

## Talking About Italian Politics

### Alert: Lessons on budget law from Dr. Daron Acemoglu

While **reading the budget law** drafted by the Italian government for 2019 pointing to a 2.4% deficit, we couldn't avoid thinking of what Dr. Daron Acemoglu wrote in his 2012 book "Why Nations Fail". In his book Dr. Acemoglu examines **the factors that are responsible for the political and economic success or failure of states**. To cut a long story short, Dr. Acemoglu differentiates **'inclusive institutions'**, promoting economic prosperity while providing an incentive structure that allows talent and creative ideas to be rewarded, and **'extractive institutions'**, which are the **ones that extract wealth from those who are not among the elites**.

Bearing in mind the recent statements of **MP Massimo Baroni of M5S**, who two days before the Budget law was introduced said in an interview to an Italian radio station that **"...thanks to citizen income, Italians could go out, have a pizza and make love once at home"** (he actually used more colorful words as reported by *// Fatto Quotidiano*), we have tried to have **an unbiased classification of the key measures introduced by the Italian government between 'inclusive' and 'extractive'**:

In [Europe - Sovereign Debt Update: Italy Goes For Fiscal Loosening](#) our economists provide more granularity on the budget law. Investors interested in the above classification should turn to page two for more detail.

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**As a starting point, we see a top-down vs. bottom-up dilemma:** While most of the goals included in the budget law could be, to a certain extent, seen as fair and reasonable in principle, they would become – at least in our view – economically unsustainable without: i) a complete overhaul of the tax system; ii) full reinstatement of legal certainties; and iii) a tightening of penalties (e.g. without an aggressive fight of tax evasion).

- **Citizen income** might be extremely ‘extractive’ in a country crippled by tax evasion and with a large black jobs market. Hence, while we can't discount that someone might agree with MP Massimo Baroni and prefer having a pizza (paid with the subsidy), we fear that **unless controls on the black market jobs are significantly strengthened** (which is not contemplated in the so-called “*contratto di governo*”), we tend to see citizen income as an extractive measure under Dr. Acemoglu's classification.
- **Pension reform:** In a country highly influenced by demographic trends (one of the countries with the lowest birth rate) and youth unemployment, **any reform aimed at favoring retired people is unlikely to be positive for both workers and younger citizens**. However, if MPS Massimo Baroni is right, Italy might soon experience another baby boom to reverse demographic trends. So, we tend to see the **"reform of the pension reform" as ‘extractive’**.
- **Tax amnesty** (regardless of the new fancy name "Fiscal Peace" was given to the new version): Italy has a long track record of tax amnesties. Allowing a new one would likely be seen as **an extractive measure** for the ones who have to pay taxes in full.
- **Flat tax is definitely an inclusive measure**. However, while we doubt that those who were evading tax might start to pay taxes once the tax rate is lower (they might even be irritated as they might save less than before), the simple question is **how the government could finance extractive measures while cutting one of the few visible and recurrent revenue streams**.
- **Infrastructure spending is an inclusive measure**. However, we still miss the details of these investments and - to be fair - **would much depend on the capability of the government to actually start spending**. Given the **different nature of the two parties (NIMBY vs. Infrastructure), the risk is that such extra spending might only remain on paper**.

While **Italy has always been a mix of ‘inclusivity’ (especially in the North) and ‘extracting’ (mostly in the South)**, we fear that **the government might potentially be transforming Italy into a full extractive country**. Assuming we were Dr. Daron Acemoglu watching Deputy Prime Minister and Minister of Job Luigi Di Maio appearing on a balcony to state his triumph in front of his "elites", we fear that investors might think of Italy heading in the wrong direction.

While we hope we are wrong, **our feeling is that it is likely to get worse before it gets better and we expect further pressure (and volatility) on Italian securities in the weeks to come**. The budget law is due to be introduced on October 15<sup>th</sup>, with Parliamentary discussions to begin on October 20<sup>th</sup>.

## Appendix A-1

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