

# Fiscal Constitution and Public Spending in Italy

**Lorenzo Codogno**

London School of Economics

[L.Codogno@lse.ac.uk](mailto:L.Codogno@lse.ac.uk)



Lorenzo Codogno Macro Advisors Ltd

Founder and Chief Economist

## Fiscal Constitutions and Public Spending in International Perspective

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## Fiscal Constitution and Public Spending in Italy

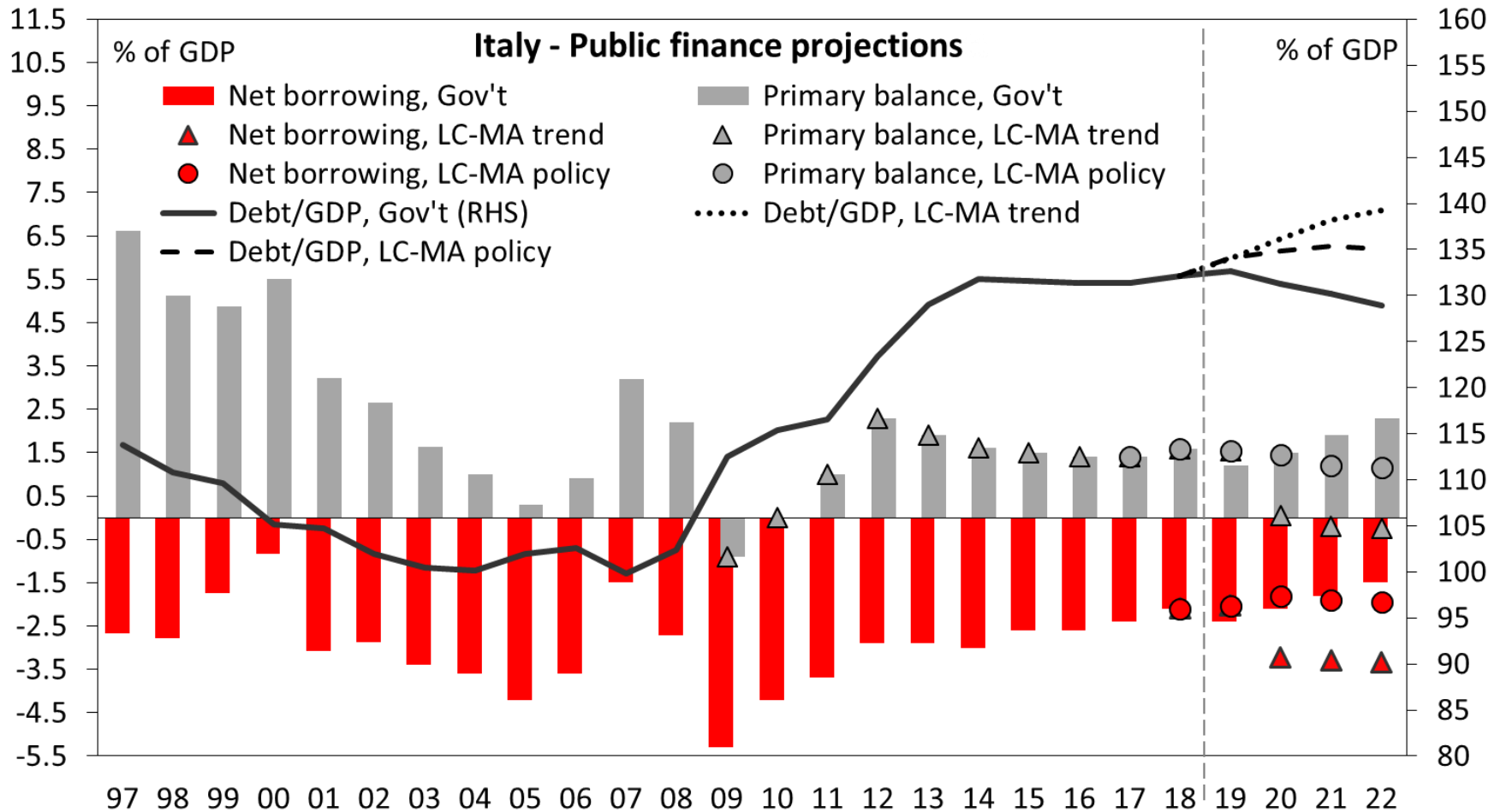
Arenas	Rules and Conventions	
	Formal	Informal
'Political'	<p>(1)</p> <p><b>Example:</b> legal/statutory procedures for Parliamentary or Cabinet approval of budgets and spending estimates</p>	<p>(2)</p> <p><b>Example:</b> personal relationships (cooperative or otherwise) between Prime Minister and Chancellor (Finance Minister) over public spending</p>
'Bureaucratic'	<p>(3)</p> <p><b>Example:</b> official procedures for reporting, monitoring and approving items of spending</p>	<p>(4)</p> <p><b>Example:</b> personal relationships (cooperative or otherwise) between budget monitors and spending departments</p>

## Fundamental design of fiscal Constitution: Italy and the EU

- ◆ **Political and formal:** Italy's fiscal constitution is embedded into the EU fiscal framework. Domestic rules and procedures relatively robust.
- ◆ **Political and informal:** Difficult to analyse and draw conclusions. Every spending item has its own interest group behind. Some evidence of electoral cycles. The role of tax expenditures.
- ◆ **Bureaucratic and formal:** Overregulation, too detailed legislation, lack of budgetary responsibility at civil servant level. Tradeoffs between control and efficiency.
- ◆ **Bureaucratic and informal:** Very little evidence. Performance budgeting and benchmarking was introduced 10 years ago, but implementation is lacking.

## ITALY' PUBLIC FINANCES AT A GLANCE

# Worrying debt dynamics following the crisis

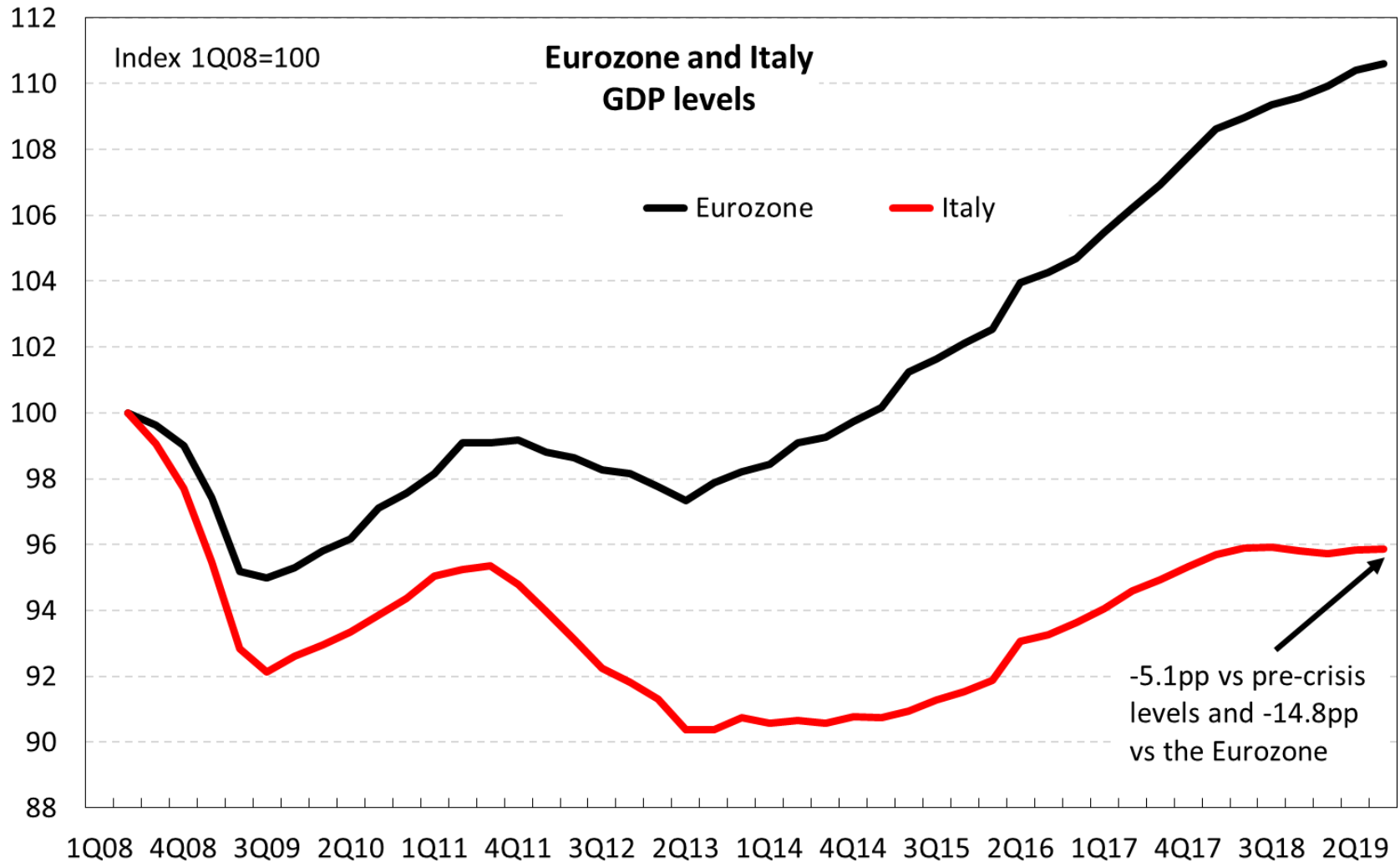


Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculations.

Notes: Gov't = April's DEF, policy = policy scenario, trend = no policy change scenario, Debt/GDP on the right-hand scale.

## ITALY' PUBLIC FINANCES AT A GLANCE

# Debt dynamics boosted by lower GDP growth, not spending



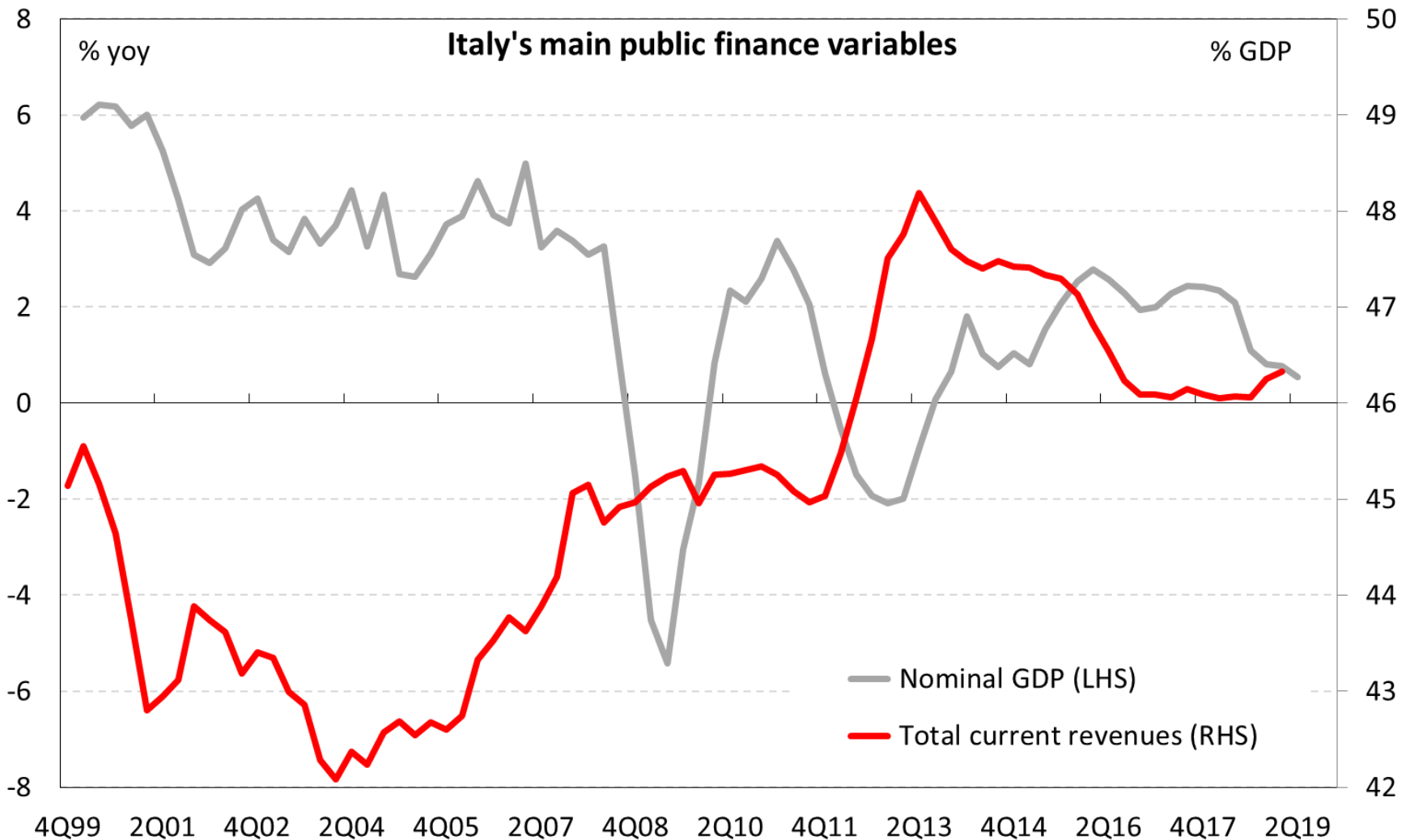
Source: Eurostat, ISTAT, Thomson Reuters Datastream, LC-MA calculations.

## Key features of public spending in Italy

- ◆ **Primary spending** level is average by Eurozone standards, but it is heavily biased towards social benefits, especially **pension spending**. Wide divergence in regional spending and efficiency (Title V).
- ◆ A sizeable chunk of overall spending is sucked by the large **debt servicing burden**, despite the low interest rate environment.
- ◆ **Underspending** is particularly significant in **education**, making for the **highest elderly bias** in the EU (after Greece).
- ◆ Large divergence in **wages** among public sector workers. Significant reduction in public employment and **total wage expenditure** (post-crisis wage freeze lasted 8 years) over the years.
- ◆ The past rapid increase in current spending and constraints in cutting expenditure during the crisis has crowded **capital spending**.

## ITALY' PUBLIC FINANCES AT A GLANCE

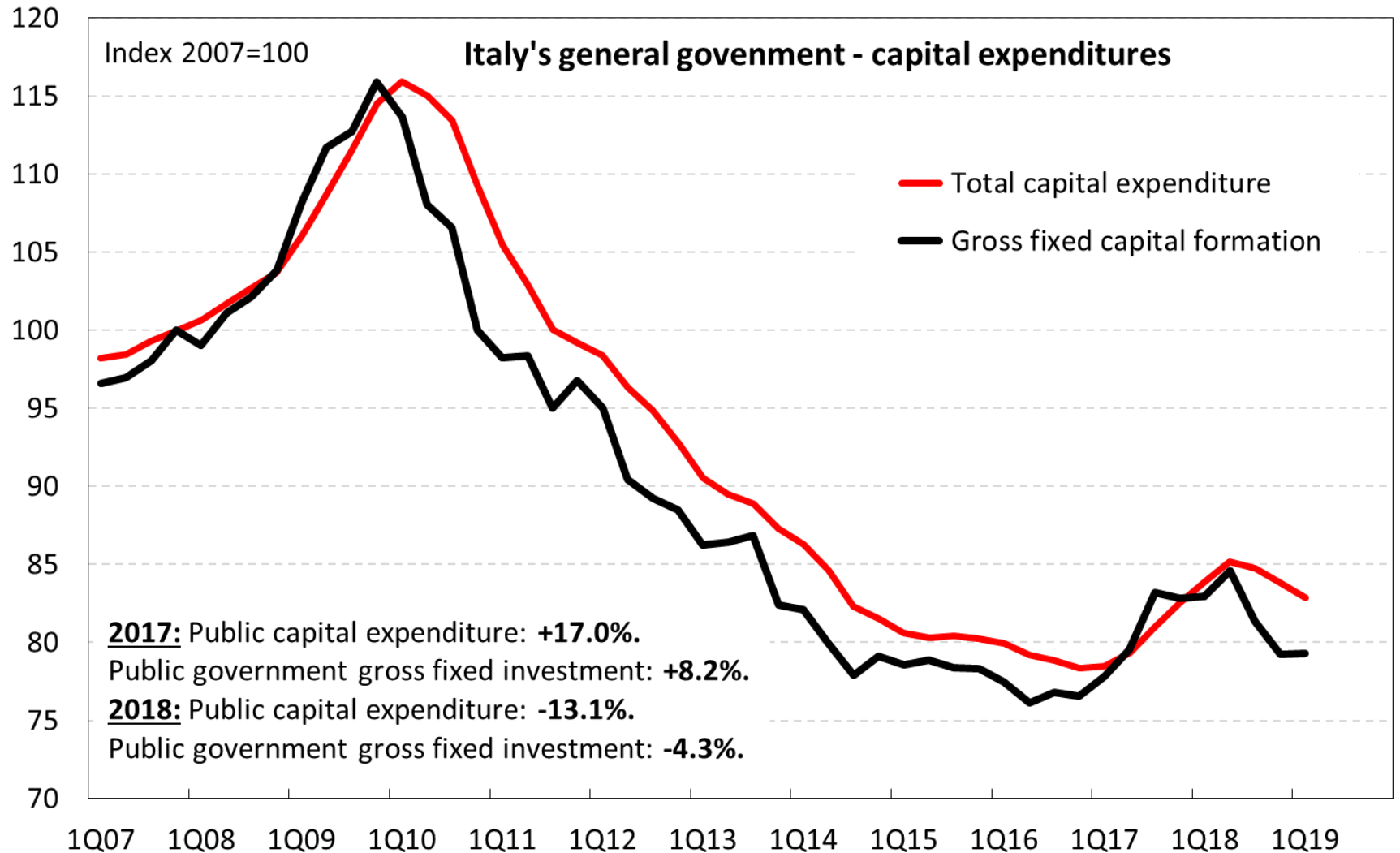
# 2011-12 fiscal adjustment mostly through higher revenues



Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data. GDP

## ITALY' PUBLIC FINANCES AT A GLANCE

# Public investment collapsed

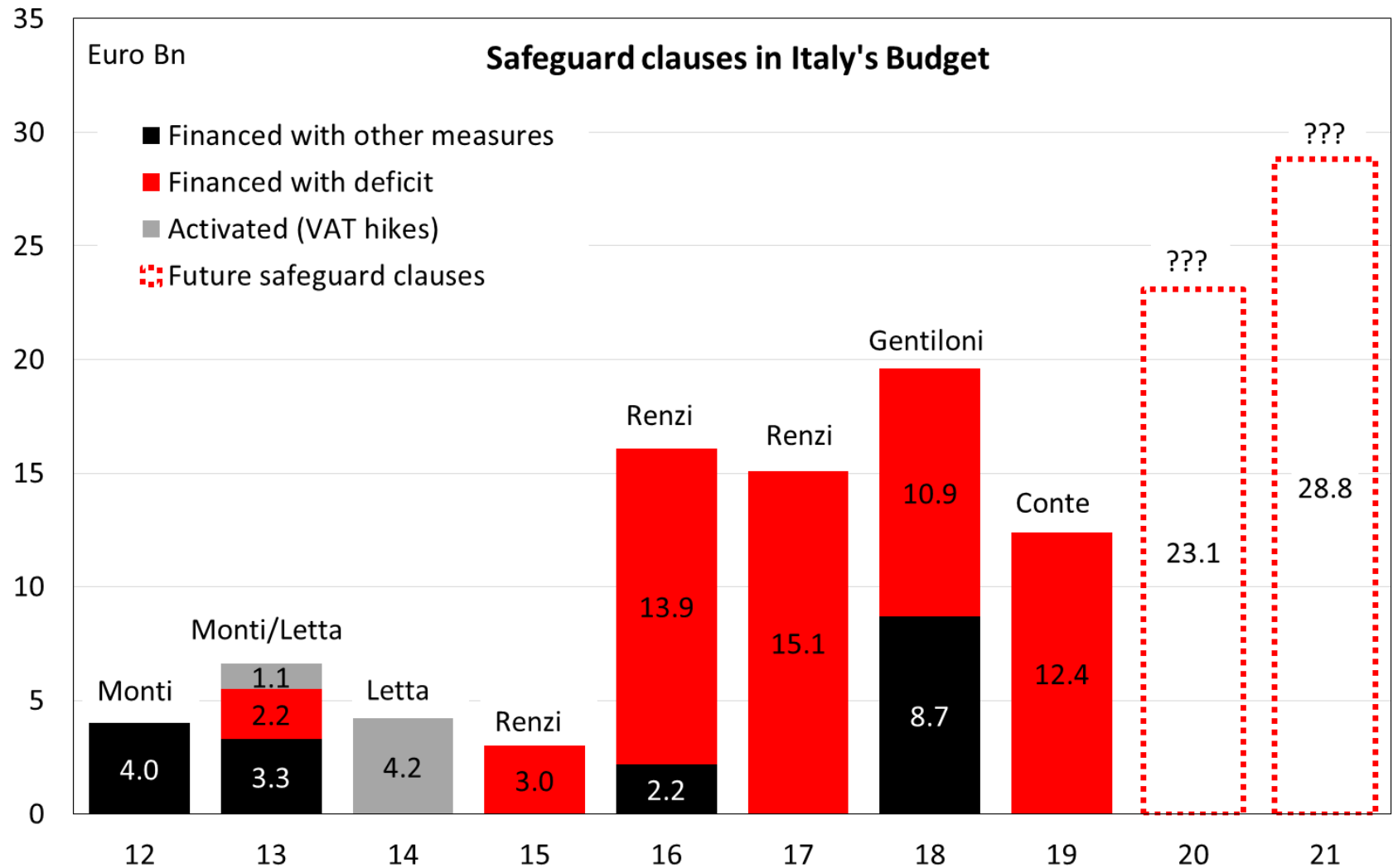


Source: TR Datastream, ISTAT, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.



## ITALY' PUBLIC FINANCES AT A GLANCE

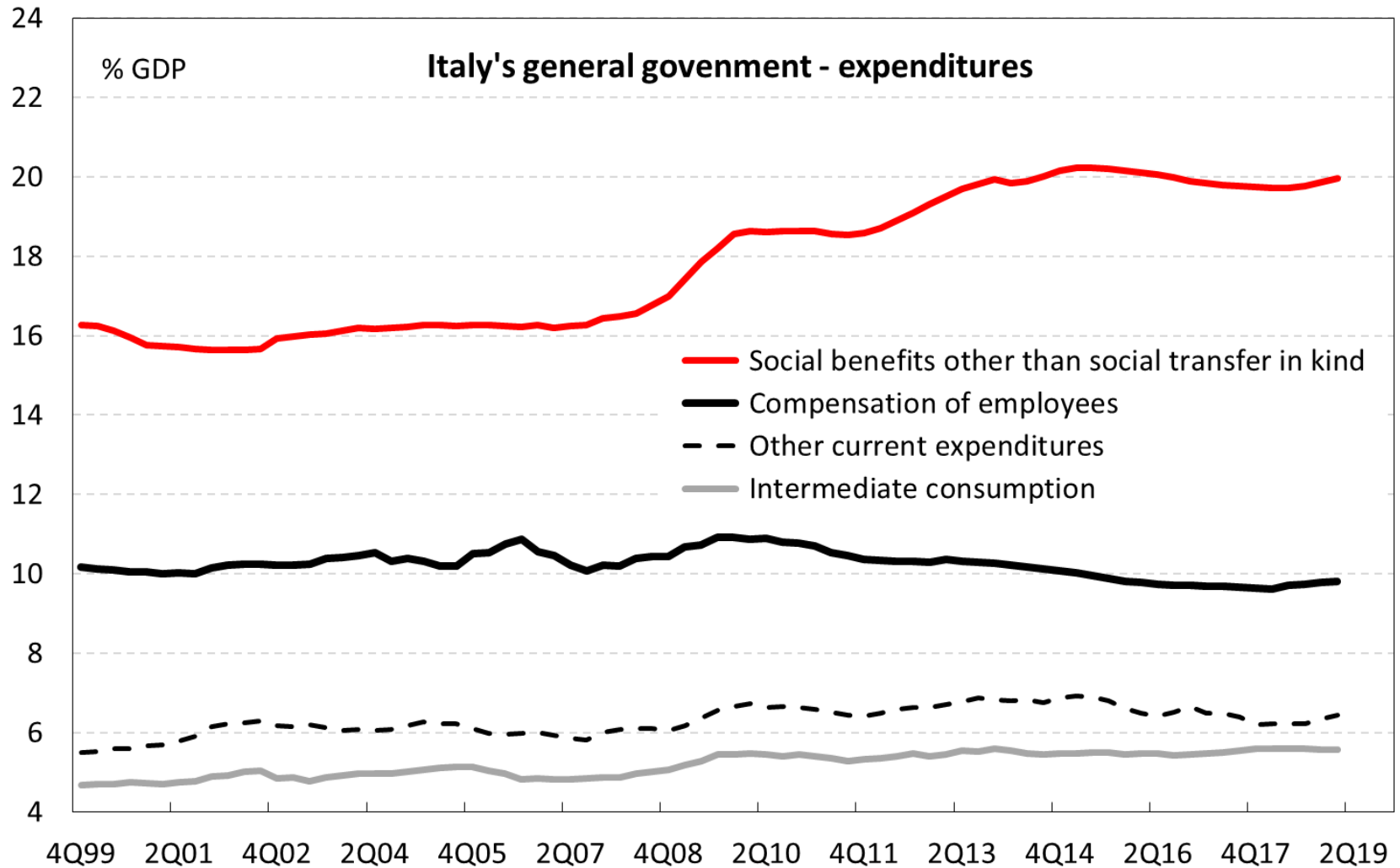
# Safeguard clauses to gain time for cuts in current spending



Source: Italian Ministry of Economy and Finance, Confindustria, LC-MA calculations.

## ITALY' PUBLIC FINANCES AT A GLANCE

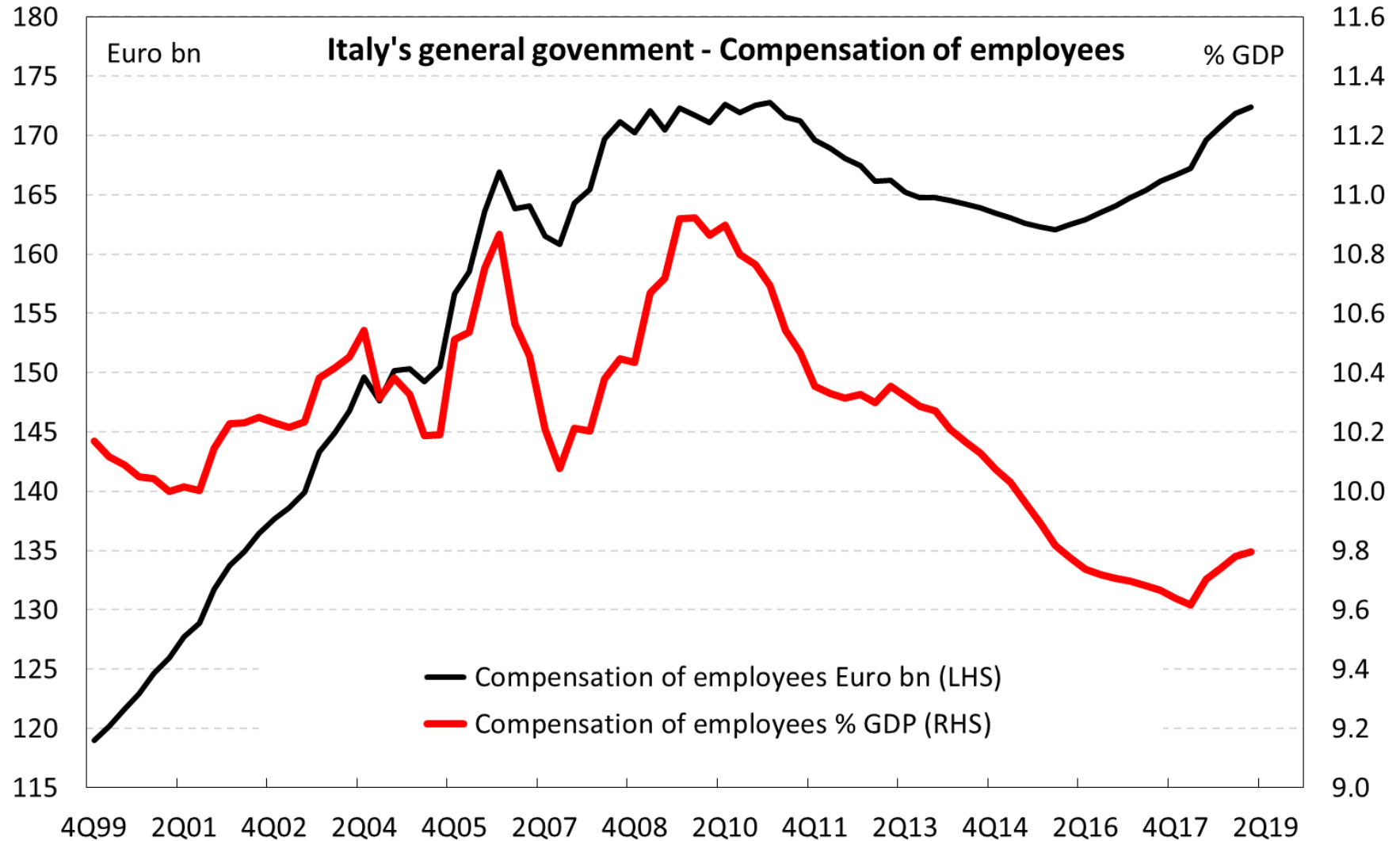
# Jump in pension spending as % of GDP



Source: TR Datastream, Italy's Ministry of Economy and Finance, LC-MA; four-term moving average of quarterly data.

## ITALY' PUBLIC FINANCES AT A GLANCE

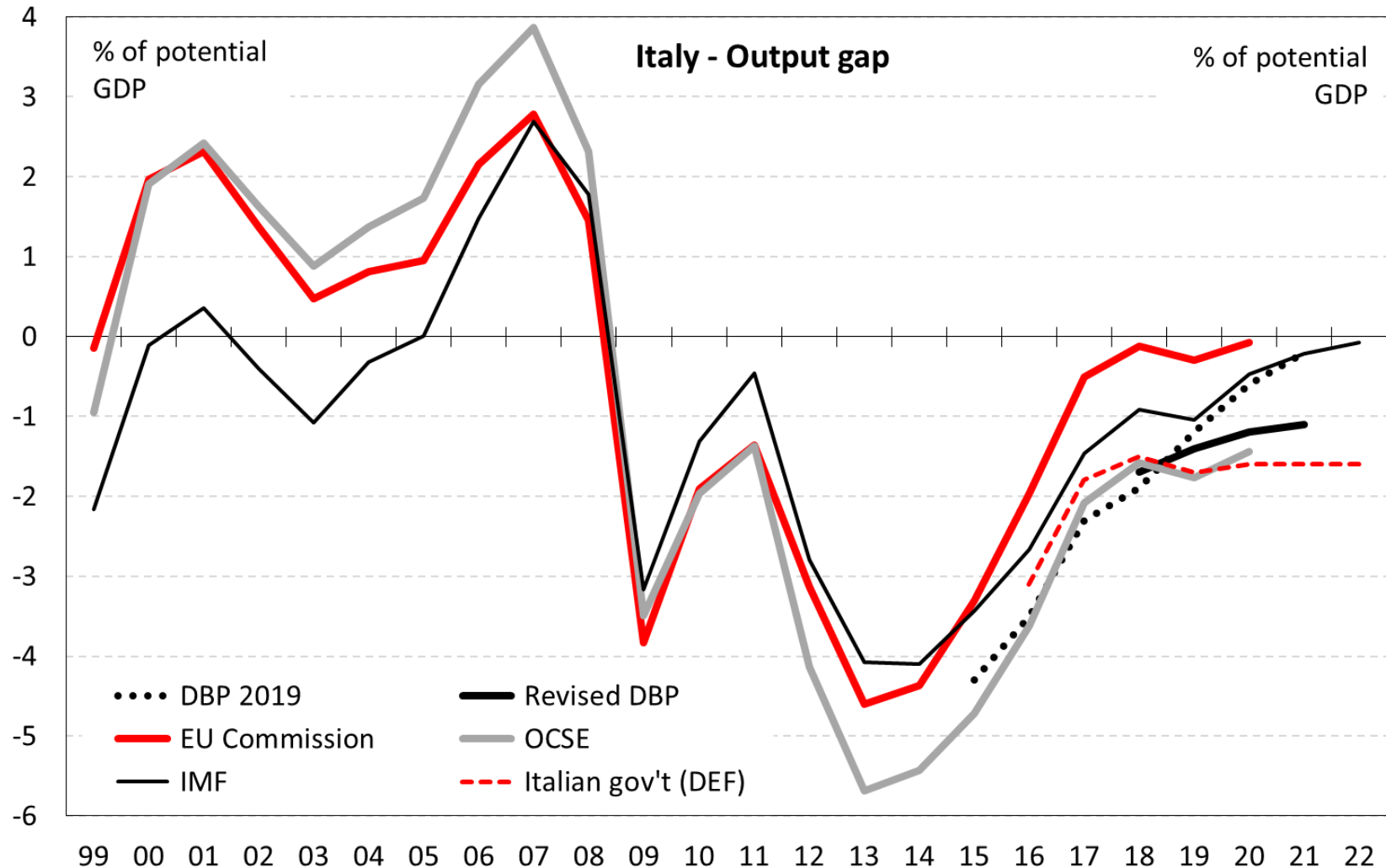
# Compensation to public sector employees declined



Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, LC-MA calculatons; 4-term moving average.

## ITALY' PUBLIC FINANCES AT A GLANCE

# Spending trends affected by uncertainty on the output gap



Source: TR Datastream, Italian Ministry of Economy and Finance, IMF, OECD and EU Commission, LC-MA calculations.

## The Stability and Growth Pact and the Six-Pack

- ◆ The Stability and Growth Pact (SGP) is a **set of rules** for the coordination of national fiscal policies in the EU. It contains two arms: **the preventive and the corrective arm**.
- ◆ The preventive arm seeks to ensure **sustainable fiscal policies over the economic cycle** through the achievement of the medium-term budgetary objective, which is individual for each member state.
- ◆ The corrective arm seeks to ensure that EU countries take **corrective action** if their national budget deficit or public debt exceeds the Treaty reference values of 3% and 60% of GDP respectively.
- ◆ The **'Six-pack'** (2011) strengthened the rules of the SGP and their application. It added the **expenditure benchmark** in the assessment of countries' fiscal positions and required new minimum standards for **national budgetary frameworks**.

## The preventive arm of the SGP is based on two pillars

- ◆ The first one is the country-specific **Medium-Term Objectives (MTO)** defined in terms of structural deficit, so as to take into account economic cyclical fluctuations (lower fiscal correction in bad times and higher efforts in good times). Member States should ensure an yearly adjustment of **at least 0.5pp of GDP** towards their MTO.
- ◆ The second pillar is the **expenditure rule**, introduced by the **Six Pact**, which limits planned growth rates of public expenditure to the country-specific benchmark set at European level.

## Expenditure rule as a way to reach the MTO

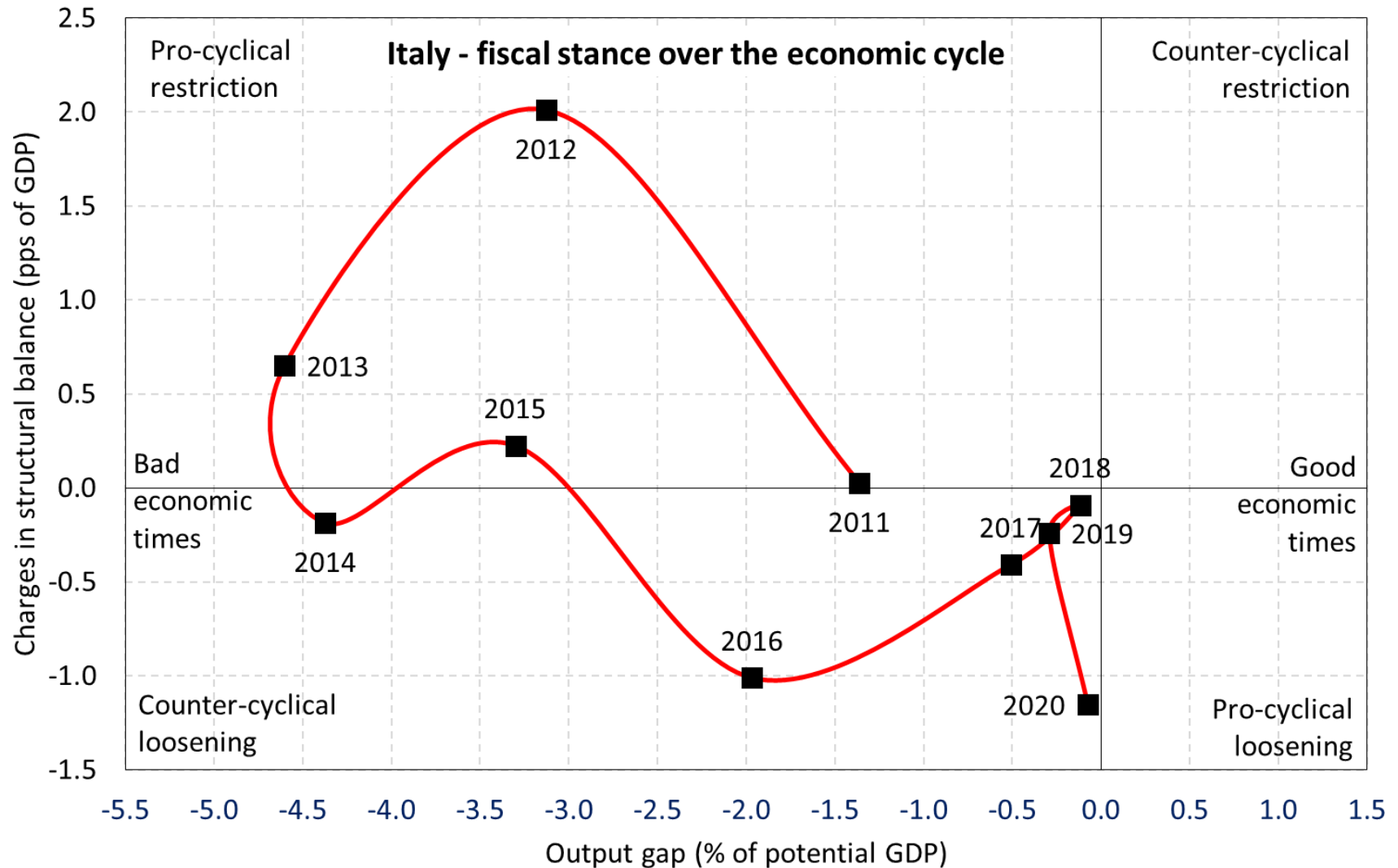
- ◆ The reference expense aggregate **excludes the component of the expenditure most linked to the economic cycle**, the interest expense as not directly controllable by governments, and considers smoothed gross fixed capital formation. It should avoid **pro-cyclical spending behavior**.
- ◆ For countries that have reached the MTO, real growth of the reference expenditure aggregate must be aligned with that of the **potential output**. **Compliance with the spending rule** implies that the country continues to remain on its MTO.

## Issues with the EU fiscal framework

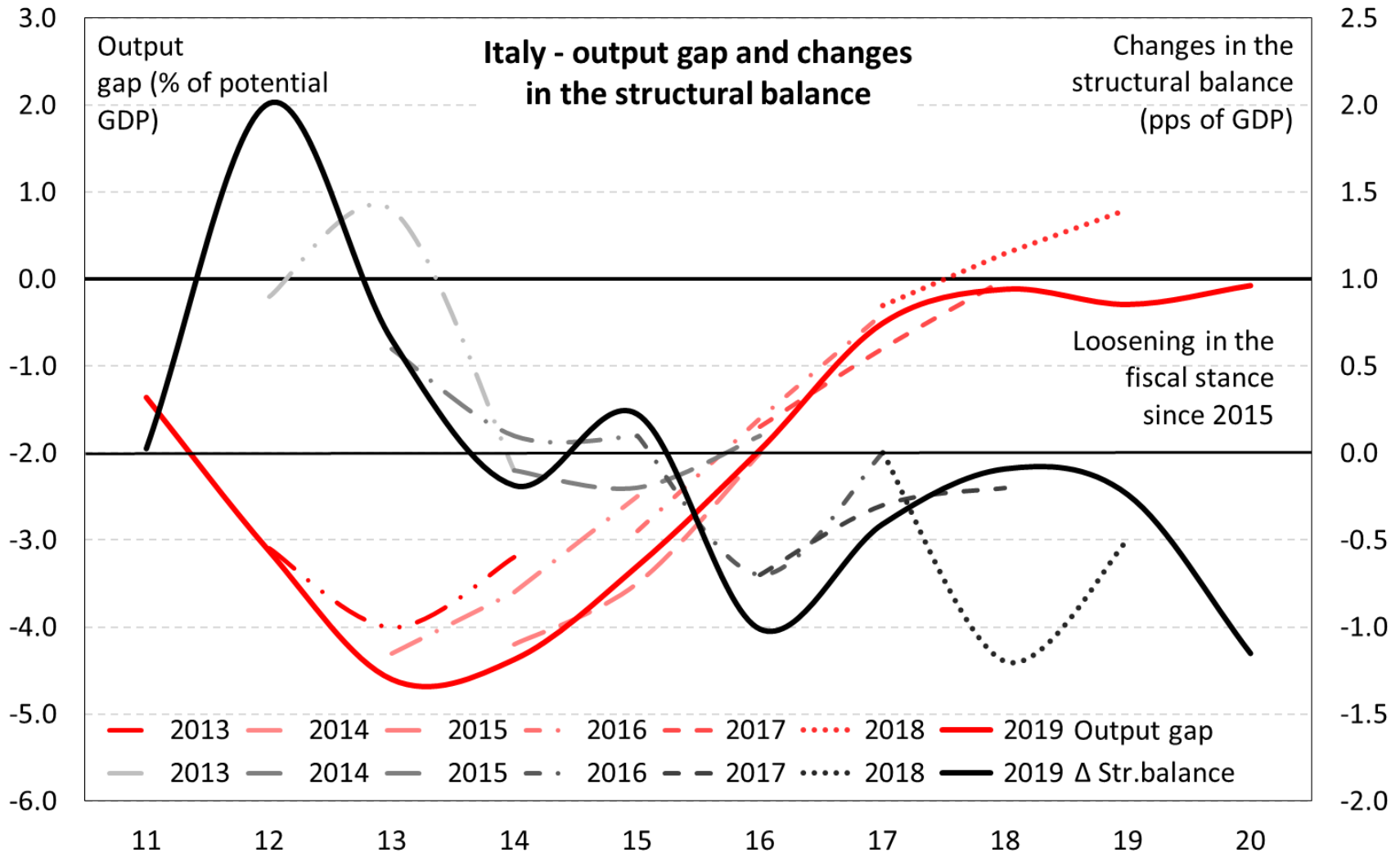
- ◆ **Structural balances:** Well-identified drawbacks mainly due to potential output and output gap measurement, volatility and deep revisions. Risk of excessively tight pro-cyclical policies.
- ◆ **Flexibility for reforms:** Structural reforms increase **potential growth** and thus lower the **structural part of the deficit**, often imply either near-term recessionary effects or need to compensate losers.
- ◆ **Public investments:** More flexibility for public investment.
- ◆ **Pro-cyclicality:** Fiscal policy has turned pro-cyclical no matter the “true” level of the output gap. Are rules really working?
- ◆ **Sanctions** are proposed by the Commission and approved by Council (reverse majority rule). (Remunerated) deposit of 0.2% of GDP to be converted into a fine in case of non compliance. Never applied.



## Pro-cyclical policies since the crisis

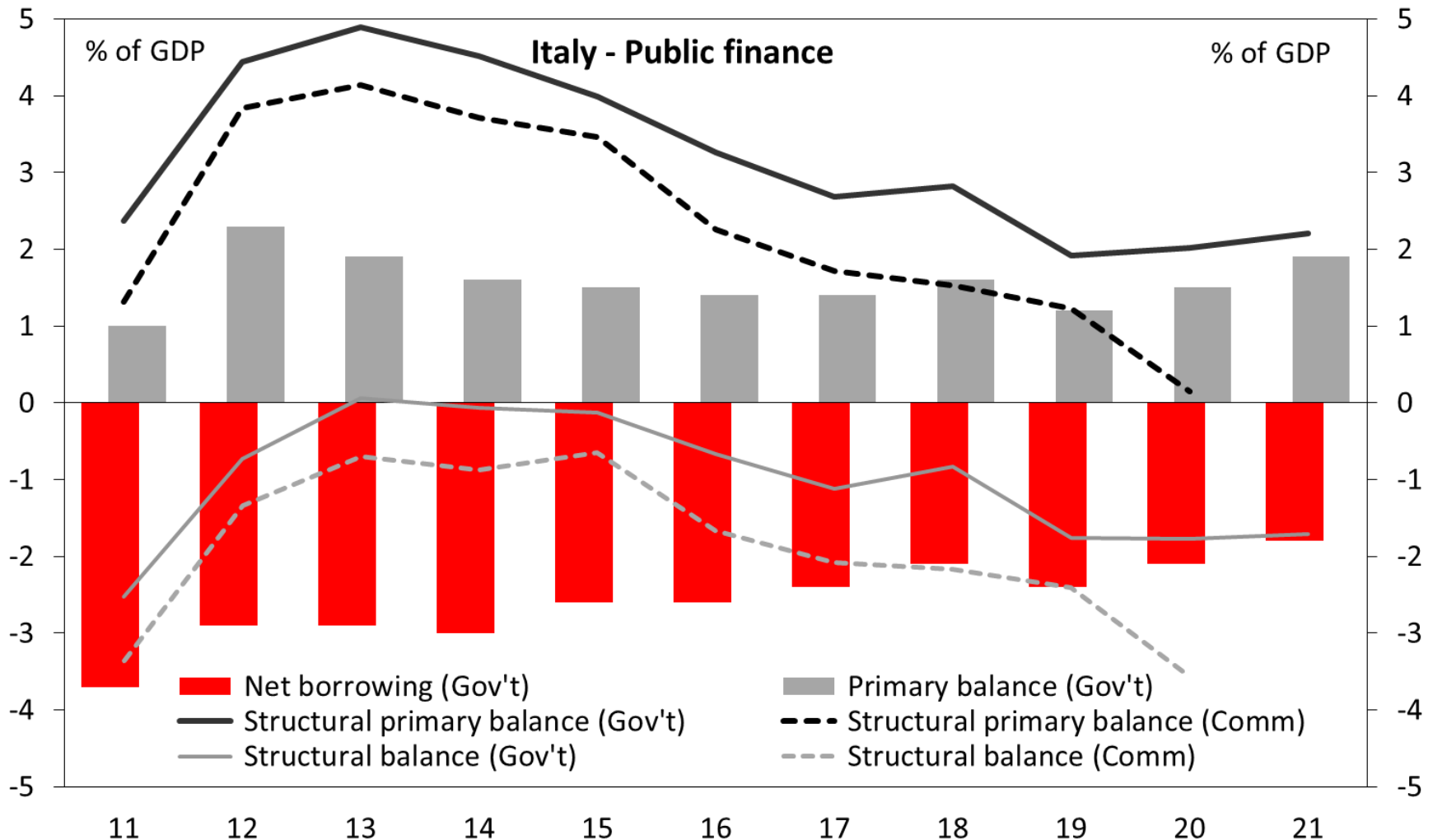


# Loosening in the fiscal stance since 2015



Source: European Commission, AMECO, Thomson Reuters Datastream, LC-MA calculations.

## Structural primary balance declining since 2014

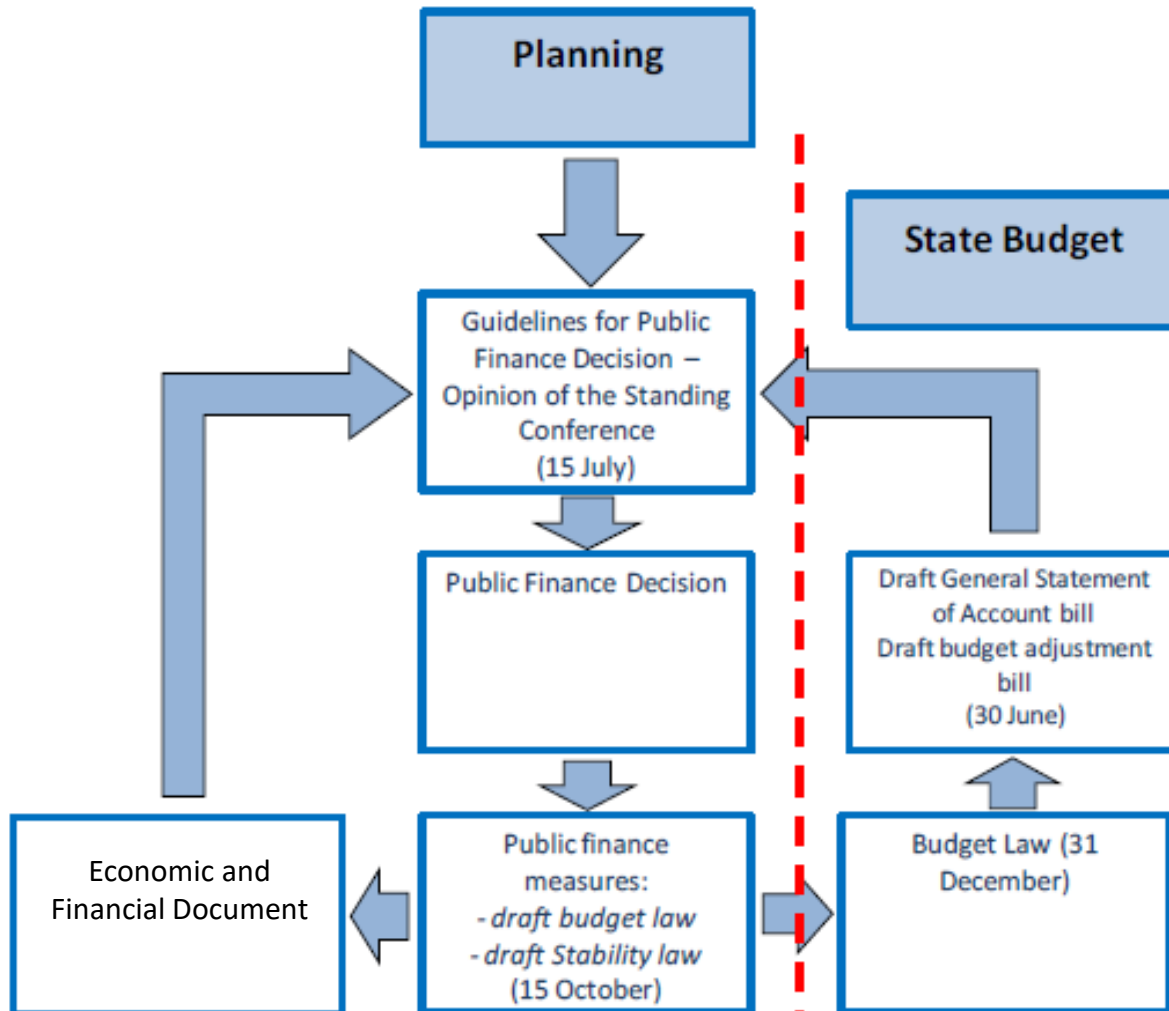


Source: Thomson Reuters Datastream, Italy's Ministry of Economy and Finance, EU Commission, LC-MA calculations.

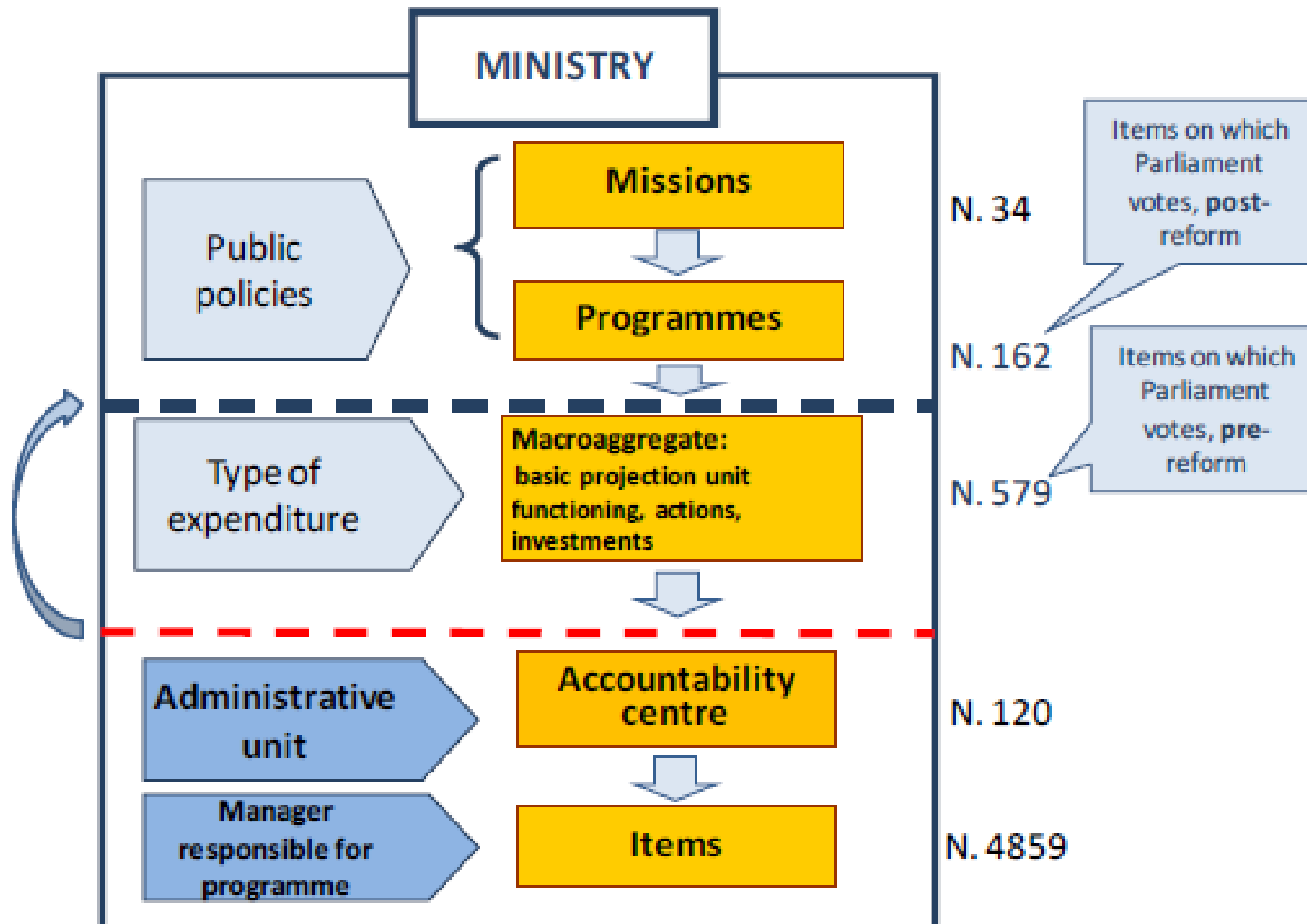
## Fiscal rules are just part of the story

- ◆ Many other institutional features help strengthening the fiscal framework.
- ◆ Legislated **broad principles** that guide the formulation of fiscal policies.
- ◆ Effective **budget mechanisms** and procedures designed to minimise deficit biases.
- ◆ Strong **transparency requirements** and public oversight.
- ◆ The operation of **independent fiscal agencies** tasked with the monitoring and assessment of fiscal developments.
- ◆ Last but not least, **politics** ...

## How does the process work?



## How does the process work?



## THE EU FISCAL FRAMEWORK AND PUBLIC SPENDING

# How does the process work?

MINISTERO DELL'ECONOMIA E DELLE FINANZE			
Missione	Programma	Centro di Responsabilità	Azione
032 Servizi istituzionali e generali delle amministrazioni pubbliche	002 Indirizzo politico	1 GABINETTO E UFFICI DI DIRETTA COLLABORAZIONE ALL'OPERA DEL MINISTRO	0001 Ministro e Sottosegretari di Stato
			0002 Indirizzo politico-amministrativo
			0003 Valutazione e controllo strategico (OIV)
	003 Servizi e affari generali per le amministrazioni di competenza	2 DIPARTIMENTO DELL'AMMINISTRAZIONE GENERALE DEL PERSONALE E DEI SERVIZI	0001 Spese di personale per il programma
			0002 Gestione del personale
			0003 Gestione comune dei beni e servizi
			0004 Gestione e sviluppo dei servizi e dei progetti informatici
	004 Servizi generali delle strutture pubbliche preposte ad attività formative e ad altre attività trasversali per le pubbliche amministrazioni	3 DIPARTIMENTO DEL TESORO	0001 Spese di personale per il programma
			0002 Approvvigionamento di carte valori, pubblicazioni ufficiali, Gazzetta ufficiale e altri prodotti carto-tecnici forniti dall'Istituto Poligrafico e Zecca dello Stato e relative attività di vigilanza e controllo
			0003 Contributo alla ristrutturazione industriale dell'Istituto Poligrafico e Zecca dello Stato S.p.A.
			0004 Sistema statistico nazionale (SISTAN)
			0005 Rappresentanza negoziale delle pubbliche amministrazioni
			0006 Formazione, ricerca e studi per le pubbliche amministrazioni
			0007 Commissione per la valutazione, la trasparenza e l'integrità delle amministrazioni pubbliche
			0008 Supporto alla gestione amministrativa dei servizi generali per le amministrazioni pubbliche
0009 Agenzia per l'Italia Digitale			

## CONCLUSIONS

### Benefits of expenditure rules

- ◆ Revisions in the growth rate of **expenditure aggregates** (linked to medium-term potential estimates) far smaller than revisions in potential output and output gap figures in specific years.
- ◆ Limited **pro-cyclicality** in the expenditure benchmark.
- ◆ Spending more directly **under control of policymakers** (and more accountability on their part).
- ◆ Possible linkage to **multiannual expenditure ceilings**.
- ◆ Direct link to medium-term **debt dynamics**.



## CONCLUSIONS

### Potential pitfalls of expenditure rules

- ◆ **Ratcheting up** or down: breaches get incorporated into the base.
- ◆ Treatment of **investment** is challenging: exclusions produce risks and potential distortions, inclusion risk producing pro-cyclicality.
- ◆ They miss the **turning points** in potential growth.
- ◆ **Asymmetry in cycle** (expansions longer than contractions) risk forcing sharp spending retrenchments in inappropriate times.
- ◆ Potential for cutting inefficient and wasteful spending. Most of the times, expenditure control only works if there is **increase in efficiency and/or deep reforms** of how public goods and services are delivered to citizens.
- ◆ At the root of misallocation of resources are **political decisions**.