The challenge facing Italy’s new coalition

On 22 October, Giorgia Meloni was officially sworn in as Italy’s first female prime minister. However, the new Italian government might soon come under pressure to address soaring energy prices and support struggling families and businesses. **Corrado Macchiarelli** *and* **Mara Monti** *write that Meloni’s right-wing coalition will face a delicate balancing act between maintaining the support of its electorate and upholding commitments undertaken with Brussels.*

Regardless of how you view the Meloni-led coalition government politically, there are economic reasons not to panic too much (at least for now). In fact, the response from the financial markets so far has been a mere blip. Meloni’s political future undoubtedly depends on the state of the economy. But recent events have already served as a warning to the new coalition about the possible consequences of reckless tax cuts: Meloni simply needs to look at what has happened in the UK.

When Liz Truss, the (soon to be former) UK Prime Minister, unveiled a tax plan on 23 September, with costs both for short term inflation and medium term growth, the pound hit a record low versus the dollar and intra-day volatility of government borrowing costs rose dramatically. The Bank of England was forced to step in by purchasing bonds when the yield on the UK 30-year gilt surged above 5% for the first time since the early 2000s.

For Italy, the political responsibility is much larger. The country has one of the highest debt burdens in the eurozone and among advanced economies (147% debt/GDP ratio). The government also issues debt in a currency the Bank of Italy has no direct control over, and it therefore has to rely on the ECB’s new anti-fragmentation tool, which comes with heavy strings attached and cannot be used to correct for “policy errors” – using ECB President Lagarde’s latest words.

Markets remain calm – but for how long?

The first important sign of what’s to come and how much investor nervousness will be sustained will be the response to Italy’s 2023 budget proposal. This is scheduled to be sent to the European Union by the middle of next month.

Based on recent estimates produced by the National Institute of Economic and Social

Research regarding Italy's term premium (a measure of investors' confidence), Italy – a country that has had historically elevated term premia due to structural factors and high public debt – has experienced term premia increases of over 200 basis points, decoupling in trend from the rest of Europe, and getting close to that of Greece. It is highly likely that markets are reacting more strongly to domestic political developments than other fundamentals, given the outcome of the recent election.

Investors will be watching the incoming government for any indications of budgetary divergence from the previous administration, much as happened for the UK. Yet, the new administration has enormous economic challenges ahead. Despite departing Prime Minister Mario Draghi's best efforts, Italian growth predictions for next year have been cut to less than 0.5%, making it more difficult to sustain debt. Meloni, who is deemed far less credible than her predecessor, must handle increasing interest rates and skyrocketing inflation, which portend a cost of living crisis.

One specific suggestion Meloni made during her campaign was to lower the tax rate for self-employed individuals to 15% on revenues up to €100,000 each year. Her party wants to reduce the income tax structure from four rates to one rate by 2027. Meloni thinks she can pay for the plan by taking away about €9 billion that was allocated in 2023 for a programme to alleviate poverty known as "citizens' wages" and money from the government's settlement of unresolved tax evasion cases. These reductions are meant to stop the government from increasing the national debt.

But Meloni has also committed to raising the minimum pension and blocking an increase in the retirement age, as well as mitigating the effects of the energy crisis after the war in Ukraine. It is unclear where the funding for these measures would come from without adding to the debt, which is for now projected to decrease to 142.5% by 2027 after hitting a peak in 2020.

Italy needs Europe as its debt of GDP remains close to 150%

Compared to earlier this year, Meloni has now adopted a more tolerant stance toward Brussels. The incoming administration's fiscal strategy might have significant repercussions if it deviates too far from the budgetary guidelines of the European Union.

First of all, Italy may be deprived of a portion of the EU's NextGenerationEU economic recovery plan, totalling €800 billion. At the end of September, the European Commission authorised the next €21 billion of Italy's €191 billion EU pandemic recovery budget, consisting of grants and loans, taking the total Italy has now received to €46 billion (or 24% of the NGEU ringfenced monies until 2026). Future tranches are conditional on the continuation of structural reforms and the achievement of investment targets, both of which were agreed upon by the departing PM Draghi.

Disputes between the Italian government and Brussels might be on the not-too-distant horizon. EU rules requiring economies to keep budget deficits under 3% of GDP and public debt under 60% of GDP, which have been suspended due to Covid-19 until the end of 2023, will soon become binding again.

Of course, the large-scale funding made accessible by NGEU, as well as the ECB's new Transmission Protection Mechanism's conditionality, will operate as a disciplining mechanism for the incoming Italian government. However, this also implies that the Italian government will not be able to keep its commitments to the electorate, since the promised lax fiscal policy would raise borrowing costs and risk triggering a liquidity crisis.

To stay on the beaten track, Meloni's government will have to scale back most of its spending promises, otherwise it will come into direct opposition with Brussels, thus re-evoking old diatribes with the European Commission. This would require a delicate balancing act between the promises made to the electorate and Meloni's other coalition parties, particularly Matteo Salvini, on the one hand, and Brussels, on the other.

Italy remains divided on Europe

Italy was a founding member of the European Union and traditionally a strong supporter of Brussels, but it is too early to say whether the election of Meloni's government represents a major U-turn.

Meloni – who on the campaign trail referred negatively to changes in Italian culture on several key issues such as immigration, Islam, European integration, "woke ideologies" and what she described as "LGBT lobbies" – has, since the election, adopted more moderate tones. She has accepted NATO policy on Ukraine and the necessity of sending weapons to Kyiv, despite her allies – the Lega of Salvini and Forza Italia of Silvio Berlusconi – having been close friends of Putin in the past.

However, in the European Parliament, Meloni's Fratelli d'Italia (Brothers of Italy) sits with the European Conservatives and Reformists (ECR), a group whose stated mission is to halt or reverse the process of integration that has underpinned the European project since the Treaty of Rome in 1957. Recently she has said she considers the Hungarian government of Orbàn to be an inspiration due to his battle to assert the supremacy of national law over European law and the European Court of Justice. However, the latest Eurobarometer poll on Italy, conducted in June-July 2022 just before Draghi resigned, showed Italians are evenly divided on Europe with 46% trusting the EU and the same percentage not.

Hungary and Poland have more trust in Europe than Italy

Although Eurosceptics are not the majority in Italy, the country also appears to be divided when compared to Poland, where 64% of citizens tend to trust Europe (an increase of 11% from last Autumn), and Hungary, where 56% are pro-EU. In Sweden, where the far-right Sweden Democrats finished second in the last election, 61% of surveyed citizens appear to trust the EU versus 39% who do not.

It is interesting to note that although votes for Eurosceptic parties are increasing, trust in Europe continues to be solid overall. All the Baltic nations trust Europe, with support in Lithuania standing at 69% (+10% from last winter), Estonia at 48% and Latvia 56%. In Finland, around 60% are EU supporters, whereas in Romania trust stands at 54%.

Among countries which tend not to trust European institutions on average, Greece has a majority of citizens who say they tend not to trust the EU (60% vs just 37% who tend to trust the EU). For France, the figures are 53% of citizens who do not trust the EU vs 34% who tend to trust it. Austria, Slovenia and Slovakia all have similar scores, with around 50% of citizens tending not to trust the EU vs 44% who tend to trust it. Interestingly, in a large number of countries where a nationalistic ideology tends to prevail, trust in Europe remains solid despite the obvious antagonism with Europe and the rejection of any supranational oversight.

Most Italians appear to trust Europe more than their own government

If Meloni's government chooses to take inspiration from sovereigntist rhetoric and pursue a battle against European integration, it might not find this an easy challenge. Although the latest Eurobarometer data show 46% of Italians tend to trust European institutions, a large majority, 63%, are reported not to trust their own national government.

The figures for the Italian parliament are slightly worse: with a majority of 66% of Italians reporting they tend not to trust the Italian parliament versus just 30% saying they do. As a result, the gap between trust in the EU and trust in national government has increased to 13 points – the largest since Autumn 2010, when the EU was in the eye of a storm during the sovereign debt crisis.

Italy has always been in favour of increasing EU integration, ever since its foundation. This is confirmed by Eurobarometer data which show 71% support a European Economic and Monetary Union with a single currency, and only 23% oppose it.

Italians' support for a common EU defence and security policy (73%) is slightly lower than the European average (77%), whereas support for a common energy policy is in line with the EU average (74% in Italy vs 75% at the European level). Support for a common foreign policy is also in line with the EU (71% in Italy and 70% at the European level). And while only about half of Italians support further EU enlargement in the future (52% vs 37% against), 46% of Italians remain positive about the image of Europe, representing a further increase of four percentage points from the same survey last Autumn.

Furthermore, 56% of Italians were satisfied with the EU's response to Russia's invasion of Ukraine, which remains less than in Poland and Portugal (78%) but more than France (45%). However, when asked about the national government's reaction to the war in Ukraine, 52% were satisfied. Regarding the EU and Covid-19, 58% were satisfied with the measures taken to fight the pandemic, broadly in line with the same level of satisfaction for the national government.

Conclusions

Attitudes towards the European economy have worsened since the winter of 2021-2022, with a significant proportion of citizens thinking Europe's economy is in bad shape: Italy, France and Spain are the most pessimistic countries and 59% of Italians judge the current situation to be particularly bad, with 90% of them reporting to have felt the impact of the war in Ukraine.

Inflation, energy supply, the economic situation, unemployment and taxation are the most important issues facing the country at the moment, and the new Italian government will have to answer these questions while addressing soaring energy prices and providing support to struggling families and an ailing business sector. Yet, Italians' support for EU institutions appears greater than support for national political institutions.

EU funding and ECB support should keep the new coalition in check and the new government will face strong external pressure to continue with the commitments and reforms that began under Draghi. Even if some fiscal continuity seems warranted for the short term, there may be significant differences between the Italian government and the European Commission regarding whether such reforms have been – in fact – implemented. In this sense, additional financial market turmoil might not be completely excluded.

What is clear is that for a country with a debt-to GDP ratio hovering around 150% of GDP, the answer to these problems cannot be an open confrontation with Brussels, whether the government decides to openly adopt sovereigntist rhetoric or not.

Note: This article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: Presidenza della Repubblica

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