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Fiscal Prospects for Italy

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Abstract: After the pandemic peak, public debt over GDP in Italy has fallen sharply thanks to high real and nominal economic growth; a few institutional changes have further reduced concerns about its medium-term sustainability. Yet, the debt ratio is still too high and needs to be reduced. The gradual adjustment path forecasted by the new Eu fiscal rules seems broadly able to reach this objective without imposing too harsh policies that might turn out to be economically and politically counter-productive. Still, without a serious reform of the Eu and the Eu budget, there remains the problem of how Italy and the other European countries will finance the new spending priorities dictated by the green deal and the mutated geo-political situation. And in the longer run, the demographic shock remains the most serious concern for public debt sustainability.

Keywords: public debt; Italy; fiscal rules; forecast of debt

JEL Classification: H62; H63; H68

1 State of the Art

The main problem of Italian public finances is the still very high level of debt, with the consequent need for a fiscal adjustment. The adjustment must be implemented while old and new spending priorities are emerging. Moreover, *tax pressure*, the ratio between tax revenues and GDP (currently 43 %), is already very high and could be difficult to increase further.[1]

1 To be more precise, a lot could be done to make the Italian tax system both more equitable and more efficient by sharing differently the tax burden across potential tax bases and taxpayers. The current government is involved in a comprehensive tax reform that, aside from some simplifications, does very little on all these fronts. However, the good news is that thanks also to the commitment taken by the Italian government to access the funds of the NGEU, tax evasion, always a structural

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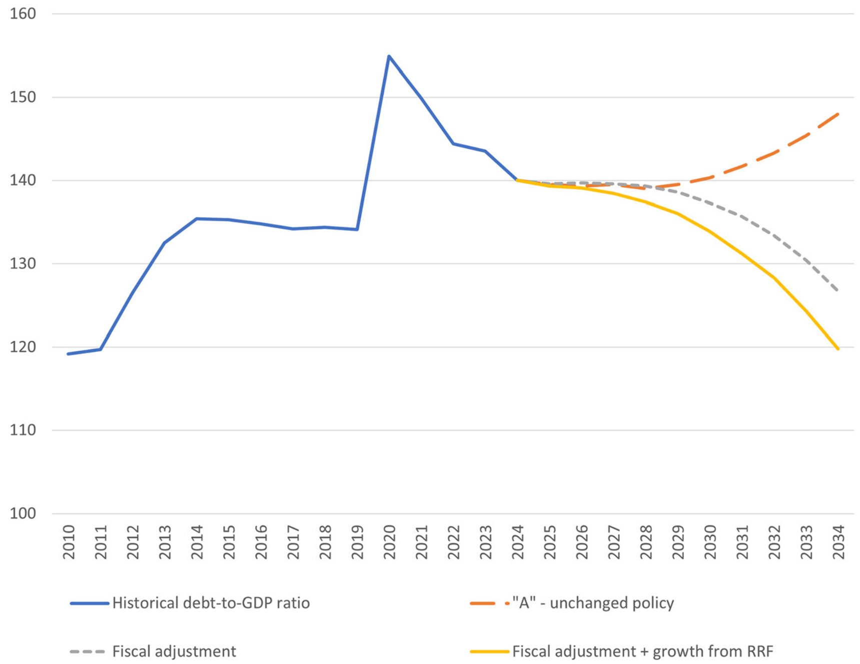

Figure 1: The evolution of the Italian debt over GDP ratio under different hypotheses. Source: NADEF.

Figure 1 illustrates the evolution of the Italian public debt-to-GDP ratio since 2010[2] and some forecasts for the future (to be discussed below). After peaking in the pandemic year 2020 at 155 %, the ratio quickly fell in the subsequent years, because of the fast GDP recovery in 2021–2022, still low real interest rates, and the surge in inflation in 2022–2023. Thanks to high nominal and real growth rates, the *snowball effect* has been strongly negative in 2021–2023, allowing for a sharp decline in the debt ratio.[3] However, in 2023, the debt-over-GDP ratio still stands at around 140 % of GDP,

problem in Italy, seems to be receding, particularly for VAT. While it is hard to believe that taxes could be raised further, some substantial extra revenues could derive by reducing tax evasion.

2 For a more general discussion of the genesis of the Italian public debt and of his consequences see Bordignon and Turati 2022.

3 The snowball effect in a particular year is given by the difference between the cost of debt and nominal GDP growth multiplied by the debt-to-GDP ratio of the previous year. When nominal growth is higher than the cost of debt, the snowball effect is negative and it allows for a decline of the debt-to-GDP ratio, a decline that is faster the higher is the original debt-to-GDP ratio.

the second highest in Europe, after Greece.[4] The headline deficit is also still very high, accountably well above 5 % of GDP in 2023, largely because of the legacy of the huge support provided by the government budget to the private sector during the pandemics.[5] The primary surplus is still heavily negative, in sharp contrast with the pre-pandemic period when Italy reached and maintained a primary surplus (ranging in the interval between 1 and 2 % of GDP) for several years.

The current government's budget plans aim to bring the headline deficit below 3 % by 2026, when the primary surplus should again reach 1.5 % of GDP, a process that however might be accelerated by the re-activation of EU fiscal rules in 2024 (see below). The reduction in the debt ratio is, however, likely to halt in the next 2–3 years, despite fiscal adjustment and a still slightly negative snowball effect, because of the legacy of some interventions passed during the pandemic that will imply negative stock-flow adjustments.[6] The decelerating real growth rate might also affect the envisaged fiscal adjustment process.

The cost of debt has increased following the change in the monetary stance of the ECB and the sharp increase in the policy rates, but interest payments in 2023 (3.8 % of GDP) increased only by 0.4 % of GDP relative to 2019, thanks to a larger nominal GDP and the long average duration of Italian debt (7.8 years) with consequently limited annual rollover. According to government forecasts, the cost of debt should increase in the future (interest payments are estimated to increase by another 0.4 % of GDP in the next two years), but, as a matter of fact, after a peak in mid-2023, interest rates on Italian debt are presently below government's estimates, fuelled by expectations of a reduction in the ECB interest rate. Even the spread between the Italian ten-year bond (BTP) and the German Bund, a reliable thermometer of financial market perceptions of the riskiness of Italian debt, after having reached a maximum of 250 basis points at

4 According to the preliminary last revision by ISTAT, the National Institute of Statistics (March 2024), in 2023 the debt-over-GDP ratio was lower than expected by government, 137 % rather than 140 %.

5 Data on headline deficits in 2022 and 2023 must be taken with care because they are heavily affected by the decision taken by Eurostat in 2023 on how to account for the huge tax allowances introduced in 2020 to support private housing restructuring for energy saving. Eurostat's view was that they are *payable* and hence must be registered in the years in which the decisions were taken rather than in the years where they manifest themselves in the form of reduced tax payments (the next five years). This heavily inflated headline deficits (an accrual measure) in 2022–2023, reducing them in future periods.

6 Particularly, the legacy of the tax allowance on housing restructuring (see the previous note). In 2023, the current government weakened this measure for the future, but banks and private citizens are still allowed to claim the entire allowance for the expenditures borne in the period 2021–2023. To counteract this effect, the government decided to sell its shares in a few publicly owned private firms up to 1 % of GDP for the next three years. According to government, this should be enough to keep debt-to-GDP on a slightly declining path.

the end of 2022 (following the change in the stance of monetary policy), it fell after, and it has been consistently below 150 points in the last months (128 points at the time of writing). The new ECB's Transmission Protection instrument (TPI), launched in July 2022, although never implemented, has probably played a role in dampening market risk perceptions.

In assessing the sustainability of Italian public debt, one should also consider that a large share of it is held by the Italian central bank (about 26 %) and to a smaller extent (2–3 %) by the ECB. The envisaged ECB process of selling and limited repurchasing of national governments' debt will slowly and gradually reduce this share,[7] but for a few years, Italy will still benefit from it, as the interests paid on the debt held by central banks are returned to the Italian Treasury (in the form of distributed dividends by the Italian central bank).[8] Moreover, while Italian public debt held by Italian banks has been slowly reducing (at about 24 % of the total), the share in the hands of Italian households (11 %) and Italian investment funds (14 %) has been increasing. Foreign investors now only hold about 24 % of Italian debt (this share was 43 % before the Euro crisis). While this might have some negative redistributive effects (the average debt holder is richer than the average taxpayer), it also means that interests on public debt are largely paid to Italian residents, thus supporting aggregate demand. Moreover, Italian residents are less likely to sell Italian bonds than foreign holders in case of turbulence in the financial markets, sustaining the demand for Italian debt instruments.

Finally, the Italian economy looks more robust than it was in the pre-pandemic period. Cumulative real growth in the 2019–23 period has been stronger than in the other main European economies. Thanks to the grants and loans from the Recovery and Resilience Facility (RRF), public investments have been sharply increasing in the last 3 years (+1 % of GDP), halting the ongoing deterioration in public capital stock. Private investment also peaked in 2023. Participation in the labour market and occupation rates, although still lower than in the average EU, are at record levels. The current account deficit, after the fall for the increase in energy prices in 2022, has turned positive again in 2023. Exports have boomed (overcoming 730 billion in 2023), weathering the terms of trade shock better than in other EU countries.

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7 According to some estimations (OCPI, 2023) the decisions taken by ECB in July 2023 on the two programs PSPP and PEPP should entail a reduction in the share of Italian debt held by the Euro system of about 30 billion euro per month. But the current holding of Italian debt by the Euro system is close to 700 billion.

8 Although the Italian central bank's profits might turn out to be negative in 2023 or however smaller than in the past, given the higher rates that central banks now must pay on their deposit facility.

2 Challenges

This somewhat rosy picture, however, quickly darkens if one looks at future longer-term challenges. Debt sustainability essentially depends on future growth, which directly affects revenues and indirectly market expectations; spending pressures; and interest rates.

Future growth. As well known, productivity and GDP growth have been particularly low in Italy in the last two decades, exacerbating fiscal and social problems. The faster growth of the post-pandemic period, fuelled by large budget deficits and supported by the RRF, has improved expectations, but it is still to be seen whether this higher rate of growth can be sustained in the future. In particular, the jury is still out on whether the RRF-induced reforms and investment, beyond the short-term Keynesian effect of supporting aggregate demand, will also have the effect of increasing the overall productivity of the economy.[9]

But even leaving this issue aside, the *demographic shock* is by far the most pressing problem Italy is going to face in the next decades. This is of course not only an Italian problem, but it is particularly pressing in Italy. The Italian population is both shrinking (from 59 in 2022 to 54 million in 2050, according to ISTAT forecasts) and aging, because of the combination of a very low fertility rate (1.24 children per woman) and a long and still increasing life expectancy. The labour force has already started shrinking, with the dependency ratio (the ratio of over 65 out of the active population in the age interval 20–64 years) that is expected to rise quickly in the next decades, from 39 % in 2025 to 44 % in 2030 and to 57 % in 2040.

The government is trying to react with an array of policies supporting women fertility on one hand and incentivising female labour market participation on the other. But even if these policies would work, several simulations suggest that the situation is likely to become unsustainable without a sharp increase in immigration (currently, immigrants are only 8.5 % of the population). Higher spending for aging (see below) coupled with a shrinking tax base would lead again to a sharp increase in the debt ratio. Here the problem is mainly political, with the native population mostly opposing any further increase in immigration. It is, however, telling that even the current right-wing government, despite its strong anti-immigration stance, has been forced (by the pressure of Italian companies struggling to find workers) to open again the flows to legal migrants (450.000 in the next three years), although these flows are still largely insufficient to meet labour demand.

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9 According to estimations by the Minister of Economy, the national RRF plan, if correctly executed, should increase the annual rate of potential growth of the Italian economy to 1.4 % from the 0.6 % currently estimated. About a third of this increase is due to higher total factor productivity.

Spending pressures. The aging population is also going to add to spending pressures. In the next few years, the numerous baby boom generations of the sixties and seventies will retire from the labour market. According to ISTAT estimations (based on the AWG methodology of the Commission), pension spending should increase by slightly more than 1 % of GDP (from 16 % of GDP in 2023 up to 17.3 % in 2045) to decrease after to reach 13 % in 2070 (because of a less generous pension system and a reduction in the number of pensioners). Health spending would also increase up to 2050 (by about 1 % of GDP, from the current 6.2 % to an estimated 7.2 %) as well as spending for the assistance of dependent old people (by another 0.5 % of GDP).

Moreover, new spending priorities are emerging. There is a need to fund the digital and energy transitions, reduce the dependency on un-friendly countries on key factors of production, increase defence spending, and heavily invest in the new technologies that are emerging and where Italy (like the rest of Europe) is lagging. However, these are fundamentally EU public goods: while it is very unlikely that a fiscally constrained country such as Italy could face all these new spending priorities on its own, it is unlikely that even EU countries with sounder finances could do much better on their own. There are spill-over effects and huge returns of scale that can be gained only by moving some of these spending responsibilities to the European level. Moreover, without completing the capital and banking union is also unlikely that enough private resources could be mobilized to finance at least partly these processes.[10]

Interest rates. Debt sustainability also depends on future interest rates. By gradually reducing its debt-to-GDP ratio, a country like Italy could further reduce the risk premium it pays on its debt. This would both reduce interest spending for the government and improve access to credit by private companies, as the interest rate paid on government bonds also affects the interest rate asked by banks to provide credit. However, there is still the open issue of which is the "natural" interest rate to which future interest rates will converge. Specifically, remains still unanswered the question of whether the very low real interest rates that we have witnessed in the last decade are just a consequence of the extremely loose monetary policy adopted by central banks or whether they depend on more structural phenomena as the hypothesis of "secular stagnation" (Blanchard 2023) would suggest. Should very low or even negative real interest rates return in the future, this would make it much easier to sustain public debt even for a highly indebted country such as Italy.

10 The EU Commission estimates in 650 billion of Euro the extra spending in the EU needed to finance the energy and digital transition up to 2030. At least a fifth of this extra spending should be funded with public money.

3 New Fiscal Rules and Adjustment Policies

The Italian fiscal situation is on an unsustainable track given the current policies. With inflation returning to its normal level, nominal growth (6.3 % in 2023, according to ISTAT) is bound to decelerate and the negative snowball effect will disappear or even change sign. If Italy does not reconstruct quickly a positive primary surplus, debt-over-GDP is bound to increase again. This is illustrated in Figure 1 taken by the official government estimations in 2023 where the evolution of the debt-to-GDP ratio in the next 10 years is forecasted under three different scenarios:[11] (1) unchanged policy; (2) fiscal adjustment; (3) fiscal adjustment with the assumed improvement in potential growth induced by the RRF. At unchanged policy, debt-over-GDP will start increasing again after 2025; with the assumed fiscal adjustment it would instead fall, and the fall would be faster if the RRF plan would keep its promises of an increase in potential growth.

How large is the needed fiscal adjustment? With the approval of the reform of the EU fiscal rules, there is a bit more clarity on this issue. The new rules will enter into force after a transition period up to 2027 where Italy, together with France and several other countries, will be subjected to an Excessive Deficit Procedure (EDP). During the EDP period, when Italy will need to reduce its headline deficit-to-GDP below 3 %, the adjustment will be around 0.5 % of GDP of the structural deficit, with some leeway to be considered for the spike in interest payments. In the following 7 years, according to simulations on the original proposal of the Commission (Darvas, Lennart Welslau, and Jeromin 2023; Gabbriellini, Nocella, and Flavio 2022), the adjustment should be still around 0.5–0.6 % per year of the structural primary deficit.[12]

That would mean reaching a primary surplus at the end of the period of around 2.5–3 % of GDP. This would be tough but probably still sustainable for the country, considering that the primary surplus always ranged between 1 and 2 % of GDP in the decade preceding the pandemic. It would mean dismantling all the remaining supporting policies introduced since the pandemic and being strict on recurrent spending,[13] surely a politically complicated issue (voters get used to extra support) but not an impossible one. The success of the strategy also depends on future growth

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11 Forecasts are based on the standard hypotheses of the Debt Sustainability Analysis used by the EU Commission for public finance and macroeconomic variables. See the Debt Sustainability Monitor 2022 for details.

12 As well known, the adjustment is computed to make it highly likely a declining debt-over-GDP over the next 10 years of completion of the program considering aging costs.

13 As we said already, this does not consider the need to finance new spending priorities. If these are added to the picture, the required adjustment might become unfeasible.

and the evolution of future interest rates, as noted above. However, a continuously declining debt-to-GDP ratio should also ease the risk assessment of financial markets, thus leading to a reduction in the risk premium. In turn, the reduced interest burden would make it easier to support the fiscal adjustment, freeing resources to support priority spending.

However, the final compromise reached on the EU fiscal rules also imposed two extra requirements: (1) the debt-to-GDP ratio should fall by at least 1 % each year during the adjustment program; (2) adjustment needs to continue until the headline deficit-to-GDP is below 1.5 % per year. The first constraint does not bite,[14] the second might, imposing in some circumstances an excessive and probably unsustainable burden on the country.[15] But even forgetting Italy, the main problem of the final compromise on EU fiscal rules is that the constraints on debt and headline deficit will also affect EU countries in more comfortable fiscal situations (with, say, debt-over-GDP in the range between 60 and 90 %[16]). The result might be a deflationary impulse that the EU economy might not need, particularly in the current changing geopolitical situation, where the traditional sources of growth for the EU economy (cheap energy price, low defence spending, opening of international markets) are all put in jeopardy (Draghi 2023). A deflationary macro-impulse at the EU level would also make it more difficult for high-debt countries to pursue their adjustment process. Moreover, the new fiscal requirements might also be incompatible with the new spending priorities facing European countries, unless they are complemented by higher spending at the EU level to address these challenges.[17]

14 The constraint on debt only enters in force after exiting EDP, that is, after the country headline deficit-to-GDP is below 3 %. But algebraically, a highly indebted country that keeps its deficit below 3 %, automatically reduces its debt-over-GDP by at least 1 % per year, provided that *nominal growth* is at least equal to 2 %. In passing, the reason why Italy failed to reduce its debt in the 10 years preceding the pandemic period, despite consistently positive primary surplus, it is because both real and nominal growth (inflation rate was close to zero in the period) was particularly low or even negative.

15 Estimations by Bruegel suggest that Italy should reach a primary surplus of 4.6 % of GDP to satisfy the deficit constraint, a target very difficult to achieve both on political and economic grounds. While the figure depends on hypotheses on future interest rates, it however suggests that the deficit constraint might turn out to be too strict for a country with high debt and therefore high interest payments.

16 For these countries debt over GDP must fall of at least 0.5 points per year.

17 See for instance the proposal for EU public good financing detailed in Bakker, Beestma and Buti (2024).

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