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Fiscal Consolidation Policies in the Context of Italy's Two Recessions*

FRANCESCO FIGARI† and CARLO V. FIORIO‡

†*University of Insubria; Institute for Social and Economic Research (ISER); Dondena (francesco.figari@uninsubria.it)*
‡*University of Milan; Irvapp-FBK; Dondena (carlo.fiorio@unimi.it)*

Abstract

Italy experienced a double-dip Great Recession: after the start of the global financial crisis, Italy had a second serious recession in 2011 as a result of the sovereign debt crisis. The reaction of Italian governments was minimal at the beginning but more serious action has been taken to address Italy's fiscal problems since the start of the sovereign debt crisis in 2011. The policies adopted have helped to move the public finances to a more sustainable position, but household real incomes decreased by 13 per cent, with this reduction being quite unevenly felt across the household income distribution. The medium-term outlook is still uncertain: a great deal depends on the capacity of the Italian economy to reduce the level of public debt and to return to sustained economic growth, which has been very weak for more than a decade.

Policy points

- Policies implemented over 2011–14 focused on ensuring public finance sustainability, which has been the main target for Italian governments since the mid 1990s, even at the expense of economic expansion.

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- The distributional pattern of fiscal consolidation measures has been only slightly progressive, with very limited support for the poorest.
- The economic crisis gave new impetus to complete the reform of the pension system, which is now financially sustainable, and to address a comprehensive reform of the labour market.
- Recently, some measures to reduce the tax wedge have been introduced largely by decreasing the tax burden of low earners and the social security contributions paid by firms on open-ended contracts.
- Nevertheless, continuous and further announced changes on residential property taxation highlight some limited long-term planning ability.

I. Introduction

The Great Recession hit Italy hard and hit it twice: first, during the diffusion of the 2008 global financial crisis and, second, during the sovereign debt crisis that started in 2011. By the end of 2014, real per-capita GDP was almost 16 per cent below its 2007 level, reaching the level recorded in 1998. As a consequence, Italian public debt increased by nearly 30 per cent of GDP between 2007 and 2014.

The reaction of Italian governments was modest during the first part of the Great Recession, mostly aimed at rebalancing the budget and at exiting the Excessive Deficit Procedure opened by the European Commission in 2005, with only minimal care given to stimulating growth. When the sovereign debt crisis spread from Greece to Italy due to its large public debt vulnerability, Italy reacted by appointing a technocratic government. It implemented significant economic measures, including new taxes and spending cuts, which amounted to between 4.5 and 6 per cent of GDP in 2012 and 2013, in order to exit the new Excessive Deficit Procedure opened by the European Commission in 2009.

Household real income went down by 13 per cent between 2007 and 2013, falling back to the levels recorded in 1988, and poverty levels increased considerably.[1] Having apparently returned the public finances to a sustainable position, the current Italian government is now trying to restore economic growth and to boost household income, mainly through measures aimed at lowering the high level of tax burden.

II. Impact of the financial crisis: the macro picture

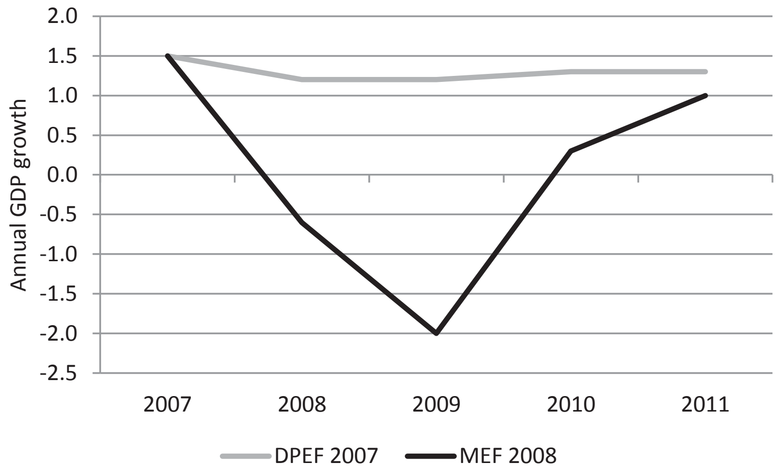
1. National income

When the crisis struck Italy at the end of 2008, the economy had already been growing sluggishly for many years, despite a long period of declining

[1] Brandolini, 2014.

FIGURE 1

Real GDP forecasts made just before the crisis



Note: DPEF 2007 – Economic and Financial Programming Document 2007–2011 issued in June 2006; MEF 2008 – Italy Stability Programme issued in January 2008.
Source: State General Accounting Department.

unemployment. In the 10 years before the onset of the economic downturn, real GDP grew by less than 1.5 per cent per year and the forecasts for GDP growth for the years from 2008 onward made before the crisis were about 1.2 per cent per year (Figure 1, grey line). However, at the beginning of 2008, the forecasts dramatically changed (Figure 1, black line), pointing to a decrease of real GDP of about 0.6 per cent in 2008 and 2 per cent in 2009 and a subsequent expected recovery from 2010 onwards.

In fact, in the first phase of the Great Recession, GDP fell far more in Italy than in most other European countries: in 2009, real GDP was 6.5 per cent lower than in 2007. Furthermore, Italy did not follow other European economies in the recovery: by 2011, GDP had increased only by 1.6 per cent from the trough it reached during the Great Recession, and since then it has declined again. The double dip of the Great Recession following the sovereign debt crisis caused a fall of 7 per cent in GDP between 2011 and 2014 and GDP is still far from regaining its pre-crisis level.

Considering the evolution of GDP on a per-capita basis, the situation is even worse. GDP per capita fell almost 8 per cent between 2007 and 2009; there was a weak recovery of less than 1 per cent in 2010–11 and then a new severe and so far uninterrupted fall – of almost 9 per cent – between 2011 and 2014. Up to 2010, household disposable income declined less severely than per-capita GDP, in part because of the cushioning effect of wage supplementation schemes. In addition, individuals also maintained their consumption levels by making use of accumulated private savings and reducing their wealth holdings. However, since 2011, household income has declined more than GDP as a consequence of adverse developments in the labour market, the increase of long-term unemployment not covered by unemployment benefits, the newly-introduced fiscal consolidation measures and the absence of a generalised social safety net for working-age people.[2]

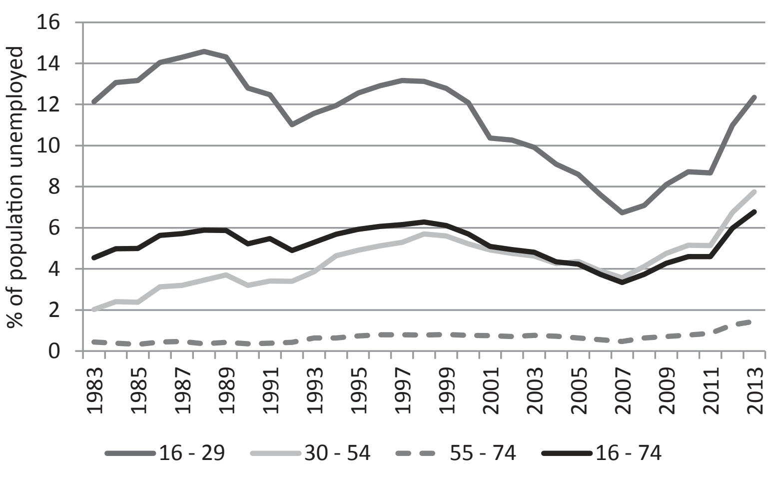
2. Labour markets

The decade prior to the Great Recession witnessed a long period of decreasing unemployment (Figure 2), which was at least partially justified by the massive flexibility introduced in the labour market which induced a larger participation of marginalised workers, such as immigrants, youths and those with temporary contracts.[3] This decline was sharply reversed after 2008.

In the years before the crisis, the employment rates of adult (30- to 54-year-old) and mature (55- to 74-year-old) workers increased and those of younger adults (16–29) were roughly stable. With the onset of the crisis, the employment rate of young individuals fell steadily, with a reduction of about 25 per cent from 2008 to 2013 (Figure 3). At the same time, employment rates of

FIGURE 2

Evolution of share of population unemployed: overall and by age group

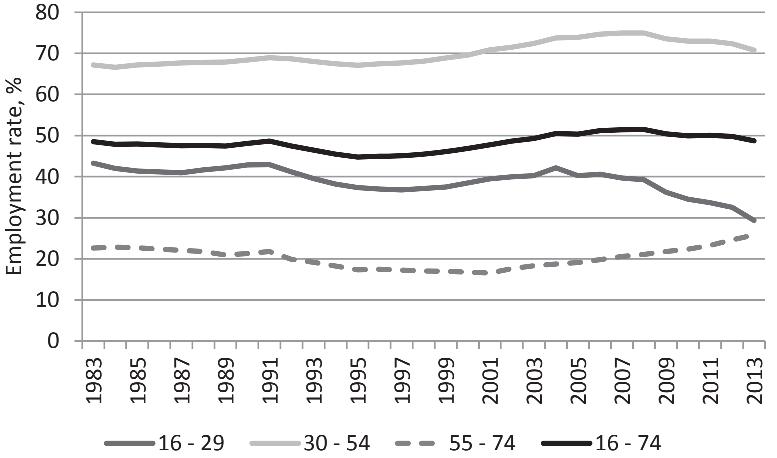


Source: Authors' calculations based on EU Labour Force Survey.

[2]Brandolini, 2014.
[3]Berton, Richiardi and Sacchi, 2012.

FIGURE 3

Evolution of employment rate: overall and by age group



Source: Authors' calculations based on EU Labour Force Survey.

older workers continued to rise, driven by increases in the statutory retirement age.

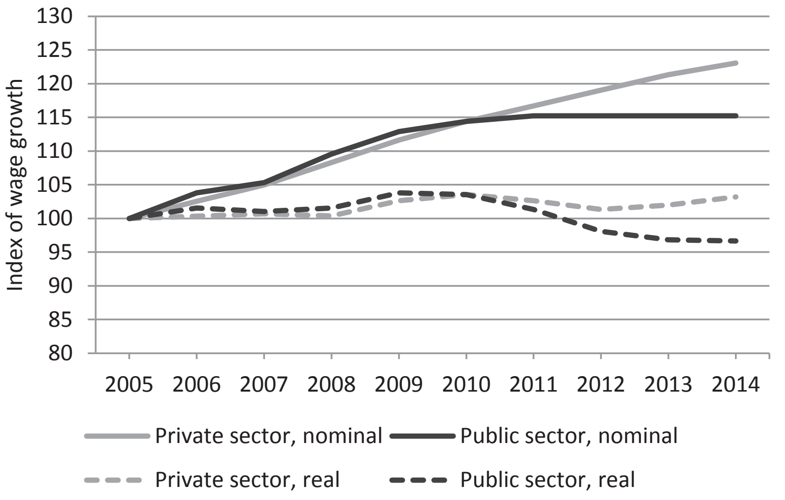
The labour market followed the evolution of GDP, although with a lag. There has been a clear fall in employment rates, and a rise in unemployment rates, since the beginning of 2012. During the first recession, employers reduced working time, made use of the Wage Supplementation Scheme (*Cassa Integrazione Guadagni*), declined the renewal of fixed-term contracts and avoided replacing workers leaving for retirement. With the onset of the second recession, the number of job losses increased considerably due to shutting down of firms and layoffs combined with a significant decrease in transitions into employment, particularly among marginalised workers.[4]

Since the beginning of the 2000s, real wage growth had been very slow – on average, less than 0.5 per cent per year. The striking difference between the evolution of gross wages in the private and public sectors since 2011 is due to wage freezing policies and the ending of contract renewals in the public sector. Furthermore, the dynamics shown in Figure 4 hide other important features of the Italian labour market, where the real wage at first employment decreased progressively over time while uncertainty about career prospects increased, making the youth situation much worse than the one shown by the average patterns.

[4]Baldini and Toso, 2014.

FIGURE 4

Change in real and nominal gross wage growth



Note: The consumer price index (CPI) is used as the deflator.
Source: Istat, data warehouse I.Stat.

III. Public finance responses

1. Fiscal stance before the crisis

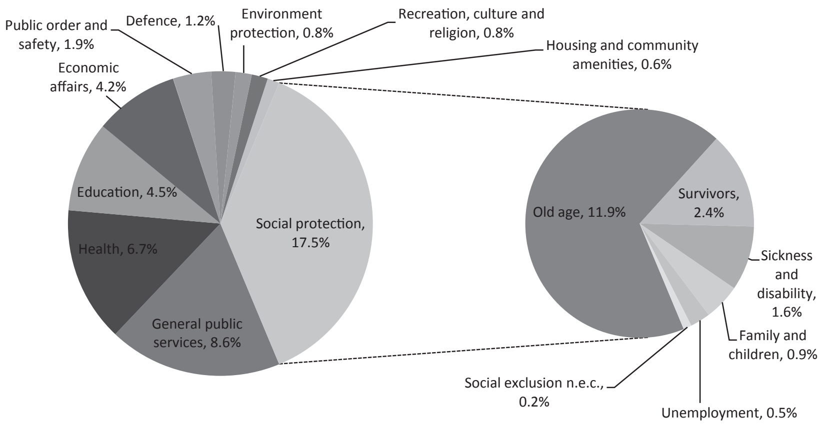
At the onset of the crisis, Italy's public finances looked better than they had a couple of years earlier and the government was considering measures to stimulate growth. In 2007, the net borrowing of the Italian economy reduced by 3.3 percentage points, reaching 1.3 per cent of GDP after three years above the 3 per cent threshold imposed by the Stability and Growth Pact. This prompted the European Commission to recommend that Italy be removed from the Excessive Deficit Procedure started in 2005. The reduction of net borrowing was mostly due to the increased tax pressure, which produced a primary surplus (that is, borrowing net of interest on debt) of around 3 per cent (compared with zero in 2005).

In 2007, public revenues accounted for 45.2 per cent of GDP and public expenditures for 46.8 per cent.[5] Figure 5 shows the decomposition of public spending in 2007 by main functions. The largest share of expenditures was accounted for by social protection (17.5 per cent of GDP), of which the largest share was taken by old-age benefits (11.9 per cent of GDP). General public services accounted for 8.6 per cent of GDP (of which 4.7 per cent of GDP was

[5]Eurostat, 2015.

FIGURE 5

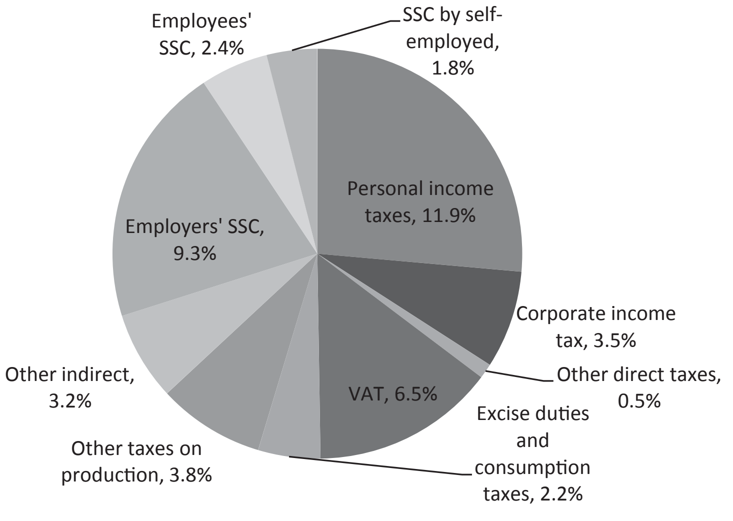
Composition of public expenditures in 2007, with a breakdown for social protection (% of GDP)



Note: Slices show the size as a percentage of total spending. Labels show the size as a percentage of GDP.
Source: Authors' elaborations using Eurostat (2015).

FIGURE 6

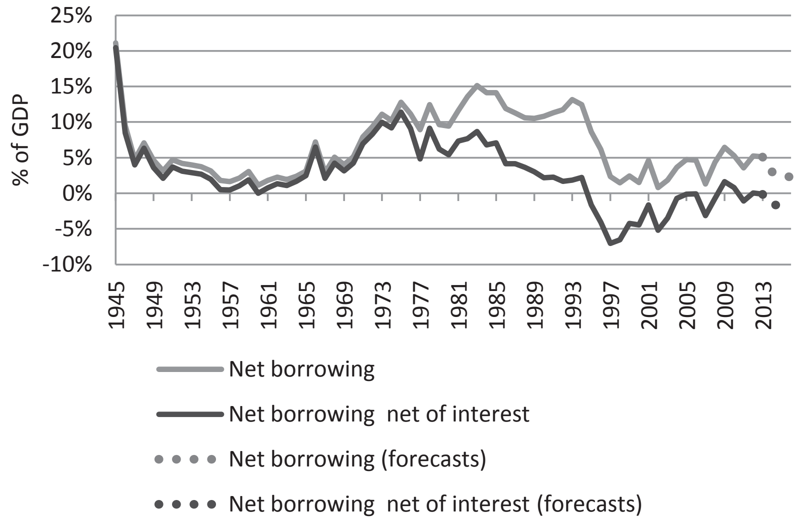
Composition of public revenues in 2007 (% of GDP)



Note: SSC = social security contributions. Slices show the size as a percentage of total taxation. Labels show the size as a percentage of GDP.
Source: Authors' elaborations using Eurostat (2015).

FIGURE 7

Borrowing as a share of GDP



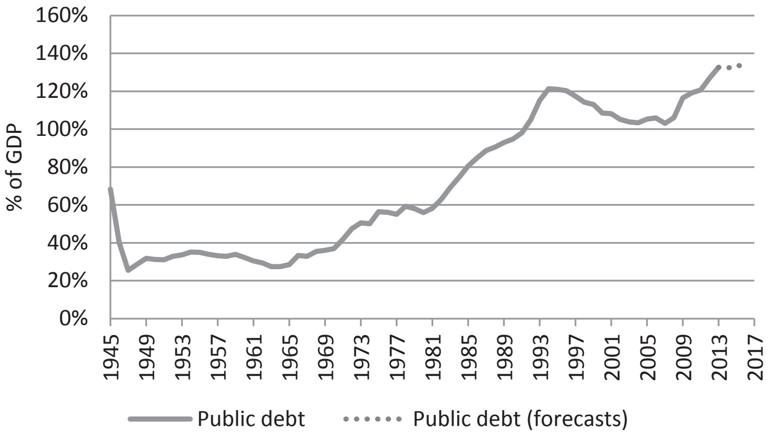
Note: Out-turns for 1945–2013; official forecasts for 2014 onwards.
Source: Authors' elaborations using MEF (2011), Baffigi (2011) and Bank of Italy (2014 and 2015). Figures for years 2014 to 2016 are based on predictions by the Bank of Italy (2015).

interest payments on government debt), health for 6.7 per cent and education for 4.5 per cent. On the revenue side, the high level of taxation was split roughly into three nearly equal parts: direct taxation, which accounted for 15.9 per cent of GDP, indirect taxation (15.7 per cent) and social security contributions (13.5 per cent). Direct personal income taxation accounted for over a quarter of total revenues (Figure 6). As a percentage of GDP, corporate income taxation accounted for about 3.5 per cent and capital taxation for 1 per cent. Revenues from inheritance tax and tax amnesties were negligible in 2007.

Even though Italy's public finances were in reasonable shape in 2007, the Italian government had little room to implement countercyclical policies when the crisis hit. This was the result of a combination of various internal factors, including the choice to be part of the monetary union since its beginning, which meant abandoning the traditional policies of competitive devaluations. Figure 7 shows primary net borrowing (i.e. borrowing net of interest on debt) and net borrowing from 1945 to 2016. In the immediate aftermath of the Second World War, the primary deficit remained at below 5 per cent of GDP for about 20 years, but it increased to between 5 and 10 per cent for most of the 1970s and 1980s. During this latter period, the welfare system was greatly reformed with the introduction of the 'lower secondary school' system and the

FIGURE 8

Public debt as a share of GDP



Note: Out-turns for 1945–2013; official forecasts for 2014 onwards.
Source: Authors' elaborations using Francese and Pace (2008), Baffigi (2011) and Bank of Italy (2014 and 2015). Figures for years 2014 to 2016 are based on predictions by the Bank of Italy (2015).

extension of compulsory education up to the age of 14 in 1962, the introduction of the national health-care system from 1974, and the introduction of a social security system in 1969 and its gradual expansion thereafter.

The expansion of the welfare system was mostly funded by debt, which remained below 100 per cent of GDP until the end of the 1980s, partly thanks to high inflation (which fluctuated between 10 and 25 per cent during the 1970s). However, the level of public debt doubled in about a decade after 1981, reaching about 120 per cent of GDP by 1992 (Figure 8). This evolution of public debt was favoured by the weakness of the Italian political system, the slowdown of economic growth, the reduction of inflation and its effect on debt repayment. Following the financial and currency crisis that hit the country in September 1992, Italy started a period of important reforms, in particular of the pension and health-care systems, aimed at continuing to make progress with the process of economic integration at the EU level.

At the very beginning of the crisis, Italy's public finances were in a relatively favourable position, with there being concrete plans to achieve high primary surpluses, although a high level of public debt remained. According to the European Commission (2006 and 2009),[6] Italy appeared to be at medium risk with regard to the long-term sustainability of its public finances, and the long-term budgetary impact of ageing was lower than the EU average.

[6]See Box 1 for some details on the Italian budgetary process.

BOX 1

The Italian budgetary process

Following the new rules adopted by the EU for the coordination of the economic and budgetary policies of member states, the Italian planning cycle starts with the submission, by 10 April each year, of the Economic and Financial Document (DEF) with its separate sections containing the Update of the Stability Programme (PS) and the National Reform Programme (PNR). The DEF is sent to Parliament by the government.

Once the Economic and Financial Document has been considered by Parliament (adoption of resolutions), the Stability Programme and the National Reform Programme are sent to the European institutions by 30 April.

By 20 September, the government sends to Parliament the Update Note of the DEF, which contains an update of macroeconomic and public finance forecasts as well as planning targets integrating any comments from the EU Council.

Following EU Regulation numbers 472 and 473, the Draft Budgetary Plans (DBP) are sent to the European Commission by 15 October. The DBP contains an update of the estimates indicated in the previous PS. The document takes into account revisions of final data and outlines the following: the reasons for any differences with respect to the estimates contained in the Stability Programme drawn up in April; the public finance measures proposed by the government for achieving the programmed targets; and the impact on the public accounts and economic growth.

By 30 November, the European Commission adopts and presents to the Eurogroup an opinion on the DBP that contains an evaluation of the consistency of the budget with respect to the programmed targets.

By the end of the year, the Budget Law is approved and the process terminates.

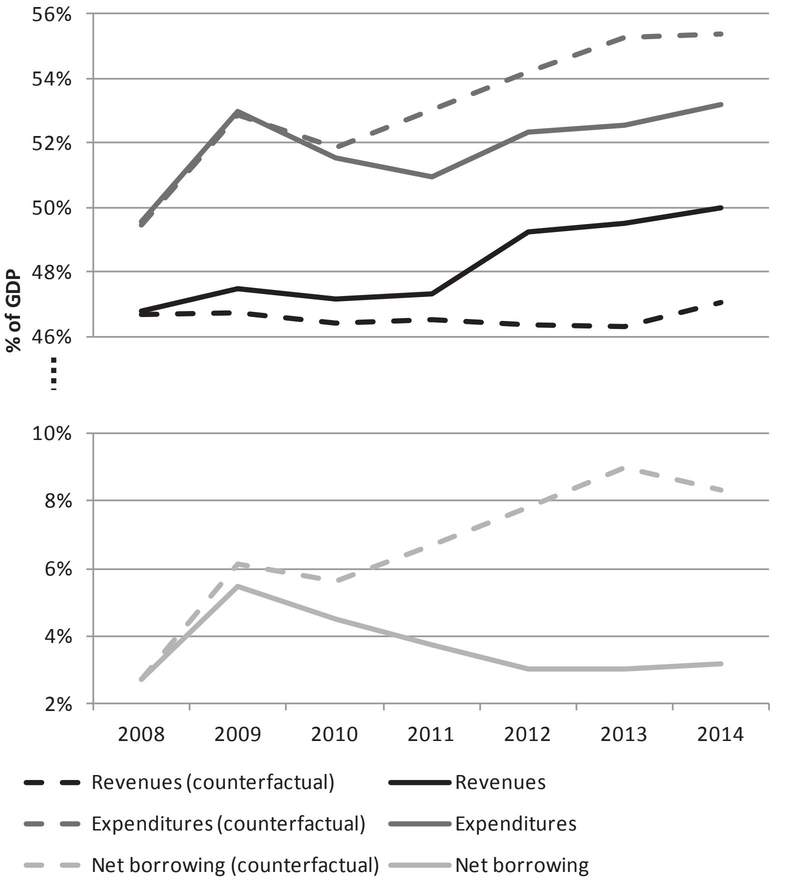
Since the 2012 constitutional reform adopted in line with the European Fiscal Compact, the Parliamentary Budget Office (PBO) was set up to analyse and verify the performance of the public finances, produce independent forecasts, assess compliance with the budgetary rules and define corrective mechanisms in motion. In line with EU rules, if the PBO's assessments differ significantly from those of the government, the latter must explain why it believes it can confirm its assessments or bring them into line with those of the PBO.

2. How did the crisis affect the public finances?

In 2009, soon after the onset of the economic crisis, the Italian government's net borrowing increased to about 6 per cent of GDP, mostly due to the contraction

FIGURE 9

Taxation, spending and borrowing with and without policy responses



Note: Counterfactuals refer to a scenario without policy response.
Source: Authors' elaborations using Bank of Italy (2014) and Istat (2015).

of national income, despite a strong increase in government revenues and only a slight increase in government expenditures. However, it was the 2011 sovereign debt crisis that hit Italy the hardest. Figure 9 shows the counterfactual development of total government revenues and expenditures, along with that of the government deficit, using the latest available published data series and subtracting from these the estimated effect of policy measures taken since 2008. Had no policy response been introduced, the government deficit would have jumped to about 9 per cent of GDP by 2013, assuming that no other effect would have happened. Comparing the out-turns and forecasts for taxation, spending and borrowing during the crisis as a share of GDP, Figure 9 shows the importance of implemented policies in maintaining government net borrowing at levels relatively close to 3 per cent of GDP for the first year of the Great Recession and reducing it to about 3 per cent since 2012.

The latest estimates by the European Commission (2015) predict a level of net borrowing of 2.6 per cent in 2015 and 2 per cent in 2016. The structural deficit is expected to diminish by less than 1 per cent of GDP. Debt should peak in 2015, at 133 per cent of GDP, and start reducing in 2016, after increasing by 30 per cent of GDP since the onset of the crisis. In 2018, the debt to GDP ratio is projected to return to a level close to that of 2011 (120.5 per cent). The planning scenario for 2015–17 complies with the debt reduction rules, but there is no safety margin in the event of even the smallest deterioration in the macroeconomic situation.[7]

3. What was the fiscal response to the crisis?

The reaction of Italian governments to the crisis was relatively mild up until 2011, with light Budget Laws mostly aimed at maintaining the stabilisation of the public finances and reducing the contagion effect of the financial crisis to the real economy. In 2008, the three so-called ‘anticrisis decrees’ issued were mainly aimed at increasing revenues by increasing tax audits and VAT on television services. They also introduced a tax amnesty (named the ‘tax shield’), which provided incentives to return capital stocks from abroad, partly used for allowing a delay of personal income tax payments at the end of 2009. No significant expansionary policies were implemented, mostly because the high level of public debt did not leave much room for increasing expenditures.

It was only in 2011 that important policies were introduced to reduce public expenditure, particularly on public employment, health care, education and pension benefits. After the new technocratic government was appointed in late 2011, a wider set of policies was introduced to counteract the effects of the sovereign debt crisis. These measures amounted to 3.1 per cent of GDP in 2012 and to 4.7 per cent in 2013.[8] Cumulated with other existing policies, these contributed to reducing the government deficit by 4.8, 5.9 and 5.2 per cent of GDP in 2012, 2013 and 2014 respectively.

While the public finances improved, and the structural budget has been in balance since 2013, the economy fell into a second serious recession in 2012–13. After 2013, additional resources were made available by the government to reduce the tax wedge, in order to support the economy, employment and households’ incomes. According to official estimates, these measures had no impact on net borrowing, as they were offset by increases in

[7]Bank of Italy, 2014.
[8]Bank of Italy, 2014.

TABLE 1

The size of the economic policies undertaken since the onset of the economic crisis

Million euros

		2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
DL 112/2008	Revenues	1,890	5,842	5,702	5,729					
	Expenditures	1,554	−4,051	−11,435	−25,196					
	Net borrowing	−336	−9,893	−17,138	−30,925					
LF 2009	Revenues		834	521	397					
	Expenditures		834	521	397					
	Net borrowing		0	0	0					
'Anticrisis plans'	Revenues		4,649	2,190	610					
	Expenditures		4,608	1,902	311					
	Net borrowing		−41	−288	−299					
LF 2010	Revenues			3,321	1	−93				
	Expenditures			3,272	−47	−155				
	Net borrowing			−49	−48	−62				
DL 78/2010	Revenues			831	3,899	9,291	6,879			
	Expenditures			795	−8,232	−15,778	−18,154			
	Net borrowing			−36	−12,130	−25,068	−25,033			
LS 2011 / LB 2011	Revenues			−76	−18	−308	−335			
	Expenditures			−76	−18	−310	−335			
	Net borrowing			0	−1	−2	0			
DL 98/2011	Revenues				1,871	6,609	13,285	28,295		
	Expenditures				−237	1,031	−11,121	−19,677		
	Net borrowing				−2,108	−5,578	−24,406	−47,973		

(*Continued*)

TABLE 1
Continued

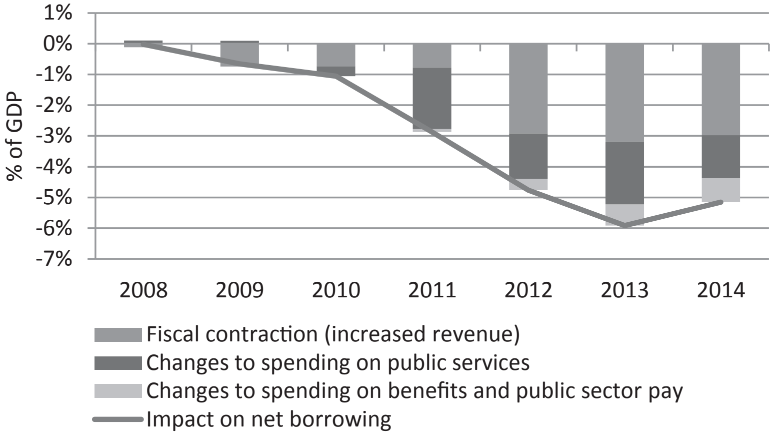
Million euros

		2008	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*
DL 138/2011	Revenues				732	14,068	22,121	10,521		
	Expenditures				0	−8,630	−7,738	−1,301		
	Net borrowing				−732	−22,698	−29,859	−11,822		
LS 2012−14	Revenues					205	−228	−47		
	Expenditures					−185	−390	−149		
	Net borrowing					−391	−162	−102		
DL 201/2011	Revenues					19,366	16,962	14,891		
	Expenditures					−879	−4,358	−6,540		
	Net borrowing					−20,245	−21,320	−21,430		
DL 95/2012	Revenues					−3,392	−6,766	−10,237	−10,300	
	Expenditures					−3,994	−6,781	−10,264	−10,928	
	Net borrowing					−602	−16	−27	−627	
LS 2013−14	Revenues						−1,892	−876	−283	
	Expenditures						427	−1,014	−662	
	Net borrowing						2,319	−138	−379	
Various DLs in 2013	Revenues						−126	1,524	1,021	1,205
	Expenditures						6,029	448	36	418
	Net borrowing						6,155	−1,076	−985	−788
LS 2014−16	Revenues							2,244	234	1,367
	Expenditures							4,702	−3,281	−5,936
	Net borrowing							2,458	−3,515	−7,304

Note: LF stands for Financial Law (*Legge Finanziaria*), LS for Stability Law (*Legge di Stabilità*), LB for Budget Law (*Legge di Bilancio*) and DL for Decree Law (*Decreto Legge*). ‘Anticrisis plans’ is the common name given to three decrees issued at the onset of the crisis (DL 185/2008, DL 5/2009 and DL 78/2009). The various DLs issued in 2013 include DL 35/2013, DL 43/2013, DL 54/2013, DL 63/2013, DL 69/2013, DL 76/2013, DL 91/2013, DL 101/2013, DL 102/2013, DL 104/2013, DL 120/2013 and DL 133/2013.
Source: Istat, 2014.

FIGURE 10

Composition of the public finances responses



Source: Authors' elaborations using Bank of Italy (2014), Istat (2015) and EUROMOD G1.5.

VAT and some direct taxes (in particular the local taxes on property) and by spending cuts.

Figure 10 and Table 1 provide an illustration of the size of the interventions since 2008 and their effect in terms of increased revenues, reduced spending and budget deficit, as shares of GDP. Focusing on the measures with a direct impact on households, cuts to spending on benefits and public sector pay ranged from 0.1 per cent of GDP in 2011 to 0.8 per cent in 2014 mainly due to the freezing of public salaries and pensions. The commitment to keep the public finances in order is self-evident. In fact, notwithstanding low or even negative GDP growth, revenues increased as well as expenditures reducing, contributing to a decrease in the level of public borrowing by about 6 per cent of GDP in 2013.

IV. Policy responses: an opportunity for reform?

1. Changes to tax and benefits

As reported in Tables 2 and 3, most of the tax and benefit changes were implemented in 2012, with unpopular reforms – such as the reintroduction of real estate taxation on the main residence and the reform of the pension system – being approved and implemented in just a few weeks.

Up to 2013, most of the policy changes involved tax increases (with the exception of an increase in the tax credits for dependent children) and cuts in social benefits and public sector pay. They did not include measures to

TABLE 2

Major tax changes post-crisis

	2011	*2012*	*2013*	*2014*
Social security contributions (employee and employer)	Increase in rates paid by temporary workers			
Social security contributions (self-employed)		Increase in rates		
Tax on rental income	Optional fixed rate (i.e. 21%) applied on most private rental income instead of including it in the progressive income tax			
Property tax		New property tax (i.e. IMU) on main and other residences	Property tax (i.e. IMU) only on other residences	New tax on housing services (i.e. TASI) on main and other residences
Solidarity contributions		3% of taxable income above €300,000 per year; deductible from personal income tax		
Personal income tax		Regional personal income tax surcharge: increase in rates in most regions	Increase of tax credits for dependent children	Increase of tax credits for employees

(Continued)

TABLE 2

Continued

	2011	*2012*	*2013*	*2014*
Personal income tax *(continued)*				Reduction of fiscal burden on labour income ('bonus' of €80 per month) for employees with taxable income below €26,000 per year
Tax on income from capital		Decrease of tax rate on deposits (from 27% to 20%) and increase of tax rate on bonds (if not state bonds) and dividends (from 12.5% to 20%)	Financial transaction tax	Increase of tax rate on dividends, bonds (if not state bonds) and deposits from 20% to 26%
Indirect taxes		Increase of standard VAT rate from 20% to 21% Increase of excises on fuel and tobacco	Increase of standard VAT rate from 21% to 22% (1 October 2013)	
Regional tax on productive activities (IRAP)		Increase in rates		10% decrease in rates

Note: All policies reported in the table have been simulated with the exception of the financial transaction tax and the regional tax on productive activities (IRAP).
Source: National legislation. See EUROMOD country report (Ceriani, Figari and Fiorio, 2015) for more details.

TABLE 3

Major benefit and public sector wage changes post-crisis

	2011	*2012*	*2013*	*2014*
Unemployment benefit			Replaced by a relatively more generous scheme (in terms of coverage and adequacy)	
Public pensions		Pensions between €90,000 and €150,000 per year subject to a 5% cut, 10% between €150,000 and €200,000 per year, and 15% above €200,000 per year No indexation of pensions above three times the minimum amount (approximately €1,400 per month in 2012) Structural reform extending retirement age and defining contributory pension system for all workers		New solidarity contribution (6% between 14 and 20 times the minimum amount; 12% between 20 and 30 times the minimum; 18% above 30 times the minimum) Partial indexation of pensions above three times the minimum amount
Public sector salaries	No indexation of public salaries	Public salaries between €90,000 and €150,000 per year subject to a 5% cut, and 10% above €150,000 per year		

Note: All policies reported in the table have been simulated with the exception of the structural reform of the pension system, which mainly does not affect the cohort of workers and retired people observed in the data.
Source: National legislation. See EUROMOD country report (Ceriani, Figari and Fiorio, 2015) for more details.

compensate or alleviate the impact of the wider economic circumstances. Only at the beginning of 2014 was there a first signal of some fiscal stimulus measures targeted at employees. These included a reduction of their tax burden, with new tax relief measures (worth €7.4 billion) and additional expenditure (€0.2 billion). Most of the tax relief (€6.7 billion) consisted of a reduction in the tax wedge for average- to low-income payroll workers. A 10 per cent permanent reduction in the tax rate of the productive activity regional tax (IRAP) was also introduced in 2014 with the aim of increasing aggregate demand.[9] However, the effectiveness of such measures in boosting employment has been questioned, mainly because of the absence of a clear-cut policy and adequate resources allocated to it.[10]

On the revenue side, the most relevant measures, in terms of budgetary effects and hence distributional impact, concerned local taxes on residential property and related services (specifically, waste collection), taxes on income from capital (decreased in 2012 and then increased in 2014) and the increase in the VAT standard rate (from 20 per cent to 22 per cent). The fact that there were continual changes to the same taxes shows that most of the measures did not follow medium- or long-term plans but were measures announced and introduced at one point and then revised according to political and economic circumstances.

On the expenditure side, the most relevant measures were the cuts and the limitations to the indexation of public sector salaries and public pensions, which impacted on disposable income in the subsequent years. In terms of structural changes, the reform of public pensions was an important attempt to stabilise further the pension system and it represents the culmination of 20 years of reforms with an important impact mostly on those who will retire in the future.

In order to analyse the distributional impact of the measures implemented in 2012, 2013 and 2014, we make use of EUROMOD,[11] based on information derived from the 2010 IT-SILC,[12] corrected to account for changes in employment and market incomes in the period covered in the simulations.[13]

The analysis of the redistributive impact of the fiscal consolidation measures is based on a counterfactual scenario defined as the continuation of pre-fiscal-consolidation policies – that is, what would have happened in the absence of the fiscal consolidation measures. Given the absence of relevant policy changes since the onset of the crisis until 2011, our counterfactual scenario is based on the tax–benefit rules in place in 2011 indexed according to established indexation rules and conventions (i.e. public sector pay, pensions and benefits

[9]Bank of Italy, 2014.
[10]Arachi and Santoro, 2014.
[11]Sutherland and Figari, 2013.
[12]Ceriani, Fiorio and Gigliarano, 2013.
[13]Navicke, Rastrigina and Sutherland, 2014.

indexed mainly by prices and no indexation of personal income tax bands).[14] Moreover, we have estimated the impact of the increases in the VAT standard rate and in the main excise duties as a proportion of disposable income based on the incidence of (pre-reform) VAT by income decile groups.[15]

The overall fiscal consolidation, generated by the household income-based measures included in the analysis, ranges from 2.4 per cent of pre-austerity disposable income in 2012 to 2.5 per cent in 2013 and 2.7 per cent in 2014. These figures are well below those found for other Mediterranean countries and Baltic republics in the same period and in line with those for the UK.[16]

Figure 11 shows the cumulative effect of the different types of measures, by income decile groups, from the counterfactual scenario representing the policies in place in 2011 to the years considered in each panel. In 2012, policy changes present a slightly inverted U-shaped pattern, with the poorest and richest income groups contributing more in relative terms. Towards the top of the income distribution, this effect is primarily due to the incidence of real estate tax (on main and other residences) and the limited indexation of public pensions, which imposes larger losses in percentage terms in the middle and top of the distribution than at the bottom, where pensions kept pace with the consumer price index. Several progressive measures implemented in the same year (for example, the solidarity contribution and a marginal cut in very high public pensions and public salaries) have only a limited effect due to narrow targeting. At the bottom of the income distribution, most of the effect is due to the property tax (almost 60 per cent of households in the first quintile are owner-occupiers) and the increase in indirect taxes, well known to be regressive if measured with respect to current income. The effect of public sector pay cuts is captured, net of any reduction in income tax and social security contributions; as a consequence, the figures for income tax are net of reductions due to the decreased tax base in these respects. The main reason for the decrease in income tax at the top of the income distribution is the changes in capital income taxation.

In 2013, a slightly progressive pattern emerged, mainly due to the abolition of the real estate tax on the main residence and the cumulative effect of the freezing of public pensions and public sector salaries which impact largely on those in the middle and top of the distribution. At the bottom of the distribution, households benefited from the positive impact of changes to unemployment benefit, which was expanded to cover apprentices as well and was made relatively more generous. At the same time, the increase of the standard VAT

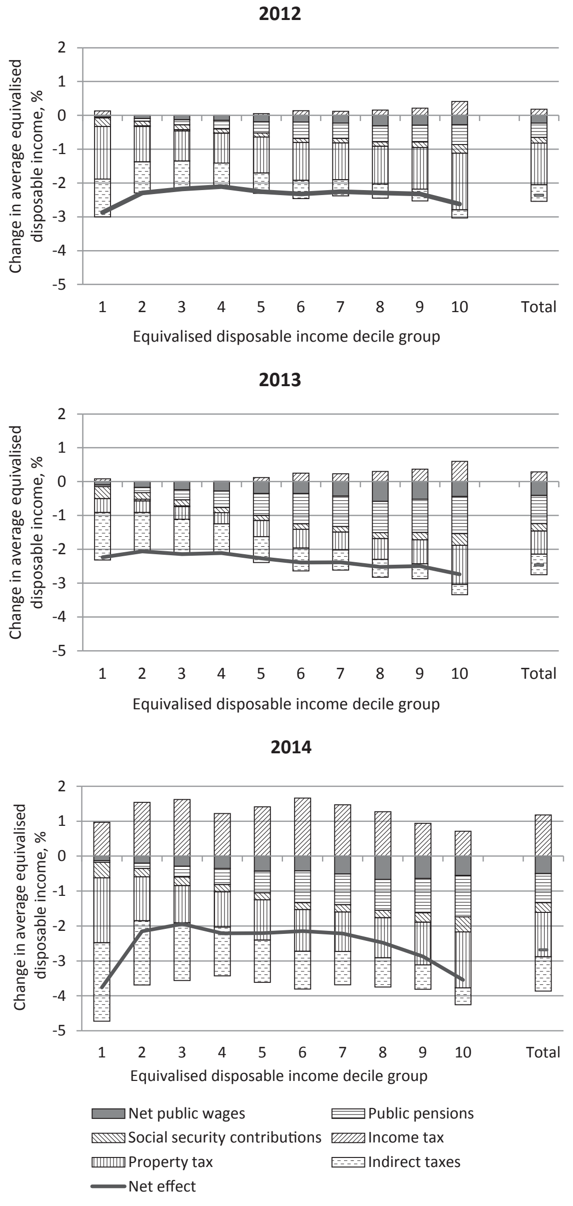
[14]While some fiscal tightening measures were implemented prior to 2011, these largely comprised cuts to spending on public services (as shown in Figure 10). It is difficult to allocate these cuts to individual households and so the effect of these measures is not captured by EUROMOD. We therefore focus on the effect of changes to taxes and benefits introduced from 2011 onwards.

[15]Taddei, 2012.

[16]Avram et al., 2013; Emmerson and Tetlow, 2015 (in this issue).

FIGURE 11

Redistributive impact of tax and benefit changes, 2012–14



Note: Each panel shows the cumulative effect of the different types of measures, by income decile groups, from the counterfactual scenario representing the policies in place in 2011 up to the year considered.
Source: Authors' calculations using EUROMOD G1.5.

rate from 21 per cent to 22 per cent (in October 2013) reduced the potential progressivity of these other fiscal consolidation measures.

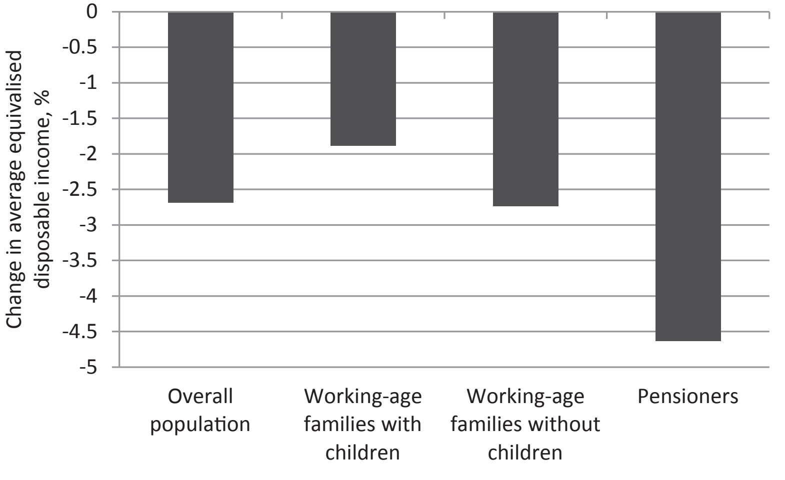
As mentioned, 2014 was the first year to witness some fiscal stimulus measures targeted at employees through an increase of tax credits for employment income and, above all, through the concession of a monthly ‘bonus’ of €80 for employees with yearly taxable income below €26,000, which have a clear redistributive effect. However, such measures are not well targeted on the poorest because they are defined at the individual level and under the condition of receiving at least €8,000 of annual income from employment. This undermines the potential equity and efficiency effects of these measures, which is a well-known problem of the Italian social safety net.

However, the overall net impact of the fiscal consolidation measures is affected by the increase in indirect taxes from October 2013 onwards and the new real estate tax (TASI) that replaced the previously-existing one, with an increased regressivity effect because of the abolition of tax credits for the main residence and for families with dependent children which can be reintroduced at local level and are not captured in our analysis.

The fiscal consolidation measures marginally rebalanced the Italian welfare system, which has traditionally been biased in favour of elderly people. Figure 12 reports the proportional change in disposable income that occurred in 2014

FIGURE 12

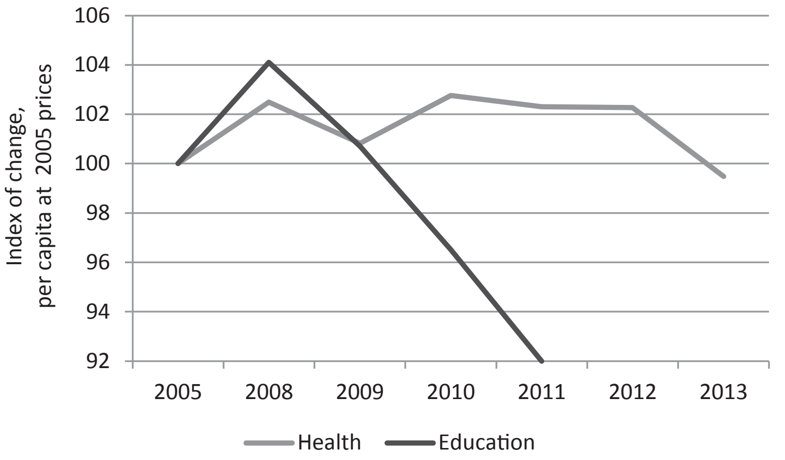
Impact of tax and benefit changes by family type, 2014



Note: Cumulative effect of consolidation measures from the counterfactual scenario representing the policies in place in 2011 up to 2014. Family types are mutually exclusive and derived based on the presence of at least one individual with the mentioned characteristics in the same order as appearing in the figure.
Source: Authors’ calculations using EUROMOD G1.5.

FIGURE 13

Spending cuts by function



Source: OECD, 2014b and 2014c.

for the overall population and for (a) working-age families with children (defined as aged under 18), (b) working-age families without children and (c) pensioners (defined as aged 65 or more). Overall, it shows the larger burden on elderly people, which is due to the property tax levied on the main residence and the limited indexation of public pensions that cumulates over the years. Families with children, likely to have at least one dependent adult and on average with lower income than families without children, tend to have benefited more from the recent stimulus measures.

2. Changes to spending on public goods and services

As shown in Figure 10, since 2011 spending on public services was subject to a cut of more than 1.5 per cent of GDP per year, affecting public services with a direct impact on household welfare. The most significant reductions in public services were those related to health and education services: both sectors witnessed a sharp reduction in per-capita expenditure from 2009 (Figure 13). The reduction in per-capita spending was particularly sharp in the educational sector because enrolment increased; cuts were delivered in large part by not renewing teachers' contracts. Italy is the only OECD country where spending in the educational sector did not increase overall between 1995 and 2011.

The cuts to the health sector, imposed by the governmental spending review mainly as linear cuts to the budgets of the local health authorities, emerge clearly after 2012. Prior to this, the system had proved to be financially sustainable and was characterised, in comparison with most European countries, by high levels of performance in terms of both efficiency and quality.[17] Expenditures in the health-care sector were brought about by the termination of fixed-term employment contracts, cuts in pharmaceutical expenditures and rebalancing of expenditures in eight out of 21 Italian regions.

3. Other structural reforms

The technocratic government introduced, in 2011–12, two main structural reforms. One related to the pension system and the other to the functioning of the labour market.

The reform of the pension system was implemented at the end of 2011, completing two decades of important but 'exasperatingly slow piecemeal' reforms of the pension system.[18] The reform did not change the overall nature of the system but increased the statutory retirement ages for employees in the private sector from 60 years to 62 years for women and from 65 years to 66 years for men. The retirement age is subject to a gradual increment up to 66 years and 7 months for both men and women in 2018, with further adjustment depending on the evolution of life expectancies. The reform also abolished pensions based exclusively on years of work irrespective of age and imposed the contribution-based method of calculating benefits for all workers. As a consequence, the Italian pension system is now fully financially sustainable[19] and expenditure on pensions as a share of GDP is projected to decline between 2015 and 2030 (particularly as a result of the increased statutory retirement age); expenditure is expected to increase again between 2030 and 2045, due to a worsening in the workers/pensioners ratio because more numerous cohorts are reaching retirement age, and then to decrease again due to the full implementation of the contributory system (Figure 14). However, the actual financial sustainability of the pension system will depend on the evolution of GDP and, in particular, on the effect of the increased retirement age on the labour market participation of young people and on overall productivity.

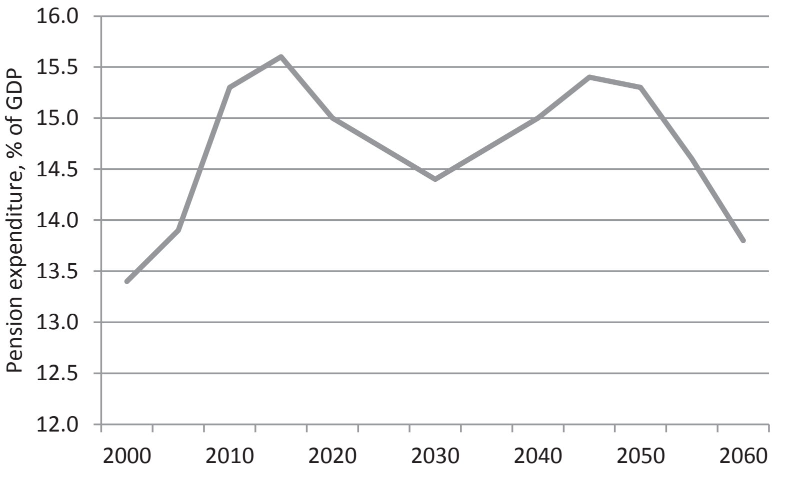
On the labour market side, in recent decades reforms of work security and flexibility have not been implemented as expected, giving rise to a model of flex-insecurity. This has shown its main shortcomings during the recent economic crisis: rising unemployment, limited access to social security and, due to low wages, depletion of the savings that individuals had to rely upon in bad times.[20]

The labour market reforms initiated in 2012 aimed to reaffirm the centrality of open-ended contracts through fiscal incentives and job subsidies but aimed,

[17] Caruso and Dirindin, 2013.
[18] Fornero, 2013.
[19] OECD, 2013.
[20] Berton, Richiardi and Sacchi, 2012.

FIGURE 14

Evolution of pension expenditure



Source: MEF, 2012.

at the same time, to establish greater flexibility in fixed-term contracts (by abolishing the need to specify the reason for issuing this type of contract) and to extend a more generalised safety net with new unemployment benefits for workers with fixed-term contracts.

Over recent years, a substantial reduction of the tax wedge on new contracts has been implemented in different stages by a temporary reduction in social security contributions targeted at elderly workers and women[21] and a more generous wage subsidy, corresponding to one-third of the gross salary, granted to firms hiring young workers for a period of 18 months.[22] Moreover, since the beginning of 2015, firms are exempted from paying social security contributions on new permanent contracts for three years.[23]

Despite the economic crisis having hit the Italian economy very hard at the time that major labour market reforms were being made, official statistics show an increase in the share of open or fixed-term contracts and apprenticeships and a reduction in the share of temporary contracts since the end of 2013.[24]

New measures, aimed at defining a comprehensive reform of the labour market, have been introduced by the new government at the beginning of 2015. They included the so-called Jobs Act – which has the potential to reduce the widespread segmentation of the Italian labour market and to provide more

[21] Fornero Law, N. 92/2012.
[22] Giovannini–Letta Law, N. 99/2013.
[23] Stability Law, N. 190/2014.
[24] ISFOL, 2015.

clarity on the costs and time involved in the dismissal of workers for economic reasons – further incentives for firms to hire or convert more workers to permanent contracts, and efforts to promote the participation of women and to extend income support to all the unemployed.[25] Overall, according to the OECD (2015), the reforms under way could, over 10 years, boost average annual per-capita GDP growth by 0.6 per cent, productivity by 3.6 per cent of GDP and employment by 2.7 per cent.

V. Conclusion

Besides the huge effects of the Great Recession on the Italian economy, great efforts have been made by governments to keep the public finances under control, limiting the level of net borrowing and the increase of public debt.

The effects of the economic crisis and of austerity measures on household income are of great current relevance, not only in their own right but also because the way in which the cost of the crisis is distributed has implications for macroeconomic recovery prospects and for financial stability, as well as for the political acceptability of policy interventions. In the Italian case, the impact of the two recessions on living standards must be seen in the context of an economy that had stagnated for almost a decade, with average-income households losing their purchasing power and facing increasing occupational insecurity, and with governments obliged to carry out fiscal consolidation and implement structural reforms to acquire new confidence in international markets.

The direct effects of the economic crisis, characterised by a second dip in 2011 and still affecting the Italian economy, were generally felt more by non-elderly households due to the large impact on their employment opportunities and salaries. Italian governments implemented a series of consolidation measures, mostly at the beginning of the second recession which hit the national economy at the end of 2011. These measures are much smaller than those implemented in other Mediterranean countries, in part due to the relatively good position of the public finances prior to the Great Recession and in part due to the reliance on structural reforms implemented in the same period.

Overall, the distributional pattern of fiscal consolidation measures gives the opportunity to highlight some issues and prospects for the Italian tax–benefit system. The burden imposed on individuals and their families was overall slightly progressive across the top 90 per cent of the income distribution. However, those at the very bottom of the income distribution lost out through increases in indirect and property taxes. This pattern demonstrates the absence of any generalised social safety net, which represents a chronic problem of the Italian welfare system and is unique within the European context. There has

[25]OECD, 2014a.

also been a marginal shift from taxes on labour income to taxes on consumption and income from capital, following the wide consensus on growth-friendly tax reforms. However, the shift has also involved a net revenue increase, which reduces any potential positive impact there might have been on aggregate demand had the shift been revenue neutral. Most of the burden of fiscal consolidation has fallen on pensioners and public sector employees, who were less affected (than working-age adults and workers in the private sector) by the wider consequences of the recession. However, the decline in their real income reduces aggregate internal demand, and the medium-term outlook is still uncertain: a great deal depends on the capacity of the Italian economy to return to sustained economic growth, which has been absent for more than a decade.

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