Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 18/02/2019

The trick of the Italian budget law

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Abstract

Italy escaped the EU excessive deficit procedure for now because the Italian government has curbed the three main electoral promises by underestimating the costs of the planned measures.

Zusammenfassung

Italien ist dem EU-Verfahren bei einem übermäßigen Defizit vorerst entkommen, weil die italienische Regierung die drei wichtigsten Wahlversprechen durch Unterschätzung der Kosten der geplanten Maßnahmen eingedämmt hat.

A perfect escape?

After a vivid dispute with the European Commission, a deficit of 2.04% was agreed – well above the past limits compatible with the Stability and Growth Pact.

According to the initial draft of the Italian government budget from October 2018, the budget deficit would stay at 2.4% in 2019. However, after a vivid dispute with the European Commission, a deficit of 2.04% was agreed (**Table 1**). This compromise permits Italy to avert the EU excessive deficit procedure, although this would no longer enable the reduction of the debt ratio as envisaged by the Stability and Growth Pact.[1]

The compromise was eventually reached because the Italian government has curbed the three main electoral promises – citizenship income, abolishment of the pension reform and (for 2020 and 2021) safeguards on the value added tax (VAT).

In particular, despite the government assurances, there is a major gap between the agreed and potentially required funds to cover all seven million Italians potentially entitled to the "citizenship income". The budget law allocates 7.1 billion Euro to this scheme – two billion Euro less than the already tightly planned budget draft from October 2018. Moreover, of these seven billion Euro one billion Euro would be used to reinforce the job centers and 2.5 billion Euro to renew the preceding scheme of the so called inclusion income (REI, or *reddito di inclusione*). This implies that only 3.6 billion Euro could be effectively spent on specifically the citizenship income, which is far too little if all possible beneficiaries are to be reached.[2] The same holds for the years 2020 and 2021. According to the budget plan, funds would increase slightly in absolute terms to 8.1 billion Euro in 2020 and 8.3 billion in 2021, but only because funds for the period 2020-2021 are supposed to cover the whole year instead of nine month like in 2019.

The funds for the revocation of the so called "Fornero" pension reform are also being cut (or "saved", as that the measure can most probably start only in the second half of the year) by almost three billion Euro to 3.97 billion Euro in 2019. These funds are supposed to rise to 8.3 billion Euro by 2020 and 8.7 billion Euro by 2021, but would still remain far below the estimated 13 billion Euro needed to dial back the pension reform.

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[1] Tofall, N.F. (2019), „Regelbruch mit Segen der EU-Kommission", Flossbach von Storch Research Institute, Kommentar on January 4, 2019, available at https://www.flossbachvonstorch-researchinstitute.com/de/kommentare/regelbruch-mit-segen-der-eu-kommission/.

[2] In a previous note we estimate the total needs of a citizenship income for ca. 17 billion Euro, in addition to two billion Euro to strengthen the job centers. See Gehringer, A. (2018), "Italy's "government of change" and public finances out of balance", Flossbach von Storch Research Institute, Economic Policy Note 8/6/2018, available at: https://www.flossbachvonstorch-researchinstitute.com/fileadmin/user_upload/RI/Studien/files/study-180304-italys-government-of-change.pdf.

Table 1. Economic accounts of public administration in Italy, based on the adopted budget law from December 2018.

	2018	2019	2020	2021	2018	2019	2020	2021
EXPENDITURES	In billions of Euro				As a % of nominal GDP			
Consumption expenditures	312,031	316,159	319,315	318,030	17.7%	17.5%	17.2%	16.7%
Social expenditures, of which:	349,780	365,181	379,758	389,393	19.9%	20.3%	20.5%	20.5%
Pensions	269,230	278,137	290,362	289,302	15.3%	15.4%	15.6%	15.2%
Other social benefits	80,550	87,044	89,396	91,091	4.6%	4.8%	4.8%	4.8%
Other expenditures	65,630	67,662	67,638	68,055	3.7%	3.8%	3.6%	3.6%
Total current expenditures	727,440	749,002	766,711	775,477	41.3%	41.6%	41.3%	40.7%
Interest payment	64,476	66,019	69,292	72,924	3.7%	3.7%	3.7%	3.8%
Capital expenditures	54,910	54,331	62,907	63,289	3.1%	3.0%	3.4%	3.3%
Total expenditues	846,826	869,352	898,909	911,690	48.1%	48.2%	48.4%	47.9%
REVENUES								
Tax revenues, of which:	503,177	515,046	543,188	556,148	28.6%	28.6%	29.3%	29.2%
Income tax	248,960	255,083	256,277	260,042	14.1%	14.2%	13.8%	13.7%
Indirect tax	252,848	258,929	285,867	295,050	14.4%	14.4%	15.4%	15.5%
Capital tax	1,369	1,034	1,045	1,056	0.1%	0.1%	0.1%	0.1%
Social constributions	234,161	241,426	245,866	249,844	13.3%	13.4%	13.3%	13.1%
Other current revenues	73,139	72,801	72,207	73,093	4.2%	4.0%	3.9%	3.8%
Revenues in capital account	2,181	3,324	3,627	3,635	0.1%	0.2%	0.2%	0.2%
Total revenues	812,659	832,597	864,889	882,719	46.1%	46.2%	46.6%	46.4%
Balance	**-34,167**	**-36,755**	**-34,021**	**-28,970**	**-1.94%**	**-2.04%**	**-1.83%**	**-1.52%**
Nominal GDP	**1,761,208**	**1,802,525**	**1,855,483**	**1,903,388**				
Growth of nominal GDP	*2.1%*	*2.3%*	*2.9%*	*2.6%*				

Source: "Nota tecnico-illustrativa alla legge di bilancio 2019-2021", Ministero dell'Economia e delle Finanze, Dipartimento della Ragioneria generale dello Stato. Full publication available at: http://www.rgs.mef.gov.it/_Documenti/VERSIONE-I/attivita_istituzionali/formazione_e_gestione_del_bilancio/bilancio_di_previsione/bilancio_finanziario/2019-2021/LB/LB/NotaTecnico-Illustrativa_LB-2019-2021.pdf.

Finally, regarding the safeguard measures on VAT, they will not be introduced in 2019 (implying 12.5 billion Euro less revenue), but could be reintroduced in 2020 and 2021 – against the previous government's promises.

It is plausible to expect that the government will push to deliver on its electoral promises sooner than later.

These estimates should be, however, treated for what they are--namely a pie in the sky – for two main reasons. First, the implementing decrees for the planned measures must still be announced in the coming months. And since these measures are the symbol of the joint venture between the ruling parties Lega and Cinque Stelle, it is plausible to expect that the government will push to deliver them sooner than later. Second, Italy entered a recession at the end of 2018, which renders the entire government's budget planning far more complicated and less predictable.

Scenario analysis

Accounting for these uncertainties and based on the available information, we run three scenarios – 1) "benign", 2) "government +", and 3) "adverse" – on the evolution of the Italian government budget over the three-year period of the government projections between 2019 and 2021.

Scenario 1: In the "benign" scenario we assume that the government is able to deliver on the formal commitments contained in the current budget law, but unable to deliver on its electoral promises under the "contract of the 'government of change'".[3] However, we take the downward revised estimates of real GDP growth and CPI inflation of the European Commission (EC), from early February 2019.

Scenario 2: Under "government +", we take the growth forecasts of the European Commission from the benign scenario, but assume that the costs for both the citizenship income and the pension reform are underestimated.[4] We also make the plausible hypothesis that the government would not raise VAT, resulting in 12.5 billion Euro less revenues in each 2020 and 2021. It should be noted that we make conservative assumptions here, as we consider only the minimum, or flagship "adjustments" to bring the government plan more in line with the election promises. Accordingly, any further extension to this minimum would mean an even higher deficit ratio.

Scenario 3: In the adverse scenario, the Italian economy would enter a recession in 2019 (with nominal GDP growth of -1.5%, which is half the magnitude observed in 2009) and would turn back to grow moderately afterwards, in line with EC forecasts. Accordingly, following the experience of

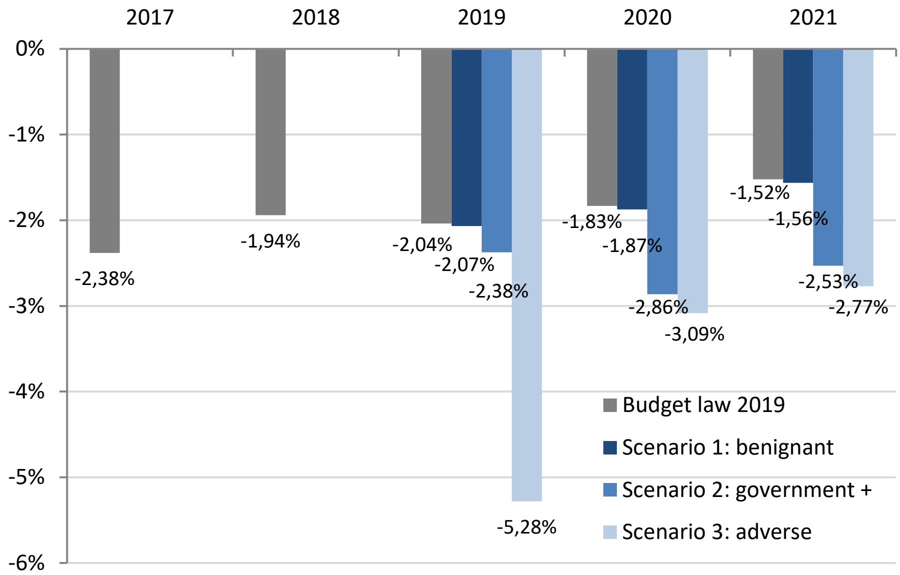
[3] Ibid.

[4] Specifically, for both citizenship income and the pension reform we add half of the gap between our previous estimates (see footnote 1 for the reference) and the government projections as of the 2019 budget law. This results in 5.5 billion Euro additional expenditures (3.5 billion Euro for citizenship income and two billion Euro for the pension reform) in each year between 2019 and 2021.

the past crises, we assume that the expenditure/GDP ratio would rise by three percentage points in each year in the period 2019-2021, compared with the ratio observed in the pre-crisis year.

Figure 1 illustrates the three scenarios and compares them with the baseline of the Italian government from the budget law. The mere slowdown in economic growth as currently predicted by the EC would not have a significant impact on the path of the deficit ratio, provided that the Italian government sticks to the numbers promised to the EC.

Figure 1. Balance of the Italian government budget as a percentage of nominal GDP according to the budget law from December 2018 and to three different scenarios



Source: "Nota tecnico-illustrativa alla legge di bilancio 2019-2021", Ministero dell'Economia e delle Finanze, Dipartimento della Ragioneria generale dello Stato. Full publication available at: http://www.rgs.mef.gov.it/_Documenti/VERSIONE-I/attivita_istituzionali/formazione_e_gestione_del_bilancio/bilancio_di_previsione/bilancio_finanziario/2019-2021/LB/LB/NotaTecnico-Illustrativa_LB-2019-2021.pdf.

For the three scenarios: own elaborations based (Flossbach von Storch Research Institute) on information provided in the "Nota tecnico-illustrativa alla legge di bilancio 2019-2021", Ministero dell'Economia e delle Finanze.

However, as argued above, this is a rather unlikely scenario, compared to the other two scenarios. Should the "government of change" enforce its most important election promises, the deficit ratio would reach 2.38% in 2019, 2.89% in 2020 and 2.53% in 2021.

Finally, in case of the assumed economic recession the deficit ratio would rise to 5.28% in 2019, before falling to 3.09% and 2.77% in the following two years.

To sum up, Rome managed to kill three birds with one stone so far. The government 1) reached a compromise with Brussels on the budget, 2) negotiated a budget deficit lying already above the limit compatible with the fiscal rules of the Stability and Growth Pact, and 3) included all the promised measures in its budget law, albeit in homeopathic doses. The way of minimal confrontation with Brussels helps Rome to save face ahead of the European elections in May 2019. But after the elections, the Italian government could use the favor of the hour and enter the next round of its budget-game. Experiences so far point to that.

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