Rome's Mission: Impossible

Italy will be hard-pressed to make good on all its promises.

By Tito Boeri

This week's passage of a watered-down pension-reform bill in Italy was long-awaited and overdue. But it does not change the key underlying problem: Italy has no economic policy just at a time when it needs firm guidance.

Until Giulio Tremonti resigned four weeks ago, leaving vacant his powerful post of minister of economy, the slogan was "buy time until next economic recovery."

This short-sighted approach involved a wide array of one-off measures (reaching almost 1.5% of GDP in 2002 and more than 2% in 2003), highly creative accounting in reducing the Eurostat definition of the public debt, and the most-sweeping fiscal amnesties in Italian history (covering all types of levies, from personal to corporate income and real-estate taxes and offering unlimited redemption).

Mr. Tremonti's policies have allowed Italy to meet the Maastricht criteria so far, but at very high costs. Among these costs are a structural worsening of fiscal revenues (as more amnesties are anticipated by potential taxpayers), and a further reduction in the transparency of government balances.

This way of circumventing the constraints of the Stability and Growth Pact also weakened Mr. Tremonti in his attempts to prevent an increase in public spending (raised by almost two percentage points of GDP under his reign, due, inter alia, to rather generous pay raises granted to civil servants) and push through badly needed structural reforms, privatizations and liberalization policies.

Now that recovery is beginning world-wide, even in "slow Europe," Italy finds itself paradoxically in the condition of being threatened by the cyclical upturn. A stronger recovery is likely to involve an increase in interest rates, which would inflate the cost of servicing the third-largest public debt in the world. According to estimates from the Italian Treasury, given the term structure of Italian public debt, a one percentage-point increase in interest rates involves about half-a-point of GDP worth of additional interest payments over three years.

At the same time, Italian balances are weakly responsive to cyclical conditions ("automatic stabilizers" such as unemployment benefits cover a relatively small fraction of public spending) and for a number of reasons, including political uncertainty, Italy itself is not taking part in the recovery (the GDP-growth forecasts for Italy are the worst in the euro area).

After Mr. Tremonti's resignation, the time horizon of fiscal policies became even shorter. As revealed by the watchdog website www.lavoce.info, 90% of the measures being taken to avoid the early warning from Brussels (but insufficient to prevent a downgrading of Italian public debt by Standard & Poor's) will only last this budget year and are also overly optimistic. They include, for example, almost €2 billion in cuts to the defense budget even as Italy is militarily involved in Afghanistan and Iraq, and overestimate by about €500 million the tax base of a mortgage tax. A visual impression of the myopic attitudes prevailing in the Italian government is provided by the "Documento di Programmazione Economica e Finanziaria" (Italy's main economic planning document). It is already a month overdue and is likely to be the lightest DPEF ever produced, leaving unsettled the key issue as to how to replace the one-off measures used so far.

Much stronger signals of determination to keep public spending under control are needed to reassure investors. But the ruling coalition has not found an agreement on an economic program in the last two years in government and the two-week vacancy at the minister of economy post has left the budget in the hands of political ministers. Prime Minister Silvio Berlusconi, meanwhile, has repeatedly announced that his government will cut personal income and corporate taxes by about one percentage point of GDP, as promised in his "Contract with Italians" (inspired by Newt Gingrich's 1994 Contract with America).

Markets have already discounted the pension reform, which was approved on July 28. Its approval is important, as it prevented a further downgrading of Italian public debt. However, the reform will start biting only in 2008 and there is a considerable risk that before that date early retirements will gain momentum due to the fear of being subject to the stricter rules (rumors are that the 2005 budget law will tighten access to "seniority pensions" as soon as next year). Italian workers have proved very "dynamic" in the past in anticipating these measures by retiring earlier than initially planned and a recent survey of intentions to retire carried out by Fondazione Rodolfo Debenedetti suggests that political risk (the likelihood that retirement rules are tightened) is the single most important determinant of retirement decisions.

* * *

The job description of the new minister of economy looks like a "mission impossible." He will have first to replace all the one-off measures taken to date with permanent ones: This means roughly an adjustment of €24 billion. Next, room should be found for the announced tax cut, which involves another €12 billion, and the likely increases in the costs of servicing the debt.

Although the outlook is rather gloomy, historically Italian governments have provided their best performance just at times of "extraordinary politics," such as the 1992 crisis that came with the devaluation of the lira. No doubt the situation is currently not as serious as 12 years ago not least because the euro insulates Italy from many speculative attacks (markets have not yet reacted to the downgrading of the public debt). The new minister of economy, Domenico Siniscalco (professor of economics at the University of Turin with a background in public economics), is trying hard to communicate this "feeling of emergency" to his fellow cabinet members. It is the only weapon he has in his hands to fight against the political cycle (administrative elections in 2005 and political turnout in 2006) and try to provide a time horizon longer than six months to Italian economic policy.

Mr. Boeri is professor of economics at Bocconi University in Milan and director of Fondazione Rodolfo Debenedetti. He has been a consultant to the European Commission, IMF, OECD and World Bank.