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The Italian situation: Clarification and a prediction

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| [Alberto Alesina](http://www.voxeu.org/index.php?q=node/95) [Francesco Giavazzi](http://www.voxeu.org/index.php?q=node/103)13 September 2011, VOX.EU | [**Print**](http://www.voxeu.org/index.php?q=node/6971) [**Email**](http://www.voxeu.org/index.php?q=forward&path=node/6971)[**Comment**](http://www.voxeu.org/index.php?q=node/6971#comments) [**Republish**](http://www.voxeu.org/index.php?q=node/87) |

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| *As Italy’s Prime Minister Silvio Berlusconi announces a new austerity bill based on tax rises, this column argues that the country’s leaders are in denial – it is as if they are trying to take aspirin to hide the symptoms of pneumonia. The authors predict that, with the current political class in power, Italy will soon enter another recession and, eventually, another crisis.*Under pressure from the bond market and the European Central Bank, Italy has adopted a budget that implies a sharp shift in fiscal stance.* The primary surplus is projected to move from 0% in 2011 to close to 6% in 2014, with half of the adjustment happening next year.
* The size of the shift meets the conditions the ECB had set on 11 August 2011 in order to continue buying Italian government bonds.

The composition is, however, quite different from what the ECB suggested.* The adjustment relies almost exclusively on tax increases rather than spending cuts.
* The bill does not include pro-growth measures – deregulation, privatisations, etc – that the ECB has called for as a critical component of the policy shift.

Jean-Claude Trichet has, nonetheless, endorsed the Italian budget, thus suggesting that the ECB will continue its bond-purchase programme.New legislationTwo pieces of the new legislation could have significantly improved the quality of the package. Unfortunately they have been watered down so as to become virtually void.* The first is a provision allowing employers and employees to sign firm-level labour contracts in violation of nationwide contracts and, within some limits, also of existing labour laws.

Such contracts would only require the approval of a majority of the firms' employees. Unfortunately, at the last minute the government has surrendered to the unions, making the bill almost irrelevant. The new firm-level contracts cannot be freely negotiated by employers and employees, but will require the involvement of a nationwide union. Thus the monopoly power of national unions has been protected.* A second provision delegates the government to adopt a wide-ranging reform of Italy's welfare system.

But instead of indicating how such a reform should be designed, the bill accepts that reforming the welfare system might be impossible, and introduces a safety net. If the savings produced by the welfare reform are indeed impossible to obtain, they will be automatically replaced by cuts in tax expenditures, i.e. by an increase in the tax burden. In the past we have had several proposals of welfare reform, probably the most notable one from a commission chaired by Professor Onofri in 1997. It included several important proposals that were never implemented.Looking at what happened in Italy in the recent past is a good predictor of what may happen going forward. Italy enacted a similar policy shift in the 1990s. In the run-up to the euro, between the early 1990s and 1997, the primary surplus also increased by 6% of GDP, and also mostly through higher taxes. The lesson from that experience is not encouraging. Italy did make it into the euro, but growth slowed down – from an average of 2% in the 1990s to 1% in the following decade. Moreover, the fiscal correction did not stick. By 2005, the primary surplus had vanished.The experience of Italy in the 1990s is consistent with three lessons that we have learned from examining examples of large fiscal consolidation in OECD countries with a government sector that accounts for well over 40% of GDP:1. Only fiscal adjustments based on structural reductions in spending (as opposed to temporary cuts) can have a lasting effect on the debt-to-GDP ratio.Tax-based adjustments simply keep filling the holes in the budget opened by automatic increases in spending.2. Cuts to government spending have smaller recessionary effects than tax increases.3. To the extent that spending cuts have a negative effect of output, this can be offset by enacting structural, growth-enhancing measures.Understanding – and acting on – these lessons is more important than balancing the budget in one or two years' time. A budget-balancing act achieved in the wrong way is not sustainable and is not a good medicine. Investors understand what is happening and may offset tax increases with corresponding increases in the cost of issuing government bonds.Countries such as Ireland, Portugal, Spain and the UK have understood these lessons and are, albeit with many difficulties, trying to move in this direction. They face a few very difficult years, but growth will eventually resume with sound public finances. Italy has moved in the opposite direction. There will be costs, and these costs will be long lasting and perhaps even pointless. Growth will not resume and there is a real possibility that the budget may not be stabilised. The IMF knows the three lessons very well. This is why it predicts that the new Italian budget will slow down growth and, because of this, will fail to achieve its stated debt reduction objective.A predictionWe offer a prediction: Italy will soon enter a recession. The budget may not be balanced, but the country will be kept afloat, inside the euro, by the continuing ECB bond purchases. These purchases – like an aspirin for a patient who has pneumonia – will delude Italians that the pneumonia is gone, while it is still there.At some point, Italy will be hit by a new crisis. To avoid a default, a new government (right or left – it will make no difference) will introduce a “one shot” wealth tax, which many in Italy are advocating. This will reduce the deficit temporarily, but also growth. And so the vicious cycle will start again.It is apparent that Italy needs a “change of regime” – a package of extensive fiscal and structural reforms. Unfortunately, it is not obvious that a majority of Italians have understood that the current political class is not capable of leading the country in the right direction. |

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