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The fiscal balance dilemma of Italy: investigating economic stability and growth being put in jeopardy

Introduction

Italy's economy has contracted by about 9% since 2007. To counteract the downturn and to stimulate consumption, investment and economic growth, Italian Prime Minister Matteo Renzi has planned to include tax cuts worth 18 billion EUR in the 2015 government budget. However, the European Commission asked Italy to revise its budget plans since it misses mandated targets determined by the Stability and Growth Pact (SGP). Amid pressure from the European Commission, the budget was renegotiated, revised and has by now been accepted by the Commission. In particular, Italy agreed to additional economisation of 4.5 billion EUR which translates to about 0.3% of its GDP. Moreover, the budget deficit is now expected to reach 2.9% of GDP in 2015 which is just below what is set as maximum budget deficit in the SGP. This described clash of interests epitomises what is often referred to as 'austerity versus stimulus' debate. It will be discussed austerity measures implemented by Italy and their effectiveness to stimulate economic stability and growth. Moreover, the set-up of fiscal agreements (i.e. SGP and Fiscal Compact) and their consequences for Italy will be elaborated on. Austerity measures forced on Italy and other EU member states point at the currently dominating view in EU politics that fiscal consolidation will lead to economic growth and minimise incidents of crises. Based on this train of thought, the following research question has been formulated: "To which extent is fiscal consolidation relevant to achieve economic stability and growth in Italy in the aftermath of the economic crisis?" This research question discusses the actual relevance of a balanced budget for economic growth and stability in Italy and challenges the assumption that fiscal discipline is the key factor in order to avoid crises and to reach economic growth. The underlying methodology of this paper is as follows: The analysis will be executed by means of a case study and investigate to which extent fiscal consolidation contributes to economic stability and whether austerity measures as implemented in Italy are proportional, that is, the least harmful way to restore confidence in the Italian economy. To this end, the paper analyses qu-

antitative data on budget deficits and public debts from Italy and other EU member states in order to examine whether those countries' economic performance before and during the crisis fits the assumptions on which SGP and Fiscal Compact are based. This research project will make use of quantitative data provided by Eurostat and draw on previous research in order to strengthen the findings of this analysis. There are numerous scholars who have discussed fiscal discipline in the eurozone and their findings contribute substantially to this paper. However, few scholars have focused on investigating other factors of the economic crises. This is due to and in line with the alleged importance of fiscal discipline. Consequently, the analysis will allow an assessment of whether the concept of fiscal consolidation helps avoiding crises and restoring confidence in markets and whether form, scope and timing of current austerity measures in Italy contribute to boost its economy.

1. Backgrund

Traditionally speaking, monetary policy and fiscal policy are countries' main instruments to steer their economies. Monetary policy refers to actions of a country's central bank to adjust the amount of money supplied. As member of the eurozone, however, Italy has delegated this instrument to the European Central Bank. Consequently, the only remaining policy tool is fiscal policy, which is associated with two major limitations though: Firstly, fiscal policy is "more difficult to activate and less reliable than monetary policy"[1]; secondly, leeway for Italy with respect to fiscal policy is fairly limited too, since Italy needs to adhere to its commitments under the SGP and Fiscal Compact, two legal instruments within the EU. These two instruments aim to achieve fiscal stability and it is worth noting that coordinated fiscal policy can be considered essential in an economic and monetary union like the eurozone. This is because "fiscal policy actions by one country may spill over to other countries through a variety of channels"[2] such as spending, income, and borrowing costs. These spillovers may either help or hurt partner countries. Caporale & Girardi (2011) found that "negative externalities imposed by fiscal imbalances in Italy and in the peripheral countries can result in possible crowding out effects in all other countries/regions where the real interest rates would otherwise be lower"[3]. On the other hand, fiscal policy coordination in the EU is essential but potentially reduces member states' sovereignty. With the

[1] C. Wyplosz, R. Baldwin, *The economics of European integration*, 3 ed., McGraw-Hill Higher Education, London 2009, s. 520.

[2] *Ibidem*, s. 524.

[3] A. Girardi, G. Caporale, *Fiscal spillovers in the euro area*, „Journal of International Money and Finance" 2011, nr 1164, s. 18.

outbreak of the eurocrisis and after the magnitude of the economic and financial problems of some EU member states, especially PIIGSs (Portugal, Italy, Ireland, Greece, Spain), have become apparent, politicians and economists alike apprehended a domino-effect which would bring national economies all over Europe to fall. As a consequence, numerous multi-billion bailout packages have been allocated in order to rescue countries from defaulting on their debts. In 2010, Greece was the first country to be bailed out with a 110 billion EUR rescue package. Virtually no stone has been left unturned to circumvent its default. This is especially interesting because the Greek economy accounted for only 1.8% of EU-GDP before the outbreak of the crisis. The Irish and Portuguese economies were even smaller but both countries have received bail-out packages too. Given these numbers, one could assume that each of these countries had a rather limited effect on economic growth and stability of the entire EU. Against this background it is worth noting that Italy's economy is the fourth biggest in the EU and accounts for as much as 12.5% of EU-GDP[4] whilst exhibiting unsustainable debt levels, high unemployment and declining GDP. One can only imagine the impact on other EU member states and the Euro as a currency if Italy defaulted on its debts. Whilst there has been much effort at the European level to stabilise Italy's economy, it is still performing poorly. In June 2010, an austerity package worth 25 billion EUR has passed Italy's parliament. No later than September 2011, Italy's parliament has agreed on a second austerity package worth 124 billion EUR[5]. These measures were vital to prevent Italy from defaulting on its debts, however, the extent and timing has been determined in order to comply with the SGP and Fiscal Compact. The following will discuss both SGP and Fiscal Compact separately.

2. SGP and Fiscal Compact

SGP and Fiscal Compact focus on fiscal consolidation and reduction of debts. The SGP is a rule-based framework to maintain fiscal stability and to coordinate fiscal policies in the European Union. It forbids EU member states to run fiscal deficits of more than 3% of GDP or to accumulate public debts of more than 60% of GDP[6]. The SGP contains a preventive arm (i.e. country-specific medium-term budgetary objectives) and a corrective arm (i.e. the Excessive Deficit Procedure). Article 121 and Article 126 TFEU provide the legal basis of the SGP and non-

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4 http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00001&plugin=1.

5 http://blogs.cfainstitute.org/investor/2011/11/21/european-sovereign-debt-crisis-overview-analysis-and-timeline-of-major-events/.

6 http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

compliance may lead to sanctions. The Fiscal Compact (2013) is the fiscal part of the Treaty on Stability, Coordination and Governance (TSCG) and is operating parallel to the SGP, complements it and adds more stringent rules in some respects. One of the key points of the Fiscal Compact is that member states' structural deficit should be no more than 0.5% of GDP or 1% for member states whose debt-to-GDP ratio is significantly below 60%. In contrast to actual or current deficit, structural deficit takes out effects of faster or slower economic growth[7]. The rationale behind both SGP and Fiscal Compact is that if budget deficits or public debt become unsustainable, investors refrain from investments in the country and it will subsequently run out of money. Such a scenario would be particularly dangerous in the eurozone, since problems in one country may evoke negative spillovers to other eurozone member states. Therefore, fiscal discipline is considered inevitable and assumed to restore confidence in the country and attract (foreign) investment. This in turn is expected increase consumption and wealth.

3. Empirical analysis

From the previous chapter it can be learnt that fiscal discipline stands at the core of both SGP and Fiscal Compact. If fiscal discipline was the key to avoiding an economic crisis, then those countries which had a large budget deficit prior to the crisis would be expected to have exhibited worse economic downturns compared to countries with smaller deficits. The following will investigate whether this holds true. Figure 1 shows the government deficit and surplus for selected European Union member states.

It can be seen that Spain (2004–2007) and Ireland (2002–2007) exhibited budget surpluses; however, they have been hit very hard by the crisis. By contrast, Germany, France and the United Kingdom had been running large deficits for years, yet, they exhibited a less profound recession than Spain and Ireland, for instance. In fact, it is only the case of Greece which supports the conception that a causal link between budget deficits and crises exists.

A tentative conclusion therefore is, that if such a causal link exists, it seems to be far from strong as it could only be observed in the case of Greece. Nonetheless, austerity measures imposed on Italy are based on SGP and Fiscal Compact which in turn assume such a causal link to be quite strong. These findings unveil that a balanced budget is not decisive to avoid crises, let alone that it stimulates economic growth.

[7] *Ibidem*.

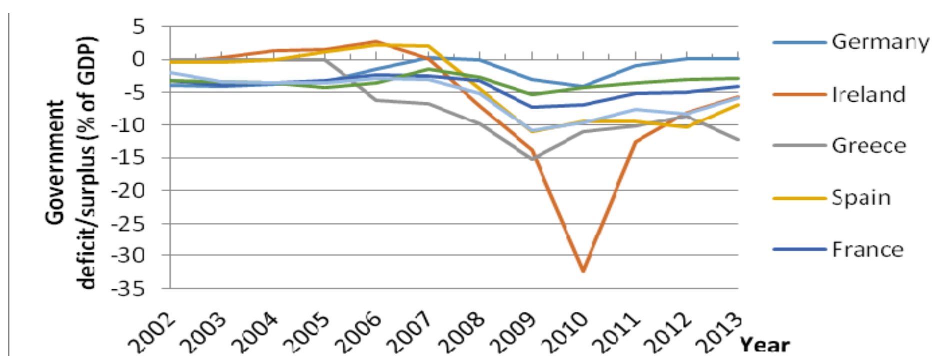

Figure 1. Government deficit/surplus (% of GDP), 2002–2013

Source: Own elaboration based on Eurostat (2014b), *General government deficit/surplus,* retrieved from http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00127&plugin=1.

In fact, fiscal consolidation is strongly related to higher unemployment and reduced output in the short-run. Fiscal consolidation equal to 1% of GDP typically reduces GDP by about 0.5%, raises the unemployment rate by 0.3%, and results in a decrease in domestic demand by 1%[8]. The tentative conclusion that output crises are not significantly associated with a balanced budget has also been confirmed by other scholars who found that banking sector vulnerability and private sector deficits were a more significant cause of the current crisis[9]. Having discussed the role of budget deficits, the following will address government gross debts, another key aspect of the SGP.

Figure 2 shows government gross debts in selected countries.

At first sight, the assumption that debts and the likelihood and intensity of crises are causally related seems to be confirmed. However, a closer look qualifies this and allows for the conclusion that the relationship is not as strong and obvious as claimed by many politicians and scholars. The first striking finding is that Belgium and the United Kingdom both have and had very high debt levels; yet, they have overcome the crisis quite well. Remarkably, their debt levels in 2009 were higher than those of Ireland and Spain. Related to this, the second point worth mentioning is that Irish and Spanish debt levels were considerably below EU-average before the outbreak of the crisis. This finding suggests that high levels of government debt are not necessarily a decisive cause of crises either. Similarly, a country may experience severe economic recessions even if its debt levels are moderate. Generally speaking, the ongoing economic downturn in Italy

[8] D. Leigh, P. Devries, C. Freedman, J. Guajardo, D. Laxton, A, Pescatori, *Will it hurt? Macroeconomic effects of fiscal consolidation*, „World Economic Outlook" 2010, s. 94.

[9] A. Mandilaras, G. Bird, *Will Europe's fiscal compact help avoid future economic crises?*, „Discussion Papers in Economics" 2012, nr 12, s. 13.

is a strong case against the contention that fiscal discipline is an effective measure to boost the economy. In fact, it has been found that three-year successive consolidations in Italy will have negative effects on GDP for the Italian economy for at least eight years[10].

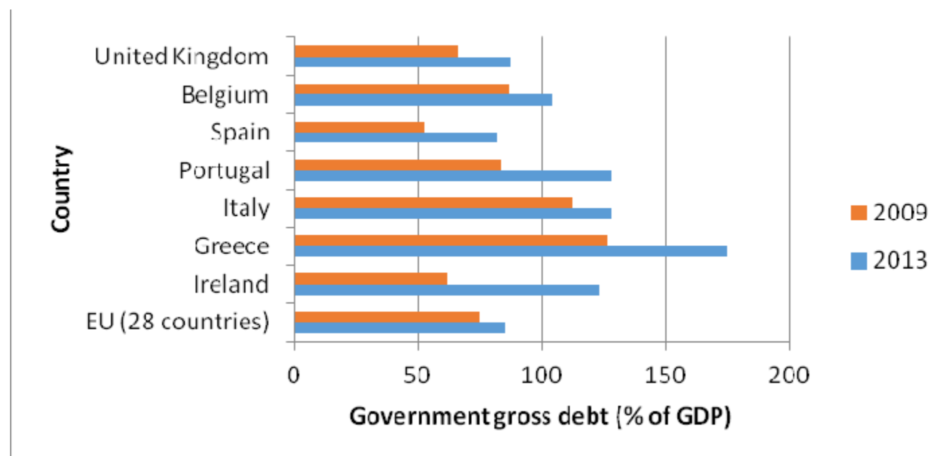

Figure 2. Government gross debt (% of GDP), 2009 & 2013

Source: Own elaboration based on Eurostat (2014c), *General government gross debt*, retrieved from http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tsdde410&plugin=1.

Furthermore, negative consolidation spillovers to other eurozone countries are expected to last three to four years and can be considerably higher if several countries introduce fiscal consolidation programmes simultaneously[11]. This holds especially true if those countries are open to trade among each other and use the same currency. In addition to that, it has been found that negative effects of fiscal consolidation are more pronounced if austerity measures are introduced at the same time across several countries and if monetary policies cannot equalise them[12]. Strikingly, these two conditions are met for the case of Italy: Firstly, the SGP and Fiscal Compact apply to all eurozone members and many are currently undergoing severe austerity measures. Secondly, Italy cannot carry out an independent monetary policy since this is responsibility of the European Central Bank.

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[10] J. Veld, *Fiscal consolidations and spillovers in the Euro Area periphery and core*, „European Economy: Economic Papers" 2013, nr 506, s. 6.

[11] *Ibidem*, s. 9.

[12] D. Leigh et al, *Will it hurt? Macroeconomic effects of fiscal consolidation*, „World Economic Outlook" 2010.

After having refuted that government debts and budget deficits are decisive to avoid crises, it is worth investigating alternative factors which influence economic performance. De Grauwe & Ji (2012) highlighted that foreign debts, similar to spreads in government bond rates, increase the default risk of the public and private sector[13]. In a similar vein, Lane (2012) argues that while current account deficits are not bad in themselves, they may turn out to be harmful and increase the likelihood of a crisis if expenditure and capital flows are concentrated in sectors with little potential productivity growth (real estate, e.g.) instead of in sectors with more scope for economic productivity growth[14]. This is also supported by the analysis of this chapter. Importantly, it does not claim that foreign debt or current account deficits are most dominant factor to economic growth and that fiscal discipline should be neglected. Instead, it proposes including factors other than fiscal deficits and government debts in order to overcome the bias in this discussion. Shifting emphasis to these alternative factors is especially valuable and goal oriented since adjusting current account imbalances is substantially less painful and has less negative side effects than austerity measures. Therefore, including foreign debt and current account imbalances into the discussion at the political and scientific level stands to reason. Whilst the aggregate current account of the eurozone is roughly balanced, there are large differences between countries, i.e. there is a current account deficit of southern European countries vis-à-vis northern European countries. It is important to recognise that "persistent deficits led to a massive accumulation of foreign debt and raised concerns into the creditworthiness"[15] of affected countries.

Conclusions

This paper has challenged the assumption that fiscal consolidation and discipline in Italy guarantees future economic stability and growth. In order to investigate this, the paper has drawn on previous scholars as well as quantitative data from Eurostat. It has been found that fiscal consolidation is necessary for Italy; however, it has also been found that the SGP and Fiscal Compact have their flaws. Moreover, it has been provided a strong case against the general assumption that only fiscal consolidation can avoid or at least decrease the likelihood of future crises. Importantly, this paper does not argue in favour of unsustainable

[13] P. De Grauwe, Y. Ji, *Mispricing of sovereign debt and multiple equilibria in the Eurozone,* „Centre for European Policy Studies" 2012, nr 361, *s*. 4.

[14] P. Lane, *The European sovereign debt crisis,* „The Journal of Economic Perspectives" 2012, nr 26(3), s. 52.

[15] A. Belke, C. Dreger, *Current account imbalances in the Euro Area: Catching up or competitiveness*?, „Econpapers" 2011, nr 1106, s. 3.

investment and expenditure, nor does it discredit SGP and Fiscal Compact as such. By contrast, this paper would like to reiterate that these instruments are vital to ensure fiscal discipline in the EU and eurozone. However, the timing and intensity of austerity measures seems to be inappropriate. Therefore, it is questionable whether the current policy path will contribute to future economic growth in Italy.

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Summary

In the course of the economic crisis a number of austerity measures have been implemented in Italy in order to comply with requirements under the Stability and Growth Pact (SGP) and Fiscal Compact. These austerity measures are in line with the currently dominating perception in EU politics that fiscal consolidation is decisive in order to restore confidence in the markets and to help affected countries overcome the economic crisis. It was taken a close look at the costs and benefits of austerity measures in Italy and investigates their impact on the Italian economy. Using quantitative data from Eurostat it is also analysed whether a balanced budget and low levels of government debt are the keys to long-term economic stability and growth. The analysis finds that this perception is biased and neglects factors like foreign debt and current account deficits. Since the austerity measures had to be implemented in order to comply with SGP and Fiscal Compact, these two legal fiscal agreements have been described to. Moreover, it was examined whether the implemented austerity measures are effective and the least harmful way to stimulate economic growth in the long run. One the one hand, this paper shows that SGP and Fiscal Compact are vital tools to the survival of the eurozone. However, it has also emphasised that timing and severity of austerity measures is not based on a rational decision making process and that current austerity measures in Italy are therefore likely to impede economic growth rather than boosting it.

Keywords: Italy, austerity measures, fiscal consolidation, Stability and Growth Pact, Fiscal Compact

DYLEMATY RÓWNOWAGI FISKALNEJ WE WŁOSZECH: STABILNOŚĆ EKONOMICZNA I WZROST W WARUNKACH NIEPEWNOŚCI

Streszczenie

W związku z kryzysem gospodarczym Włochy zostały zmuszone do wdrożenia drakońskich środków oszczędnościowych, aby sprostać wymaganiom Paktu Stabilności i Wzrostu (PSiW) oraz Paktu Fiskalnego (PF). Zgodnie z przeważającym poglądem w doktrynie tylko konsolidacja była w stanie odzyskać zaufanie rynków i pomóc dotkniętym kryzysem państwom w jego pokonaniu. W związku z tym publikacja dotyczy analizy korzyści i strat związanych z zastosowaniem środków oszczędnościowych we Włoszech i ich wpływie na włoską gospodarkę. Dodatkowo przytoczono argumenty przeciwko przeważającemu poglądowi doktryny, iż zrównoważony budżet jest kluczem do długoterminowej gospodarczej stabilności i wzrostu. Stwierdza się, że ten pogląd zniekształca czynniki, takie jak dług zewnętrzny i negatywny rachunek bieżącego rachunku płatniczego. Ponieważ środki oszczędnościowe zostały wprowadzone w celu spełnienia wymagań PSiW oraz PF, publikacja opisuje obydwa pakty finansowe, z uwzględnieniem ich efektywnych bodźców długoterminowych. Z jednej strony publikacja wykazała dla PSiW i PF istotne mechanizmy dla przetrwania strefy euro, z drugiej podkreśliła, że termin i siła oddziaływania środków oszczędnościowych nie bazowały na racjonalnym procesie podejmowania decyzji, skutkując zatrzymaniem wzrostu gospodarczego.