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CLAREMONT MCKENNA COLLEGE
THE ORIGINS OF THE ITALIAN SOVEREIGN DEBT CRISIS

SUBMITTED TO
PROFESSOR BATTA
AND
DEAN GREGORY HESS
BY
DAVID HENNINGSEN

FOR
SPRING 2012
(4/23/2012)

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Abstract

Over the past decade, the European Union has been characterized by an explosion of expenditure, insufficient revenue, high deficits and a lack of budget discipline. Financial markets in Europe are currently dealing with enormous government debts, poor government balance sheets and a weakening banking system. The purpose of this paper is to investigate the origins of the current Euro-crisis and specifically identify the extent to which it will affect the nation of Italy going forward. To understand Italy's stance amid the Euro-crisis, we proceed as follows: First, a historical background section will develop the fundamental issues that have developed in Europe over time leading to the current situation. Next, a discussion about Italian economics and politics will identify Italy's central policy issues placed in the context of the Euro-crisis. Subsequently, Italy's issues with tax evasion will be covered illustrating its history and enforcement addendums going forward. The final section of this paper will present a forward-looking prediction about the fate of Italy and the Euro-zone and will include some of the necessary steps toward avoiding an international economic collapse.

Background

The root cause of the current Euro-zone crisis is thought, by many scholars and professionals, to have started when the Maastricht Treaty was officially signed on February 7, 1992. This treaty *formally* established the "European Union" as many European officials began to discuss a collective policy that would eventually lead a

monetary union: the introduction of a single European currency—The Euro.¹ In 1997, the “European Stability and Growth Pact” was adopted by 27 member states of the European Union to maintain the stability of the monetary union in Europe. This agreement essentially set restrictive requirements for EU countries to limit their budget deficits to 3% of GDP per year while maintaining a maximum debt load of 60% of GDP.² As a result of these macroeconomic provisions, this pact proposed to limit the ability of governments to exert inflationary pressure on the European economy while establishing a long term trend of fiscal discipline.³ Unfortunately, as the graph below demonstrates, the European Union simply lacked the power to enforce these stringent economic reforms.



Life in the Red Zone

Euro-zone governments have increasingly broken their self-imposed limit of annual budget deficits of no more than 3% of gross domestic product.

Country	Limit under the Maastricht Treaty: Deficit of 3.0% of GDP													2011 estimate
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010		
Euro area	-1.5	-0.1	-2.0	-2.7	-3.1	-2.9	-2.5	-1.4	-0.7	-2.1	-6.4	-6.2	-4.1	
Austria	-2.3	-1.7	0	-0.7	-1.5	-4.4	-1.7	-1.5	-0.9	-0.9	-4.1	-4.4	-3.4	
Belgium	-0.6	0	0.4	-0.1	-0.1	-0.3	-2.7	0.1	-0.3	-1.3	-5.8	-4.1	-3.6	
Cyprus	-4.3	-2.3	-2.2	-4.4	-6.6	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.7	
Estonia	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.4	-2.9	-2.0	0.2	0.8	
Finland	1.6	6.8	5.0	4.0	2.4	2.3	2.7	4.0	5.3	4.3	-2.5	-2.5	-1.0	
France	-1.8	-1.5	-1.6	-3.3	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1	-5.8	
Germany	-1.6	1.1	-3.1	-3.8	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.2	-4.3	-1.3	
Greece	-3.1	-3.7	-4.5	-4.8	-5.7	-7.6	-5.5	-5.7	-6.5	-9.8	-15.8	-10.6	-8.9	
Ireland	2.7	4.7	0.9	-0.4	0.4	1.4	1.7	2.9	0.1	-7.3	-14.2	-31.3	-10.3	
Italy	-2.0	-0.8	-3.1	-3.1	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.4	-4.6	-4.0	
Luxembourg	3.4	6.0	6.1	2.1	0.5	-1.1	0	1.4	3.7	3.0	-0.9	-1.1	-0.6	
Malta	-7.7	-5.8	-6.4	-5.8	-9.2	-4.7	-2.9	-2.8	-2.4	-4.6	-3.7	-3.6	-3.0	
Netherlands	0.4	2.0	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.3	
Portugal	-2.7	-2.9	-4.3	-2.9	-3.0	-3.4	-5.9	-4.1	-3.1	-3.6	-10.1	-9.8	-5.8	
Slovakia	-7.4	-12.3	-6.5	-0.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.7	-5.8	
Slovenia	-3.0	-3.7	-4.0	-2.4	-2.7	-2.3	-1.5	-1.4	0	-1.9	-6.1	-5.8	-5.7	
Spain	-1.2	-0.9	-0.5	-0.2	-0.3	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.3	-6.6	

Note: Data include debt ratios for Greece, Slovenia, Cyprus, Malta, Slovakia and Estonia since 1999, even though they joined the euro zone later.

Source: European Commission

¹ Ian Barnes and Pamela Barnes, "Enlargement." *European Union Politic.*, Oxford: Oxford UP, 2010, 418

² Nick Nasad, "A History of Europe's Debt Crisis and Current Issues," *International Business Times*, 20 Feb. 2012 Web, 21 Feb. 2012, <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.

³ IBID

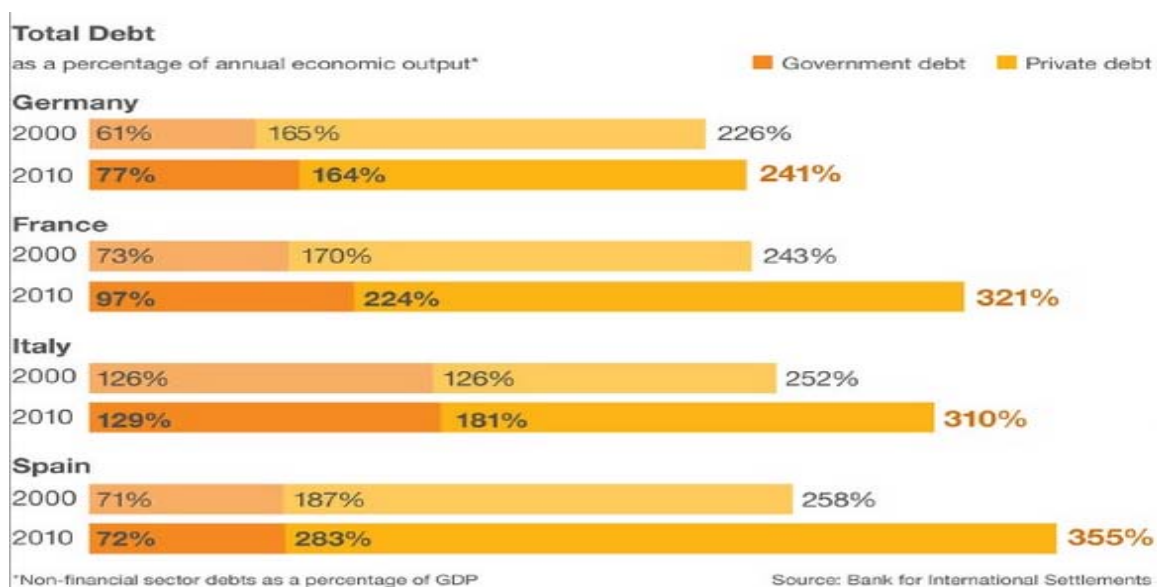
After the implementation of this pact, it was only a few years until four European countries including Portugal, Greece, Italy and even Germany breached the 3% of GDP requirement. During the nine year period preceding the financial crisis of 2008, Italy stood out as the worst offender of this pact, sustaining budget deficits in excess of 3% of GDP for six straight years. It is interesting to note that Spain met its deficit targets all nine years before the financial crisis but is now considered to be one of the biggest economies contributing to the current sovereign debt crisis in Europe. Unfortunately, there are other contributing factors that explain how the Euro-zone has vastly descended into its current economic position. Numerous scholars and researchers believe that there are two key factors that have introduced and exacerbated the current Euro-crisis: converging interest rates and growth in debt levels.⁴

I. Interest Rate Convergence & Debt Growth

As the official introduction of the Euro (€) under the Monetary and Currency Union of 1999 approached, the borrowing costs for many EU countries began a trend of convergence. Prior to the development of this trend, borrowing costs among EU countries varied widely. During the mid 1990's, countries such as Germany and France maintained 10-year bond yields ranging from 5-8% while countries like Italy, Portugal and Greece paid much higher borrowing costs ranging from 11-18%. The impact of the convergence of these interest rates was significant. As a result, Italy, a country which historically

⁴ Nick Nasad, "A History of Europe's Debt Crisis and Current Issues," *International Business Times*, 20 Feb. 2012 Web, 21 Feb. 2012, <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.

implemented generous social programs and was generally less competitive than countries in northern Europe, was now able to borrow at much lower prices. This created a massive imbalance in the sovereign bond markets as many countries like Italy, which previously maintained significantly higher borrowing costs, were able to take on much more debt to finance their public expenditures. European government and private debt loads began to explode during the first decade of the twenty-first century.



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As is evident from the above chart, EU countries began to drastically increase both government and private debt loads from 2000-2010. On average, these four countries leveraged up household and private bank debt by 25% over this ten year period. It is interesting to note that Italy maintained its government debt load within 3 percentage points but its private debt increased by 55%. Consequently, several EU countries are currently enduring a substantial cycle of deleveraging.

⁵ Bank of International Settlements

II. Issues of Competition and Trade

Upon the adoption of the Euro, it became evident that the convergence of interest rates created imbalances in the sovereign bond market which encouraged countries to assume larger debt loads. It seems as though these circumstances definitively violate the “stability” objective under the European Growth and Stability Pact. So, the question can be raised:

“Why would a country like Germany—which was the guarantee of the stability in the pact—agree to it.”⁶

The answer to this question concerns the beneficial trade and competitive advantages that Germany was able to gain as a result of having a single currency. Germany was able to capture a larger portion of the European market because countries could no longer use their currency devaluations to compete with German exports. Additionally, smaller EU countries could now take on more debt to finance purchases of more German exports. As a result, Germany was able to sustain massive trade surpluses while other economically weaker countries, such as Italy, ran enormous trade deficits.

In terms of competition, Germany has also been able to sustain significantly lower labor costs relative to southern European countries like Italy, Spain and France. In doing so, Germany put these other large exporting economies at a competitive disadvantage; a disadvantage that could only be remedied by a significant rise in German wages or an equally significant cut in the wages by these other countries. As of early April 2012,

⁶ Nick Nasad, "A History of Europe's Debt Crisis and Current Issues," *International Business Times*, 20 Feb. 2012 Web, 21 Feb. 2012, <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.

Germany has been experiencing significant cost-push inflation which has led many of Germany's largest labor unions to demand wage increases of 6-7%.⁷

III. Greek Sovereign Debt Overview

Greece is a country that has recently begun dealing with all of the aforementioned issues of trade and competition. Its current austerity measures are attempting to address these issues by proscribing policies that lower salaries and minimum wages.

Unfortunately for Greece, these measures are not nearly enough to confront its issues with excessive government debt and its current inability to meet its maturing debt and interest obligations in the near term. Consequently, Greece is in the process of restructuring its debt with its creditors. Country borrowers and their creditors have bargaining power vis-à-vis outside parties if failed negotiations interfere with trade and cause broader problems in the global financial system, such as contagion to other borrowers.⁸ This was precisely the case for Greece as it entered into what is referred to as a "selective default" early in 2012.

Under the current restructuring deals in Greece, private creditors will swap their current bond holdings for those with longer maturities and smaller coupons. This would subsequently eliminate \$100 billion of debt off of its books. These creditors are willing to compromise under this restructuring deal because they would rather receive *at least* a portion of their money back instead of receiving nothing as a result of a default on the

⁷ Barry Eichengreen, "The ECB's Lethal Inhibition." *Project Syndicate*, 12 Apr. 2012, Web. 20 Apr. 2012 <<http://www.project-syndicate.org/commentary/the-ecb-s-lethal-inhibition>>.

⁸ Carmen M. Reinhart, and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*. (Princeton: Princeton UP, 2009 Print) 62.

full amount. It is important to note also that these creditors are committing to this restructuring deal voluntarily in order to avoid the consequences of a “credit event.”⁹ A credit event is defined as “any sudden and tangible (negative) change in a borrower’s credit standing or decline in credit rating. A credit event brings into question the borrower’s ability to repay its debt. It is the defining trigger in a credit derivative contract, or credit default swap. If the borrower experiences a credit event, then the buyer of the contract must pay the seller an agreed-upon sum to cover the loss.”¹⁰ Although the austerity measures and restructuring deals currently occurring in Greece are unique, they may serve as a *small-scale*, aiding template for a larger country like Italy going forward.

IV. Euro-Crisis at Large

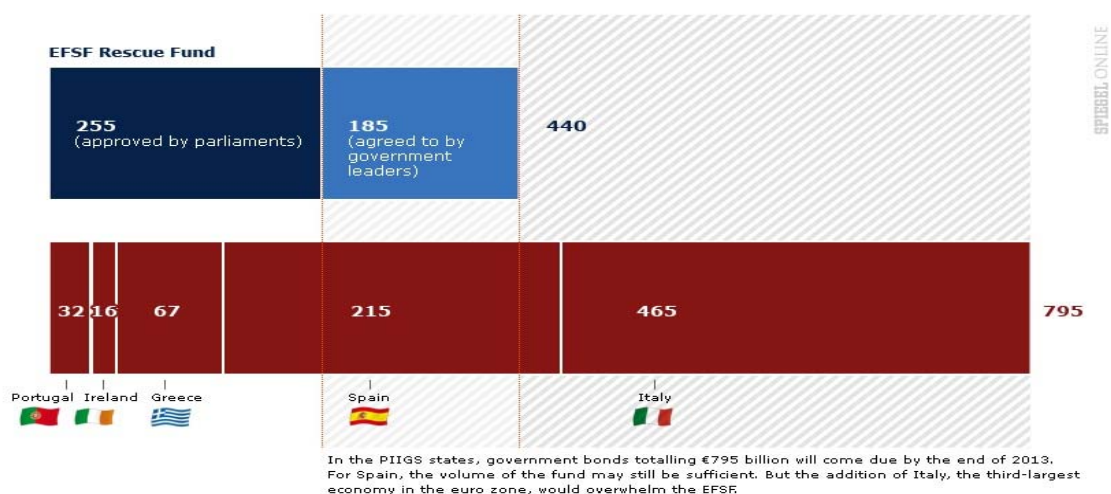
As The European Union continues to deal with the immediate sovereign debt issues in Greece, countries like Italy, Spain, France and Portugal have now become subject to scrutiny. As mentioned before, all of these countries currently hold massive amounts of public and private debt. In order to gain a comprehensive view of the debt crisis in Europe, one needs to step back and observe the true extent to which these other countries have financed their public expenditures over the last decade. The Greek economy only accounts for 2% of total GDP in European Union, whereas a country like

⁹ Nick Nasad, "A History of Europe's Debt Crisis and Current Issues," *International Business Times*, 20 Feb. 2012 Web, 21 Feb. 2012, <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.

¹⁰ "Credit Event," *Investopedia*, Web. 03 Mar. 2012 <<http://www.investopedia.com/terms/credit-event.asp>>.

Italy accounts for nearly 14%.¹¹ So, when we discuss debt to GDP ratios in excess of 100%, there is an enormous comparative difference in the resulting budget deficits. With that said, a subsequent default by a country such as Italy would be exponentially more catastrophic to the European Union and to global financial markets than a default by Greece. The diagram below demonstrates the comparative severity of the currently maturing debt that needs to be rolled over in 2012 and 2013.

Scope of the Euro Rescue Fund and the Financial Needs of Crisis Countries
in billions of euros



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The European Financial Stability Fund (EFSF), established in May of 2010, will not be able to cover the nearly \$800 billion of maturing bonds with its measly \$440 billion lending capacity.¹³ Consequently, the European Stability Mechanism (ESM), which will be established in mid-2012, will supplant the EFSF and have a lending capacity of \$500

¹¹ "Gross Domestic Product at Market Prices," *European Commission: Eurostat*, 5 Mar. 2012, Web 20 Dec.

2011, <<http://epp.eurostat.ec.europa.eu/tgm/refreshTableAction.do?jsessionid=9ea7d07e30dd61d4d5bf5eb143ada07fb9063f91c243.e340aN8Pc3mMc40Lc3aMaNyTa3qKe0?tab=table&plugin=1&pcode=tec00001&language=en>>.

¹² "The Most Important Facts about the Global Debt Crisis," Interview by Manfred Ertel and Julia A. Heyer - *SPIEGEL ONLINE*, 30 Dec. 2011. Web. 07 Mar. 2012 <<http://www.spiegel.de/fotostrecke/fotostrecke-71636-3.html>>.

¹³ "European Financial Stability Fund (EFSF)," *Economics Online*, Web. 07 Mar. 2012 <<http://www.efsf.europa.eu/about/index.htm>>.

billion. Unfortunately, neither the EFSF nor the ESM have the collective capacity to bail out the larger nations in the event of a multi-nation default.

The sovereign debt issues in Europe are beginning to weigh heavily on the banking system as both the European governments and their banks are intimately tied. Many European banks own sovereign bonds and are thereby exposed to the massive risks associated with drastically increasing borrowing costs. The potential for a collapse of the international financial system is the main concern for many economists and policy makers amid the Euro-crisis going forward. In order to surmount a calamity of this proportion, the European Central Bank has recently provided cheap refinancing and liquidity boosts to European countries with its “Long-Term Refinance Operations” (LTRO). A number of economists equate the LTRO to the Quantitative Easing packages that were implemented in the United States after the financial crisis of 2008. LTRO is often called “quantitative easing by the back door” because the European Central Bank is prohibited by law to function in the same capacity as the Federal Reserve and is technically prevented from printing more Euros to aid European countries.¹⁴ “However, by offering cheap liquidity through the LTRO, the ECB is helping to avoid a potential credit crisis and freeze in lending by engaging in [this] “quantitative easing program by the back door.”¹⁵ Although the surprise liquidity operation by the ECB put the crisis on hold—strategically allotting nearly €30 billion to 800 lenders—many economists and scholars hold the belief that the ECB's monetary policy has not been sufficiently loose

¹⁴ Kathryn M.E Dominguez, "The European Central Bank, The Euro and Global Financial Markets," 20.4: 67-88, *Journal of Economic Perspectives*, Web. 24 Mar. 2012.

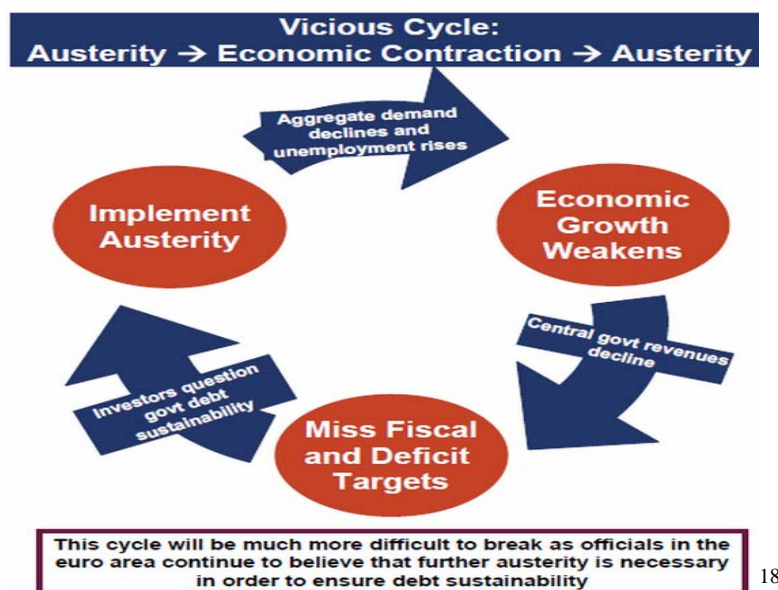
¹⁵ Johnathan, "ECB Long Term Refinancing Operation (LTRO) in Focus," *Schweitz Finance*, 29 Feb. 2012, Web. 23 Mar. 2012, <<http://www.schweitzfinance.com/2012/02/29/ecb-long-term-refinancing-operation-ltro-in-focus/>>.

enough to allow for the especially downtrodden economies to grow their way out of the crisis. Currently, The ECB is against further monetary-policy action because it believes that liquidity should only be offered to countries as a reward for budgetary austerity and structural reform. With governments hesitating to do their part, the ECB is reluctant to offer additional aid. In its view, by offering monetary stimulus to economies in need, it is only relieving the pressure on national policy makers to do what is right.¹⁶

As the European Union moves forward to combat the sovereign debt issues, it faces two distinct and potentially vicious economic cycles. The first cycle involves the implementation of austerity measures which leads to economic contraction leading to additional austerity measures and so on. Many economists argue that there exists a negative feedback sequence that is catalyzed by a nation trying to reduce its fiscal budget and excessive sovereign debt via austerity. As austerity measures are implemented, the aggregate demand decreases, thereby increasing unemployment and reducing economic growth. When economic growth declines, so too do the annual tax revenues collected by governments. As a result, a government will often miss its fiscal budget reduction targets and decrease investor confidence about sovereign debt sustainability. This brings a government back to beginning of the cycle of implementing additional austerity.¹⁷ The image below illustrates this concept.

¹⁶Barry Eichengreen, "The ECB's Lethal Inhibition." *Project Syndicate*, 12 Apr. 2012, Web. 20 Apr. 2012 <<http://www.project-syndicate.org/commentary/the-ecb-s-lethal-inhibition>>.

¹⁷Nasad, Nick. "A History of Europe's Debt Crisis and Current Issues." *International Business Times*. 20 Feb. 2012. Web. 21 Feb. 2012. <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.



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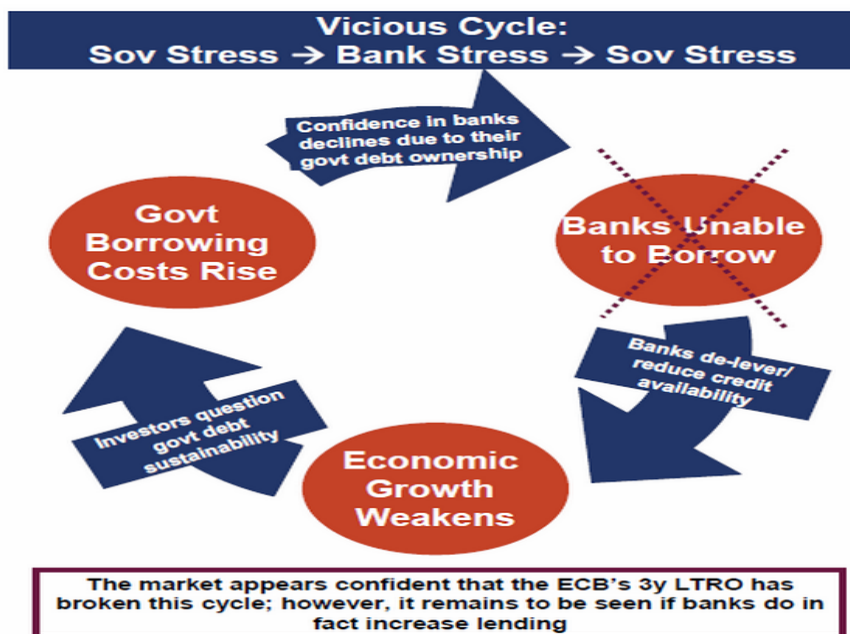
In the UN conference on Trade and Development it was stated that, “The vicious circle induced by fiscal contraction, weak financial institutions and financially fragile households is fuelling a crisis of confidence and holding back investment and job creation in the private and public sectors simultaneously.”¹⁹

The second potentially vicious economic cycle concerns the aforementioned link between banks and sovereign institutions. As economic contraction occurs and the sovereign debt investors begin to lose confidence in a government’s ability to sustain its debt load, the government’s cost of borrowing or bond yield increases. This in turn causes a decrease in confidence in the banks due to the fact that they have large holdings in government debt. Because the relationship between a sovereign institution and its banks is so strongly tied, both entities experience extremely comparable increases and decreases in market pressure. As borrowing cost pressure mounts for a sovereign

¹⁸ Barclays

¹⁹ "Fiscal Austerity Measures Driving Global Economy towards Recession." *Togo UN*. 20 Dec. 2011. Web. 24 Mar. 2012. <<http://www.untogo.org/News/Global-Economy/Fiscal-austerity-measures-driving-global-economy-towards-recession>>.

institution, banks may become unable to borrow and may reduce their credit availability which often stanches economic growth.²⁰



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Moving forward, policy makers and economists will need to analyze and focus on the impact of the previously implemented macro policies while also considering the aforesaid potential for vicious economic cycles. How will austerity measures impact economic growth and how will trends of bank lending evolve in the near term

²⁰ Nick Nasad, "A History of Europe's Debt Crisis and Current Issues," *International Business Times*, 20 Feb. 2012 Web, 21 Feb. 2012, <<http://www.ibtimes.com/articles/301418/20120220/history-europe-s-debt-crisis-current-issues.htm>>.

²¹ Barclays

The Italian Debt Crisis

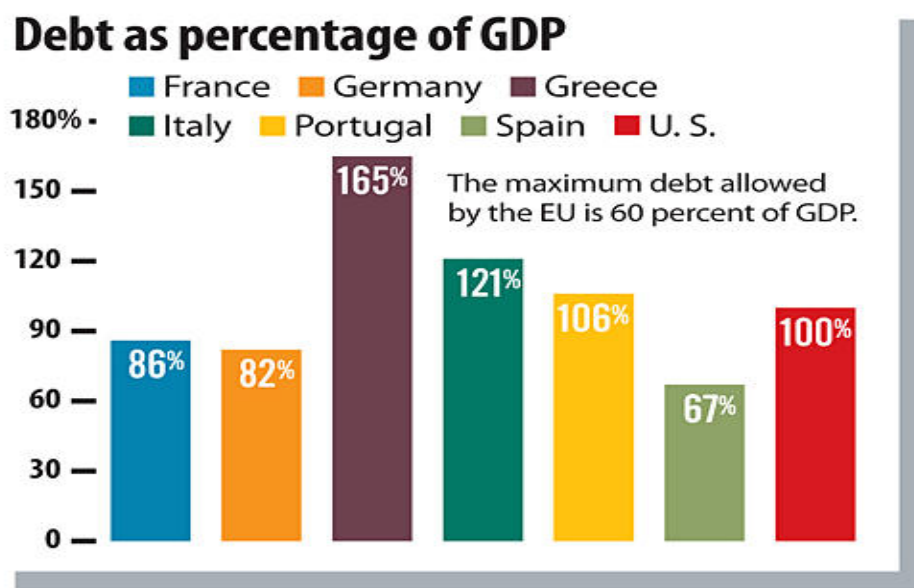
Over recent years, Italy has maintained its reputation as a major manufacturing country with banks that managed to properly mitigate the tension of the 2008 financial crisis and a population that has demonstrated prudence in saving. In this context, it is not easy to understand how Italy could be in such immediate economic and political peril. Although, many countries including Italy were breaching the budget deficit cap established in the European Stability and Growth Pact of 1997, Italy was not subject to real scrutiny until July of 2011 when Italian bond yields began to surge from 5%-7% by year end.²² This seemingly miniscule 2% movement in bond spreads brought Italy to the center stage of the Euro-crisis. In the next section of this paper, Italy's economic and political policies will be presented in the pursuit of understanding how the Italian sovereign debt crisis has developed and its potential impact on Italy, the European Union and global markets.

I. Economic Issues

Fundamentally, Italy has three severe economic weaknesses: a high debt to GDP ratio, increasing and volatile costs of servicing debt and slow economic growth. Italy has massive debts totaling €1.9 trillion, but, before recent developments, this debt load has been considered *sustainable* as the Italian government has traditionally been able to keep up with interest repayments.

²²Art Patnaude, "Italian, Spanish Bond Yields Rise," *Wall Street Journal: Markets*, 12 Dec. 2011, Web. 24 Mar. 2012, <<http://online.wsj.com/article/SB10001424052970203518404577094054256571434.html>>.

Unfortunately, this sustainability has come into question as Italy's debt to GDP ratio is now the 2nd largest of all Euro-zone countries at 121%.²³ This means that Italy is borrowing 1.21 times what its economy produces annually.



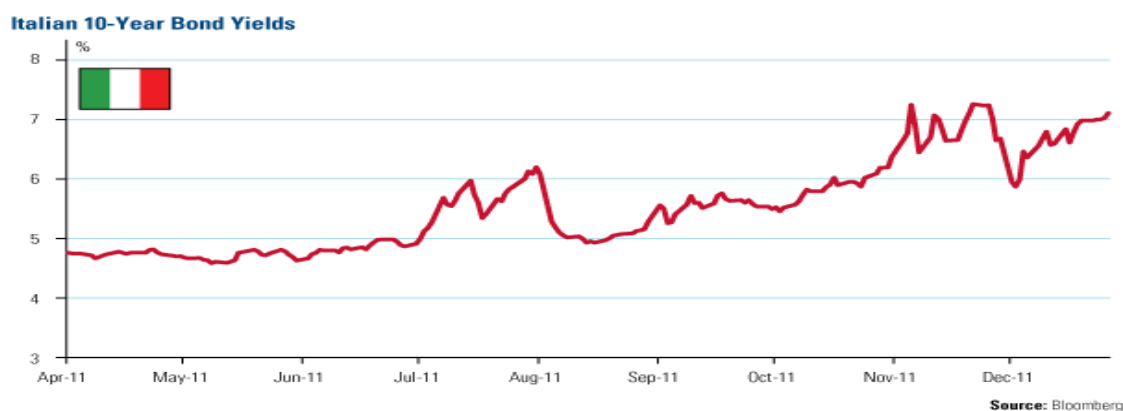
24

By maintaining a debt-to-GDP ratio in excess of 100%, Italy is explicitly demonstrating to the global markets that it is at much higher risk of default resulting from its inability to pay back its debt obligations. Coupling this Debt-to-GDP ratio with the nearly €60 billion of debt that needs to be refinanced or “rolled over” in 2012 creates an enormous dependency on sustainable costs to service debt. The standard economic measure for the cost of servicing sovereign debt is the yield on 10-year government bonds, which effectively is the return that investors require in exchange for providing long-term governmental financing. Generally speaking, “A borrower [such as Italy] can merrily roll

²³ Simon Lambert, "Eurozone Debt Crisis: Why Is Italy In Trouble and Does It Matter To You?" *Capital Gold Group – Current Economic News*, 9 Nov. 2011. Web, 06 Feb. 2012

²⁴ Simon Lambert, "Eurozone Debt Crisis: Why Is Italy In Trouble and Does It Matter To You?" *Capital Gold Group – Current Economic News*, 9 Nov. 2011. Web, 06 Feb. 2012
<<http://www.thecapitalgoldgroup.com/2011/11/eurozone-debt-crisis-why-is-italy-in-trouble-and-does-it-matter-to-you/>>

along as long as lenders have confidence, but if for some (possibly extraneous) reason confidence is lost, then lending collapses, and no individual lender has the power or inclination to stave it off.”²⁵ Beginning in July of 2011, the yield on 10-year Italian bonds jumped 200 basis points from a sustainable 5% to 6% at month end and up above 7% by November.



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This sharp increase in the Italian bond yield made the sovereign bond market go from normalcy to full blown crisis; investors were losing confidence in Italy’s ability to repay its debt. To put this into perspective, when prior European borrowing costs increased above 7%, it triggered bailouts in excess of €250 billion in Greece, Portugal and Ireland. Unfortunately, at the time when Italy experienced this surge in its bond yield, many believed that it simply had too much debt to be rescued. Investors were now beginning to avoid Italian bonds because of the massive increase in risk to their portfolios. So, as investors started to dump Italian bonds into a market where demand was clearly declining, the bonds had to be offered at lower prices in order to find buyers.

²⁵ Carmen M. Reinhart, and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*. (Princeton: Princeton UP, 2009 Print) 60.

²⁶ "The Economy and Bond Market Radar," *AdvisorAnalyst.com*, 4 Mar. 2012. Web, 26 Mar. 2012 <<http://advisoranalyst.com/glablog/tag/government-bond/>>.

Subsequently, when the prices of the existing second-hand bonds dropped while its interest rate remained constant, the yield increased. This necessitated Italy to offer higher rates on new bonds to be issued as it had to match the return that investors could achieve by purchasing the second-hand bonds instead.²⁷ In response to market hysteria, the European Central Bank announced on August 7, 2011 that it would purchase Italian bonds in an attempt to reduce its borrowing costs.²⁸ This brought yields back down to the 5% range through August and early September. Unfortunately, borrowing cost began to rally again toward 7% from mid-September to December 2011 due to economic and political uncertainty in Italy.

By late November 2011, Italy had not yet implemented adequate austerity measures to effectively combat this debt crisis. In a report by the Guardian, the panic of international markets was summed up in the following excerpt:

The risks of a full-blown sovereign liquidity crisis can increase rapidly in the absence of a determined policy response ... Persistently high interest rates increase the risk of a self-fulfilling 'run' from Italy's sovereign debt. A liquidity crisis could then turn into a solvency crisis, whose repercussions for other large euro area countries would be very acute given their exposure to the Italian economy.²⁹

A liquidity crisis occurs when a country, that is willing and able to meet its long term maturing obligations, is *unable* roll over its debt load by meeting its short term

²⁷ Simon Lambert, "Eurozone Debt Crisis: Why Is Italy In Trouble and Does It Matter To You?" *Capital Gold Group – Current Economic News*, 9 Nov. 2011. Web, 06 Feb. 2012
<<http://www.thecapitalgoldgroup.com/2011/11/eurozone-debt-crisis-why-is-italy-in-trouble-and-does-it-matter-to-you/>>

²⁸ "Timeline: The Unfolding Eurozone Crisis," *BBC News*, BBC, 13 Feb. 2012, Web. 27 Mar. 2012,
<<http://www.bbc.co.uk/news/business-13856580>>.

²⁹ Ian Traynor, "Euro Crisis: Italy at Risk of Insolvency, European Finance Ministers Warned," *Latest News, Sport and Comment from the Guardian*, The Guardian, 29 Nov. 2011, Web. 31 Jan. 2012.
<<http://www.guardian.co.uk/business/2011/nov/29/euro-italy-insolvency-warning-finance-ministers>>.

obligations. In contrast, a solvency crisis occurs when a country is perceived to be unwilling or unable to service its long term debt.³⁰ Fear of both a liquidity and solvency crisis were shaking up Italy's domestic market and International markets alike.

At this point in time, investors in the bond markets were also extremely concerned with the uncertainty surrounding Italy's ability to grow economically in both the near and long term. In theory, if Italy were able to maintain a significantly higher economic growth rate, relative to its incremental increases in government debt, it would indefinitely be able to sustain its debt obligations going forward. Unfortunately, this is not the current reality for the nation of Italy.

As Italy has developed over time, it has endured a considerable divide between its wealthy and poor citizens in the north and south respectively. The poorer citizens in the south are heavily dependent on a large, aiding public sector with an employment system that generally favors the older generation at the expense of the younger. Therefore, many of the talented younger Italian graduates move to the UK, Germany, France and the United States to make their living. Many economists find this dynamic to be a major contributing factor to Italy's lack of productivity and growth. In a special report by the Economist, it stated that, "Between 2000 and 2010 Italy's average growth, measured by GDP at constant prices, was just 0.25% a year. Of all the countries in the world, only Haiti and Zimbabwe did worse."³¹ Furthermore, Societe Generale strategist Albert Edwards noted this dismal fact:

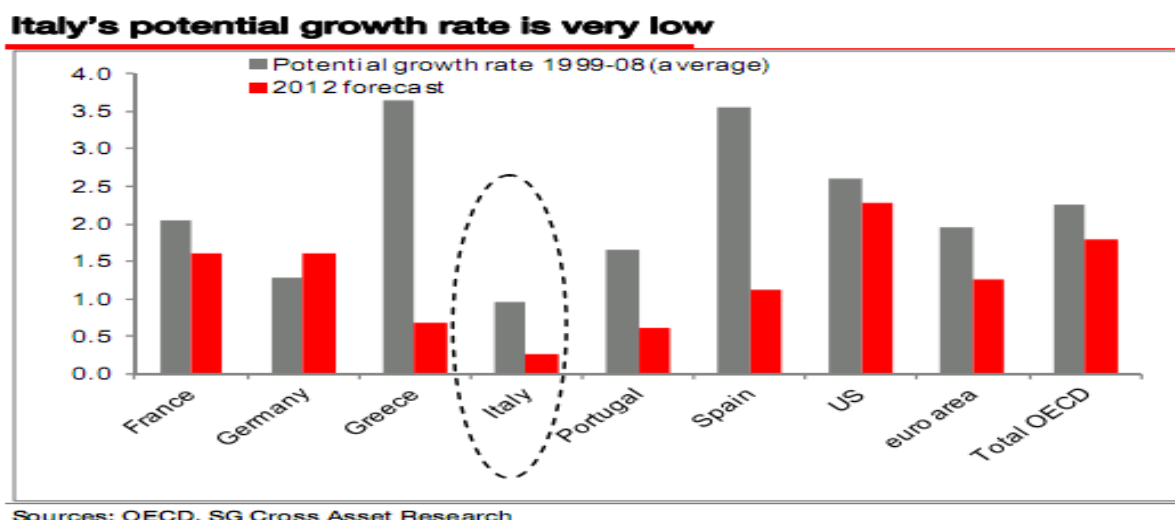
³⁰ Carmen M. Reinhart, and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*. (Princeton: Princeton UP, 2009 Print) 60.

³¹ Simon Lambert, "Eurozone Debt Crisis: Why Is Italy In Trouble and Does It Matter To You?" *Capital Gold Group – Current Economic News*, 9 Nov. 2011. Web, 06 Feb. 2012

I had a very long chat with our Italian economist, Vladimir Pillonca. He says one single variable encapsulates the depth of Italy's economic problems: GDP per capita is lower today than it was a decade ago – "one of the worst performances among advanced economies" in the IMF's words.

The real issue is Italy's incredibly low productivity growth. Hence, having been in excess of 2% yoy in the late 1990s, Italy's trend GDP growth rate is now barely positive on Vladimir's estimates.³²

The graph of the next page illustrates Italy's current lack of potential economic growth relative to five other European countries, the United States, aggregate Euro-area and the total for all countries that are a part of the Organisation for Economic Co-Operation and Development (OECD).



On September 20, 2011, the U.S. based rating agency Standard & Poors officially downgraded Italian sovereign debt from A+ to A citing Italy's "weak growth prospects and the government's inadequate response to the Euro-zone debt crisis."³³ On Monday

<<http://www.thecapitalgoldgroup.com/2011/11/eurozone-debt-crisis-why-is-italy-in-trouble-and-does-it-matter-to-you/>>

³² Cullen Roche, "The Ugly Math Behind Italy's Sovereign Debt Crisis," *Business Insider*, 01 Nov. 2011, Web. 26 Mar. 2012, <http://articles.businessinsider.com/2011-11-01/markets/30344723_1_gdp-growth-italy-debt>.

³³ "S&P Downgrades Italian Sovereign Debt Rating; Fear of Contagion Spreads International Business Times," *International Business News, Financial News, Market News, Politics, Forex, Commodities - International Business Times - IBTimes.com*, 20 Sept. 2011, Web, 16 Feb. 2012

March 12 of 2012, economic data provided more ominous news to Italy; the third and fourth quarter GDP figures of 2011 demonstrated declines of 0.2% and 0.7% respectively and confirmed that Italy is currently in a recession.³⁴ On January 12, 2012, Standard & Poors again downgraded Italy's credit rating by two notches to BBB+.³⁵ If Italy is unable to increase these economic growth figures, it will reinforce its subsequent inability to boost the necessary government revenues to cover its debt. Moreover, because of the restrictions set forth under the European monetary union, Italy will also be unable to devalue its currency in a strategic attempt to increase its competitive stance internationally and enhance its industry. All of the aforementioned economic issues forced Italy into an extremely turbulent political environment in the early fall of 2011, as policy reforms were imminent.

II. Political Issues

As the sovereign debt crisis moved from the peripheral European countries to Italy, all eyes were on the Italian government to see how it would attempt to implement policies to surmount its immediate economic and political issues. In response to the statistics that demonstrated Italy's dire economic position in mid-September, David

<<http://www.ibtimes.com/articles/216785/20110920/italy-sovereign-credit-rating-s-p-downgrade-contagion-euro-zone-berlusconi.htm>>.

³⁴ Catherine Horn, "Italy in Recession, Headache for Prime Minister Monti." *Reuters*, Thomson Reuters, 12 Mar. 2012, Web, 08 Apr. 2012 <<http://www.reuters.com/article/2012/03/12/us-italy-economy-growth-idUSBRE82B0ID20120312>>.

³⁵ Paul Taylor, "A European Debt Crisis With an Italian Twist." *New York Times Global Business with Reuters*, 23 Jan. 2012, Web, 1 Feb. 2012 <<http://www.nytimes.com/2012/01/24/business/global/24iht-inside24.html>>.

Wiley, a BBC correspondent in Rome commented: “[Italy] desperately needs some strong measures. And in the opinion of Standard & Poor's, it isn't getting them. It is going to be a rather bleak autumn and winter.” Wiley went on to note that “This is a country that has been stagnating under the leadership of Prime Minister Berlusconi for years now and doesn't show any signs of improvement.”³⁶

Silvio Berlusconi served three terms in office as the Prime Minister of Italy and essentially dominated Italian politics for seventeen years prior to his recent resignation. Under his administration, the Italian government has unsuccessfully dealt with the major economic issues of increasing debt and slow growth in productivity. Instead, his administration is more notably characterized by a long list of legal issues concerning his personal life. He has been accused of embezzlement, tax fraud, false accounting and bribery. Berlusconi underwent three major business trials as a “leader” of the Italian people: Accused of bribing British lawyer David Mills to give false testimony in 1997, accused of inflating the price paid for television rights, and accused of fraud and embezzlement over an acquisition of television rights. In addition to these legal issues, Berlusconi has also received significant attention for his unethical and unsavory dealings with women while in office.³⁷

It is abundantly evident that Prime Minister, Silvio Berlusconi, was ill-equipped to deal with the massive sovereign debt issues that he was faced with in July of 2011, especially considering the fact that he could barely remedy his own legal issues.

³⁶"S&P Downgrades Italian Sovereign Debt Rating; Fear of Contagion Spreads International Business Times," *International Business News, Financial News, Market News, Politics, Forex, Commodities - International Business Times - IBTimes.com*, 20 Sept. 2011, Web, 16 Feb. 2012 <<http://www.ibtimes.com/articles/216785/20110920/italy-sovereign-credit-rating-s-p-downgrade-contagion-euro-zone-berlusconi.htm>>.

³⁷"Profile: Silvio Berlusconi, Ex-Italian Prime Minister," *BBC News*, BBC, 11 Dec. 2011, Web, 31 Mar. 2012 <<http://www.bbc.co.uk/news/world-europe-11981754>>.

Although he attempted to implement a €54 billion austerity budget in mid-September, the S&P argued that it was insufficient and did not appropriately address Italy's fiscal problems. The S&P stated that, "The Italian government's tentative policy response to recent market pressures suggests continuing future political uncertainty about the means of addressing Italy's economic challenges."³⁸ As a result, the lack of political faith in the Berlusconi administration became one of the largest contributing factors to the decline in investor confidence concerning Italian sovereign debt.

On Monday November 16th of 2011, former European Commissioner Mario Monti was appointed and officially sworn in as Prime Minister of Italy by the current President of Italy, Giorgio Napolitano, to head a new government in an effort to avert its sovereign debt crisis. Monti's technocratic approach to governance could not be more dissimilar to Berlusconi's extravagant, scandal-ridden administration. As Berlusconi desperately spent excessive time, money and energy to achieve higher approval ratings, he failed to acknowledge the severity of Italy's financial situation. Monti, by contrast, has a deep understanding of the global banking system and market economies. Also, as a former member of the European Commission, he provides an objective political perspective to the disorderly Italian governmental structure in place.³⁹

As his first major action as Prime Minister, Monti proposed emergency austerity measures aimed to cut the Euro-area's second largest debt and ultimately regain investor

³⁸ "S&P Downgrades Italian Sovereign Debt Rating; Fear of Contagion Spreads International Business Times," *International Business News, Financial News, Market News, Politics, Forex, Commodities - International Business Times - IBTimes.com*, 20 Sept. 2011, Web, 16 Feb. 2012 <<http://www.ibtimes.com/articles/216785/20110920/italy-sovereign-credit-rating-s-p-downgrade-contagion-euro-zone-berlusconi.htm>>.

³⁹ Stephan Faris, "Monti to the Rescue: But Is the Technocrat Italian Enough to Save Italy?" *Time*, Time, 13 Nov. 2011, Web, 31 Mar. 2012 <<http://www.time.com/time/world/article/0,8599,2099368,00.html>>.

confidence in Italian government bonds. Under his plan, Monti proscribed increases in taxes, pension reforms, labor reforms, spending cuts and measures to combat tax evasion. To meet these objectives, Monti's austerity plan calls for a €20 billion package to balance the budget by 2013.⁴⁰ In terms of tax increases, Monti planned to resurrect property taxes, specifically enforcing a tax on first homes. Additionally, higher taxes will be levied on luxury items such as yachts, luxury vehicles and works of art. The general theory behind these measures is to directly increase the taxation of assets purchased by wealthier individuals in Italy.⁴¹ In order to address the issues with pensions, Monti outlined a plan to increase the pension ages for both men and women and to tie pensions to contributions rather than a worker's last salary. For men, the age to receive pension payments would increase to 66 and the age for women would increase to 62. The age for women would subsequently rise to 66 by 2018.⁴² Also, the pension reforms further proscribed that *all* but the lowest pensions would no longer be indexed to inflation.⁴³ In terms of labor issues, Monti proposed an overhaul to the labor laws which are ultimately aimed at increasing employment and promoting economic growth. The reforms call for immediate changes to the current labor provisions which make it difficult for companies to execute efficient employee lay-offs in times of economic hardship due to inefficient lay-off

⁴⁰ Chiara Vasarri, "Monti Seeks Support for \$40 Billion Austerity Package to Trim Italy Debt.," *Bloomberg* 5 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bloomberg.com/news/2011-12-05/monti-to-lobby-parliament-to-back-30-billion-euro-budget-plan.html>>.

⁴¹ IBID

⁴² "Italy Crisis: Mario Monti Announces Austerity Plan." *BBC News*, BBC, 4 Dec. 2011, Web. 01 Apr. 2012. <<http://www.bbc.co.uk/news/world-europe-16024316>>.

⁴³ Chiara Vasarri, "Monti Seeks Support for \$40 Billion Austerity Package to Trim Italy Debt.," *Bloomberg* 5 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bloomberg.com/news/2011-12-05/monti-to-lobby-parliament-to-back-30-billion-euro-budget-plan.html>>.

procedures that lead to stagnation in Italy's judicial system.⁴⁴ Concerning Italy's fiscal spending; Monti's plan would call for over €12 billion in spending cuts.⁴⁵

In an interview with Nicholas Spiro, managing director of Spiro Sovereign Strategy in London, he stated that "Monti has decided that there are no other options than to impose very tough measures in order to convince markets that the country is serious about lowering its debt."⁴⁶ Sympathetic to the Italian public, in light of these painful policy measures, Monti announced that he would give up his own salary as a part of the effort.⁴⁷ On December 16, 2011, the Italian Parliament's Lower House adopted the austerity package by a vote of 495 to 88.⁴⁸ On December 22, the Upper House gave final approval for the measures with a vote of 257 to 41.⁴⁹

The recent austerity measures implemented by Mario Monti have been met by both avid support and staunch opposition. To address the former, investors and analysts had hoped that when Monti replaced Berlusconi, he would act swiftly and shrewdly to implement urgent austerity measures. They hoped that these measures would directly combat issues caused by a stagnant economy, uncertain credit ratings on government debt and most importantly, the rising costs to service the debt. As of early April 2012, it is fair

⁴⁴ Stacy Meichtry, and Christopher Emsden, "Italy's Labor Bill Faces Scrutiny in Final Stretch." *Wall Street Journal*, 5 Apr. 2012 Web, 8 Apr. 2012

<<http://online.wsj.com/article/SB10001424052702303299604577325543228287990.html>>.

⁴⁵ Chiara Vasarri, "Monti Seeks Support for \$40 Billion Austerity Package to Trim Italy Debt.," *Bloomberg* 5 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bloomberg.com/news/2011-12-05/monti-to-lobby-parliament-to-back-30-billion-euro-budget-plan.html>>.

⁴⁶ Chiara Vasarri, "Monti Seeks Support for \$40 Billion Austerity Package to Trim Italy Debt.," *Bloomberg* 5 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bloomberg.com/news/2011-12-05/monti-to-lobby-parliament-to-back-30-billion-euro-budget-plan.html>>.

⁴⁷ "Italy Crisis: Mario Monti Announces Austerity Plan," *BBC News*. BBC, 4 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bbc.co.uk/news/world-europe-16024316>>.

⁴⁸ "Italy's Monti Wins Confidence Vote over Austerity," *BBC News*, BBC, 16 Dec. 2011, Web. 01 Apr. 2012 <<http://www.bbc.co.uk/news/world-europe-16212405>>.

⁴⁹ "Italy Senate Passes Monti's Austerity Package," *BBC News*, BBC, 22 Dec. 2011, Web. 01 Apr. 2012 <<http://www.bbc.co.uk/news/world-europe-16301956>>.

to say that the austerity measures have, for the most part, addressed the aforesaid issues in a way that has sufficiently convinced the market. At the end of the last week in March, 2012, Italy held auctions of its 6-month T-Bills, 2-year zero coupon debt, 5-year bonds and 10-year bonds. Both the 6-month T-Bills and the 2-year debt sold approximately €10.3 billion at their lowest yields since fall of 2010.⁵⁰ The 10-year and 5-year Italian bonds raised €8 billion both at the lowest yields seen at an auction since August of 2011.⁵¹ With investors explicitly accepting lower yields on debt, it appears as if they are confident in the Italian government's policies going forward.

Unfortunately, domestic support for Monti's austerity reforms has been severely declining to a point that has jeopardized its timely implementation. Many Italian citizens are furious about the economic implications of the current political agenda and are taking issue with Monti's administration. In early March 2012, polls showed that 62 percent of the Italian public was in support of the austerity package. As of early April however, that number has plummeted 18 percent to 44. Some analysts argue, the fact that Monti did not lead a party that won a general election in Italy, but was instead elected by a group of political leaders may be a contributing to the dwindling political support.⁵² Moreover, his apolitical, technocratic conduct as Prime Minister has begun to alienate him from Italian

⁵⁰ "Italy Sails Through T-Bill Auction, Bond Sale Eyed," *Wall Street Journal: Markets*, 28 Mar. 2012, Web. 2 Apr. 2012 <<http://online.wsj.com/article/BT-CO-20120328-705021.html>>.

⁵¹ Lucy Meakin, "Italian 10-Year Bonds Stay Lower After Government Debt Auction," *Bloomberg*, 29 Mar. 2012, Web. 02 Apr. 2012 <<http://www.bloomberg.com/news/2012-03-29/italian-10-year-bonds-stay-lower-after-government-debt-auction.html>>.

⁵² Walker Bruce, "Italian PM Monti's Reforms Losing Popular Support," *The New American*, 30 Mar. 2012, Web. 2 Apr. 2012 <<http://www.thenewamerican.com/world-mainmenu-26/europe-mainmenu-35/11361-italian-pm-montis-reforms-losing-popular-support>>.

citizens. After the polls in early April came out, Monti threatened to resign if popular unrest succeeded to undo the austerity measures.

At the core of the political opposition to Monti's administration are the Italian labor unions. These labor unions view the reforms to the current labor laws to be a direct attack on their job security and workers' rights. Under the traditional Italian labor laws, broad occupational protection is offered to employees and workers on permanent contracts. "Current rules make it very difficult for companies with more than 15 workers to [fire] individual employees for reasons other than gross misconduct."⁵³ In principle, the reforms to the traditional labor laws do make it easier for companies to fire employees, but it seems that these unions are not viewing the macro-benefits associated with the reforms. Consequently, Italy's largest labor confederation, CGIL, has pledged a general strike in opposition to the reforms and will be followed by many other labor unions. In response to the heavy opposition to the labor reforms, Monti, along with Labor Minister Elsa Fornero, agreed to compromise a portion of the labor bill to meet the demands of parties on the left. Under the revised bill, an increased burden of proof would be placed on the employer to provide reasons why he/she cannot rehire an employee fired due to economic difficulties. Moreover, the measure would allow damages or reinstatement in cases involving discrimination and unjustified disciplinary action.⁵⁴

The central purpose of the labor reforms is to confront Italy's lack of job creation and economic growth by eliminating or reducing the "dualism" of the Italian labor market; Italian employees who have permanent labor contracts enjoy virtually

⁵³ Nicole Winfield, "Monti Labor Reform Plans Come under Fire in Italy," *Chicago Tribune*, 05 Apr. 2012, Web, 08 Apr. 2012 <http://articles.chicagotribune.com/2012-04-05/news/sns-rt-us-italy-reformbre8340wg-20120405_1_workers-on-permanent-contracts-labor-proposals-unions>.

⁵⁴ IBID

unconditional job security while many young Italians seeking employment are subject to unstable, short-term employment contracts and are often barred entirely from employment opportunities.⁵⁵ As Italy formally entered a recession in the first quarter of 2012, the unemployment rate was at 9.6 percent nationally, but more importantly, 32.6 percent for Italians ages 15-24. A unique feature of Monti's labor reform is the introduction of a broader system of unemployment benefits which will supplant the previous system which only offered such benefits to employees under long-term contracts. On a Macro level, economists and analysts have held the belief that the rigid rules in place before these labor reforms that concerned employee hires and terminations have been considered a deterrent to foreign investments in Italy and have also created an unhealthy incentive for Italian companies to move out of the country to find more flexible market regulations.⁵⁶

In the midst of an economic recession and a sovereign debt crisis with considerable international implications, it will be interesting to see if Prime Minister, Mario Monti can continue to successfully implement policies in Italy's turbulent political environment.

⁵⁵ Stacy Meichtry, and Christopher Emsden, "Italy's Labor Bill Faces Scrutiny in Final Stretch." *Wall Street Journal*, 5 Apr. 2012 Web, 8 Apr. 2012 <<http://online.wsj.com/article/SB10001424052702303299604577325543228287990.html>>.

⁵⁶ Nicole Winfield, "Monti Labor Reform Plans Come under Fire in Italy," *Chicago Tribune*, 05 Apr. 2012, Web, 08 Apr. 2012 <http://articles.chicagotribune.com/2012-04-05/news/sns-rt-us-italy-reformbre8340wg-20120405_1_workers-on-permanent-contracts-labor-proposals-unions>.

Tax Evasion in Italy

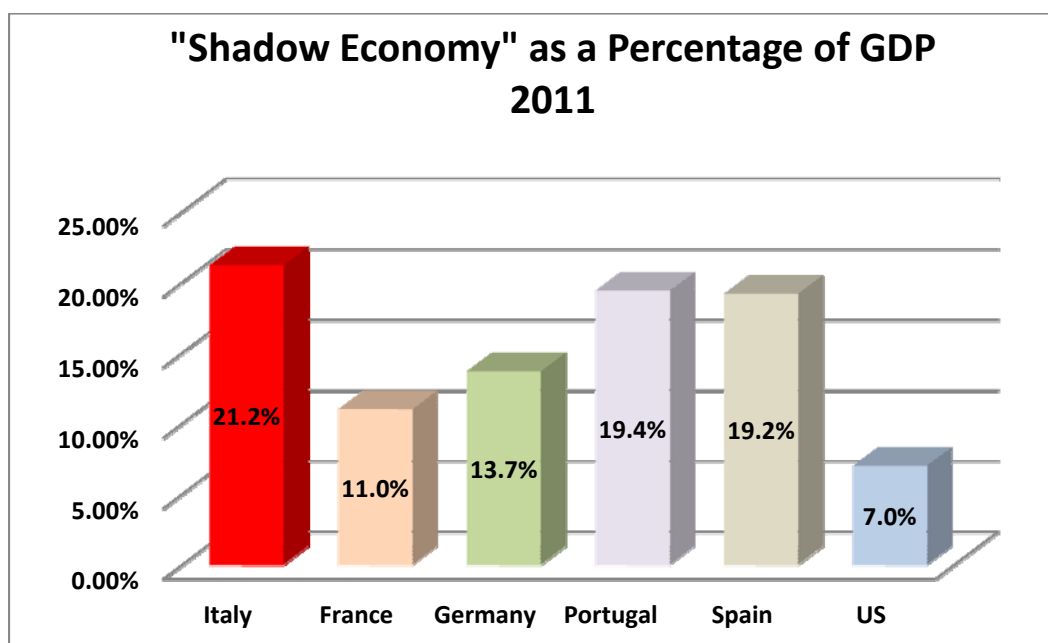
Tax evasion, or “evasione” as it is referred to in Italy, is widely considered to be a “national past-time,” and for countless years, the Italian government has turned a blind eye. Regrettably, with nearly two trillion dollars of national debt on the books, Italy can no longer afford to allow this behavior to continue. In Italy, the focus of tax evasion is concentrated around the wealthiest Italian individuals. With tax evasion becoming more and more of an issue under the leadership of Silvio Berlusconi—an extremely wealthy Italian citizen who was accused of tax dodging himself, and is famously noted for stating that “evasion of high taxes is a God-given right”—the nation of Italy has been in desperate need of immediate reforms and responsible leadership.⁵⁷ The Italian Turin based newspaper, *La Stampa*, recently noted that, “The political will and instruments to fight [tax evasion have] been missing for too long.”⁵⁸

Italian tax authorities claim that Italy loses an estimated €150 billion a year in undeclared revenues. In 2011, the Italian statistics agency (ISTAT) reported that one in four Italian citizens (approximately 15 million) did not report *any* taxable income. Of those citizens, it is estimated that three million own at least three homes. Furthermore, Italians that reported income of less than €20,000 (\$26,000) accounted for the ownership of 188,000 Lamborghinis and Ferraris, more than 500 private aircrafts, and roughly

⁵⁷ Jabeen Bhatti, Nikolia Apostolou, Eric J. Lyman, and Evangeline O'Regan, "Tax Evaders in Greece, Spain and Italy Better Beware," *USATODAY.com*, *News, Travel, Weather, Entertainment, Sports, Technology, U.S. & World - USATODAY.com*, USA Today: News, 31 Jan. 2012, Web, 02 Feb. 2012
<<http://www.usatoday.com/news/world/story/2012-01-29/tax-evaders-greece-spain-italy/52822942/1>>.

⁵⁸ "Italy Fights Tax Evasion," *Business Report*, 8 Apr. 2012, Web, 08 Apr. 2012
<<http://www.iol.co.za/business/international/italy-fights-tax-evasion-1.1211962>>.

42,000 yachts.⁵⁹ According to Radio 24, an Italian national all-news radio program, there are 2.5 million luxury cars owned in Italy, yet less than 2% of the 41 million Italian taxpayers reported income in excess of €200,000 (\$260,000).⁶⁰ The summation of these outrageous statistics suggests that tax evasion is not only an enormous fiscal issue in Italy but is also deeply ingrained in the Italian culture. Consequently, Italy has developed and maintained one of the largest “shadow economies”—as a percentage of its annual output—in Europe.



Italy’s shadow economy, which is also referred to as an “underground” or “black economy,” primarily consists of untaxed transactions that occur outside of the ordinary scope of commerce and blatant misstatements of taxable income. This activity not only

⁵⁹ Jabeen Bhatti, Nikolia Apostolou, Eric J. Lyman, and Evangeline O'Regan, "Tax Evaders in Greece, Spain and Italy Better Beware," *USATODAY.com*, *News, Travel, Weather, Entertainment, Sports, Technology, U.S. & World - USATODAY.com*, USA Today: News, 31 Jan. 2012, Web, 02 Feb. 2012
<<http://www.usatoday.com/news/world/story/2012-01-29/tax-evaders-greece-spain-italy/52822942/1>>.

⁶⁰ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

constitutes tax fraud but also severely undermines Italy's ability to collect revenue and service its national debt.

In order to directly confront the issue of tax evasion in Italy, Mario Monti has outlined a number of measures that seek to eliminate tax loop holes, and more closely monitor suspicious tax related transactions among the Italian public. A major portion of Monti's strategy to reduce Italy's shadow economy and increase government revenues involves a concentrated focus on wealthy Italian citizens. As was mentioned earlier, property taxes will be reintroduced along with increased taxes on luxury assets. What's more, Monti is pushing for a new tax bracket for the "super-rich."⁶¹ By implementing these tax provisions, Italy should theoretically increase the revenues collected from wealthy citizens. Monti has gone further in his stance against wealthy Italians, ordering tax enforcement officials to raid Italian marinas, ski resorts and other high-end consumer locations in the pursuit of prosecuting evaders and monitoring the associated businesses. Tax inspectors have been instructed to target and raid the upscale ski resorts of Cortina d'Ampezzo, in the Dolomites, Courmayeur, on the border with France, the marina in the Adriatic port of Bari and the Riviera resort of Portofino.⁶² During these raids, the Italian police (Guardia Di Finanza) checked boats, yachts and high-end luxury vehicles against

⁶¹ Jabeen Bhatti, Nikolia Apostolou, Eric J. Lyman, and Evangeline O'Regan, "Tax Evaders in Greece, Spain and Italy Better Beware," *USATODAY.com*, *News, Travel, Weather, Entertainment, Sports, Technology, U.S. & World - USATODAY.com*, USA Today: News, 31 Jan. 2012, Web, 02 Feb. 2012 <<http://www.usatoday.com/news/world/story/2012-01-29/tax-evaders-greece-spain-italy/52822942/1>>.

⁶² Nick Squires, "Italian Police Uncover Widespread Tax Evasion amongst Yacht Owners," *The Telegraph*, 4 Apr. 2012, Web, 8 Apr. 2012 <<http://www.telegraph.co.uk/news/worldnews/europe/italy/9186069/Italian-police-uncover-widespread-tax-evasion-amongst-yacht-owners.html>>.

the income declarations of their owners exposing tax evasion on an epic scale.⁶³ The Agenzia delle Entrate, Italy's Internal Revenue Service, is introducing a new cross-referencing initiative that is expected to be implemented in the second fiscal quarter of 2012 that will automatically prompt an audit if transactions made by individuals are not in line with the income reported on their tax returns.⁶⁴ Furthermore, the tax authorities proceeded to inspect the books of bars, restaurants, shops and boutiques located in aforesaid areas which revealed that most owners were failing to administer receipts to customers thereby hiding large sums of money and under-declaring their earnings.⁶⁵ In response to this, Monti has not only lowered the threshold for which tax evasion becomes a criminal offense, but he has also reduced the maximum allowed for cash transactions from €2,500 (\$3,200) to €1,000 (\$1,275).⁶⁶ This, he hopes, will deter businesses from continuing to use tax evasive strategies.

Unfortunately, the issue of tax evasion in Italy is not as easily remedied through governmental policy as one may think. It is a battle against Italian culture just as much as

⁶³ Nick Squires, "Italian Police Uncover Widespread Tax Evasion amongst Yacht Owners," *The Telegraph*, 4 Apr. 2012, Web, 8 Apr. 2012 <<http://www.telegraph.co.uk/news/worldnews/europe/italy/9186069/Italian-police-uncover-widespread-tax-evasion-amongst-yacht-owners.html>>.

⁶⁴ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

⁶⁵ Nick Squires, "Italian Police Uncover Widespread Tax Evasion amongst Yacht Owners," *The Telegraph*, 4 Apr. 2012, Web, 8 Apr. 2012 <<http://www.telegraph.co.uk/news/worldnews/europe/italy/9186069/Italian-police-uncover-widespread-tax-evasion-amongst-yacht-owners.html>>.

⁶⁶ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

it is a battle of logistics.⁶⁷ Deepa Babington, an economic journalist currently covering issues of tax evasion in Italy, noted that history may not be on Mario Monti's side stating that, "Successive governments in Italy have promised, tried and ultimately failed to cripple a flourishing grey economy in a country where dodging the system is often considered a necessity or even an art."⁶⁸ What's more, previous Italian political administrations have confronted tax evasion by introducing tax amnesty initiatives that explicitly underscore the teaching of forgiveness by the Roman Catholic Church. Attilio Befera, director of the Agenzia delle Entrate, suggested that the Italian citizens of today, most of whom adhere to the principles of Roman Catholicism, have subsequently begun to rationalize tax fraud as a part of Italian culture. He stated that "We have the concept of pardon, of penitence. From a fiscal point of view this is the sanction that I will pay when they find me."⁶⁹

In order to address the cultural issue of tax evasion in Italy, Monti will ultimately need to raise the social stigma on tax evaders. Under his administration, Italian television advertisement agencies have produced and aired commercials that refer to tax evaders as "parasites of society."⁷⁰ In addition, Angelo Bagnasco, Italian cardinal and head of the Italian Bishops' Conference, publicly denounced tax evasion in January of 2012. He

⁶⁷ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

⁶⁸ Deepa Babington, "Italy's Shadow Economy Moves into Political Spotlight," *Reuters*, Thomson Reuters, 23 Nov. 2011, Web, 08 Apr. 2012 <<http://www.reuters.com/article/2011/11/23/us-italy-economy-underground-idUSTRE7AM0YM20111123>>.

⁶⁹ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

⁷⁰ Jabeen Bhatti, Nikolia Apostolou, Eric J. Lyman, and Evangeline O'Regan, "Tax Evaders in Greece, Spain and Italy Better Beware," *USATODAY.com*, *News, Travel, Weather, Entertainment, Sports, Technology, U.S. & World - USATODAY.com*, USA Today: News, 31 Jan. 2012, Web, 02 Feb. 2012 <<http://www.usatoday.com/news/world/story/2012-01-29/tax-evaders-greece-spain-italy/52822942/1>>.

declared that “evading taxes is a sin,” and further called for “serious, effective and relentless action” to pursue tax evaders.⁷¹

Mario Monti will also need to consider the logistical tax and employment issues inherent in the Italy’s commercial infrastructure. With a corporate tax rate of 31.4% coupled with a 23% Value-added Tax (VAT) and a current maximum income tax rate of 43%, Italy is one of the ten highest taxed countries in the world.⁷² In December of 2011, Ignacio Visco, governor of the Bank of Italy, said that Italy’s overall tax burden had risen to 45%. With these figures in mind, Monti will need to balance his objective to reduce tax evasion through the implementation of closed tax loop holes and increased rates with his object to promote economic growth. Alberto Bisin, an economist at NYU stated that, “tax evasion has a significant impact on growth.” In reference to Italy’s current fiscal situation, he maintained that tax evasion keeps companies from expanding by keeping productivity lower and less traceable. In the same sense, any subsequent governmental increases in tax rates will continue to inhibit business expansion and growth. Consequently, reforms to decrease tax evasion will be difficult to implement as long as taxes are so high.⁷³

Another logistical issue concerning tax evasion in Italy involves designing measures that reduce evasion by Italy’s self employed work-force of five million. Included in this work-force are doctors, contractors, lawyers, plumbers, electricians and small business people. Under the current tax code in Italy, Italian employers deduct the

⁷¹ John Hooper, "Italian Cardinal Brands Tax Evasion a Sin," *The Guardian*, Guardian News and Media, 24 Jan. 2012, Web, 08 Apr. 2012 <<http://www.guardian.co.uk/world/2012/jan/24/italian-cardinal-tax-evasion-sin>>.

⁷² "World Tax Rates 2012," *Italy Income Tax*, 2012, Web, 11 Apr. 2012 <<http://world.tax-rates.org/italy/income-tax>>.

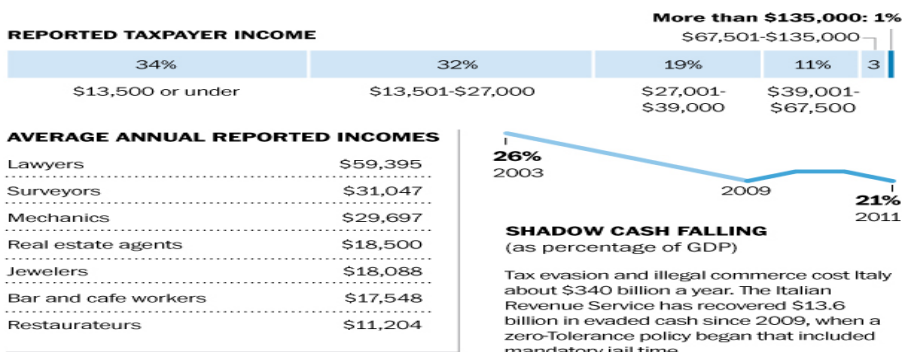
⁷³ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

appropriate taxes from their salaried workers' pay whereas self-employed individuals pay taxes on the annual income they report. In 2009, tax agency data suggested that over twenty million Italian tax payers—nearly 50% of Italy's population—reported annual income of \$20,000 or less.⁷⁴ The sheer improbability of this statistic has led economists, analysts and policy makers to conclude that a large portion of self-employed Italians earn additional “off the book” income that is not recorded on their annual tax returns.

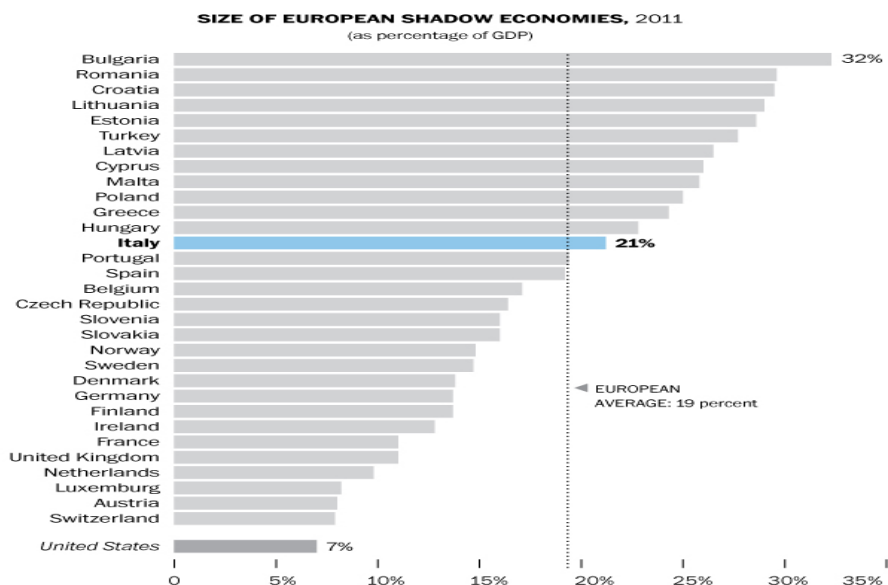
Some economists believe that the austerity measures proposed to combat tax evasion may alter how Italians buy and sell services.⁷⁵ To illustrate this idea, the services provided by self-employed Italians are currently subject to the nation's 23% Value-Added Tax (VAT). This creates an incentive for self-employed individuals, and consumers of their services, to seek “under the table,” or cash-only transactions. In a transaction of this nature, the self-employed individual will make an attractive reduced-price offer to the consumer while, at the same time, generating the same profit. The consumer will then achieve a 23% discount for the services provided. Consequently, the Italian government will not collect any revenue from these types of transactions and the self-employed individual will continue to generate untaxed income. Moreover, it is likely that the self-employed individuals will also illegally under declare income on their tax return to reduce their tax liability to the government. The graph on the following page quantifies many of the critical ideas and issues that are were presented above.

⁷⁴ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

⁷⁵ Anthony Faiola, "Amid Crisis, Italy Confronts a Culture of Tax Evasion," *The Washington Post*, 24 Nov. 2011, Web, 11 Apr. 2012 <http://www.washingtonpost.com/world/amid-crisis-italy-confronts-a-culture-of-tax-evasion/2011/11/22/gIQAef4JtN_story.html>.



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A number of clever proposals are still topics for debate concerning Italy’s fight against tax evasion. With regards to the 23% Value-Added Tax scenario described above, Massimiliano D’Angeli, a criminal defense lawyer in Rome suggested that if the services provided by self-employed individuals were tax deductible, consumers would have an incentive to ask for receipts.⁷⁷ This would be an extremely simple reform to implement and could have a massive impact. Another proposal in the tax evasion discourse, brought

⁷⁶ Italian Ministry of Economy and Finance; Friedrich Schneider, Johannes Kepler University.

⁷⁷ Rachel Donadio, and Elisabetta Povoledo, "Italy Tries Raising the Social Stigma on Tax Evaders," *The New York Times*, 24 Dec. 2011, Web, 11 Feb. 2012 <<http://www.nytimes.com/2011/12/25/world/europe/italy-tries-to-raise-the-social-stigma-on-tax-evasion.html?pagewanted=all>>.

about by the President of Istat, Enrico Giovanni, concerns the utility of the funds obtained from the aforementioned tax raids authorized by Monti; should the funds simply reduce Italy's budget deficit or should the funds be allocated to decrease the tax burden of firms operating legally?⁷⁸ The former scenario directly addresses the short-term necessity to reduce Italy's deficit while the latter scenario will likely increase Italy's long-term productivity and economic growth.

Since Monti replaced Berlusconi as Prime Minister in mid November of 2011, the Italian tax authorities have identified over €50 billion (\$65 billion) of untaxed money and prosecuted the violators responsible.⁷⁹ It appears as if the Italian public is beginning to take the crime of tax fraud seriously. Going forward, Monti and his administration will need to seriously analyze the net effects of the policies implemented to combat tax evasion while also introducing new, clever ways to close tax loop holes. Director of the Agenzia delle Entrate, Antillio Befera declared that, "more public spirit" will be needed—not only from the rich—if the fight against tax fraud is to help restore the state's finances.⁸⁰ If all of the abovementioned conditions can be met, Italy could very well see a significant reduction in its shadow economy in both the near and long term.

⁷⁸ Deepa Babington, "Italy's Shadow Economy Moves into Political Spotlight," *Reuters*, Thomson Reuters, 23 Nov. 2011, Web, 08 Apr. 2012 <<http://www.reuters.com/article/2011/11/23/us-italy-economy-underground-idUSTRE7AM0YM20111123>>.

⁷⁹ Jabeen Bhatti, Nikolia Apostolou, Eric J. Lyman, and Evangeline O'Regan, "Tax Evaders in Greece, Spain and Italy Better Beware," *USATODAY.com*, "News, Travel, Weather, Entertainment, Sports, Technology, U.S. & World - *USATODAY.com*, USA Today: News, 31 Jan. 2012, Web, 02 Feb. 2012 <<http://www.usatoday.com/news/world/story/2012-01-29/tax-evaders-greece-spain-italy/52822942/1>>.

⁸⁰ "Italy Fights Tax Evasion," *Business Report*, 8 Apr. 2012, Web, 08 Apr. 2012 <<http://www.iol.co.za/business/international/italy-fights-tax-evasion-1.1211962>>.

Sovereign Debt Outlook

It is evident that the economic and political circumstances in Italy over the past decade have dragged the nation into the pit of the European sovereign debt crisis. Because Italy has one of the largest economies in Europe, the implications of its economic collapse would undoubtedly devastate International markets. Fortunately, with the practical technocratic leadership of Prime Minister, Mario Monti, Italy has proved that it is willing to take the necessary steps to reduce its debt. In the near term, Italy will continue to deal with social and political unrest caused by the stringent austerity measures. In the long-term however, the best thing that authorities can do is to implement growth-enhancing reforms so that when the effects of fiscal tightening and uncertainty shocks taper out, Italy can gradually return to positive growth.⁸¹

At this point in time, the continent of Europe continues its battle through a complex sovereign debt crisis. As Greece concludes its structured default, the Greek debt crisis may be temporarily on hold. With continued austerity measures choking economic expansion and eliciting political hostility and social unrest, it is possible—but not certain—that a disorderly default in Greece could lead the country to exit the European Union in the future. Concerning the other Euro area countries, the debt crises have been alleviated by the generous liquidity offered by the European Central Bank to domestic

⁸¹ Chiara Vasarri, "Monti Seeks Support for \$40 Billion Austerity Package to Trim Italy Debt.," *Bloomberg* 5 Dec. 2011, Web, 01 Apr. 2012 <<http://www.bloomberg.com/news/2011-12-05/monti-to-lobby-parliament-to-back-30-billion-euro-budget-plan.html>>.

banks, a modest fiscal compact, some bank recapitalization and moves toward moderate structural reform.⁸² However, the ECB may need to provide additional stimulus to countries in the near future. “The ECB is preoccupied by moral-hazard risk – the idea that supporting spending will relieve the pressure on governments to act. But it should also worry about meltdown risk – about the danger that its own failure to act, by leading to a deep recession, will undermine political leaders’ ability to take the steps needed to put their economies on a sound footing.”⁸³

In a lecture titled *Whither the Euro: Some Lessons from the History of Fiscal Unions* conducted by Michael D. Bordo, professor of economics at Rutgers University, he offered the following insight:

Many of Europe’s woes could have been predicted from what is known about the history of monetary and fiscal unions and the theory of optimum currency areas. The creation of successful national monetary unions in the past always coincided with the set up of a fiscal union as part of the creation of a nation state..⁸⁴

At the core of the current Euro-crisis is the fact that the EU countries embarked on a unique and risky experiment—establishing a monetary union without a fiscal union. In doing so, the European Union has neglected to adequately institute a solid socio-political foundation to deal with the issues that have emerged in the past decade.

Going forward, leaders of the European Union need to analyze the historical consequences of prior fiscal unions as a tool when considering new policies to adopt in

⁸² Michael D. Bordo, "Whither the Euro: Some Lessons from the History of Fiscal Unions," Lecture, Sovereign Debtors in Distress, Marian Miner Cook Athenaeum, Claremont. 5 Mar. 2012, 25 Feb. 2012. Web, 13 Apr. 2012.

⁸³ Barry Eichengreen, "The ECB's Lethal Inhibition." *Project Syndicate*, 12 Apr. 2012, Web. 20 Apr. 2012 <<http://www.project-syndicate.org/commentary/the-ecb-s-lethal-inhibition>>.

⁸⁴ Michael D. Bordo, "Whither the Euro: Some Lessons from the History of Fiscal Unions," Lecture, Sovereign Debtors in Distress, Marian Miner Cook Athenaeum, Claremont. 5 Mar. 2012, 25 Feb. 2012. Web, 13 Apr. 2012.

the context of the current Euro-crisis. Michael Bordo illustrates two major lessons for the Euro-area that come from his survey of the history of fiscal unions. The first lesson concerns the necessity for a central tax authority to service national debt and a “Eurobond concept” to be serviced by taxes collected by a pan European fiscal authority.⁸⁵ The Eurobond concept would essentially be a government debt instrument issued in Euros by 17 Eurozone nations.⁸⁶ The chief advantage of a Eurobond would be in its ability to transfer revenues to member states in the event of asymmetric shocks. Moreover, not only would it theoretically be able to deal with debt crises in peripheral countries, it would also have a greater ability to combat contagion relative to the previously mentioned European Financial Stability Fund (EFSF) or European Stability Mechanism (ESM). The second, and arguably most significant, lesson is the importance for the European Union to establish a practical fiscal regime to support its monetary union.⁸⁷

In order to overcome a debt crisis of this magnitude, there will need to be a deep political commitment from all EU members to the European Union as a whole; one common European political entity. Only time will tell if these countries are willing to make the appropriate concessions to establish a successful monetary and fiscal union.

⁸⁵ Michael D. Bordo, "Whither the Euro: Some Lessons from the History of Fiscal Unions," Lecture, Sovereign Debtors in Distress, Marian Miner Cook Athenaeum, Claremont. 5 Mar. 2012, 25 Feb. 2012. Web, 13 Apr. 2012.

⁸⁶ "Eurobond," *Investopedia*, Web, 14 Apr. 2012 <<http://www.investopedia.com/terms/e/eurobond.asp>>.

⁸⁷ Michael D. Bordo, "Whither the Euro: Some Lessons from the History of Fiscal Unions," Lecture, Sovereign Debtors in Distress, Marian Miner Cook Athenaeum, Claremont. 5 Mar. 2012, 25 Feb. 2012. Web, 13 Apr. 2012.

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