1. **A willing suspension of disbelief: the Contract for government and the Budget**

*by Lorenzo Codogno and Silvia Merler*

In 2018, the key moment for economic and budgetary policies was the agreement between the League and the Five Star Movement (M5S) on the so-called ‘Contract for Government of Change’, which laid out a programme and informed the first ‘People’s Budget’. It tried to address the desire for change coming from the polls, but in several ways, it appeared hard to reconcile with economic and financial constraints.

The negotiation on the Contract – whose first draft was permeated with Eurosceptic elements – was an eye-opening experience for financial markets. After that, the government bond spread came under pressure.

The ensuing negotiations of the ‘People’s Budget’ initially appeared to aim at minimising the structural adjustment needed to comply with European and domestic fiscal rules. At the cabinet of ministers on 27 September 2018, the government celebrated the departure from the targets indicated in the draft of the Update to the Economic and Financial Document in favour of more expansionary policy. This move initiated a row with the European Commission and another bout of market pressure.

Eventually, financial markets took relief from the agreement with the Commission on 22 December, which avoided the opening of an Excessive Deficit Procedure. The year came to a close with Italy’s parliamentary approval of the Budget on 30 December, just before the final deadline.

By using Coleridge’s words, the Budget delivered «truth sufficient to procure for these shadows of imagination that willing suspension of disbelief for the moment»[[1]](#endnote-1). It pretended to deliver on the unrealistic electoral promises, while underlying issues remained unresolved and it was hard to detect any coherent growth strategy.

This chapter proceeds as follows. The first section presents the economic factors behind Italy’s recent political developments. The second section focuses on the economic and financial measures agreed in the Contract between the M5S and the League. The third section looks at the negotiations on the budget between Italy and the EU, while the fourth section analyses the revised budget eventually presented in December 2018. Section five takes a critical stance on three assumptions behind the budget. Finally, section six concludes.

1. **How did Italy get to the 2018 political upheaval?**

The Italian economy represents a clear case of «missed adjustment»[[2]](#endnote-2). During the first decade of the single currency, Italy could be described as being in an intermediate position between the economic models of what has become known as ‘North versus South’, or ‘Core versus Periphery’.

It did not undergo housing and private sector credit bubbles like Greece, Ireland, Portugal and Spain – which eventually had to resort to full or partial EU/IMF macroeconomic adjustment programmes to cushion the sudden stop in external financing. Private debt accumulation was more modest than in the rest of the periphery, as a consequence. The Italian current account position was also only mildly deteriorating.

This notwithstanding, Italy came under pressure in 2011 – in the midst of the Eurozone crisis – because of the risk that came to be associated by investors to its historically high public debt-to-GDP ratio in the context of a sovereign-banking crisis on the one hand, and perceived fiscal irresponsibility of the late fourth Berlusconi government. While the Italian fiscal policy had not been lax, during the pre-crisis decade, market pressure increased in the wake of the sovereign debt crisis. The spectre of a macroeconomic adjustment programme for Italy – often described as ‘too big to fail and too big to save’ – was ultimately avoided thanks to a rapid turn in the domestic political situation. After the fall of the Berlusconi Government in November 2011, the technocratic Monti Government and the Renzi Government that followed in 2014 had ambitious reform plans, which in many respects however under-delivered.

On top of the long-lived problem of the outsized Italian public sector debt and the weak reform record mentioned above, the absence of growth and its painful social consequences, Italy had further problems originated by the banking crisis of 2015-17, as the adjustment in the Italian financial sector had been much slower than in countries that had undergone EU/IMF macroeconomic adjustment programmes. Unemployment – which had spiked during the crisis – was taking a long time to climb down from its peak, and youth unemployment was still 34.7% at the end of 2017, with important North/South differences.

The combination of stagnating growth and high unemployment is reflected in the erosion of the Italian standards of living: after two decades of disappointing growth, real per capita GDP in 2017 was at the same level as in 1998. At the same time, inequality and poverty indicators have evolved differently in Italy compared to the programme countries.

The share of people at risk of poverty and social exclusion has increased from 25% before the crisis to 29% in 2017, but again with a significant regional and intergenerational gap. Individual relative poverty incidence is higher in the South, where it has also increased significantly during the crisis.

These political economy dynamics help shed light on the recent Italian political developments. The campaign for the 2018 elections, in fact, saw the emergence of two parties – The League and M5S – which share a populist and inherently Eurosceptic vein, but that tailored their respective campaign pledges so as to appeal to the different roots of discontent in the different parts of the country.

League’s core fiscal pledge included a reform of the taxation system in the direction of introducing a ‘flat tax’ for all taxpayers – a promise that appealed to workers and especially self-employed in the more economically dynamic North of the country, where the cost of living is higher, and purchasing power is lower [Boeri 2018]. League’s core fiscal programme was thus based on redistribution towards the top of the income distribution, supported by a revenue-reducing reform of the taxation system.

The M5S’s agenda was instead rooted on a redistribution towards the bottom of the income distribution, underpinned by an expenditure-increasing expansion of the welfare state through the promise of a ‘citizenship income’ – a mix of a minimum guaranteed income measure with a magnified unemployment subsidy. Due to the very diverse regional distribution of unemployment discussed above, this pledge was especially appealing to the weaker and younger constituencies mostly in the South.

The geographical distribution of the electoral results suggest that this segmentation was a success, as League (within the centre-right coalition) over-performed in the North, whereas M5S did especially well in the South. This prepared the ground for an unexpected outcome: a political government by League and the M5S, who together had the numbers to govern, without external support. The pledges of the two parties seemed largely incompatible on the surface. Once decided, however, League and M5S found themselves forced to face the difficulty of reconciling a fiscal platform based on a revenue-reducing reform of the taxation system with an opposite platform based on an expenditure-increasing expansion of the welfare state, within the delicate perimeter established by Italy’s very high public debt and low growth. The result was effectively a doubling up on electoral promises.

1. **An eye-opening experience: the League/5SM Contract**

International observers and financial markets were initially willing to give the benefit of the doubt to a possible anti-establishment government in Italy. Up until early May, government bond yield spread had recorded only mild pressure, suggesting that investors were still waiting for Italy’s political developments.

On 15 May, the online newspaper Huffington Post Italy [2018] unveiled a document that it claimed to be the draft of a Contract of government between League and M5S. The parties did not deny and only said that it was outdated.

The document revealed the intentions on the euro and fiscal matters, the two most important topics in the eyes of financial markets. While both parties had moderated their tones over the previous few months, the issue of Italy’s exit from the euro (*Italexit*) and the relationship with Europe re-emerged in that document in a way very much in line with the original programmes[[3]](#endnote-3). The guiding principles seemed to be a centrality of national interests and the non-interference in national matters. The document stated that the European governance «based on the dominance of markets and the respect of fiscal constraints that are untenable and unsustainable from an economic and social point of view» must be changed. At the same time, it called for the introduction of specific technical, economic and legal procedures that allow the Member States to withdraw from the Union, and recover their monetary sovereignty. Alternatively, it stated, the Member States should be able to stay outside through permanent opt-out clauses, to allow the start of a shared and agreed exit path in case there was a clear desire to do so. It also called for a renegotiation of Italy’s contribution to the EU budget and EU treaties, as well as for the ECB to ‘cancel’ Italian government bonds in its portfolio (worth €250 billion) at the end of its quantitative easing[[4]](#endnote-4).

The document also rejected fiscal discipline. It called for a tax amnesty while introducing more severe sanctions, although it appeared to rule out a wealth tax. It discussed the «cartolarisation of tax credits, also through instruments such as small-cut government bonds» (a softened version of the League’s campaign proposal for mini-BOTs or parallel currency). The Contract envisaged the allocation of €5 billion to allow the immediate retirement of workers who would not be eligible according to the pension law introduced by the Monti government, and it supported the introduction of ‘quota-100’, i.e. the possibility of retiring once the sum of age and the years of contribution would reach 100. Lastly, it also proposed the allocation of €17 billion to a ‘citizen income’.

This leak changed the optics for financial markets, and international observers started to believe something big was brewing in Italy. It was an eye-opening experience for those who had a very complacent attitude towards the government.

The definitive version of the Contract was unveiled on 18 May [League and Five Star Movement 2018].

On Europe, the two parties called for coordination of positions in all negotiating tables and all Council formations, hinting at a strong centralising role for the Prime Minister office. All the references to *Italexit* included in the draft leaked a few days earlier disappeared. Nevertheless, noteworthy was that the two parties wanted to change the statute of the European Central Bank, re-negotiate the European Budget (Multiannual Financial Framework) and the mechanism to allocate funds within the EU, based on the conviction that «the framework of European governance […] is currently asymmetric, based on the dominance of markets against the broader economic and social dimension».

In the section on taxation and public commercial debt in arrears, the document referred to «cartolarisation of tax credits, also through instruments such as small-cut government bonds». It was the same softened version of the League’s proposal for mini-BOTs included in the leaked draft. Although the anti-euro rhetoric was toned down in the final version of the document, the mentioned plans put Italy clearly on a collision course with Brussels. A proposal for paying part of civil servant wages with government bonds – effectively introducing a parallel currency – emerged again during the Budget debate, although it eventually disappeared.

The two parties also wanted to «radically revise» the BRRD directive as the current version «destabilised» credit in Italy and «expropriated» savers. They wanted to reimburse retail investors for the losses incurred, redefine the mission and objectives of Monte Paschi, and separate commercial and investment banking activities of all banks. They wanted to subject any credit recovery action against retail debtors to judicial authorisation. In 2018, the attitude towards banks, however, emerged only in the form of higher taxation and an appropriation of funds within the Budget for the reimbursement of investors who had lost money in the past. There was no banking crisis in 2018 and no attempt to change the BRRD at the European level, so these ideas remained untested.

The proposal for cancellation of debt by the ECB disappeared. The two parties pledged to reduce public debt by increasing economic growth rather than through ‘austerity’. They called for deficit spending to support consumption and high-multiplier investments, arguing this would help reduce the debt-to-GDP ratio. Accordingly, they argued that the European Commission should be induced to take investment off the current deficit. Moreover, they wanted to re-negotiate European Treaties and the fiscal framework «to ensure the financing of the proposals of our contract». Finally, the contract called for raising funds «by cutting on waste, debt management, and an appropriate and limited recourse to deficit spending». A vague reference to ‘debt management’ remained, but with no details. Many of these pledges faced a severe test in the Budget process.

On taxation, the contract included the proposal to offset the safeguard clauses that would have implied a sharp increase in VAT rates in 2019 and 2020. They confirmed the intention to introduce a flat tax, with two brackets at 15% and 20% for both households and companies, and a no-tax area for low-income households. They hinted at the idea of a tax amnesty (‘fiscal peace’), «to remove fiscal imbalances and obligations and favour the cancellation of debt by payment of a discounted amount» when there were demonstrated exceptional and involuntary economic difficulties».

On labour policies, the Jobs Act was criticised, but there were no concrete proposals to change it, except a stated intention to favour open-ended contracts. In July, a rollback of the Jobs Act was introduced (‘Dignity Decree’). On pensions, they called for the abolition of the ‘imbalances’ introduced by the Monti-Fornero reform and pencilled 5 billion to favour early retirement of people who could not retire according to existing legislation. The intention to introduce ‘quota-100’ was also confirmed. Finally, the document proposed instituting a citizenship income of 780 euro per month for singles, and higher for families, linked to active labour market policies, and of a citizenship pension, again of 780 euro.

The citizenship income and the rollover of the pension reform were the two flagship initiatives that informed the Budget process. In fact, the contractual nature of the economic programme made all the other priorities of the government pivot around these two projects. Overall, the Contract was a way to combine the electoral manifestos of the two parties and double up on spending plans, a problem that became all the most evident when the Budget was presented

1. **Fiscal targets and the negotiation with the EU**

Finance Minister Tria duly submitted the Update to the Economy and Finance Document to the cabinet of ministers on 27 September, as the law prescribes. The cabinet, and especially its M5S’s members, flatly rejected the fiscal targets, in favour of a more expansionary policy with a 2.4% deficit target for 2019-2021. It took a full week, until 4 October, to rework the document with new targets and send it to the Italian Parliament and the European Commission.

Trend projections showed GDP growth at 0.9% in 2019 and 1.1% in 2020 and 2021. By incorporating the proposed policy changes, GDP growth was indicated at 1.5%, 1.6% and 1.4% respectively, i.e. an increase of 0.6pp, 0.5pp, 0.3pp, relative to the trend scenario, which was supposed to be delivered by the fiscal stimulus.

Trend projections for general government balance were at 1.8% for 2018 from 1.6% estimated in April, and at 1.2% from 0.8% for 2019. Nominal growth was at 3.1%, 3.5% and 3.1% in 2019, 2020, and 2021 respectively, and the deflator was back to 1.9% in 2020. The Parliamentary Budget Office validated the trend scenario, but not the policy one. In the policy scenario, deficit-to-GDP targets were pushed up to 2.4%, 2.1% and 1.8% for 2019, 2020, and 2021 respectively. The primary surplus went down from the 1.8% projected for 2018 to 1.3% in 2019 and then up again to 2.1% in 2021. The forecast horizon was only three years, i.e. the minimum required, against a tradition of showing the whole five-year term at the beginning of a political term. In 2019, there was a sharp deterioration of the structural balance by 0.8pp and no improvement in 2020 and 2021. The objective of privatising assets for 0.3% of GDP per annum until 2020 to contribute to the debt reduction was confirmed. The debt-to-GDP ratio went from an estimated 130.9% of GDP in 2018 to 126.7% in 2021.

There was no attempt to comply with European rules in 2019 nor after that. What mattered more than the few decimal difference in fiscal targets was the signal that Italy no longer wanted to play by the rules. According to the government, «a restrictive fiscal stance, closer to current European parameters, would deprive the public budget of resources to be used to support demand and improve medium-term growth prospects and social sustainability». Moreover, this stance «is supported by the belief that the Italian economy is still far from full employment of resources and that the persistent weakness of cyclical conditions is not adequately captured by the estimates produced by the official potential output and output gap methodology».

The European Commission did not wait long to reply. On 5 October, it took note of the intention to revise Italy’s fiscal targets in deviation from the previously announced convergence towards the Medium-Term Objective (MTO) of a balanced budget in structural terms, but it had to wait for the Draft Budgetary Plan (DBP) to react officially. Meanwhile, the 10-year BPT-Bund spread reached over 300bp, threatening the stability of the whole EU [Codogno 2018b].

The government submitted the DBP on 16 October, in line with the stated objectives. In a strongly worded letter sent two days later, the Commission asked why Italy was planning such «an obvious significant deviation of the recommendations adopted by the Council under the Stability and Growth Pact» for 2019. It added that «both the fact that the DBP plans a fiscal expansion of close to 1% of GDP, while the Council has recommended a fiscal adjustment, and the size of the deviation (a gap of around 1.5% of GDP) are unprecedented in the history of the Stability and Growth Pact».

The letter also highlighted that (1) Italy’s fiscal target pointed to a ‘significant deviation’ from the structural improvement of 0.6% of GDP for 2019 recommended by the Council in 2018 and that balanced budget was not planned to be achieved by the end of the forecast horizon; (2) Italy was in non-compliance with the debt rule, as well as with the preventive arm of the Stability and Growth Pact, which up to then had avoided it to face a procedure based on debt; (3) Italy’s parliamentary budget office did not endorse the economic projections. Those three factors pointed to a «particularly serious non-compliance with the budgetary policy obligations laid down in the Stability and Growth Pact», i.e. they risked triggering an immediate Excessive Deficit Procedure. Thus, the Commission asked Italy for clarification by 22 October.

The Italian reply argued in support of the fiscal targets, without denying the breach of the fiscal framework rules. On October 23, the Commission, through a letter and its opinion on Italy’s DBP, rejected Italy’s Budget, as it «respects neither the fiscal recommendation addressed to Italy by the Council nor Italy’s own commitments». Italy was given three weeks to amend. The move was unprecedented, and the immediate reaction suggested that the Commission intended to move fast. Italy’s political leaders, however, seemed to have no intention to change the targets.

On 8 November, the Commission published its Autumn Forecasts, unsurprisingly including a sharp increase in the headline deficit forecast to 2.9% in 2019, and above 3.0% in 2020. In addition, the structural balance remained at 1.8% in 2018 but jumped to 3.0% in 2019 and 3.5% in 2020, implying an estimated expansionary stance even larger than the government’s official estimates. Italy’s fiscal stance expanded by 1.2pp instead of adjusting by 0.6pp, as required by the rules. It was a 1.8pp gap, which was perceived as too wide to be filled.

Minister Tria was able to pull out of his hat only minor changes in Italy’s revised DBP. In the accompanying letter on 3 November, the Minister argued that Italy needed an expansionary policy in order to support growth and address social issues related to bad economic performance. The first change was to a sharp increase in the pencilled amount coming from privatisation receipts. The second novelty was the request to consider recent flooding and an emergency infrastructure plan, following the collapse of the Genoa’s bridge, as ‘extraordinary events’ to allow a reduction in the required structural adjustment. However, despite Tria’s attempt to provide some sweeteners to the Commission, there was no sign that the two political leaders were about to back down anytime soon.

On 21 November, the Commission published a new opinion on Italy’s Budgetary Plan and the Article 126(3) Report, the first step in the process towards opening an Excessive Deficit Procedure based on the debt criterion. It would have been a big blow to the credibility of the EU fiscal framework, had the Commission not started this process. Following this move, the Ecofin would have needed a qualified majority to reverse it, which was close-to-impossible. Entering the EDP could have in turn even triggered a request by the Commission of a non-interest bearing deposit to Italy.

While the Italian confrontational stance did not win many friends in Europe, neither wanted European governments to provide Italy’s populist coalition with a unique launch pad for an anti-European campaign at the upcoming European elections. Thus, there was a desire for a compromise. The outbreak of the ‘gilets jaunes crisis’ in France also strengthened the Italian position. On the Italian side, it is not clear what changed the government’s attitude, but the shift broadly coincided with the disappointing outcome of the ‘BTP Italia’ auction at the end of November. The government was hoping to compensate for a lower foreign demand by selling more bonds domestically, but the result of the retail-targeted issuance was disappointing. With the BTP-Bund spread still under pressure at that time, and the risk of incurring a financial crisis just before the European elections, the government decided to change track and seek a ‘political grand bargain’ with the EU.

Tab. 1. *Official scenario: economic and public finance projections*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | 2018 | 2019 | 2020 | 2021 |
|  |  |  |  |  |
| Real GDP, % yoy | 1.0 | 1.0 | 1.1 | 1.0 |
| GDP deflator, % yoy | 1.1 | 1.4 | 1.8 | 1.6 |
| Nominal GDP, % yoy | 2.1 | 2.3 | 2.9 | 2.6 |
| Nominal GDP, Euro billion | 1761.4 | 1801.7 | 1853.9 | 1902.1 |
|  |  |  |  |  |
| Potential GDP growth, yoy | 0.7 | 0.7 | 0.9 | 0.9 |
| Output gap, % potential GDP | -1.7 | -1.4 | -1.2 | -1.1 |
| Cyclical component, % GDP | -0.9 | -0.8 | -0.6 | -0.6 |
| One-off measures, % GDP | 0.0 | 0.0 | 0.0 | 0.1 |
| General government balance, % GDP | -2.0 | -2.0 | -1.8 | -1.5 |
| Primary balance, % GDP | 1.7 | 1.6 | 2.0 | 2.4 |
| Interest expenditure, % GDP | -3.7 | -3.7 | -3.8 | -4.0 |
|  |  |  |  |  |
| Structural primary balance, % GDP | 2.6 | 2.4 | 2.6 | 2.9 |
| Change in the structural primary balance | 0.0 | -0.2 | 0.2 | 0.3 |
|  |  |  |  |  |
| Structural balance, % GDP | -1.1 | -1.3 | -1.2 | -1.0 |
| Change in the structural balance | 0.2 | -0.2 | 0.1 | 0.2 |
|  |  |  |  |  |
| Flexibility clauses |  | 0.2 | 0.0 | 0.0 |
| Change in structural balance net of flex |  | 0.0 | 0.1 | 0.2 |
|  |  |  |  |  |
| Public debt, % GDP | 131.7 | 130.7 | 129.2 | 128.2 |
| Change in public debt | 0.5 | -1.0 | -1.5 | -1.0 |
| Stock of public debt, Euro billion | 2319.5 | 2354.8 | 2395.3 | 2438.5 |
|  |  |  |  |  |
|  |  |  |  |  |

*Source*: our estimates.

Italy’s Prime Minister Conte took for himself the responsibility of negotiating with the EU on the Budget, with a full mandate by the two political masters Salvini and Di Maio. Conte first met Juncker, Dombrovskis and Moscovici in Brussels on 24 November and at the G20 meeting in Buenos Aires a week later. The crucial meeting happened on 12 December over dinner in Brussels, ahead of the December European summit.

Following negotiations with the Commission, the general government deficit target was first revised up to 2.6% from 2.4% due to lowered GDP projections, and then down to 2.04% by Budget amendments, meaning that Italy’s expansionary budget had to be reduced by almost 0.6pp of GDP. The compromise focused mostly on 2019, leaving huge safeguard clauses to narrow the gap in the following years. See Table 5.1 for the official projections.

1. **Finally, Budget unveiled**

Following negotiations with the European Commission, Italy’s revised Budget was finally unveiled on 22 December. Both the Senate and the Lower House approved it by a confidence vote and without any discussion in parliament, producing vocal protests from the oppositions.

The most significant changes related to (1) scaling down of the citizen income and rolling-back of the previous pension reform, mostly due to a delayed phase-in, (2) lower public investment spending, (3) whopping ‘safeguard clauses’ for 2020 and 2021 to make public finances consistent with the trajectory agreed with Brussels. There was also a 0.2pp safeguard clause for 2019, by which the government froze some funds until monitoring of public accounts would confirm that fiscal targets had been met. The Commission explicitly mentioned this safeguard clause in its letter to the Italian government, while giving its green light to what Dombrovskis’ labelled as «borderline compromise».

The revised Budget was mildly expansionary for 2019, and strongly expansionary in 2020 and 2021, by about 1.0% of GDP in both years, most of it due to permanent increases in spending.

There was a reduction in tax expenditure and various tax benefits for companies, mostly introduced by previous governments, thus raising the overall corporate tax burden, especially in 2019 (0.18% of GDP). There were also measures to reduce tax benefits for banks and insurance companies, mostly for 2019 (0.23% of GDP). There were measures to facilitate the closure of pending litigations with the tax agency and the payment of open positions with haircuts fine-tuned to income capacity, which may be considered as a tax amnesty. Moreover, the introduction of a mandatory electronic invoicing system, a project started by the previous government, went ahead as an expected effective way to fight tax evasion and increase efficiency. These two latter measures were expected to produce marginal results in 2019, but almost two decimal points of GDP in 2021.

The promise to reduce taxation translated into a 15% flat tax for companies with a turnover below €65,000, and 20% between €65,000 and €100,000, i.e. mostly shopkeepers and autonomous workers (the political backbone of the League). Overall, the extra revenue accounted for about half a percentage point of GDP in 2019, and a bit more than two decimal points in 2020-2021.

On the spending side, expenditure-restraining measures were scaled back to a modest 0.10-0.15% of GDP in 2019-2021, far below the initial ambitious plans to fight ‘waste’ by an in-depth spending review.

The government scaled down spending on the introduction of the so-called ‘quota 100’. The amount allotted was only 0.22% of GDP in 2019, and was projected to increase to 0.44% and 0.45% in 2020 and 2021. The Budget only provided for an allocation of funds, as details were to be later unveiled by a specific decree. It was not clear whether this appropriation of funds in the Budget was enough to make good on the electoral promise of a sizeable reduction in retirement age. The government introduced limitations for accessing early retirement and claimed the reform was to be introduced on an experimental basis for three years only. Pension restraining measures, in the form of reduced indexation and a solidarity tax on pensions above €100,000 per year, did little to fund the extra spending. The de-indexation, however, was projected to increase pension savings sharply over time, so it may become a way to redistribute resources within the pension system beyond the initial 3-year period, without significantly increasing the overall spending on pensions as a percentage of GDP. The second flagship initiative of the government, i.e. the citizenship income, was downsized as well, at about 0.3% of GDP throughout the forecast horizon.

Finally, the well-publicised plans to boost public investments were reduced substantially, even though they would have provided the highest multiplier effect. Partly, this was the recognition that budgeting investment is not enough, absent proper administrative procedures to facilitate implementation. Partly, public investments were, as usual, the first casualty when governments faced the need to cut on the Budget, as they could be delayed at a low political cost. Following negotiations with the Commission and the reduction of various investment funds, the overall Budget showed almost half decimal point reduction in public investments in 2019 (€1.0 billion), while there was an increase of 0.3% of GDP in 2020-2021.

All the above changes in taxation inevitably translated into an increase in the projected tax burden from 42.0% of GDP in 2018 to 42.4% in 2019, from an initial projection of 41.9% for 2019[[5]](#endnote-5), following five years of gradual reduction.

Overall, it was hardly the revolutionary ‘People’s Budget’ that had been promised. Former Finance Minister Padoan said the agreement with the Commission was a Pyrrhic victory[[6]](#endnote-6). Possibly, it was even worse: a Faustian pact to kick the can down the road and pretend that Italy was compliant for 2019, pushing a massive problem of adjustment further into the future.

1. **Three weak assumptions at the base of the ‘budgetary ‘borderline compromise’ exercise**

The Italian budget is a weak and dangerous compromise in that it is based on very optimistic and weak assumptions. Three of them need to be stressed: very rosy expectations on future GDP growth; the ambiguous use of the so-called safeguard clauses; and the over-optimistic privatisation receipts.

The expansionary stimulus was substantially smaller than its original version. On top of that, the outlook for the economy had deteriorated since September. Not only 3Q18 GDP came out on the weak side, posting a -0.1% qoq, but also leading indicators, foreign trade, industrial production and consumption all weakened, and the chance of a technical recession had increased.

Thus, as part of the deal with the Commission, the government revised economic projections to 1.0%, 1.1% and 1.0% for 2019, 2020 and 2021 respectively. The negative carryover into 2019 justified lowering GDP projections by 0.35pp, according to the government. The remaining part, i.e. about 0.2pp, was due to the reduction in the expansionary stimulus to demand in the revised Budget[[7]](#endnote-7).

Tab. 2. *Alternative scenario: economic and public finance projections*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | 2018 | 2019 | 2020 | 2021 |
|  |  |  |  |  |
| Real GDP, % yoy | 1.0 | 0.3 | 0.4 | 0.4 |
| GDP deflator, % yoy | 1.1 | 0.9 | 1.1 | 1.2 |
| Nominal GDP, % yoy | 2.1 | 1.2 | 1.5 | 1.6 |
| Nominal GDP, Euro billion | 1761.4 | 1782.6 | 1809.7 | 1839.1 |
|  |  |  |  |  |
| Potential GDP growth, yoy | 0.4 | 0.5 | 0.5 | 0.5 |
| Output gap, % potential GDP | -0.4 | -0.6 | -0.6 | -0.7 |
| Cyclical component, % GDP | -0.9 | -0.8 | -0.6 | -0.6 |
| One-off measures, % GDP | 0.0 | 0.0 | 0.0 | 0.1 |
| General government balance, % GDP | -2.0 | -2.5 | -3.9 | -4.3 |
| Primary balance, % GDP | 1.7 | 1.2 | -0.1 | -0.3 |
| Interest expenditure, % GDP | -3.7 | -3.7 | -3.8 | -4.0 |
|  |  |  |  |  |
| Structural primary balance, % GDP | 1.9 | 1.5 | 0.3 | 0.1 |
| Change in the structural primary balance | 0.0 | -0.4 | -1.2 | -0.2 |
|  |  |  |  |  |
| Structural balance, % GDP | -1.8 | -2.2 | -3.5 | -4.0 |
| Change in the structural balance | 0.1 | -0.4 | -1.3 | -0.5 |
|  |  |  |  |  |
| Flexibility clauses |  | 0.2 | 0.0 | 0.0 |
| Change in structural balance net of flex |  | -0.2 | -1.3 | -0.5 |
|  |  |  |  |  |
| Public debt, % GDP | 131.8 | 133.5 | 135.7 | 138.0 |
| Change in public debt | 0.6 | 1.7 | 2.1 | 2.4 |
| Stock of public debt, Euro billion | 2321.4 | 2380.5 | 2455.5 | 2538.9 |
|  |  |  |  |  |
|  |  |  |  |  |

*Source*: our estimates.

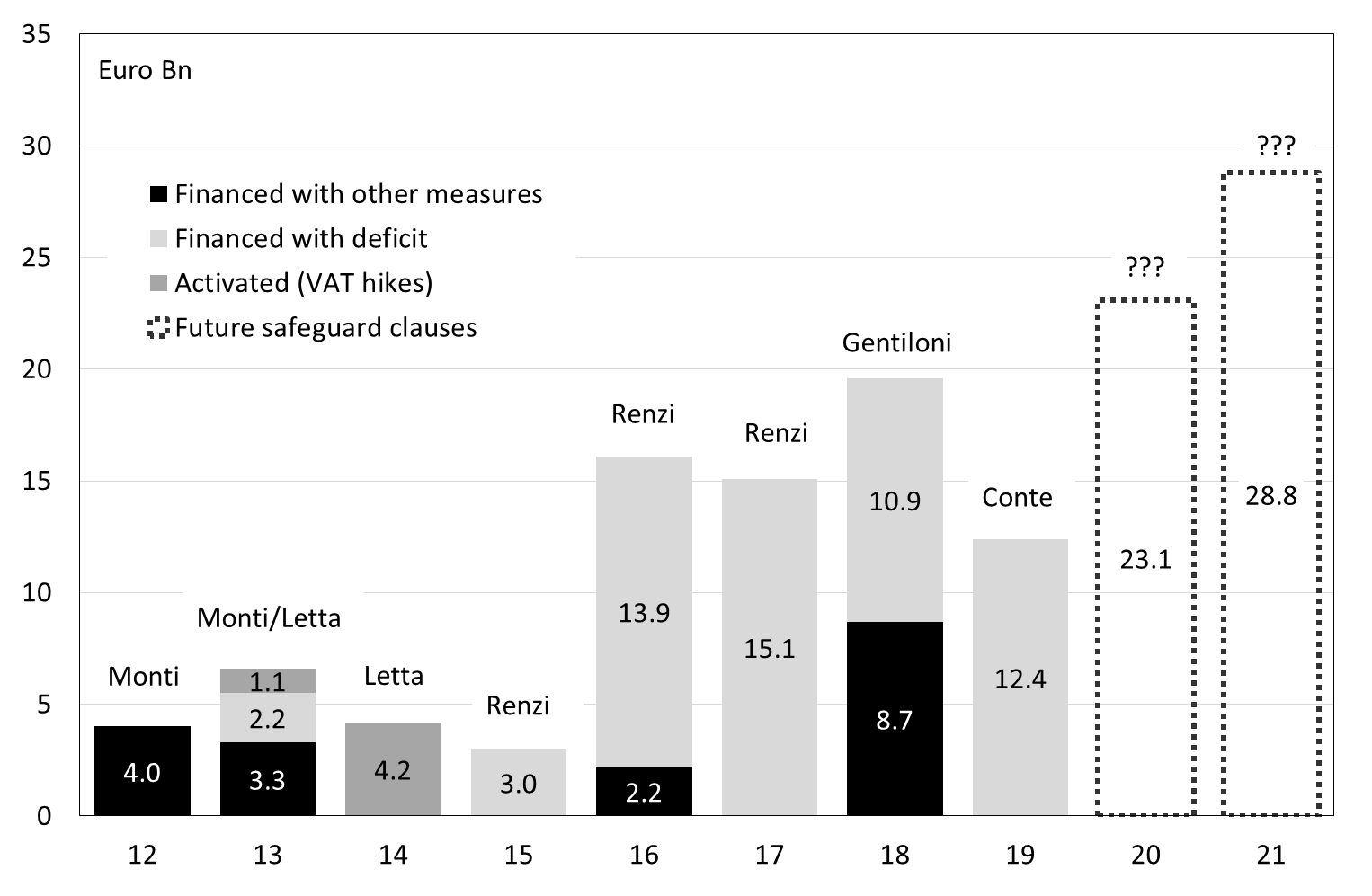
Available leading indicators at the end of 2018, suggests that 2019 will be off a weak start and that GDP growth is likely to be much lower than official projections. Assuming 0.3% GDP growth in 2019 and 0.4% in both 2020 and 2021, general government deficit would increase by 0.38pp in 2019, 0.75pp in 2020 and 1.06pp in 2021, relative to the government’s policy scenario.

The second key issue is related to safeguard clauses. The Monti government first introduced safeguard clauses for 2012 to make a reduction in spending binding. The practice was followed year after year since then. In order to avoid triggering the increases in VAT legislated with the safeguard clauses, the governments had to come up with extra financing by structurally reducing expenditure. Over time, however, the original rationale of these clauses was lost, as financing increasingly came from the deficit.

In addition, the size of the safeguard clauses has steadily risen, as it became increasingly difficult to address in advance projected future deficit increases. The fact that these increases are legislated as safeguard clauses does not matter much in practice, because all political parties have the incentive to avoid pulling the trigger on a VAT rise. They are fig leaves to avoid formally pencilling in a higher deficit in future years’ projections. Therefore, it is more realistic to net the safeguard clauses from fiscal projections. The Italian Treasury cannot ignore them in official projections as it would mean denying the validity of the law, but correctly the European Commission no longer include them in its projections.

In the Budget, the government was able to decommission €12.4 billion VAT hikes for 2019 by recourse to deficit. However, in order to square the circle and comply on paper with the deficit reduction path agreed with the Commission, it increased the size of existing safeguard clauses for 2020 and 2021. The fact that these clauses become bigger every year is merely the recognition that Italy’s public finances have entered a path increasingly difficult to sustain. Governments, unable to address in advance the growing deficits by tighter fiscal policy instead of safeguard clauses, always hope for an unlikely and surprising upturn in the economy to solve all problems. However, year after year, growth has under-delivered, and the safeguard clauses have kept increasing. Those in place for 2020 and 2021 amount to €23.1 billion and €28.8 billion respectively, i.e. 1.2% and 1.6% of projected GDP. The headline VAT rate would increase from the current 22% to 25.2% in 2020 and 26.5% in 2021. Needless to say that by disregarding these clauses, the deficit would go up sharply well above the 3.0% threshold in 2020-2021 (Figure 1).

Fig. 1. *Safeguard clauses in Italy’s Budget*

*Source*: Italy’s Ministry of Economy and Finance, Confindustria, our estimates.

Finally, the unrealistic boost promised for privatisation receipts. Various governments have increasingly embellished deficit and debt figures with privatisation receipts that never materialised. The Conte government projected privatisation receipts at 1.0% of GDP in 2019, and 0.3% in 2020, plus extra revenues from the dismissal of real estate assets. There are however several underlying reasons why such a high stream of privatisation receipts is hardly feasible. There are only six listed state-owned companies left in the Treasury’s portfolio. Altogether, the Treasury’s stakes in them were worth about 1.2% of GDP, at December 2018 market prices. The Treasury also owned many non-listed companies; some of them are big, such as CDP and the national broadcasting service RAI. However, both League and M5S had publicly argued against dismissing the public ‘jewellery’. Therefore, the 1.0% of GDP pencilled in the Draft Budgetary Plan had to come from local government, but the central government cannot seize control of companies where there is a local government stake as the Constitution protects the rights of local government. This time, the government is promising that 5%-15% of the proceeds would stay at the local level, but it remains unclear how the 1.0% of GDP target could be met, unless by selling some of the companies in the hands of the Treasury to Cassa Depositi e Prestiti, for future privatisation.

On the real estate side, the government pencilled €0.95 billion of privatisation on top of the already included €0.7 billion. Over the past few years, it has been able to cash about €1.0 billion per year, on average, but the ‘easy bits’ have already been privatised. The total value of real estate properties amounts to about €280 billion, but the amount of ‘available for sale’ does not exceed €12 billion.

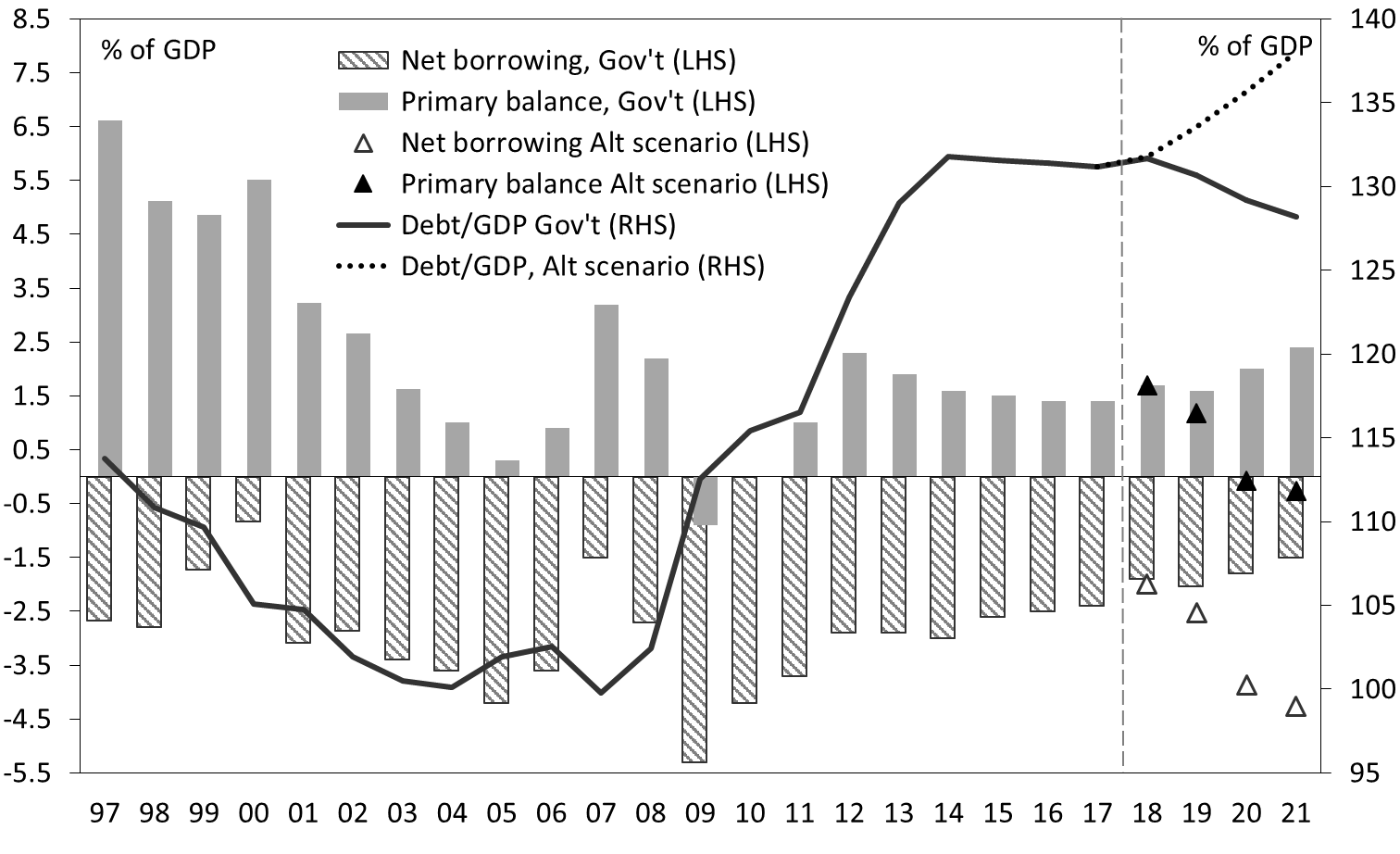
Overall, it is more realistic to expect no more than 0.1% of GDP in privatisation in 2019, 2020 and 2021, half of it coming from proceeds in real estate assets and thus reducing both deficit and debt, according to accounting rules.

How does a revised no-policy-change scenario look like if we (1) change the economic growth assumptions, (2) delete the safeguard clauses, and (3) reduce privatisation receipts? We leave the assumptions on interest rates unchanged in line with official projections[[8]](#endnote-8) and show the result of this exercise in Table 5.2.

The deficit widens to 3.9% in 2020 from an estimated 2.5% in 2019, with the debt ratio rising by more than 2.0pp. The structural deterioration is 1.3pp of GDP as opposed to the required adjustment of 0.6pp.

How does the Budget impinge on the long-term sustainability of Italy’s debt? We assume that Italy’s potential growth gradually rises over time from a downwardly revised 0.5% in 2021 to 1.0% in 2030 and that actual GDP growth follows the same pattern from 2022 onwards. We also assume that the GDP deflator gradually increases from 1.0% in 2021 to 1.9% in 2030, as a recognition that Italy’s GDP growth will remain somewhat weaker than the rest of the Eurozone, and thus inflation developments will lag as well. This brings nominal GDP growth from 1.4% in 2021 to 2.9% in 2030. A third assumption is that interest rates will move up only very gradually, with short-term interest rates (1-year T-bills) increasing from 1.06% as in the official projections for 2019 to 1.57% in 2021 and to 2.6% in 2025, then stabilising. Long-term interest rates (10-year bonds) are assumed to move from the official projections of 3.66% in 2019 to 4.27% in 2021 and 5.50% in 2025, and then stabilise. This implies that the yield on 10-year Bunds reaches 4.0% in 2025 and that the spread gradually declines to 150bp. The implied cost of borrowing and interest rate expenditure are calculated according to the elasticities of Italy’s outstanding stock of debt. Finally, the primary balance is assumed to stay at the level reached in 2021, i.e. a deficit of 0.3% of GDP (Figure 2).

Fig. 2. *Italy’s Public finance scenarios: official and alternative projections*

*Source*: Italy’s Ministry of Economy and Finance, our estimates.

The so-called ‘snowball effect’, i.e. the dynamics between nominal growth and the cost of borrowing, would remain unfavourable throughout the horizon adding about 2.0pp to the debt ratio each year in 2022-2030. The dynamics of Italy’s public debt would become explosive.

The government would have to increase the primary balance to at least 2.0-2.5% to offset the unfavourable ‘snowball effect’ and ensure the sustainability of Italy’s public finances. Moreover, the interplay between nominal economic growth and the cost of borrowing may be less favourable than indicated in this scenario. Therefore, to be on the safe side and at least stabilise the debt to GDP, Italy would need tightening measures to the tune of 3.0-3.5% of GDP in 2020-21, which appear unfeasible in the current political environment. The bottom line is that it would not take much for Italy to move into a self-fulfilling crisis scenario.

**6. Conclusion: Sustainability risks on the rise**

The coming to power of the League-M5S coalition has undoubtedly been the defining moment of 2018, and one whose economic consequences could be long lasting. The negotiation of the ‘People’s Budget’ exposed the difficulty in reconciling economic reality and the electoral pledges of parties that had campaigned on opposed fiscal platforms. The result was an open confrontation with the European Commission that went very close to turning into an outright Excessive Deficit Procedure.

At the end of 2018, the Italian economy entered a technical recession, but this was only partly due to the weakness common to the whole Euro Area and mostly to the self-defeating nature of the government’s economic policies, which resulted in the widening of spreads on government securities and a negative impact on business confidence and investment. In these conditions, «putting money in the pockets of Italians» is likely to produce no positive demand stimulus at all.

The Budget crystallises a higher level of current expenditure. What future government would then have the political courage to cancel these measures, without the pressure of a new financial crisis?

The Budget also does little to correct the anomalies of spending in Italy. Quite the opposite, it accentuates them. Italy has one of the highest pension expenditure in Europe relative to GDP, and the counter-reform of the current government increases it further. More fundamentally, the government plans imply backtracking on past growth-enhancing structural reforms and its overall thrust of the Budget reflects an anti-business attitude while introducing potentially dangerous incentives that could structurally reduce labour supply. Together with the prohibition of accumulation of income from work with those from pension, this could induce crowing out of part-time and temporary jobs or incentivise the shift to undeclared work.

To sum up, the Budget has all the cards to produce substantial structural damage to the economy. While the government has succeeded in introducing measures – such as ‘quota 100’ and the citizenship income – that are key from an electoral standpoint, the risk (or hope) is that voters will realise soon enough what the overall cost and the side effects of this will be. On the other hand, the spat with Brussels – and its resolution, whose timing appears linked to the outbreak of the ‘gilets jaunes’ protests in France – proved that the Commission is not a pure technocratic body that governs by rules and rules by numbers, but rather a political actor, open to political compromise. The compromise fixes 2019 only, but by kicking the can, it creates a major adjustment cliff in 2020 and 2021, when safeguard clauses amounting to 1.2% and 1.6% are expected to kick in. De-commissioning them without recourse to deficit will require a major adjustment. If we assume this does not happen, then by changing the assumptions on economic growth and privatisation proceeds the deficit would reach close to 4.0% in 2020-2021, with a negative primary surplus and a debt-to-GDP ratio that increases from 131.7% in 2018 to close to 138% in 2021. The fact that the Commission was open to overlook all this suggests that if the Italian government has not won, the Commission indeed has not won either. Both are exposed to the political fallout of a significant economic risk laying ahead.

The issue is whether Italy remains in a slow-burning crisis mode, or is an accident waiting to happen.

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1. **Notes**

   Samuel Taylor Coleridge, *Biographia Literaria*, 1817, Chapter XIV [↑](#endnote-ref-1)
2. Merler (2019). [↑](#endnote-ref-2)
3. For a discussion of the potential consequences of *Italexit* see Codogno L. and G. Galli [2018], *Perché è uno scenario catastrofico per il lavoro e il risparmio (Why it is a catastrophic scenario for jobs and savings?)*, in *Cosa succede se usciamo dall’Euro? (What would happen if we exit the euro?)*, edited by Carlo Stagnaro, Milan, IBL Libri, pp. 105-120; Codogno L. and G. Galli [2017], *L’Euro è un’opportunità: uscirne non risolverebbe nessuno dei problemi dell’Italia” (The Euro is an opportunity: exiting would not solve any of Italy’s problems”), in Unione Europea: 60 anni e un bivio (European Union: 60 years at a junction)*, edited by Luigi Paganetto, Gruppo dei 20, Rome, Eurilink University Press; Codogno L. and G. Galli [2017], *Italexit is not a solution for Italy’s problems*, in Europp, London School of Economics. [↑](#endnote-ref-3)
4. The European central bank buys only about 8% of the asset purchase programme of the European System of central Banks. The remaining 92% is generally bought by the Bank of Italy. Therefore, the ECB did not even have 250 billion of Italian government bonds in its portfolios, but this fact was apparently not known to the writers of the draft version of the Contract. [↑](#endnote-ref-4)
5. According to preliminary estimates by the Parliamentary Budget Office in a parliamentary hearing of his President Pisauro on 22 December. [↑](#endnote-ref-5)
6. Interview with La Stampa on 22 December. [↑](#endnote-ref-6)
7. It went from 0.6pp to 0.4pp according to official estimates. [↑](#endnote-ref-7)
8. Based on forward rates in mid-September and probably unrevised since then. [↑](#endnote-ref-8)