SWP Comment
NO. 53 DECEMBER 2019

PD and M5S: The Italian Alliance of Convenience

The Power of the Status Quo in a Challenging Economic Context

Emanuele Caggiano and Paweł Tokarski

The attempt to provoke early elections in August 2019 by the leader of the League, Matteo Salvini, unexpectedly led to a pragmatic coalition of the Five-Star Movement (M5S) and the Democratic Party (PD) and the formation of a second government under Giuseppe Conte. This government operates in a fragile political equilibrium where a fear of early elections, which could pave the way for Matteo Salvini to power, is the main stabilising factor. The pragmatic political calculation of the PD and M5S supported by Matteo Renzi's new party "Italia Viva" may be enough to maintain the coalition for a certain time, but it will not generate any major growth incentives for Italy, which are crucial in maintaining the sustainability of public debt.

Political instability in Italy has been long considered the main issue that adversely affects its entire economic system. Weak state institutions and short-term economic policies cannot provide proper answers to structural challenges. Since the first government of the Italian Republic, formed in July 1946 under the leadership of Alcide De Gasperi until 2019, Italy has had 67 governments in 73 years. The Giuseppe Conte's last government only stood for 14 months. The future of the current one does not look very promising either. It is dependent on an unusual alliance between two parties that used to be competitors at regional and national level. The emergence of Matteo Renzi's new centrist party, Italia Viva, has further complicated cooperation between the coalition partners. Although public support for the party is low (around 5%), without the support of Italia Viva the coalition of the PD and M5S does not have a majority in parliament. However, since Salvini's Lega has gone into opposition, several factors have reinforced the incentives for the PD and M5S to continue cooperating and avoid new elections.

PD and M5S: Factors for Cooperation

The most obvious motive for the cooperation for both parties is the fear that the next parliamentary elections in Italy will lead to a victory of the right-wing coalition led by Matteo Salvini. The personal conflict between the current Prime Minister Giu-

Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

seppe Conte and Matteo Salvini also plays a significant role. It has grown since the Lega-M5S coalition was created in June 2018 and peaked when Salvini suddenly left the government and the coalition in August 2019. Both politicians are currently leading the confidence rankings and this political duel forms the main line of confrontation in Italian politics.

Another significant factor that could contribute to the stability of Conte's second government are changes to the way parliament functions. On 8 October 2019 the Italian Parliament approved a reduction in the number of its members by one third (from 945 to 600). Fewer seats in parliament means the current deputies have less chance of being re-elected. This is primarily a problem for the parliamentarians of the Five-Star Movement, which has suffered considerable losses in the polls since joining the coalition with the Lega. Several members of the M5S, including its leader Di Maio, will be prevented from being re-elected by the movement's rule that no member of parliament may be elected more than twice. If the M5S does not change this internal rule MPs of the movement, most of whom are members of parliament for the second time, will not be inclined to hold early elections.

Due to the reduction in the number of parliamentarians, the government will have to amend electoral law. The discussion about the new electoral law will take time and no new elections will be called until there is a vote on the changes. Both M5S and Italia Viva have no incentive to support early elections. They would prefer to change the current mixed electoral system (partially based on majority voting) and to introduce a full proportional vote that would allow the two parties to both play an important role in a future government coalition. Besides, the M5S has an internal competition between members who support Di Maio and those who are more supportive of Giuseppe Conte. The PD is the only party that is rather indifferent to early elections, as it is likely to retain a similar number of seats in any future parliament. However, both the PD and M5S plan to change their internal party structures in early 2020, which will also be a disincentive for elections to be held during that time.

Another important reason for the current coalition to continue is the election of a new president by the parliament in 2022. In times of political instability, the president has fundamental powers to maintain the constitutional equilibrium. He names the prime minister and appoints ministers on the advice of the prime minister. In 2018, President Mattarella refused the nomination of Paolo Savona (an economist supporting Italexit) as finance minister, preventing any negative reactions from investors, which might have threatened the fiscal stability of the country. To avoid a Lega-dominated parliament choosing a successor to Sergio Mattarella and dominating the country's political system, the M5S and PD will attempt to keep control of parliament until that time.

Furthermore, continuing the cooperation will allow the coalition partners to extend the influence of their political parties on the economy. More than 70 managers of the largest public enterprises are about to end their terms of office and need to be replaced. This affects, for example, the largest energy firms (Enel, Eni, Terna), defence company Leonardo and Poste Italiane, which will have to replace its executive boards in early 2020. In addition, the PD and M5S will have an impact on the appointment of many leading positions in state institutions, such as the president of the National Authority for Anticorruption (ANAC).

The Economy: Between Firefighting and Structural Problems

From the outset, the new government of Giuseppe Conte has had to deal with urgent economic issues. The key issue and one of the main formal reasons for the alliance between the M5S and PD was 2020 budget legislation to avoid raising VAT from 22% to 26.5%, which could have badly affected consumers and further undermined confidence in the Italian political class. To manage that, the government had to find around 23 billion euros in the budget from extra taxes and cuts in public spending. New taxes include ecotaxes (plastic tax) and higher taxes on gambling. The government also announced a plan to recover between 3 and 4 billion euros by fighting tax evasion, which was supported by, for example, electronic invoicing and creating incentives for online payments. At the same time, the government aims to increase fines for tax evaders, including the confiscation of goods or prison sentences. However, it is doubtful whether these measures will help close the gap in the budget, which will put public finances under further stress. Here, the prospects are grim as there are no signs of any substantial recovery for economic growth in Italy. In 2019 and 2020 GDP is expected to grow by only 0.1 percent and 0.4 percent respectively. The fiscal effect provided by the 2019 budgetary policy was much smaller than expected. The citizen's basic income (Reddito di Cittadinanza), introduced in 2019, has reached fewer people and generated a weaker-than-expected demand stimulus.

With public debt reaching a record level of 136% of GDP in 2019, this squeeze on public finances considerably reduces Italy's scope for growth-oriented spending. For example, according to the Osservatorio CPI (an Italian public finance watchdog), in 2020, only 100 million euros is going to be invested in Industry 4.0 to support the technological development of the economy's most productive sector. Italy's industrial sector is suffering from low innovation and lack of new technologies, which is largely due to the composition of the market. A large proportion of the industry is made up of small or medium enterprises that cannot afford to invest in innovations and struggle to adjust to new, more difficult conditions on the market created by trade conflicts and stricter environmental standards. These conditions are also challenging for the largest firms, for instance current and previous governments have had to deal with the increasingly difficult situation of the largest steel company in Europe, ILVA, located in the Southern Italian city of Taranto, employing around 8,000 people.

One of the main problems in Italy is the decline in real wages over the last decade compared to the rest of Europe, which has contributed to weak domestic demand, hampering economic growth. The government is at least trying to reverse it by lowering labour taxation. Another similar proposal agreed between the coalition partners, is the introduction of a minimum wage (from eight to nine euros per hour). However, due to the north-south pay gap, a minimum wage imposed at national level may be counterproductive in some regional labour markets. This issue will continue to play an important role in electoral debates in 2020.

Another bone of contention is the new, more generous pension system that the Conte's first government planned to introduce. Known as the "Quota 100", it would create an additional burden on public finances and will be postponed until 2021. The new pension system will be one of the most important battlegrounds inside the coalition. Italia Viva and the PD are against this expensive pension reform that is expected to cost around 20 billion euros over three years. Both parties would prefer to invest more in infrastructure, education, research and innovation. These policies will not only be more efficient in terms of public debt but they can generate wealth and growth for new generations. However, M5S politicians are afraid that Salvini, who pushed the new pension system, will use this issue against the M5S in any electoral campaign.

Challenging Year 2020

Elections will be held in eight of the 20 Italian regions in 2020, starting with Emilia-Romagna and Calabria in January. The decision taken by M5S not to ally with the PD in Emilia-Romagna will not only contribute to a good result for the right-wing parties grouped in one coalition, but will also increase conflicts in the government coalition. After a poor result in Umbria in October, another defeat in Emilia-Romagna would cause frustration among PD members and lead to more scepticism about its cooperation with M5S, which will be a test for the coalition. However, the incentives for both parties to remain in government will remain strong. Early elections would most likely result in a right-wing populist coalition of the Lega, Fratelli d'Italia and Forza Italia taking power, with Matteo Salvini as prime minister. A newly created grassroots protest movement, "The Sardines", directed mostly against Salvini, has enjoyed considerable media coverage. However, its establishment as a political force could increase the fragmentation of the left side of the political scene. The increasingly plausible scenario of Salvini as prime minister would lead to an increase in interest rates on Italian bonds, which are already priced at a similar level to Greek ones.

Italy is the only Eurozone member which still has not meaningfully recovered from the euro crisis. This is visible on the labour market, in the poor state of public finances, in problems in the banking sector, in structural challenges and not least in the gap between the north and the south of the country. Trade conflicts and the impending Brexit do not provide a favourable background for Italian exports, which contribute significantly to economic growth. The main problem is that Italy needs a comprehensive, long-term reform package focused on increasing investment, productivity, innovation and restructuring of the workforce training system. Such a package is unlikely to be created and implemented in the current political context of permanent electoral campaigns and the poor state of public finances. The political class in Italy is a long way from solving the long-term challenges of the country concerning the labour market, efficiency of public institutions and budgetary spending, risks in the banking sector and infrastructural problems. Italy's internal political debates are disproportionately focused on migration, mainly because of Salvini, who raises these issues via social media. His use of the issue of reform of the European Stability Mechanism (ESM) as a pretext for anti-European rhetoric has stiffened M5S's resolve on this question. This shows that with pre-election rhetoric in Italy intensifying, the political space for Eurozone governance reforms is coming to an end.

The political blockades at the national level and the poor state of state finances will exacerbate demands from Rome for a more expansionary fiscal policy in Germany and more flexibility of Eurozone fiscal rules. Italy's growing public debt will sooner or later trigger speculation about its sustainability. The new European Commissioner for Economic and Financial Affairs, Paolo Gentiloni, will play a key role in the dialogue with the current and next Italian Government on fiscal policy issues. For the new ECB President, Christine Lagarde, Italy could be the biggest challenge of her term of office. It is the only institution with sufficient resources to stabilise Italy's public debt in the event of rising spreads of government bonds and the ability to operate at limited political cost.

Emanuele Caggiano was an intern in the EU / Europe Division at the SWP.
Paweł Tokarski is a Senior Associate in the EU / Europe Division at the SWP.

SWP
Stiftung Wissenschaft und
Politik
German Institute for
International and
Security Affairs

Ludwigkirchplatz 3 — 4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761
doi: 10.18449/2019C53