Flossbach von Storch
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Italy's "government of change"

and public finances out of balance

AGNIESZKA GEHRINGER

- Italy's political risk is not expected to diminish soon.
- The yellow-green coalition of the Five-Star Movement and the League re-emerged and with it a negative outlook for Italy's public finances.
- The net negative fiscal impact from the new government program could reach over €100 bn annually, increasing Italy's public debt from the current 132 percent of GDP to over 140 percent at the end of the legislature.

The "government of change" finally achieved the backing it needed. After Italy's President, Sergio Mattarella, accepted May 31 the list of ministers presented by Giuseppe Conte, the new designated prime minister, on June 6 the new coalition of the Five-Star Movement and the League overcame the last hurdle of the vote of confidence in parliament.

There is still much to worry about regarding Italy, given that the yellow-green coalition (of the Five-Star Movement and the League) is expected to comply with the underlying "contract for the government of change" ("*Contratto per il governo del cambiamento*") stipulated between the parties on May 18.[1] This is what can be clearly interpreted from both speeches of Prime Minister Conte in the Senate on June 5 and in the lower-house Chamber of Deputies on June 6. The net negative fiscal impact could amount to over €100 bn annually.[2]

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[1] The full text of the contract is available on the website of the blog of the Five-Star Movement at: https://s3-eu-west-1.amazonaws.com/associazionerousseau/documenti/contratto_governo.pdf.

[2] The net impact estimated by the Five-Star Movement should be also of €100 bn, however, in total, i.e. to be distributed over the five-year legislature term. This calculus is due to the leader of the Five-Star Movement at the Chamber, Giulia Grillo (asserted on May 17 in the TV broadcast *Carta Bianca* on Raitre).

What can be expected from the "government of change"?

Table 1 summarizes the contract's measures according to their negative or positive effect on government finances. Among the former, there are measures – marked with a star – which might have a positive long-term impact and thus could transform into a positive, although very unsure, effect in the future. Moreover, all measures – positive or negative – are divided into two parts, related to either receipts or expenditures. Where viable, we have included estimates of the fiscal impact, as summarized by an analysis of the *Osservatorio Conti Pubblici Italiani* of the *Università Cattolica del Sacro Cuore*.

The biggest negative impact on public finances is expected from lower receipts of €50 bn a year due to the **flat tax**.[3] This higher fiscal burden could be potentially alleviated by a positive impact on aggregate demand, as argued by the proponents of the idea within Lega. However, empirical evidence on such a presumed positive impact is inconclusive and the causality is not fully clear.[4] More evident seems to be the negative redistributive impact of the flat tax. There are estimates suggesting that half of the reduction would benefit the richest (especially those with a family income above €80,000), whereas the impact on middle and lower income-classes would be modest.[5]

Lower receipts of €12.5 bn per year are also expected due to cancellation of the safeguard clauses, implying increases in the **value added tax** (VAT). The abolition of the **gasoline excise** would imply additional gap of €6 bn in the public sector budget.[6] Both measures could potentially have a positive impact on growth in the long run, given that a lower VAT burden could stimulate household consumption and the removal of the gasoline excise would reduce costs to the entire private sector (thus potentially higher private demand for consumption and investment). However, given the one-off nature of this measure, the positive growth impact is likely to be limited.[7]

[3] The idea is introduced under point 11 of the contract, entitled "financial administration: flat tax and simplification". The estimate of €50 bn is due to Massimo Baldini and Leonzio Rizzo, with details available at: http://www.lavoce.info/archives/53078/quasi-flat-tax-la-classe-media-risparmia-poco/. In particular, they point that the "quasi flat tax" would involve two tax rates, a lower of 15 percent applicable to incomes under 80 thousand Euro and a higher of 20 percent for incomes above €80,000. Moreover, additional progressivity would be achieved due to deductibility of three thousand Euro, which is either multiplied by the number of family members from incomes under €35,000, or multiplied by the number of dependent family members for incomes between €35,000 and €50,000, or is simply subtracted from the gross family income for incomes above €50,000.

[4] See IMF Fiscal Monitor, October 2017.

[5] Estimates are by Massimo Baldini and Leonzio Rizzo. For details, see "Anche la 'quasi' flat tax costa 50 miliardi", La voce, May 15, 2018, available at: http://www.lavoce.info/archives/53078/quasi-flat-tax-la-classe-media-risparmia-poco/.

[6] Both measures are described under point 11 of the contract.

[7] Moreover, the positive impact should be contained also due to the relatively high level of private indebtedness. Consequently, a higher disposable income might possibly be used to repay outstanding debt.

Table 1. Measures included in the government program and their possible impact on public finances, in € bn

Negative		Positive	
Lower receipts:		*Higher receipts:*	
⇨ Flat tax on income	50.0	⇨ Higher tax revenues in the future thanks to demand pull (both domestic and external)	
⇨ Sterilization of safeguard clauses on VAT*	12.5		
⇨ Abolishment of the gasoline excise*	6.0		
Higher expenditures:		*Lower expenditures:*	
⇨ Base income and base pensions	17.0	⇨ Reduction of the number of parliamentarians	0.1
⇨ Family policies	17.0	⇨ Reduction of "golden pensions"	0.1
⇨ Abolishment of the pension reform	13.1	⇨ Abolishment of life annuity for members of parliament	0.1
⇨ Reinforcement of job centers	2.0	⇨ Reduction of international missions	0.2
⇨ Increase of civil indemnity for retired due to invalidity	1.8	⇨ Reduction of use of "blu cars", state aircrafts and personal security	
⇨ Recruitment of additional policemen	0.4		
⇨ Investment (rail and bicycle infrastructure, young entrepreneurship etc.)*			
⇨ Sustain to small fishery			
⇨ Increase of funds to incentivize environmental entrepreneurship			
⇨ Compensation for "expropriated" bank investors (small shareholders and savers)			
⇨ Indemnity for victims of violent crimes			
⇨ Improvement and increase in number of sports facilities			
⇨ Broadening of "no-tax-area" for university fees			
⇨ Increase in salaries for university teachers and researchers			
Total	**119.7**		**0.5**

Source: "Contract for the government of change" stipulated between the Five-Star Movement and the League, own elaborations Flossbach von Storch Research Institute; the reported expenditures and receipts are estimates taken from the summary analysis of the *Osservatorio Conti Pubblici Italiani* of the *Università Cattolica del Sacro Cuore*, available at http://osservatoriocpi.unicatt.it/cpi-elezioni-2018-commenti-ai-programmi-di-finanza-pubblica.

Among the measures with a negative fiscal effect resulting from increasing expenditures, the most serious impact is expected from the introduction of the **base income** for families and pensioners with incomes/pensions (for a single person) lower than €780 per month. The estimated cost of this measure would amount to 17 billion Euro per year.[8] Moreover, the abolition of the recent **pension reform** is also being considered, which would require 1) an additional €5 bn to facilitate the exit from the labor market for categories of workers currently excluded and 2) €8.1 bn due to changing age parameters.[9] Regarding

[8] These measures are included in point 19 on "citizenship income and citizenship pension".

[9] Section 17 entitled "Pensions. Stop the Fornero law" deals with this. The modified age parameter is based on the so called rule of 100, implying that the pensionable age is achieved if the sum of the worker's age and the years of contributions is equal to 100. The aim is to permit workers to exit the labor market upon 41 years of paid contributions. This would mean the minimum

family policies, the government contract mentions several measures ranging from free kindergarten services and maternity bonus and even financial assistance for nanny's services. The total cost could reach €17 bn, which is the estimate declared in the Five-Star Movement's electoral program regarding family policies.

Higher **investment** expenditures are mentioned in different sections of the program, regarding rail, bicycle and water infrastructures, construction of ships and airplanes, investment in new technologies in finance and sustain to young entrepreneurs (in this regard, explicitly, in the mountainous regions), among others. However, the contract is too vague to derive any plausible cost estimate.[10]

Finally, there are several – albeit smaller – provisions with the potential to bring the overall gross cost of the underlying economic program above the estimated amount of €119.7 bn per year. However, due to limited information provided in the contract, it is difficult to come up with a concrete estimate.

How should all this be financed? The program does not offer much on the positive side so far. It postulates savings obtained by the reduction of the number of parliamentary seats, of the so-called "golden pensions" and of international missions, as well as the abolition of life annuity for members of parliament. However, the total amount to be saved is by no means commensurate to the financial needs of the coalition program, leaving an immediate fiscal gap of almost €120 bn. It is also highly improbable that the sufficient receipts to cover these needs – not to mention the reduction of public debt – would be generated by higher economic growth and exports. For that to be plausible there is both insufficient past evidence and too much ambiguity in the contract.

pensionable age of 59 years. Moreover, the coalition plans to experiment with the so-called „female option" ("opzione donna"). This would permit women to exit the labor market at the age of 57-58, provided 35 years of contributions have been paid.

[10] The analysis of the *Osservatorio* CPI comes up with a cost of €6 bn, by assuming an additional investment spending of 0.35 percentage points of GDP. However, based on the text of the contract, this estimate should be treated as highly unsure.

Public finances out of balance

To better grasp the political and economic spirit of the prospective yellow-green coalition, it is useful to analyse budgetary and economic projections of both the Five-Star Movement and the League, elaborated shortly before the March elections (**Table 2**).[11]

Both projections are overoptimistic and scarcely realistic in many aspects. Assumptions over real GDP growth and the growth of GDP deflator do not match the economic reality in Italy. It is true that real GDP growth rebounded last year and achieved 1.6 percent, but this was more than double compared with the average over the previous three years (0.7 percent). Also, the growth GDP deflator stayed at 0.9 percent on average over the last five years, which is significantly below the assumptions of both models.

Table 2. Fiscal and economic projections of the League and the Five-Star Movement

	League				
	2018	2019	2020	2021	2022
Real GDP growth (%)	2.0	2.3	2.4	2.5	2.5
GDP deflator growth (%)	1.8	1.9	2.0	2.2	2.2
Nominal GDP (in € bn)	1,782	1,857	1,938	2,029	2,125
Expenditures (net of interests)*	45.8	44.6	42.8	41.7	40.6
Receipts*	46.5	44.8	43.4	42.4	40.9
Primary balance*	0.7	0.3	0.6	0.7	0.3
Interest payment*	3.6	3.5	3.6	3.6	3.7
Gov. deficit*	2.8	3.2	3.0	2.9	3.3
Gov. debt*	**129.6**	**127.6**	**125.2**	**122.5**	**120.3**
	Five-Star Movement				
	2018	2019	2020	2021	2022
Real GDP growth (%)	1.4	1.7	2.0	2.0	2.0
GDP deflator growth (%)	1.1	1.5	1.7	1.9	2.0
Nominal GDP (in € bn)	1,759	1,815	1,882	1,955	2,033
Expenditures (net of interests)*	44.2	42.9	41.4	40.0	39.0
Receipts*	46.2	45.4	44.6	43.8	43.0
Primary balance*	2.0	2.5	3.2	3.8	4.0
Interest payment*	3.6	3.9	4.0	4.1	4.2
Gov. deficit*	1.6	1.4	0.8	0.3	0.2
Gov. debt*	**129.9**	**126.7**	**122.4**	**117.6**	**112.8**

* as a % of GDP

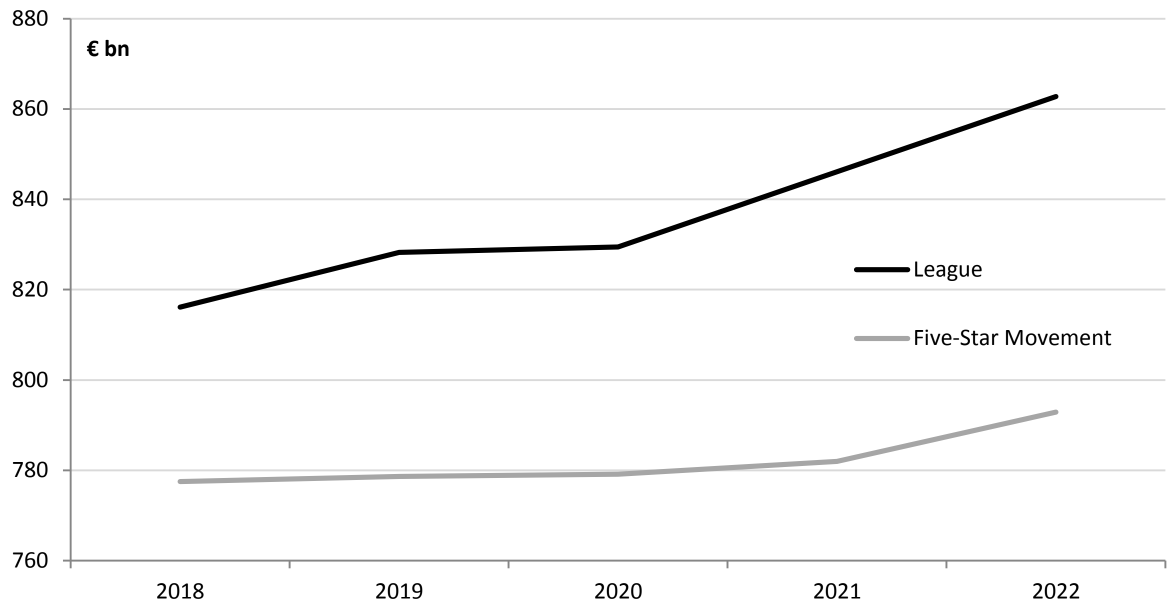
Source: Projections of Lega (http://osservatoriocpi.unicatt.it/cpi-Quadro_Lega_FinPubblica_Elezioni2018.pdf) and of the Five-Star Movement (http://osservatoriocpi.unicatt.it/cpi-quadro_programmatico_di_finanza_pubblica_Forza_Italia.pdf).

[11] Budgetary and economic projections of the League are available at: http://osservatoriocpi.unicatt.it/cpi-Quadro_Lega_FinPubblica_Elezioni2018.pdf and of the Five-Star Movement at: http://osservatoriocpi.unicatt.it/cpi-quadro_programmatico_di_finanza_pubblica_Forza_Italia.pdf.

However, even more striking is the fact that both projections assume only a modest increase in the trajectory of primary expenditures (**Figure 1**). This is at odds with both the government contract and the previous political programs from before the elections.

Assuming that half of the planned measures would be implemented, that Italy's economy would remain on an expansionary GDP path of the last five years, and that the ECB's monetary policy would continue to keep the cost of refinancing low, Italy's public debt could increase from the current 132 percent of GDP to 141 percent at the end of the legislative period (**Figure 2**).[12] Once realized, it is unlikely that the markets will stay calm.

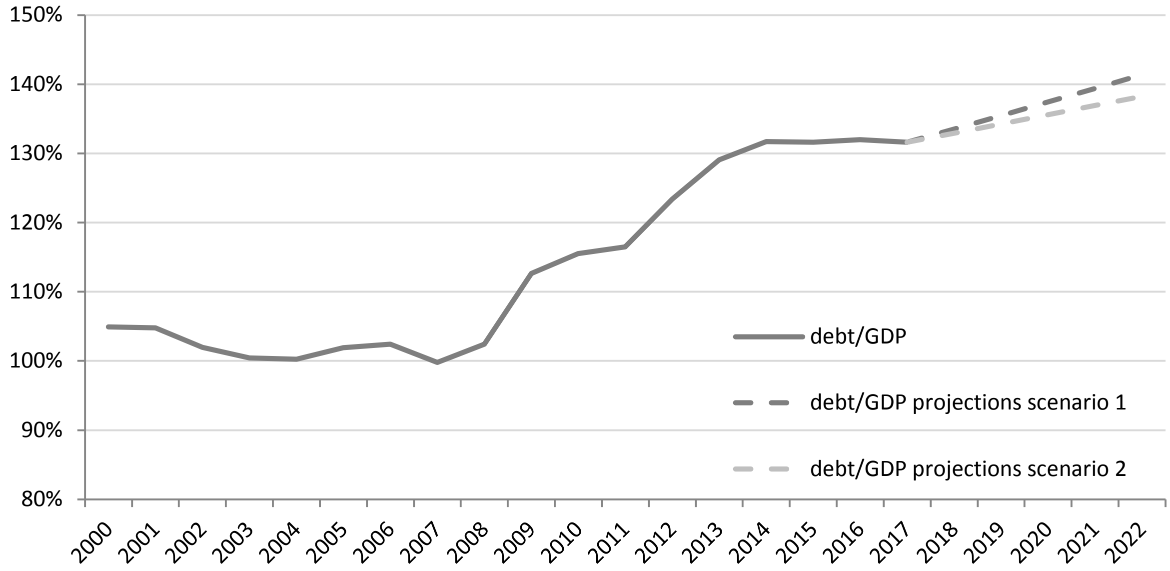
Figure 1. Projections of primary expenditures by the coalition parties



Source: Own elaborations Flossbach von Storch Research Institute based on budgetary projections of League, available at: http://osservatoriocpi.unicatt.it/cpi-Quadro_Lega_FinPubblica_Elezioni2018.pdf, and of the Five-Star Movement, available at: http://osservatoriocpi.unicatt.it/cpi-quadro_programmatico_di_finanza_pubblica_Forza_Italia.pdf

[12] *Osservatorio* CPI arrives at a debt increase to 137 percent of GDP in 2022. Their projection assumes, however, that the expansive measures would be introduced only gradually over the five-year period.

Figure 2. Italy: government debt to GDP, 2018 – 2022 projections upon the "contract for the government of change"



Note: Both scenarios assume that only half of the measures would be implemented. Scenario 1 assumes a constant nominal GDP growth rate of 1.3 percent per year and that the differential between the nominal interest rate and the nominal GDP growth rate would be positive and constant at 0.5 percentage points. Scenario 2 assumes a higher nominal GDP growth rate of 1.7 percent per year.

Source: Own elaborations Flossbach von Storch Research Institute

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Publisher: Flossbach von Storch AG, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com, *Directors:* Dr. Bert Flossbach, Kurt von Storch, Dirk von Velsen; *Registration*: No. 30 768 in the Commercial and Companies Register held at Cologne District Court; *VAT-No*. DE200075205; *Supervisory authority*: German Federal Financial Services Supervisory Authority, Marie-Curie-Straße 24 – 28, 60439 Frankfurt / Graurheindorfer Straße 108, 53117 Bonn, www.bafin.de; *Authors*: Dr. habil. Agnieszka Gehringer; *Editorial deadline*: June 6, 2018