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Fiscal consolidation and growth – the Italian experience

draft remarks

Under the agreements reached at the European level, Italy undertook to achieve budget balance by 2014. This goal, set out in the 2011 update of the Stability Programme, was subsequently brought forward to 2013.

In order to reach this goal in an environment of severe financial market strains, last summer the Government introduced two budget correction packages, followed by a third package in December.

Overall, the correction is equal to € 48.9 billion in 2012, € 75.7 billion in 2013 and € 81.3 billion in 2014. In proportionate terms, it amounts to 3% of GDP in 2012, 4.6% in 2013 and 4.8% in 2014.

With reference to the total package, for the final year, 66% will be composed of permanent revenue measures, while the remaining 34% will comprise permanent expenditure measures.

The predominance of revenue-side measures is explained at least in part by the substantial spending cuts at both the central and local government levels made in recent years; further reductions, as well as the reallocation of expenditure to priority areas, will be implemented on the basis of the findings of the spending review begun with the recent budget packages.

In any event, the growth of primary expenditure is slowing. On the basis of the latest official forecast (December 2011) and of the last correction package, in the period from 2012 to 2014 primary expenditure is expected to grow by 0.7% in nominal terms. As a proportion of GDP it would decline by more than one point (from 44.7% to 43.5% at the end of the period).

Additional positive effects from spending restraint will be generated in the medium and long term as a result of the pension reforms adopted in 2010 and 2011, which also raised retirement age and will entail increasingly higher savings over time[1]. All of these factors need to be taken into account to assess the sustainability of public finance and ultimate success of fiscal consolidation efforts.

These corrective measures, which are considered necessary by all the political parties, institutions and the social partners as well, have been adopted in a context of sluggish growth[2] and will cause economic activity to slow further: the last fiscal package - entailing a correction of 1.3% of GDP for each year - will have, according to Bank of Italy's estimates, a negative impact of 0.5% for the

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[1] From € 7.2 billion in 2014 to € 20 billion in 2020 (1.2% of GDP).

[2] -0.4% in 2012, +0.3% in 2013 and +1% in 2014 according to last Government estimates (December).

two-year period 2012-2013, while, according to a number of research institutes, it could be more than 1%.

If GDP should perform worse than the trend assumed by the Government at the time the corrective measures were enacted, the achievement of budget balance could be more difficult, especially in a situation affected by the uncertainty about developments in the financial market crisis.[3]

It is therefore essential for fiscal consolidation to be accompanied by measures to foster growth. This is what the Italian Government is seeking to achieve with the measures – currently before Parliament – concerning the liberalisation of the services sector and the simplification of administrative procedures. They aim not only to open major segments of the economy to competition, but also to remove obstacles and uncertainties that until now have adversely affected investment decisions by private players, the effectiveness of public expenditure and the execution of infrastructure works critical to the recovery and the development of backward areas. Preparatory work is also under way to introduce greater flexibility into the labour market, on which talks have begun with the unions. In this respect, specific measures were adopted with the December package to reduce labour taxation and promote employment of women and young people.

Against this backdrop, two issues must be addressed, namely the size of the impact of the liberalisation measures on growth and, above all, the time necessary for those effects to be transmitted to the economy: while the effects of restrictive fiscal policies are transmitted fully in the short term, the impact of liberalisation will only make itself felt in the medium and long term. In this connection, it would be interesting to learn more about liberalisation and market reform measures in other countries, which have had a positive impact on growth also in the short term.

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[3] The Bank of Italy (*Economic Bulletin* no. 63, January 2012), underscoring the exceptional uncertainty over the course of the sovereign debt crisis and its impact on the financial markets, the stability of the banking industry and its capacity to continue lending to the economy, sets out two alternative scenarios based on different assumptions concerning interest rate developments. In the first, assuming yields on Italian government securities remain at their early-January level for two years (about 7% for long-term securities, with a spread of 500 basis points with respect to rates on 10-year Bund), GDP is forecast to decline by 1.5% in 2012 and register no growth in 2013 as a whole. In the second, assuming that at least partially normal conditions return to the financial markets, such as to allow a rapid decline in yields on government securities (to about 5% on long-term securities, with a spread of 300 basis points) and the easing of strains in the credit market, GDP is forecast to contract by 1.2% in 2012 and expand by 0.8% in 2013. In both scenarios, additional downside risks for economic activity would be posed by a deterioration in confidence in the ability of European governments to cope with the debt crisis. However, a boost to growth could come from structural measures to revive the Italian economy, the effects of which are not factored into the forecasts.