Social Europe

Italy 2017: Back To Austerity

by Marcello Minenna on 19 January 2017

The political turmoil that followed the Renzi government's resignation after the results of Italy's referendum on constitutional reforms, the hurried appointment of the new executive and the endless emergency of Monte dei Paschi overshadowed the letter that the European Commission sent on December 5th to the outgoing administration. In concise terms, the letter confirmed what was already in the air: a significant gap between the deficit numbers in Italy's budget plan for 2017 and those envisaged under the Fiscal Compact rules. The EU required 1.1 points of GDP in additional financial effort, around €16 billion; that figure arises from the difference between the structural deficit targeted by the government (-0.5%) and the +0.6% calculated by Brussels bureaucrats via a very strict application of the rules.

That strict request has since been relaxed by pointing, informally, to some flexibility: the Commission could allow an additional 0.3% owing to the migration crisis and natural disasters and a 0.5% in a somewhat arbitrary "tolerance". The not so subtle message sent to the incoming government was that, at least on a 0.3% correction (€4bn more or less), the Commission was unwilling to negotiate. Hence the Gentiloni government has come into being already burdened by several urgent issues. With all due respect to the objective of greater job creation and growth set out in his inaugural address, Gentiloni will need to find a way to fill the budget gap, immediately after saving the banking system. This could happen as soon as next month. The last minute rumors in Italian newspapers indeed confirm that the negotiations with the EU about the additional measures have already begun.

The Commission also suggested some "preferred" ways to collect the extra revenues: extraordinary spending cuts, or one-off measures ("windfall measures") that have the ominous flavor of taxes on financial or real estate wealth. Much of this role-playing on the need for a series of corrective maneuvers had already been seen at the end of 2014. Then a stronger than expected GDP growth pulled the Renzi government out of trouble. But it could be different this time.

Realistically, it would be difficult for a weak and temporary Gentiloni government to impose unpopular fiscal measures such as a wealth tax. However, it might be easier to reactivate some of the safeguard clauses neutralized by the 2017 budget law. Introduced gradually by previous governments, these clauses impose automatic VAT increases in case of a significant deviation from the deficit objectives. An elementary accounting exercise shows that an increase in the reduced VAT rate (that applies on a limited class of goods) from 10% to 13% could free up to € 6.5bn, a sum well above the Commission's informal demand.

Given it would be merely a partial advance (maybe to April) of a future tax raise to be implemented in 2018, this decision could come at the least political cost. Moreover, given the recent positive boost for GDP (+0.3% in Q3 2016) and industrial production (+0.7% month on month in November), this limited VAT increase could go largely unnoticed.

Of course, negative effects on private consumption and GDP are likely, but not that early. The empirical evidence of recent increases (09/2011 and 10/2013) shows that the VAT increase should not impact private consumption immediately but with a lag of 7-8 months, a timespan that could be well beyond the expected survival of both government and Parliament. Obviously, this makes the measure more attractive from a political point of view.

However, the general VAT rate is expected to follow a two-step increase in 2018-2019 from the present 22% to a whopping 27%, the highest rate in the European Union (shared with Hungary), due to the implementation of the debt brake rule (a compulsory reduction in public debt to the extent of 1/20 at year). This would imply a very restrictive fiscal stance that signals trouble ahead for the Italian economy.

The hard facts say that the major part of the fiscal adjustment requested for 2015-2019 has been unloaded on the final years, 2018 and 2019, now fast approaching. Italy's primary surplus should increase from 1.5% in 2016 (one of the highest in the entire Eurozone, apart from Germany's) to 3.2% in 2019 and should stabilize at that level for the foreseeable future. This will translate into €23bn of additional taxes, of which €19bn will be collected as soon as next year.

It would be wishful thinking to imagine that economic growth will not be affected by such a substantial increase in the tax burden. Moreover, the macro-economic scenario of the end of 2017 will probably be characterized by higher interest rates given the presumed end of the ECB's *Quantitative Easing*. Hence Italy will be trapped in an unfavorable scenario in which both fiscal and monetary policy works against economic recovery – a restrictive stance never experienced even under the austerity regime of Mario Monti.

It is self-evident that the Fiscal Compact is an accounting nightmare for the Italian economy. From a political perspective, the Italian government can indeed have something to say. In July 2017 the European Parliament will vote for the integration of the Fiscal Compact into secondary EU law. This will mean a status change from an inter-governmental treaty to EU internal law, after an overall assessment of experience so far. Certainly, it would be a significant chance to discuss and redefine the binding rules on debt and deficit in a more flexible way.

But it’s hard to imagine that a Parliament where Germany and the other core countries (Austria, the Netherlands and Finland) all support the Fiscal Compact in its current form could radically modify the Treaty. Other Eurozone members that have ratified the Treaty have transposed it into ordinary law rather than the constitution like Italy and Germany: much easier to modify. Even if Italy were able to re-negotiate a Fiscal Compact with a “human touch”, it would be difficult for future governments to by-pass the constitutional obligation to a balanced budget.

The Italian economy appears on a headlong course for another phase of austerity and hardships. A new, austerity-induced recession at the gates of the new election cycle could push the anti-euro political forces to unprecedented and dangerous heights, with incalculable consequences for the long-term future of the Eurozone – or even its short-term stability.