support for those who had lost or never acquired the right to unemployment benefits. The law also aimed at strengthening the role of apprenticeship contracts as the main entry point to the labour market.
 13. This part of the law also had a difficult start and was not taken up by firms to the expected extent. The length of time between renewals of fixed-term contracts was shortened (Law Decree 76/2013, 'Decreto Lavoro'); the restrictions on the number of times they could be renewed were relaxed (Law decree 34/2014); the legal limits on their length were extended (from 12 to 36 months); and regulation of the apprenticeship contract was simplified.
 14. IRAP (Imposta Regionale sulle Attività Produttive) is a tax levied in proportion to turnover.
 15. Empirical analysis has warned of the dubious efficacy of tax credit policies in creating additional jobs (see Cipollone and Guelfi 2002; Anastasia 2013). In fact, these policies do not create new jobs, but only attempt to redirect demand for labour towards more disadvantaged categories of workers. Despite several rounds of employment subsidies, the unemployment rate of young people aged 15–24 soared from a low of 20 per cent in 2007 to 39 per cent. This figure conceals large inequalities: in the South the unemployment rate is 50.5 per cent (and 56.1 per cent for young women).

Moreover, reductions of labour taxes – that is, ‘domestic devaluation’ – if implemented simultaneously by all countries, not only result in a zero-sum game, but, in recessionary conditions, are likely to trigger a deflationary process. The focus on youth employment was maintained in 2013, with 794 million euros (over three years) earmarked to subsidise employment stabilisation (Law Decree 76/2013 ‘Decreto Lavoro’). The Italian Plan on the Youth Guarantee for 2014–2020 is the first sign of a move towards a systemic approach to tackle youth unemployment based on improving education and training systems and facilitating transition from school to work.

Finally, the measures aimed at fostering productivity also relied primarily on tax rebates on the productivity bonuses negotiated at the second level of wage bargaining, as well as on ‘liberalisation’ measures.

Industrial relations: towards a new model?

In recent years there have been several attempts to weaken the trade unions by isolating CGIL, the main left-wing trade union confederation. In January 2009 a ‘separate’ agreement between two of the three main trade union confederations (not signed by FIOM-CGIL) and Confindustria (the Confederation of Italian Industry), with the backing of the government, refreshed the 1993 agreement and introduced new rules for wage indexation at the national level, while leaving to the second level (firm level) the distribution of productivity gains. In a round of negotiations at the plant level, Fiat imposed a new contract that introduced clauses that departed from the national contract. The bargaining on the new rules took place under emergency conditions and the threat of relocation (to Poland and Serbia). Once again the agreement was not signed by CGIL. In the heated debate that accompanied and followed the negotiations, Fiat opted out of the collective agreement by establishing a new company, to be known as ‘New Fiat’. The question is whether, under pressure of the global crisis, the new model of industrial relations successfully imported into Italy from the United States by Mr Marchionne – Fiat’s CEO – is likely to spread. Further efforts to increase flexibility by encouraging decentralised bargaining at firm/territorial level, and the possibility of derogating from the legislation on dismissals, were introduced by Law 148/2011 and reinforced by the Agreement on Productivity (November 2012), which extended to 2014 the tax exemption for productivity bonuses (enacted by the 2012 Budget Law), and broadened the

coverage of the second level of bargaining to include issues of work organisation, working-time, tasks and training (Fondazione Giacomo Brodolini 2014). The June 2011 inter-confederal agreement was signed by the three main trade union confederations. Although fiercely contested from within CGIL, this agreement paved the way to end CGIL's isolation.

The Italian welfare model

To conclude, the policies implemented in the crisis indicate a continuity with the philosophy inspiring the reforms implemented in the two previous decades in the areas of welfare and labour: cuts in social investment and social expenditure, privatisation, regressive taxation and pension reforms, labour market flexibility and weakening of national collective bargaining, scant recourse to active labour market policies and reliance on employment subsidies to cope with the surging unemployment of the weakest categories in the labour force. These policies have failed to achieve growth in the past (Zenezini 2014) and it is not clear how more of the same medicine in a time of deep crisis might produce different outcomes.

4. Effects of austerity and social policies

Six years into the crisis, the index of industrial production is still well below the level attained in 2007; productive capacity has shrunk by a quarter; consumption, investment and public spending have all dropped, with only the foreign component of demand showing some dynamism. While the fall in imports, combined with a rebound of exports, has brought the current account close to equilibrium, by reducing GDP and tax receipts, the crisis and the austerity policies have sent the debt/GDP ratio soaring above 130 per cent.

Employment conditions have dramatically worsened for all, but with very different outcomes because of the lack of universal relief measures: workers on typical contracts were initially shielded from unemployment through large-scale resort to the '*Cassa integrazione*' (Redundancy Fund); workers on temporary contracts – mainly young people of both sexes – and (male) immigrants endured labour shedding; and involuntary part-time soared in female employment.

Household impoverishment

Poverty indicators based on income and wealth summarise these developments well. The collapse in families' incomes and employment opportunities, and the lack of a universal safety net have resulted in an increase in poverty among lower income families and an impoverishment of the middle class. The share of Italian families in absolute poverty doubled between 2007 and 2012 (from 4.1 per cent to 8.0 per cent, with a sharp acceleration since 2011), with households with children, single parents and unemployed heads of family recording the sharpest increase (ISTAT 2014: 174). The share of severely deprived households (defined as families exhibiting four or more out of nine indicators of severe material deprivation) increased by more than 7 percentage points in three years (from 6.9 per cent in 2010 to 14.5 per cent in 2012). With widespread unemployment, pensioners are often the only ones left with a reliable source of income to support the family, while previously inactive women have been shoved into the labour market to supplement or make up for the loss of the male's income. While increases in the incidence of absolute poverty and material deprivation have been registered throughout Italy, they disproportionately affect households in the southern regions.

Policies to counter poverty and social exclusion are traditionally inefficient in comparative terms: social transfers are estimated to reduce relative poverty by only 20 per cent in Italy compared with 34 per cent for EU28 (ISTAT 2014: 177).¹⁶ Lacking a decent social protection system and a minimum income, worsening economic conditions and fiscal austerity measures call for a reinforced role for the family as income shock absorber, a role that it may increasingly find it difficult to maintain in the future. In fact, an increasing proportion of households have begun to deplete their savings. Moreover, the declining average size and changing composition of households – declining marriage and increasing divorce rates, increased number of single-parent families and the decline in fertility – might well have decreased their redistributive capabilities. Even so, with the welfare state being rolled back, traditional 'familism' is likely to remain Italian families' last resort. Insofar as income redistribution takes place inside the family, it is likely to favour increasing inequality and decreasing intergenerational mobility. Since families' main resource for absorbing external shocks (unemployment, disability, early retire-

16. According to Baldini *et al.* (2013) this poor result is due not so much to scant resources (17 billion euros in 2011) as to their inefficient use (see, for instance, footnote 11 above).

ment) is savings, which are very unequally distributed, reliance on families as insurers against social risk tends to reinforce social inequality.

Indeed, while rising inequality is a fairly general trend across the OECD countries, Italy has recorded the sharpest increase since 1992 and is now among the European countries with the highest inequality in income and wealth. The relative stability of the synthetic index of income inequality (Gini coefficient) conceals the multiple composition effects illustrated above. Income distribution has become more fragmented and unequal between and within social classes, among wage earners, across generations, between geographical locations and inside families. These multiple dimensions of inequalities have changed the relative position of social classes and have fragmented and split the social fabric: the malaise of the middle classes stems not only from their economic difficulties, but also from the disillusionment and frustration generated by uncertainty about their children's future and bleak labour prospects (Simonazzi and Villa 2010).

Macroeconomic consequences

At the height of the crisis, it was held that what set Italy apart from the other 'PIIGS' (Portugal, Italy, Ireland, Greece and Spain) was the financial security of Italian families. Still in 2009, it was estimated that the ratio of families' wealth, net of the public debt, to GDP was a remarkable 4.5. However, the length and depth of the crisis is eroding households' wealth,¹⁷ while overall inequality in wealth distribution is increasing: the richest 10 per cent own about 50 per cent of total wealth. Indebtedness as a share of income (still at very low levels compared with the EU average) also increased from 30.8 to 65 per cent between 2008 and 2012. The fall in disposable income caused the erosion of savings and a decline in the saving rate, concentrated on the lowest quintile, on households of young people and tenants. When considered in conjunction with the pension reform, this trend in young people's incomes and savings is suggestive of the problems that this generation will have to face in its old age.

As income volatility translates into a greater perceived insecurity, consumption is reduced and, as past savings are depleted, the prolongation of the downturn compels households to further cut consumption to at-

17. According to Bank of Italy's estimates, since 2008 households' wealth has diminished by 5.7 per cent (one-third of GDP).

tempt to safeguard the future.¹⁸ Insecurity helps explain the failure to boost growth of the only vaguely ‘pro-growth’ measure that the Renzi government has enacted, namely the 80-euro bonus given to low-wage workers. According to Confcommercio (a national association of retailers), Italian families were holding back from shopping ‘because their uncertainty about the future was stronger than the actual increase in funds in their pockets’. Inequality in income distribution is paralleled by polarisation in consumption: while the bottom 10 per cent accounts for only 4 per cent of total consumption, the top 10 per cent commands 22 per cent of it. The decline in the quantity of consumption has gone hand in hand with a quality downgrade: an increasing share of families declared that they had had to reduce either the quantity or the quality of their consumption relative to the previous year. This is the paradox of a productive system whose success has been based on the production of luxury goods (‘made in Italy’) that all too many Italians can no longer afford to consume: exports and imports of consumer goods increasingly differ in quality, imports being of much lower quality.¹⁹

5. What is to be done? The periphery and Europe

Macroeconomic effects of EMU

We can now see that, given the enormous distance separating the economic and political institutions of the Nordic-Continental countries from those of the European South, it was a mistake for the Mediterranean countries to enter a monetary union without a fiscal and political union. Survival of the weak in a currency union requires solidarity,²⁰ something that has never abounded within the European Community.²¹

18. Between 2007 and 2011 a 5 per cent reduction in GDP induced a fall in consumption of only 1 per cent; in 2012 the 2.4 per cent reduction in GDP was accompanied by a reduction in consumption of 4.3 per cent.

19. See Simonazzi, Ginzburg and Nocella (2013) for an analysis of the change in the pattern of consumption of poorer German families since the Hartz reform along these lines.

20. See the estimates of the federal transfers in the United States in *The Economist* (2011), or West German net transfers to the eastern *Länder*, estimated at about 900 billion euros between 1991 and 2003 (half of one year GDP) (Dustman *et al.* 2014).

21. It is now fashionable to say that economists have warned, since the very beginning, of the very demanding conditions required for a currency area to work properly. It is fair to say, however, that for a long time mainstream economists and politicians alike have let themselves be carried away by the ‘convergence play’, seriously underestimating the risks and costs inherent in wage and price flexibility as a prerequisite for convergence. See Simonazzi and Vianello (1998) for an early warning.

In the midst of the 'tsunami' that wrecked the financial markets, creating a panic among savers and inundating the sovereign debt and banking systems of half of the euro area countries, 'a controlled process of successive, agreed steps' was deemed the right answer. For too long the EU leaders, led by Angela Merkel, refused to acknowledge how interwoven national financial institutions had become. The leadership vacuum, lack of statesmanship and conflicting national interests have systematically prevented the timely adoption of the measures required to defuse the financial time bomb and that were later forced upon them by a new, ever deeper crisis. Even after her sweeping victory – or perhaps because of it – the German chancellor did not change course, however, turning down any call for greater integration or financial support for growth-enhancing projects, let alone requests to deviate temporarily from the budget targets because of exceptional circumstances (that the austerity measures helped to create).²² Finally, Germany's Constitutional Court has de facto undermined the only action that was capable of sedating the financial markets and preventing a domino effect on the whole financial system.

Solidarity is not only scarce, but also a very perishable good. Convergence, or at least self-sufficiency, must be perceived as attainable, sooner or later, and this demands that suitable policies be devised and implemented. The structural reforms implemented in the past few decades, and relentlessly requested by the ECB, the European Commission and Germany as a condition of assistance, are based on the premise that market competition is the only mechanism capable of guaranteeing growth. Innovation and successful enterprise supposedly are never the result of a coherent design, devised by an enlightened planner: it is the market that selects the most promising projects while letting the others fail along the road. This – it is argued – is the only way by which the Italian economy will break the vicious circle between public budget re-equilibration and recessionary fiscal consolidation, and this is what reforms should aim to achieve.²³ Thus, any failure to achieve the target can be ascribed to incomplete, half-hearted structural reforms: hence

22. The finance minister Pier Carlo Padoan's written request to the Commission on 16 April 2014 seeking authorisation for a change in objectives, due to severe recession, was greeted with dismay in Brussels and with outright rejection in Berlin. 'Italy request to push back budget targets dismays Brussels', *Financial Times*, 17 April 2014.

23. See '*Idee per la crescita*', a forum launched by a group of economists which aims at addressing the key question of how to stimulate and ensure sustainable growth in Italy on a liberal agenda. <http://www.eief.it/idee-per-la-crescita/>

the call for more labour flexibility, more spending and tax cuts, more deregulation and privatisations. The corollary is: the sooner, the better. Fiscal consolidation first, and no need to worry about the deflationary effects of balancing the budget (Perotti and Zingales 2011)²⁴; the belief is that austerity produces ‘confidence’ and confidence will produce growth. Implementation of ‘structural reforms’ at the national level is thus made a condition for the enactment of policies at the community level targeted at facilitating the financing of the deficit (quantitative easing) and/or coordinated growth. The devastation of the peripheral countries’ economies has barely dented this approach, nor convinced policymakers that, no matter how desirable and urgent some of these reforms may be, they are not, by themselves, capable of jumpstarting growth.

Italy’s (and other Southern European countries’) failure to achieve recovery is thus due more to these misguided policies than to delayed reforms. While there is agreement that some fundamental features are holding back growth and need to be fixed – the dysfunctional role of bureaucracy, the deterrent effect of high taxes (for those who pay them), the existence, within the public budget, of large pockets of privilege and waste, a political stalemate making bold reforms to clean out cronyism and corruption almost impossible – the main fault of this approach, and not a small one, is the idea that it will suffice to ‘unfetter entrepreneurship’ to restart growth. An alternative policy must be based on the tenet that aggregate demand must increase in order to create new job opportunities, and public (physical and human) infrastructure needs to be part of it. The tax base must be more equally spread and service provision must improve. This calls for a solution to the quandary of public employment and bureaucratic inefficiency. The concept of taxes must be connected again with the concept of services: people need to relearn that what they pay is for their health, education, child and elderly care. We need an industrial policy to identify the direction of development, guide investment, endeavour to ensure that the increase in demand does not leak out in imports and devise means to support the upgrading of value chains. New industrial relations and the revision of labour market

24. This position recalls Andrew Mellon’s advice: ‘liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate ... it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.’ Andrew W. Mellon, adviser to President Herbert Hoover during the Great Depression. Hoover, Herbert, *The Memoirs of Herbert Hoover*, Volume 3: *The Great Depression*. Herbert Hoover Presidential Library and Museum. www.hoover.nara.gov. Retrieved 20 August 2014.

deregulation are also needed, distinguishing between flexibility and insecurity. Indebted countries surely must do their homework, but we must reach an agreement on which 'structural reforms' are most needed. Moreover, structural reforms take time to achieve results and are best implemented in a context of growth.

Meanwhile, economic conditions have deteriorated rapidly: austerity is killing growth and the spectre of deflation is haunting Europe, the inevitable result of simultaneous, self-defeating demand suppression and wage cuts. With inflation low or even negative and low or negative growth, nominal GDP will hardly increase and may even contract, boosting the debt to GDP ratio. Ever larger primary budget surpluses would then be required simply to keep the debt to GDP ratio from rising further. According to IMF estimates (computed with reference to the more favourable conditions prevailing in 2013), the heavily indebted European sovereigns should run an average primary surplus: 5.6 per cent for Ireland, 6.6 per cent for Italy, 5.9 per cent for Portugal, 4.0 per cent for Spain and 7.2 per cent for Greece in the decade 2020–2030 in order to first stabilise and then reduce their debt/GDP ratios to the 60 per cent level targeted by the EU's Fiscal Compact by 2030 (IMF 2013). Drawing on historical experience, Eichengreen and Panizza (2014) doubt that these large primary surpluses can be politically and economically acceptable and, we might add, successful. Italy has in fact run a primary surplus since the early 1990s, but that did not stop the weight of the debt from climbing. Moreover, history teaches us that the consequences of a general deflation can be disastrous.

Europe must resume growth if the countries of the periphery are to have a chance of growing out of their debt. But the situation has so deteriorated that growth alone will not suffice to defuse the time bomb represented by deflation and the debt overhang, calling for some sort of financial relief. This inevitably calls into question Germany's policies and attitude.

The grumbling hive

The survival of the common currency very much depends on the existence of a common interest linking surplus and deficit countries and capable of supporting a commonality of policies: a political entity that takes care of Europe. But interests within Europe are diverging. In 2011 George Soros expressed the view that 'with Germany's reunification, the

main impetus behind the integration process was removed' (Soros 2011). The impetus might have been weakened further by the crisis. The economic crisis and fiscal austerity have depleted the Southern European markets. They are no longer as important to Germany as the more dynamic extra-EU markets;²⁵ the eastward integration of German industry has provided a cheap, skilled workforce and an increasingly interwoven network of suppliers and markets. Despite an increase in German wages since 2009 (see the chapter on Germany in the present book), there are two reasons to expect any beneficial effect for the southern countries to be modest: first, the rate of Germany's domestic demand expansion is still very low and second, its spillover effects within the euro zone are likely to be smaller because of the increasing importance gained by non-euro countries in German imports of consumption goods. Thus, even somewhat stronger and more balanced growth in Germany could not outweigh the disastrous impacts of austerity and of deregulatory EU policy approaches (see the chapters by Leschke *et al.* and Schulten/Müller in this volume).

External policies are also likely to diverge: what is good for Germany is not necessarily good for the weaker countries of the European Union. German industry's conquest of new emerging markets may require a more liberal trade policy than one that the southern European countries can afford.²⁶ The domestic industries of the latter will have to face competition in their own markets, competition made stiffer by the impoverishment of families. Moreover, without Germany, the euro would be weaker. A strong euro can harm Germany less, because of the composition of its exports and the positive effects that a strong balance and a strong euro may have on the price of imported consumption goods and on the capacity to finance exports, as argued above. Conversely, a strong euro can harm the Southern countries, whose exports are likely to have a higher price elasticity. Finally, the trade surplus entails bottom-low interest rates in Germany, which gives German firms the privilege of low credit costs compared with those paid by firms in other countries, as well as low rates on long-term financing offered to foreign buyers of investment goods. Thus, the 'spread' in interest rates signals two sides of the

25. Between 2008 and 2012 German exports to Italy, Spain and Greece fell by 10 per cent, 27 per cent and 40 per cent, respectively.

26. Conflicting interests – between big business and labour, as well as between countries – may also unravel the Transatlantic Trade and Investment Partnership (TTIP), a comprehensive free trade and investment treaty currently being negotiated between the European Union and the United States.

same coin when it comes to understanding the German business model and its side-effects on the economies of other advanced capitalist countries within the euro zone, such as Italy.

Can Germany stand alone? For German voters, their country's post-war economic miracle was built on a hard currency, prudent finances and strong exports. It is hard for German voters to fathom that – unintended consequences of – these very virtues are at the heart of the current crisis (Knight 2011). As noted by former UK prime minister Gordon Brown, 'There is some truth in the argument that Germany will only agree to become a bigger part of the solution when faced with the evidence that it is also a big part of the problem' (Brown 2011). Emergency intervention is needed to pave the way for long-term construction: this is a growth strategy that would mean easing up on austerity for the weakened countries of the periphery and enacting strategic investment stimulus measures in both periphery and surplus countries, emergency measures to cope with the debt overhang, as well as new rules that prevent the formation of the very disequilibria that led to the present predicament. This would be a bitter pill to swallow for the German electorate and their political class. There has been little so far to encourage hope.²⁷

Time is running out fast and it will become more and more difficult to ensure the sustainability of peripheral countries' debt. We may have reached a point at which not even a compliant Germany would be able to pay the bill for everyone and, if deflation continues, the alternative scenario can no longer be ruled out. As Barack Obama has said, European leaders' lack of vision and resolve is scaring the world.

27. During the spring the *Financial Times* published details of a document jointly issued by the German and Finnish finance ministries which strongly rebuked Brussels for easing austerity demands, citing in particular the additional flexibility given to France and Spain for reducing their budgets to within EU deficit limits (Hugh 2014).

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