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# Italy's Spending Maze Runner

An analysis of the structure and evolution of public expenditure in Italy

Dimitri Lorenzani, Vito Ernesto Reitano

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Dimitri Lorenzani, Vito Ernesto Reitano

### Abstract

This paper explores the composition and developments of public expenditure in Italy and compares them with other big Member States. On the basis of this analysis, it draws several possible policy implications. Based on the latest available data by economic classification and function, Italy's public expenditure appears to be increasingly biased towards the elderly, while growth-enhancing spending has been markedly restrained during the crisis. Debt-servicing costs absorb significantly higher resources than in the rest of the euro area, so that Italy's public expenditure remains above the euro area average as a share of potential GDP despite slightly lower primary expenditure. Overall, the paper suggests that it may be difficult in the future to contain Italy's primary expenditure solely by relying on spending cuts, while leaving the current perimeter of State action unchanged. A systematic and rigorously implemented spending review would be needed to increase the efficiency of public expenditure and make its composition more growth-friendly, in order to support ongoing structural reform efforts and boost the country's potential growth. Finally, positive spending review measures enacted so far in Italy, such as the so-called "Fornero reform" to reduce the much higher-than-average pension expenditure and ensure its sustainability in the long run, should be fully implemented also with the objective of increasing labour market participation and the adequacy of future entitlements.

**JEL Classification:** E61, E62, E63, H50, H60, H72.

**Keywords:** Italy, spending review, public expenditure, pensions, Fornero reform, debt, deficit, potential growth, structural reforms, Stability and Growth Pact.

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## 1. INTRODUCTION

In recent years, there has been a growing interest, by both the research community and the general public, in understanding how, and how efficiently, public resources are allocated in the different Member States. This is confirmed, among others, by the recent open knowledge project from the campaign group *Open Spending* <sup>(1)</sup>, breaking down the public expenditure of as many worldwide governments as possible based on publicly available national accounting data. Understanding the structure of general government expenditure, as well as what lessons can be drawn from its evolution over time in response to macroeconomic and contingent circumstances, is in fact a *condicio sine qua non* to be able to come to more efficient and effective planning and management of public resources. This applies both to the public authority, who has to face this challenge on a daily basis, as well as to the constituencies. The latter need in fact to be adequately equipped to form an opinion and a voting choice on public resource allocation, directly affecting the quality of their lives also through public service provision. All this reinforces a crucial aspect of public spending accountability. This complex and articulated process, when formalised, goes under the name of *spending review*. <sup>(2)</sup>

The “*spending maze runner*” challenge has received increasing attention in the case of Italy in recent years, as broad evidence of lingering inefficiencies in the allocation of public resources from both the research community and governmental sources has led to several spending review exercises being carried out since 2007, although at an irregular pace and with mixed success. This was first led by the urgency to achieve fiscal consolidation targets during the global financial crisis, but has more and more been presented and perceived as a crucial tool to expand the available fiscal space to prioritise new, and ideally more growth-enhancing, spending in the context of aggregate expenditure restraint. The spending review challenge has both an economic-financial aspect, focussed on reducing “wasteful spending” and freeing resources also in short run, and a more institutional aspect, aimed at achieving a durable improvement in the design of the general government policies, including as far as the management of public resources is concerned. <sup>(3)</sup> The latter, more long-run, dimension is at least as important as the former, since it might progressively lead to an increasingly performance-informed budgeting process in Italy, coupled with a step-change in the institutional setting, without which other reform efforts might not be able to deliver their full economic impact. In this context, confirming the heightened topicality and policy relevance of the spending review challenge in Italy, in July 2015 the country received by the Council of the European Union a country specific recommendation to “ensure that the spending review is an integral part of the budgetary process”. <sup>(4)</sup> The recent Commission opinion on Italy’s 2016 Draft Budgetary Plan <sup>(5)</sup> has further reiterated the recommendation by asking, as far as a systematic spending review process is concerned, “more effort [...] across all levels of government”.

This paper analyses the structure and the evolution of public expenditure in Italy in a both diachronic and EU-wide comparative perspective. The most recent available data on general government expenditure aggregates are assessed for Italy, in comparison with peer EU Member States, both in terms of broad economics classification and of functional categories. Expenditure developments are normally taken as a share of potential GDP <sup>(6)</sup> – which can be used as a measure of a country’s

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<sup>1</sup> See <https://openspending.org/>, an initiative based on what was done in the United Kingdom by the project *Where Does My money Go?* (<http://wheredoesmymoneygo.org/>).

<sup>2</sup> Spending reviews can be defined, following OECD (2013) and Vandierendonck (2014), as “*the systematic and in-depth scrutiny of baseline expenditures with the objective to detect efficiency savings and opportunities for cutting low-priority or ineffective expenditures in a coordinated effort*” and “*much more than a tool for cutting aggregate expenditure. Properly viewed, it is a core instrument for ensuring good expenditure prioritization – more specifically, for expanding the fiscal space available for priority new spending in a context of firm aggregate expenditure restraint*”. It should be noted that spending reviews are only one possible way of proceeding to come to better planning and management of public expenditure. Additional tools, which are however beyond the scope of this work, include, among others, rules constraining expenditure and correction mechanisms for overruns.

<sup>3</sup> See Hinna and Marcantoni (2012).

<sup>4</sup> See [http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index\\_en.htm](http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm)

<sup>5</sup> See [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/dbp/2015/it\\_2015-11-16\\_co\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf)

<sup>6</sup> Potential output can be defined as “the best composite indicator of the aggregate supply side capacity of an economy and of its scope for sustainable, non-inflationary growth”, estimated on the basis of the commonly agreed methodology in Havik K. *et al.* (2014). The focus on developments in general government expenditure as a share of potential GDP used in this paper

capacity to finance its spending – and, when possible, excluding the impact of one-off expenditure. <sup>(7)</sup> Potential GDP estimates are based on the Commission 2015 autumn forecast. <sup>(8)</sup>

Several papers are already available in the literature analysing Italy's general government expenditure and its evolution, efficiency, and effectiveness. These tend to either feature quantitative analysis aimed at disentangling specific efficiency profiles of Italy's resource allocation, as in IMF (2014), or examine only partial aspects of the impact of public spending choices at large, such as its relationship with long-term growth in Barbiero and Cournède (2013) and with Italian regional convergence in Vittorio (2009). Others focus on sector-specific spending review processes, for instance in healthcare in Medeiros and Schwierz (2015), or take a horizontal perspective looking mostly at common features across all Member States, as in Vandierendonck (2014). A panoply of descriptive statistics, for Italy as well as for the EU Member States, can be found in studies carried out by the Italian government, as in RGS (2015). With respect to the mentioned analyses, the present work has the more targeted scope to provide a simple analytical basis, grounded in the direct observation and explanation of Italy's public expenditure developments since the adoption of the euro, to assess its structure and quality also in relative terms compared to the rest of the Euro Area. In doing so, the paper also aims at highlighting policy options in the context of Italy's ongoing spending review, including the resource allocation strategy and areas of possible future savings. While a full-fledged analysis of the economic impact of targeted spending review actions in Italy is beyond the immediate scope of the paper, it may well represent a natural extension of it for forthcoming research.

As *caveats*, it should be borne in mind that the conclusions drawn in this work deliberately refer only to the expenditure side of Italy's budgetary policy. However, increasing the efficiency and quality of public spending should always be regarded as part of a two-pronged strategy also aimed at minimising the distortionary impact on economic growth of the revenue side of the budget, including by exploring avenues to simplify the tax code and enhance tax compliance.

The structure of this work is organised as follows. Section 2 outlines the developments of public expenditure in Italy since the euro adoption and analyses its structure based on broad economic categories, also in comparison with other big EU Member States. Section 3 delves into the composition of Italy's primary expenditure broken down by COFOG functions of government. Section 4 focuses on prospects for the quality and efficiency of Italy's general government spending, also taking into account recent policy developments as regards the ongoing spending review. Section 5 features concluding remarks, including relevant stylised facts drawn from the analysis as well as policy implications.

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can be considered consistent with the fact that, in EU budgetary surveillance practices, the expenditure benchmark (introduced by the 2011 reform of the Stability and Growth pact) aims at containing the growth rate of government primary expenditure net of discretionary revenue measures at or below a country's medium-term potential economic growth rate.

<sup>7</sup> One-off expenditure is typically capital expenditure. E.g. it includes the sale of UMTS (mobile phone) licences (recorded as negative expenditure in one year only, namely in 2000 for Italy), the sale of real assets, as well as capital injections and guarantee calls (recorded as capital transfers), which have been a distinct feature in some countries during the financial crisis, notably benefitting financial institutions.

<sup>8</sup> See [http://ec.europa.eu/economy\\_finance/eu/forecasts/2015\\_autumn\\_forecast\\_en.htm](http://ec.europa.eu/economy_finance/eu/forecasts/2015_autumn_forecast_en.htm)

## 2. STRUCTURE AND TRENDS OF PUBLIC EXPENDITURE IN ITALY

This Section explores some stylised facts on the structure and evolution of Italy's public expenditure since the euro adoption. The observation that Italy's total public expenditure as a share of potential GDP has been steadily growing since 1999, mainly driven by primary expenditure, leads to the analysis of the main drivers behind these developments. These include the denominator effect, in particular Italy's exceptionally sluggish potential growth since the onset of the global financial crisis, the numerator effect, in particular the insufficient containment of current primary expenditure before the crisis and actions to curb it thereafter, as well as some institutional aspects. In doing so, particular attention is paid to the composition of Italy's primary expenditure by broad economic categories. <sup>(9)</sup>

### 2.1. Developments in Italy's public expenditure between 1999 and 2014

**Italy's total public expenditure is still above the EA average mainly due to the higher cost of servicing public debt.** In 2014, Italy's total public expenditure as a share of potential GDP was approximately 1 pp above the EA average (at 49.2% vs. 48.2%), second only to France (56.4%) among big Member States <sup>(10)</sup> (see Graph 2.1) and was the sixth largest in the EA. <sup>(11)</sup> This occurred despite the fact that Italy's primary expenditure net of one-offs stood at 44.7% of potential GDP, i.e. slightly below the EA average <sup>(12)</sup> of 45.3%. The reason is that Italy's interest bill, at 4.5% of potential GDP in 2014, absorbed much more resources than in the EA, where it accounted for 2.6% of potential GDP on average. The evolution of Italy's total public expenditure between 1999 and 2014 shows a steady increase of around 1.7 pps of potential GDP, of which around three quarters occurred in the crisis years (between 2007 and 2014), compared to broadly stable public expenditure in the EA. This increase was however below those observed in France (3.9 pps of GDP) and the United Kingdom (5.4 pps of GDP) among big Member States between 1999 and 2014.

**Expenditure dynamics in the 1999-2007 pre-crisis years were driven by significant rise in primary expenditure as a share of potential GDP,** of around 2 pps, <sup>(13)</sup> only partially offset by a decrease in the interest bill of 1.5 pps of potential GDP. The former reflects a general trend of all big EU Member States but Germany to increase primary spending at a considerably faster pace than potential GDP growth between the euro adoption and the inception of the crisis, although in Italy this was more accentuated than in any other big Member State but the United Kingdom. Overall, Italy's primary spending increased in nominal terms by 4.4% per year on average, well above the current estimate of average nominal potential growth of 3.8% over the same period. As regards interest expenditure, the mentioned fall since 1999, well above that observed in the EA (at 1.5 pps of potential GDP vs. 1 pp), reflects the fact that Italy was, together with Spain, the big Member State benefitting the most from the reduction in nominal yields ensuing from the euro adoption.

**Over the crisis, between 2007 and 2014, observed expenditure dynamics were mainly related to a still sustained increase in primary spending as a share of potential GDP** (of some 1.6 pps) only partially offset by a marginal decrease in interest expenditure. The former, below the average EA increase (of 1.8 pps of potential GDP) but above that observed in all big Member States except France (at 3.2 pps), was mainly due to a period of exceptionally sluggish potential growth. The slight

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<sup>9</sup> The economic classification distinguishes public expenditure in broad categories on the basis of its economic destination, for instance intermediate consumption, compensation of employees, social benefits, gross fixed capital formation, etc.

<sup>10</sup> Throughout this paper, the expression "big Member States" (in terms of both GDP and population) refers to France, Germany, Italy, Spain, and the United Kingdom.

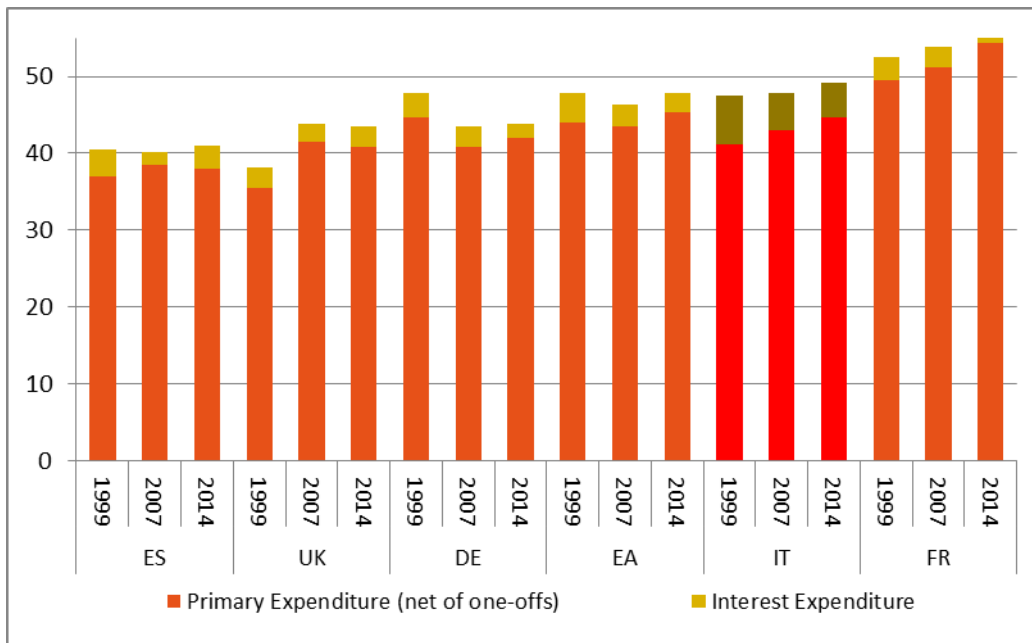
<sup>11</sup> After Finland, France, Belgium, Austria, and Portugal, respectively.

<sup>12</sup> Due to data availability over time, the adopted definition of Euro Area throughout this paper refers (unless otherwise specified) to an EA18 aggregate excluding Greece from the EA19.

<sup>13</sup> These results are partly due to the revision of potential GDP growth in past years that involved big Member States to a different extent, being France, Italy, and Spain the most hit by the crisis. For instance, Italy's forecast output gap in 2007 was revised upward by 2.5 pps of potential GDP between spring 2008 and autumn 2015 (from -0.3% to +2.2%); similarly, the upward revision was of 3.5 pps for Spain (from 0.4% to +3.1%) and 3.3 pps for France (from -0.2% to +3.1%), while for Germany and the United Kingdom it amounted "only" to 1.1 pps (from +0.7% to +1.8%) and 1.9 pps (from +0.4% to +2.3%), respectively.

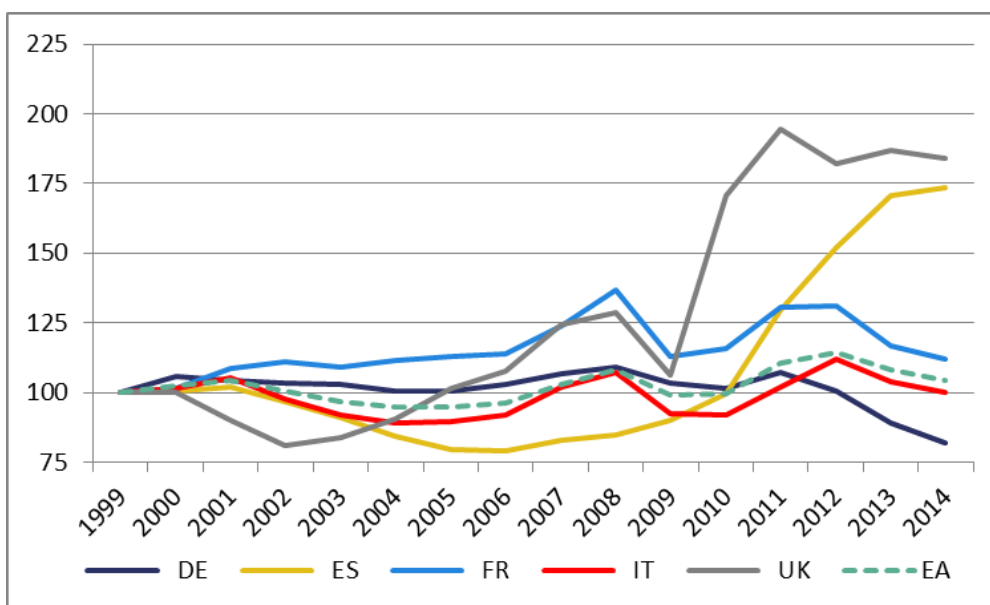
drop in interest expenditure was instead the result of the sharp spike in nominal yields ensuing from the 2011 sovereign debt crisis, followed by a declining trend thanks in part to Italy's cautious debt-management coupled with ECB actions to address the EA crisis. As a result, Italy's interest bill in nominal terms reverted in 2014 to the 1999 level (see Graph 2.2), experiencing the most favourable performance among big Member States after Germany (where the annual interest bill in nominal terms shrank by 18% between 1999 and 2014). By contrast, interest expenditure soared in both Spain and the United Kingdom as of 2009-2010, mainly due to a significant increase in debt levels related to banks' support in the aftermath of the global financial crisis.

Graph 2.1: Total general government expenditure (1) and components in selected EU countries, % of potential GDP



Source: AMECO. (1) Excluding one-off expenditures. Countries are ranked by increasing total expenditure shares in 2014.

Graph 2.2: Interest expenditure at current prices in selected EU countries (1999=100)



Source: AMECO.



**Although somewhat below the EA average, Italy's primary expenditure is above what is needed to reduce its relatively higher tax burden.** While Italy's expenditure developments are hereby compared to the most immediate aggregate of reference, i.e. the average in (the rest of) the EA, different starting conditions as well as competitiveness considerations imply that this comparison should be qualified. In fact, Italy has a higher cost of servicing its sovereign debt than the rest of the EA, amounting in 2014 to around 2¼ pps of potential GDP, as well as a more demanding fiscal medium-term objective, <sup>(14)</sup> by some ¼ pp of potential GDP, set by the Member State also in light of its very high debt-to-GDP ratio. This implies that Italy should achieve a much lower level of primary spending than in the rest of the EA in order to avoid a relatively higher tax burden. Namely, as the required fiscal effort still needed to achieve the respective MTO was broadly comparable between Italy and the rest of the EA in 2014 (at around 1 pp of GDP), Italy should aim at a level of primary expenditure some 2.5 pps lower than the rest of the EA. Based on 2014 data, this would imply compressing Italy's primary expenditure by a further 1½ pps of potential GDP so as to attain the MTO and create at once the fiscal space to reduce the tax burden to a level comparable with that of the rest of the EA. At the same time, a higher-than-average tax burden is not a competitive drag *per se* to the extent that it serves to finance higher growth-enhancing expenditure items such as investment, education, and research. This is even more the case if it is shift away from productive factors onto less distortionary items such as taxation on wealth, and in particular recurrent property taxation. This appears highly relevant for a country like Italy, displaying a rather high level of households' wealth, <sup>(15)</sup> coupled with a negative net financial asset position of the government sector. <sup>(16)</sup> Furthermore, it should be taken into account that Italy's main primary expenditure items, i.e. generous pension entitlements (see Section 3) and compensation of employees cannot be easily compressed in the future, especially after two recent Constitutional Court rulings on these issues. <sup>(17)</sup>

## 2.2. Drivers of public expenditure: analysis of the denominator effect

**Sluggish potential growth was a major driver of the increasing primary expenditure ratio despite efforts to contain public spending dynamics.** Between 1999 and 2014, Italy's primary expenditure grew at the second slowest pace in the EU after Germany both in real terms <sup>(18)</sup> (by a mere 1% per year on average, while in the EA it grew by 1.6% per year) and in nominal terms (by 3% per year on average, while in the EA it grew by 3.3% per year). However, Italy's much lower potential GDP growth – which can be used as a measure of a country's capacity to finance its spending – implied that, over the same period, the share of primary spending in potential GDP expanded from 41% to 44.7%, i.e. above most big Member States. As a comparison, German primary expenditure increased below the country's potential growth and its share in potential GDP shrank from 44.7% in 1999 (i.e. higher than in Italy) to 42% in 2014. However, it is worth noting that Italy's low potential growth is arguably, at least to some extent, also the result of ineffective public spending policies, failing to support more sustainable growth based on physical infrastructure, human capital, and innovation. Looking forward, the fiscal effort needed in the short-term to achieve Italy's medium term objective of a balanced budget in structural terms together with recently announced tax cuts <sup>(19)</sup>

<sup>14</sup> Italy's medium-term objective (MTO) is that of a balanced budgetary position in structural terms, which reflects the objectives of the Stability and Growth Pact. A balanced budget rule has been enshrined in the Italian Constitution since April 2012. Italy's 2016 Draft Budgetary Plan foresees the achievement of the MTO by 2018.

<sup>15</sup> Based on Bank of Italy (2014), households' wealth in Italy is the second highest in the EA after France.

<sup>16</sup> Worth around 100% of Italy's GDP in 2012, compared to around 60% in the EA.

<sup>17</sup> On 30 April 2015, the Italian Constitutional Court (ruling 70/2015) declared unconstitutional (on equality grounds) the part of the Decree Law 201/2011 (so-called "*Salva Italia*") blocking the indexation to the cost of living over the years 2012-13 of pensions slightly above gross EUR 1400 per month (i.e. three times above the minimum ceiling). On 24 June 2015, the Italian Constitutional Court (ruling 178/2015) declared unconstitutional, starting from the publication date of the ruling (23 July 2015), and without retroactive effect, the freezing of collective bargaining for public wages introduced by the Decree Law 98/2011, specified by the DPR 122/2013, and extended by the 2014 and 2015 Stability Laws.

<sup>18</sup> Figures in real terms throughout the paper refer to deflation by the GDP deflator unless otherwise specified.

<sup>19</sup> The 2016 Budget Law foresees the following tax cuts: (i) the abolition of recurrent property taxation on first residences (worth overall EUR 3.6 billion or 0.22% of GDP), with a full compensation to Municipalities of the related lost revenue; (ii) a cut of property tax on agricultural real estate and immovable machinery for productive use (amounting together to EUR 935 million or 0.06% of GDP); (iii) a tax break on productivity premiums to promote second-level firm bargaining (worth around EUR 430 million or close to 0.03% of GDP in 2016); (iv) a reduction by 40%, for an overall duration of two years, on employers' social contributions paid on new permanent employees hired in the course of 2016 (with a negative impact on

and repeal of legislated increases in VAT would require very large expenditure cuts. These would amount to around 1.5 pp of GDP in 2017, just to avoid the large VAT hike now foreseen for that year and at the same time reduce the structural deficit in accordance with the requirements of the Stability and Growth Pact. Further adjustments, overall in the order of 1 pp of GDP, would be needed in the following years for Italy to reach its medium term objective.

**Sluggish potential growth also weighs on Italy public debt dynamics relative to the rest of the EA.** Italy's underlying debt developments are less favourable than in the rest of the EA not only because of a much higher debt-to-GDP ratio (at 132.3% vs. 85.3% in 2014) but mainly due to a larger differential between debt-servicing cost and nominal potential growth. More specifically, the implicit cost of servicing Italy's public debt<sup>(20)</sup> declined steadily between 1999 and 2004, in line with the rest of the EA (see Graph 2.3), which in both cases almost entirely offset falling nominal potential growth resulting in a broadly constant differential between debt-servicing cost and growth, in the order of 1 pp, similar to the rest of the EA. This implied in turn only minor changes in the underlying debt dynamics related to the so-called *snow-ball effect*.<sup>(21)</sup> However, the differential between Italy's nominal potential growth and the implicit debt-servicing cost began to widen in 2005-2007, while in the same period the higher potential growth helped the rest of the EA to curb the underlying debt-to-GDP dynamics. The fact that the global financial crisis hit Italy's nominal potential growth harder than the rest of the EA made the gap with the debt-servicing cost rise more markedly, to around 4 pps in 2010 vs. 1.8 pps in the rest of the EA. Thereafter, due to the sovereign debt crisis, Italy started paying a significant risk premium relative to the rest of the EA in a context of very low nominal potential growth (on average at around 0.7% in Italy over 2011-2014 due to both low inflation and negative real potential growth). This has implied a persistently large gap between implicit interest rates and nominal potential growth in Italy, while in the rest of the EA the gap has been closing fast and is forecast to even turn negative after 2015. Underlying debt dynamics are forecast to improve in Italy from 2016, as lower spot interest rates are gradually reflected in the implicit debt-servicing cost<sup>(22)</sup> and nominal potential growth recovers. Namely, the differential between debt-servicing cost and potential growth is expected to narrow but remain sizeable at around 2 pps, while it should turn negative in the rest of the EA. In this context, Italy's debt sustainability remains challenging, as a high primary surplus of around 2.5% of GDP would be needed just to stabilise the debt-to-GDP ratio. Further improvement is forecast on a no-policy change basis in 2017, when the differential between Italy's debt-servicing cost and potential growth is set to revert to around 1 pp. Should this favourable trend continue and further reduce the differential to 0.5 pp in the medium term, a primary surplus of 0.6% of GDP would be needed to stabilise Italy's debt ratio, yet a much more sizeable one, in the order of 4% of GDP, would still be required to ensure compliance with the debt rule of the Stability and Growth Pact. Overall, a two-pronged strategy towards putting Italy's general government debt ratio on an adequate downward path should hinge over the medium term upon both maintaining a high primary surplus and boosting potential growth through bold structural reforms and a more growth-oriented budget.

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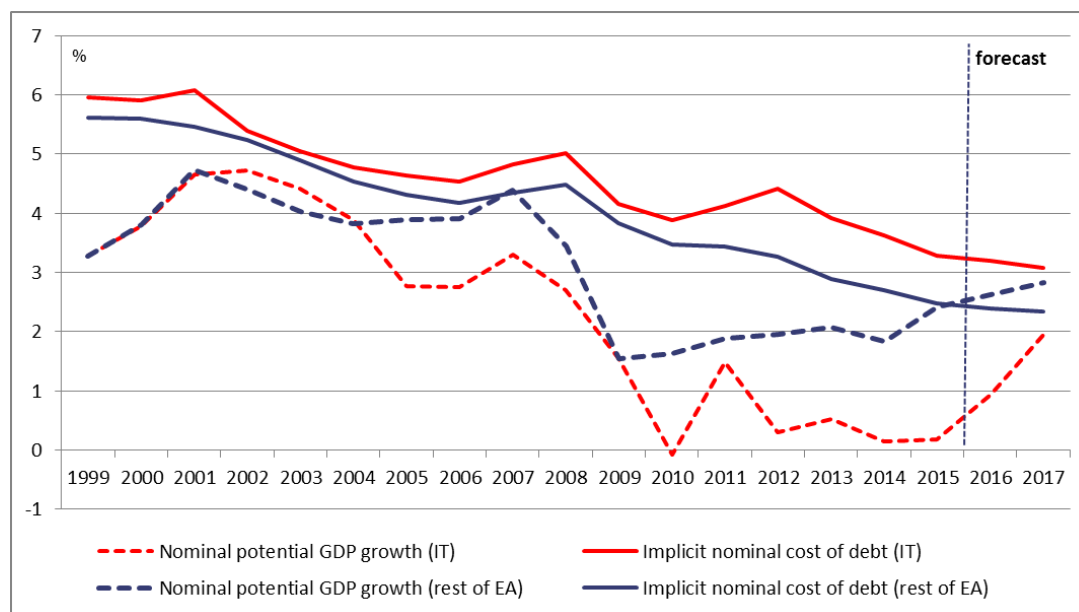
revenues of EUR 830 million or 0.05% of GDP in 2016 and further EUR 1.2 billion or 0.075% in 2017); (v) the introduction of incentives for companies to invest through the possibility to deduct 140% of the spent amount instead of 100% (with a negative impact on revenues mainly in 2017, by EUR 934 million or 0.05% of GDP); (vi) as of 2017, a reduction in the corporate income tax ("IRES") by 3.5 pps (to 24% from 27.5%, worth 0.17% of GDP).

<sup>20</sup> The implicit nominal cost of debt in year  $t$  can be defined as the average nominal yield paid by the government to service the outstanding debt at the end of year  $t-1$ .

<sup>21</sup> The snow ball effect can be defined as the endogenous change in the debt-to-GDP ratio implied by the difference between nominal growth and the implicit debt-servicing cost. For instance, an implicit interest rate 1 pp higher than nominal growth implies *ceteris paribus* an annual increase in the debt ratio of some 0.6 pp with a 60% debt ratio and of 1.5 pps with a 150% debt ratio. It could be argued that any debt level is intrinsically on a sustainable path as long as the differential between real growth and real interest rates is not negative. However, high debt levels are normally associated with higher sovereign risk premia (and possibly lower growth via higher interest rates for the private sector), which impact on such differential. In addition, monetary policy might not always be able to respond to lower growth and inflation (e.g. in case of idiosyncratic shocks hitting only a few MS in the EA and/or when the zero lower bound is reached), implying a possible increase in such differential in bad economic times. The other factors affecting the change in the debt ratio are the primary balance and the stock-flow adjustment related to all transactions affecting public debt but not the government balance (e.g. privatisations or support to EA programme countries).

<sup>22</sup> Given Italy's government debt structure, it takes around 6 years for a change in the yield curve to be fully reflected in the debt-servicing cost.

Graph 2.3: Implicit nominal cost of debt vs. nominal potential growth in IT and rest of EA



Source: AMECO.

### 2.3. Drivers of public expenditure: analysis of the numerator effect by economic categories

**Only after the 2011 sovereign debt crisis, Italy's primary expenditure was curbed by a marked slowdown in current spending dynamics.** As previously mentioned, during the pre-crisis years 1999-2007, Italy's current primary expenditure grew in nominal terms at 4.4% per year on average, slightly above the EA average (3.9%) and well above the country's average nominal potential growth in the same period (at 3.8%) –see Graph 2.4. These dynamics were broadly in line with the EU average and with those observed in France over the same period, but much more marked than in Germany and more muted than in Spain and the United Kingdom. The expenditure restraints needed as of 2008 in the context of the fiscal consolidation to correct the excessive deficit as well as those to reassure financial markets after the 2011 sovereign debt crisis resulted in Italy's current primary expenditure growing at a much slower pace of 2% per year between 2007 and 2014. This was still above the low nominal potential growth recorded in that period (at around 0.9% on average, of which -0.4% real growth and +1.4% deflator) but considerably below both the EA average of 2.8% and the growth rate recorded in any other big Member State (3.2% in the United Kingdom, 3.1% in France, 3% in Germany, and 2.2% in Spain).<sup>(23)</sup>

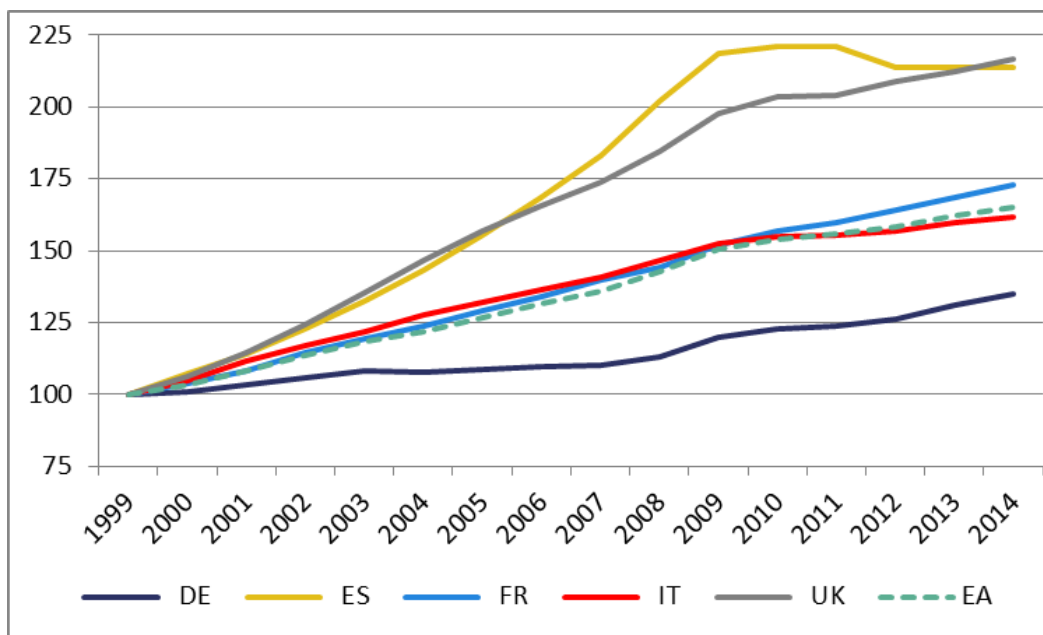
**Italy's public wage bill has been significantly contained since 2010.** The increase in Italy's current primary spending, considerably above nominal potential growth between 1999 and 2007 (see above), was mainly driven by intermediate consumption (net of sales) and social transfers in kind (increasing by some 6.6% per year on average), as well as by social transfers in cash other than pensions (increasing by close to 5% on average) –see Graph 2.5. Among the other items of current expenditure, both compensation of employees and pension spending rose in this context slightly above potential growth, at around 4% per year. On the contrary, the deceleration in the pace of current primary spending in nominal terms between 2007 and 2014 was mainly due to the decline in the public sector wage bill, related to both the freezing of nominal wages since 2010<sup>(24)</sup> and a substantial reduction in the number of public employees (by around 1.3% per year, on average). On

<sup>23</sup> The similar dynamics of Spain's current primary expenditure to Italy are explained by its marginal contraction over 2009-2014 due to the more stringent fiscal adjustment required after the previous boom years (with an average 8% yearly increase over 1999-2008).

<sup>24</sup> However, it must be noted that, following a Constitutional Court ruling on this issue in June 2015, public wages are likely to start increasing again as of 2016.

the other hand, the fact that the moderate post-crisis dynamics of current primary expenditure remained above the extremely low nominal potential growth registered over that period was mainly driven by the following factors: (i) social transfers in cash other than pensions increased by 5.1% on average, as expected in a crisis period when wage supplementation schemes and unemployment benefits tend to rise sharply, but also as a result of the tax credit on low-wage employees (so-called “80 EUR bonus”) introduced in 2014;<sup>(25)</sup> (ii) pension expenditure growth, although decelerating to 2.6% per year due to the significant reform enacted in 2012 to curb its dynamics,<sup>(26)</sup> remained persistently above nominal potential growth.

Graph 2.4: Current primary expenditure at current prices, selected EU countries (1999=100)

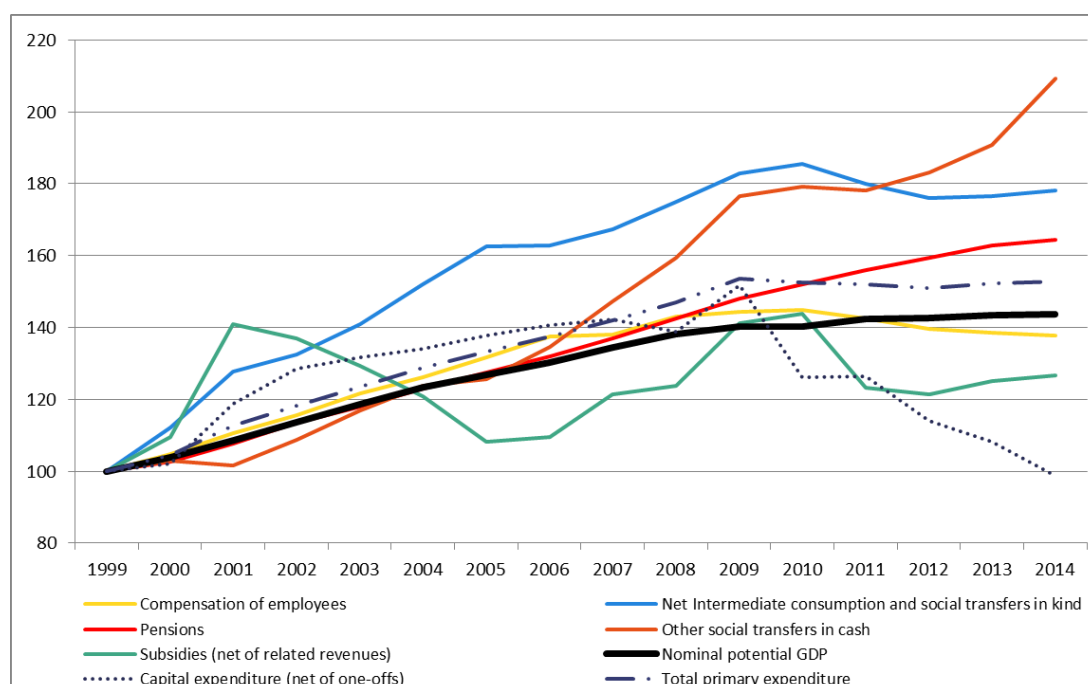


Source: AMECO.

<sup>25</sup> This tax credit recorded as a social transfer, worth 5.9 bn EUR (or 0.35% of GDP) in 2014 and 9.5bn EUR (or 0.6% of GDP) per year thereafter, was made permanent by the 2015 Stability Law. If one excluded this tax credit from social transfers in cash other than pensions in 2014, the yearly increase in this expenditure item between 2007 and 2014 would go down to 3.9% on average.

<sup>26</sup> The so-called “Fornero reform” (introduced through Law 214/2011) modified the Italian pension system as of January 2012 as follows: (i) the Notional Defined Contribution (NDC) method was extended also to the previously exempt workers under the Defined Benefit (DB) regime; (ii) the ‘exit window’ mechanism was abolished and replaced by a corresponding increase in the minimum age and/or contribution requirements; (iii) the periodicity of the indexation mechanism, linking the eligibility requirements to changes in life expectancy, was shortened from 3 to 2 years as of 2019, with transformation coefficients defined at administrative level and applying automatically; (iv) insurance under a single social security institute (INPS) was extended to all workers in the private and public sectors (except freelance and professionals funds); (v) the alignment process of statutory retirement age (SRA) of women in the private sector to the other workers was accelerated, in order to be fully phased in by 2018; (vi) the minimum requirement to be entitled to old age allowance was increased by 1 year as of 2018 and then fully aligned to SRA; (vii) early retirement based on a combined age-and-contribution requirement (35 years) was abolished, except under the NDC regime up to 3 years before the SRA, with at least 20 years of contributions and 1256 EUR monthly pension in 2015, indexed with the 5-year average of nominal GDP; (viii) contribution rates for self-employed were gradually raised from 20% to 24% in 2018; (ix) over 2012-2013, pensions above 3 times the minimum threshold (about 1400 EUR per month) were not indexed to the cost of living. It is worth noting that, on 30 April 2015, the Constitutional Court declared point (ix) of the reform unconstitutional and on 18 May 2015 a Decree Law was adopted by the government to operationalise this ruling, at the same time confirming the Stability Programme targets (details at [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/20\\_scps/2015/12\\_it\\_scp\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/12_it_scp_en.pdf)). It should also be noted that the mentioned reform foresees the possibility of early retirement only: (i) for workers previously enrolled in the defined-benefit scheme (i.e. with contributions paid before December 1995) aged above 62 and conditional on more than 42.5 years of paid contributions in 2015 (one year less for women –42 years and 10 months as of 2016, to be updated in 2019 based on life expectancy developments), with penalties in case of retirement before the age of 62 (1% and 2% per year, respectively for retirement above 60 and below 60); and (ii) for workers fully affected by the new defined-contribution system under both the same conditions mentioned in (i) and at the age of 63 years and 3 months in 2015 (63 years and 7 months as of 2016) plus at least 20 years of paid contributions, with the right to a pension amounting to at least 2.8 times the social assistance (i.e. around EUR 1256 per month in 2015).

Graph 2.5: Trend of selected primary expenditure items in Italy (1999=100)



Source: AMECO and ISTAT

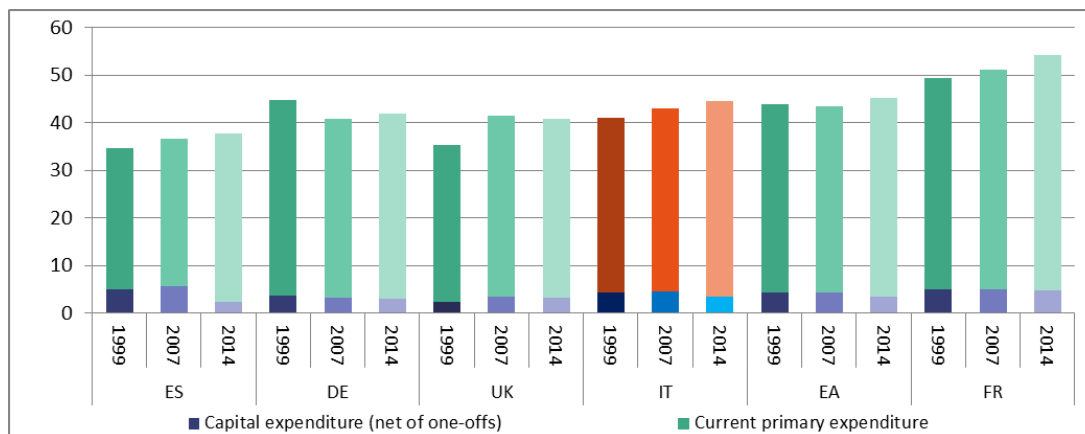
**Capital expenditure was severely cut since the inception of the crisis.** Italy's capital expenditure considerably contributed to the fiscal consolidation needed after the crisis and was thus one of the few expenditure items to record negative growth in recent years, at -5.1% per year on average – see Graph 2.5. Namely, the country's total capital spending net of one-offs accounted for 3.4% of potential GDP in 2014, slightly below the EA average of 3.6%,<sup>(27)</sup> considerably down from 4.7% in 2007 (see Graph 2.6). As a comparison, during the crisis the share of capital spending in potential GDP decreased much faster only in Spain among big Member States, from 5.8% to 2.4%, whereas it only marginally declined in France (from 5.1% to 4.8%), the United Kingdom (from 3.5% to 3.2%), and Germany (from 3.2% to 3.1%). The trend of Italy's capital expenditure between 1999 and 2014 is mainly due to the dynamics of gross fixed capital formation (see Graph 2.7 - panel A). Namely, Italy's public investment rose at an average pace of close to 4% per year before the crisis (1999-2007), only slightly below the EA average (4.6% per year) and kept on increasing even faster between 2007 and 2009 also to support the economy in the aftermath of the global financial crisis. Overall, Italy's gross fixed capital formation rose between 1999 and 2009 at an average yearly pace (4.7%) in line with the EA average and slightly above France, although less than half the one observed in Spain and the United Kingdom. Nevertheless, this positive trend was reversed between 2009 and 2014, when Italy's public investment dropped in nominal terms by 34%, reverting in 2014 to the 1999 nominal level. As a comparison, the average decrease in the EA over the same period was 17%, with a nominal level in 2014 still around 30% higher than in 1999. Among big Member States, a more marked decrease in public investment between 2009 and 2014 was only observed in Spain (by more than 60% in nominal terms).<sup>(28)</sup> Instead, the residual component of capital expenditure (see

<sup>27</sup> Looking at the EA as a whole, it must be noted that, with the exception of France, capital expenditure (net of one-offs) tended in 2014 to be higher in recently acceded Member States, signalling catching-up dynamics and exploitation of EU structural funds for investment projects. Namely, the highest shares of capital expenditure in potential GDP were recorded in Estonia, Slovenia, France, Malta, Latvia and Lithuania, respectively.

<sup>28</sup> Instead, in the United Kingdom the crisis led to a broad stabilisation of public investment at a nominal level just below the peak reached in 2009 (180% higher than in 1999); France's gross fixed capital formation grew steadily over 1999-2013 at 3.4% per year on average, with a reversal in 2014 only; German public investment slightly declined over the pre-crisis years and recorded a moderate increase of 3.9% per year after the crisis entirely accounting for the, still quite muted, overall yearly

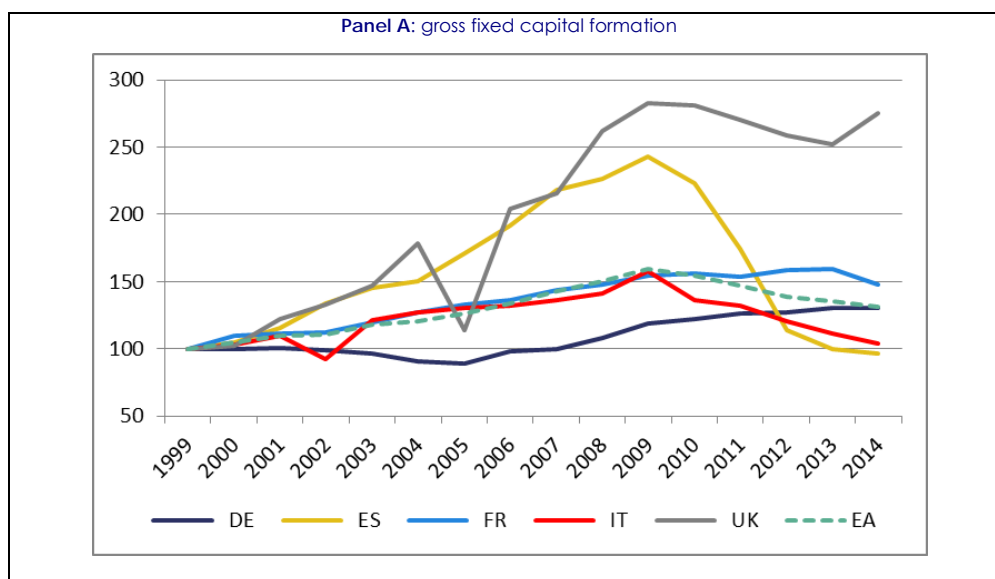
Graph 2.7 – panel B) showed slow but steady growth in Italy (1.9% per year) between 1999 and 2014, similarly to France (2.9% per year) and differently to Spain or the United Kingdom, where the one-off impact of bank-rescuing operations in specific years (e.g. 2009 and 2012) steered the trend.

Graph 2.6: Capital and current primary expenditure (1), selected EU countries, % of potential GDP

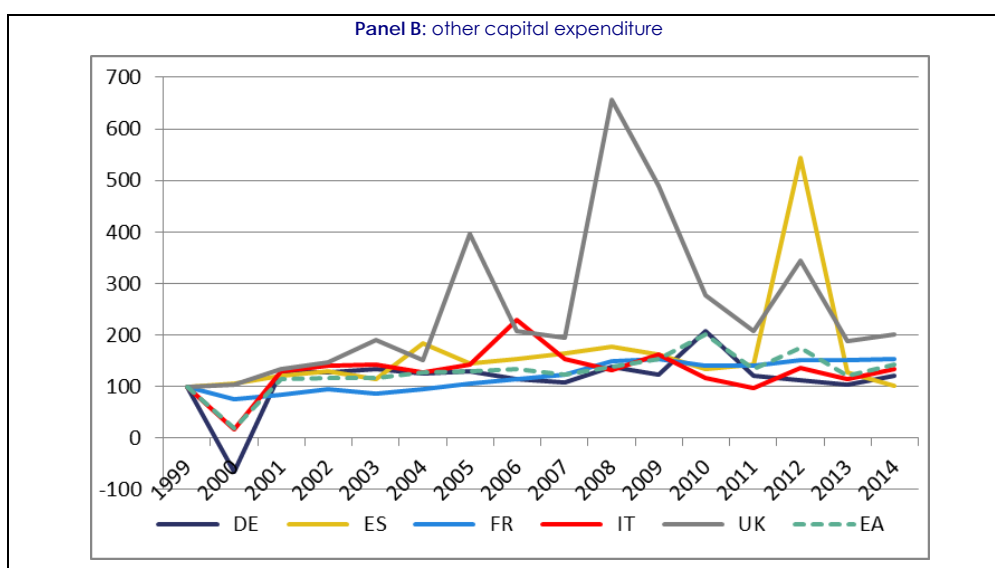


Source: AMECO. (1) Excluding one-off expenditures. Countries are ranked by increasing capital expenditure (net of one-offs) as a share of potential GDP in 2014

Graph 2.7: Components of capital expenditure at current prices, selected EU countries (1999=100)



growth pace of 1.8% over 1999-2014. In real terms, Germany capital expenditure started declining already in the early 2000s, falling behind potential GDP growth.



Source: AMECO.

**Social cash pay-outs have dominated Italy's primary spending more than in any other big Member State but France.** As in the rest of the EA, the bulk of Italy's primary expenditure is absorbed by the economic category "social transfers other than in kind" <sup>(29)</sup> – hereafter, cash social transfers. However, Italy stands out in this respect (see Graph 2.8), as cash social transfers accounted for more than 19.5% of its potential GDP and 44% of its total primary expenditure in 2014, considerably above the EA average of 16.9% and 37%, respectively. Among big Member States, only France spent slightly more than Italy on cash social transfers as a share of potential GDP (19.8%). Conversely, Italy's "net intermediate consumption and social transfer in kind" are, at 5.8% of potential GDP, well below the EA average (7.7%). Italy's shares of other economic categories of primary expenditure in potential GDP are broadly in line with the EA average. Some further notable features across big Member States are: (i) France's higher-than-average compensation of employees (12.8% of potential GDP) due in part to relatively lower efforts than in Italy and Spain to curb the public wage bill over the crisis years; <sup>(30)</sup> (ii) Germany's higher-than-average share of "social transfers in kind supplied to households via market producers" <sup>(31)</sup> and lower-than-average compensation of employees, mainly due to the fact that hospital health care is considered there as provided by third parties rather than by the government. <sup>(32)</sup>

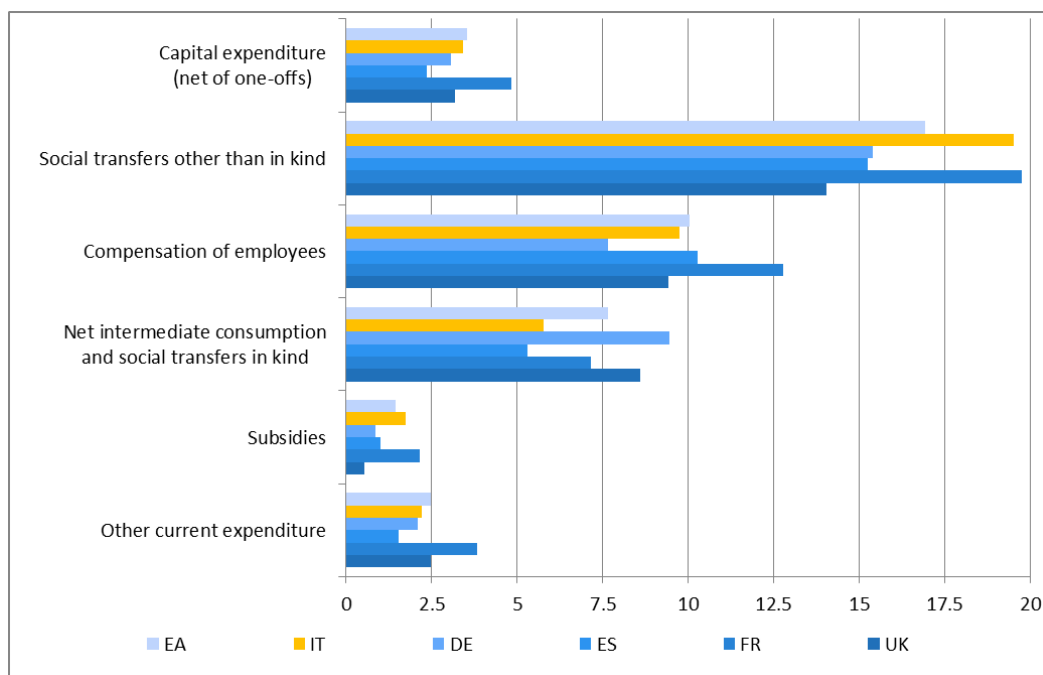
<sup>29</sup> Social benefits other than social transfers in kind consist of all social benefits in cash –both social insurance and social assistance benefits- provided by government units, including social security funds, and no-profit institutions servicing households (NPISHs).

<sup>30</sup> More specifically, the "gel du point d'indice" enacted in France in 2011 froze the public sector index mark as of that year. However, this measure seems to have started having an impact on public wage dynamics only very recently (growth by 2% in 2011, 1.9% in 2012, 0.6% in 2013, and 0.2% in 2014), likely also because the change of reference index related to the normal progression in career by public employees might have partially offset the mentioned freezing (as a result, the wage per head in the public sector increased by 1.2% y-o-y between 2011 and 2014 in the public sector, against 1.6% in the private one). Furthermore, while employment in the public sector decreased in 2011 and 2012 (by 1% and 0.5%, respectively), following Sarkozy's commitment not to replace one retired civil servant out of two, it accelerated again as of 2013 (growing by 0.6% in 2013 and 1.4% in 2014). All in all, compensation of employees increased by 1.7% on average in the French public sector between 2011 and 2014, against 2.1% in the private sector.

<sup>31</sup> This is reported in the graph together with intermediate consumption, net of sales.

<sup>32</sup> There are two ways in which the government can ensure direct provision of goods and services: (i) producing them, in which case the resources are spent as compensation of employees and consumption of fixed capital; and (ii) outsourcing part of the production to units outside the government sector (including public-controlled companies), by purchasing from them goods and services used as inputs of the production (which are recorded as intermediate consumption) while remaining in charge of the direct provision.

Graph 2.8: Composition of primary expenditure by economic category, % potential GDP (2014)



Source: AMECO

#### 2.4. Drivers of public expenditure: analysis of institutional aspects

**Broad spending responsibilities are in the remit of local authorities, although this is not matched by autonomous fiscal capacity.** Italy's institutional structure, as enshrined in the Constitution, foresees the presence of different layers of government and, in particular, of 20 Regions and several Municipalities (8047 as of January 2015) in addition to the central government.<sup>(33)</sup> Based on the Constitution, local governments have “exclusive responsibility”<sup>(34)</sup> for essential expenditure items, including healthcare spending and tourism for Regions, as well as local public services, social assistance, and nursery schooling for Municipalities. More specifically, in 2014 local governments accounted for a larger share of general government primary expenditure, broadly stable at around 30% since 1999, than of total revenues, at 16%, only marginally up from 14% in 1999 (see Graph 2.9). In terms of composition by economic categories (see Graph 2.10), local levels of government represent: (i) a major and increasing share of overall net intermediate consumption and social transfers in kind (at 85% in 2014, up from 77% in 1999), reflecting in particular the relevance of healthcare spending (under the exclusive competence of the Regions since 2001); (ii) a broadly constant share of compensation of employees, at around 41% since 1999; (iii) a large but recently declining share of investment expenditure, from above 60% before the crisis to 55% in 2014 as local authorities substantially cut investment to compensate for the lower transfers made by the central government to achieve the fiscal targets. Around half of local governments' expenditure is financed

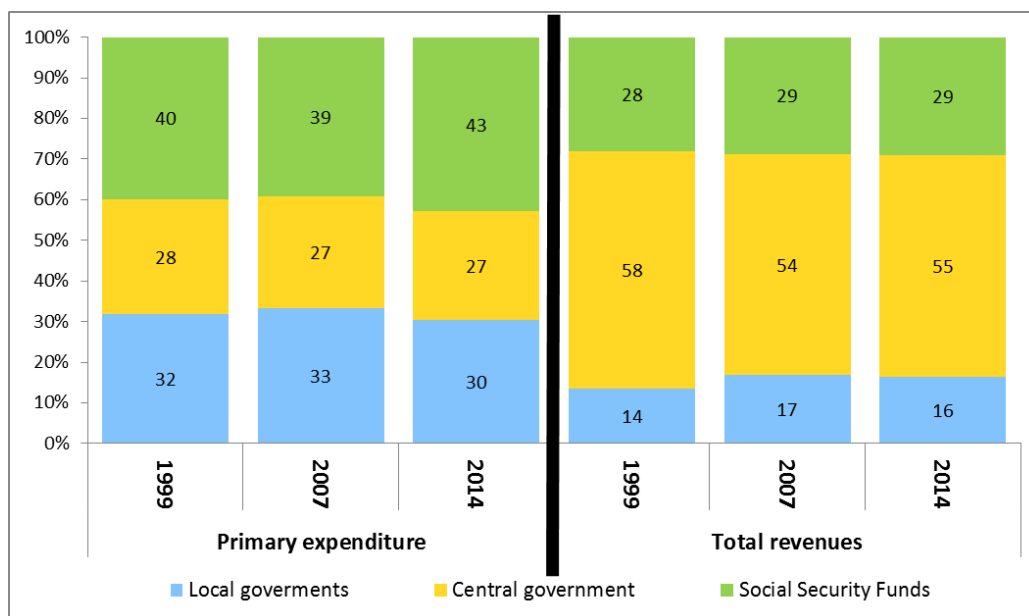
<sup>33</sup> Provinces, at an intermediate level between Regions and Municipalities, are not discussed in this paper not only because they retain limited spending responsibilities compared to the other government layers but also because a broad revision of the Italian institutional structure aimed at abolishing them is currently underway. The relevance of Provinces to the scope of this paper seems thus more related to the potential savings linked to the said institutional streamlining, estimated by the Cottarelli report (see Section 4) at around 500 bn EUR.

<sup>34</sup> It is worth noting that, however, these exclusive legislative competences exerted by the local governments are defined residually, i.e. by exclusions once constitutionally identified the fields of exclusive responsibility of the central government as well as those of “concurrent legislative competence” between the State and the local governments (e.g. energy and transport infrastructure). This allocation is modified by the draft constitutional law for the reform of the institutional framework that the current government plans to approve by 2016.



by transfers from the central government. These transfers are in the process of becoming increasingly detached from an allocation system based on historical expenditure levels, which has so far tended to “institutionalise inefficiencies”. In this context, their allocation should increasingly reflect the theoretical outcome of models based on standard costs and standard borrowing requirements combined with revenue sharing mechanisms based on VAT and income tax capacity.<sup>(35)</sup> Particular progress in this context has been recorded in the field of health care-related transfers to Regions. The relatively high share of spending by regional and local authorities requires making the spending review an intrinsic feature of the budgetary process at all levels of government. This is a *condicio sine qua non* to reduce expenditure while, at the same time, avoid compromising the quality of the output for instance reducing the currently high dispersion of public procurement (see Section 4). At the same time, it should be noted that the broad remit that the Italian Constitution entrusts to regional and local authorities in terms of spending responsibilities is not reflected in a corresponding autonomous taxation capacity. According to Graph 2.10, regional and local governments still represented in 2014 a small share of direct taxation, at 15%, although rising from 9% in 1999 mainly as a result of higher personal income surtaxes (“*addizionali IRPEF*”) stipulated by Regions and Municipalities as a response to cuts in central transfers. On the other hand, the share in indirect taxation rose much less since 1999, and actually declined over the crisis years to 29% in 2014, as higher property taxation was more than offset by lower regional taxes on productive activities (so-called “*IRAP*”). In this context, the abolition of the property tax on first residences (“*TASI*”) foreseen by the 2016 draft Budget Law, together with the prohibition to increase other local tax rates will further limit the autonomous fiscal capacity of the Italian Municipalities. In fact, the applicable TASI rates in 73% of them were below the theoretical ceiling and could thus represent a lever of fiscal manoeuvre.<sup>(36)</sup> Furthermore, the fact that the draft Budget Law foresees full compensation of the Municipalities’ actual revenue loss relative to 2015, rather than only of those theoretically associated with the standard tax rate, might distort the fiscal choices of local authorities by failing to take into account the fiscal effort actually carried out by some of them on the expenditure side.

Graph 2.9: Expenditure/revenue shares of local/central governments and social security funds

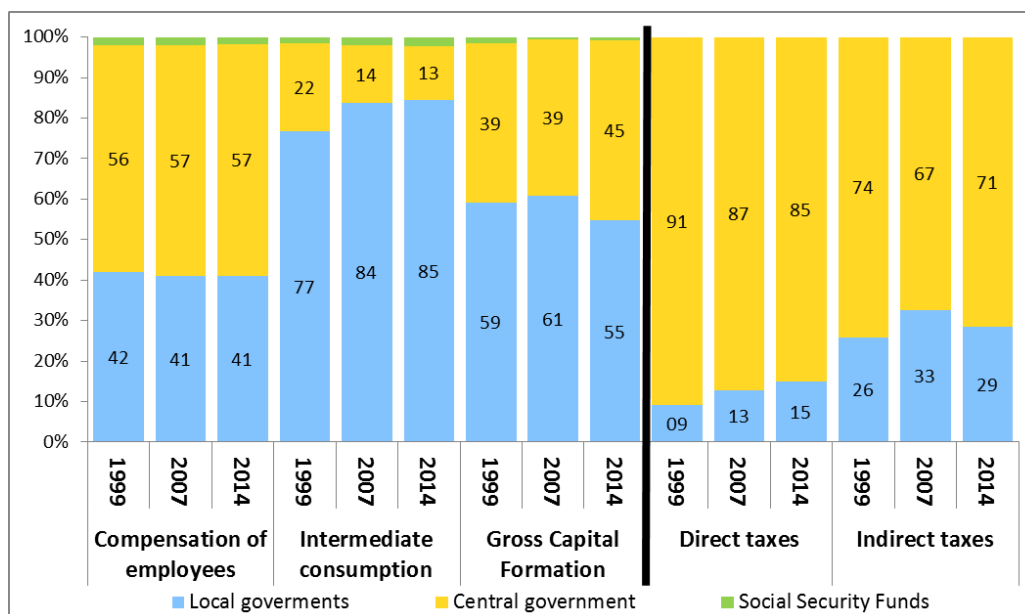


Source: ISTAT

<sup>35</sup> *Standard borrowing requirements* are the main parameters on which, pursuant to the enabling law 42/2009 on the so-called fiscal federalism, the financing of the essential levels of services and the allocation of central transfers to local and regional authorities should be based. These parameters were first quantified at the end of 2013, and published in 2014, for the essential functions carried out by ordinary Regions. In 2015, standard borrowing requirements and other indicators of “autonomous fiscal capacity” are to be used to allocate 20% of the “Fondo di Solidarieta` Comunale”.

<sup>36</sup> For a more detailed account on this, see the audits of Parliamentary Budget Office (UPB) and of Bank of Italy on Italy’s 2016 Budget Law.

Graph 2.10: Details on expenditure/revenue of local/central governments and social security funds



Source: ISTAT

### 3. ITALY'S PRIMARY EXPENDITURE BY ECONOMIC FUNCTIONS

Following the analysis of Italy's primary expenditure by broad economic categories, this Section discusses its composition disaggregated by so-called "functional classification" (COFOG).<sup>(37)</sup> This breaks down general government expenditure on the basis of the purpose for which public funds are used, including, among others, social protection, health care, education, and defence, and can thus usefully complement the previous analysis of expenditure developments by economic classification from a more functional viewpoint.<sup>(38)</sup> Overall, this analysis sheds further light on interesting qualitative aspects of Italy's public spending, such as its bias towards the elderly.

#### 3.1. Composition of public expenditure: analysis of social protection spending

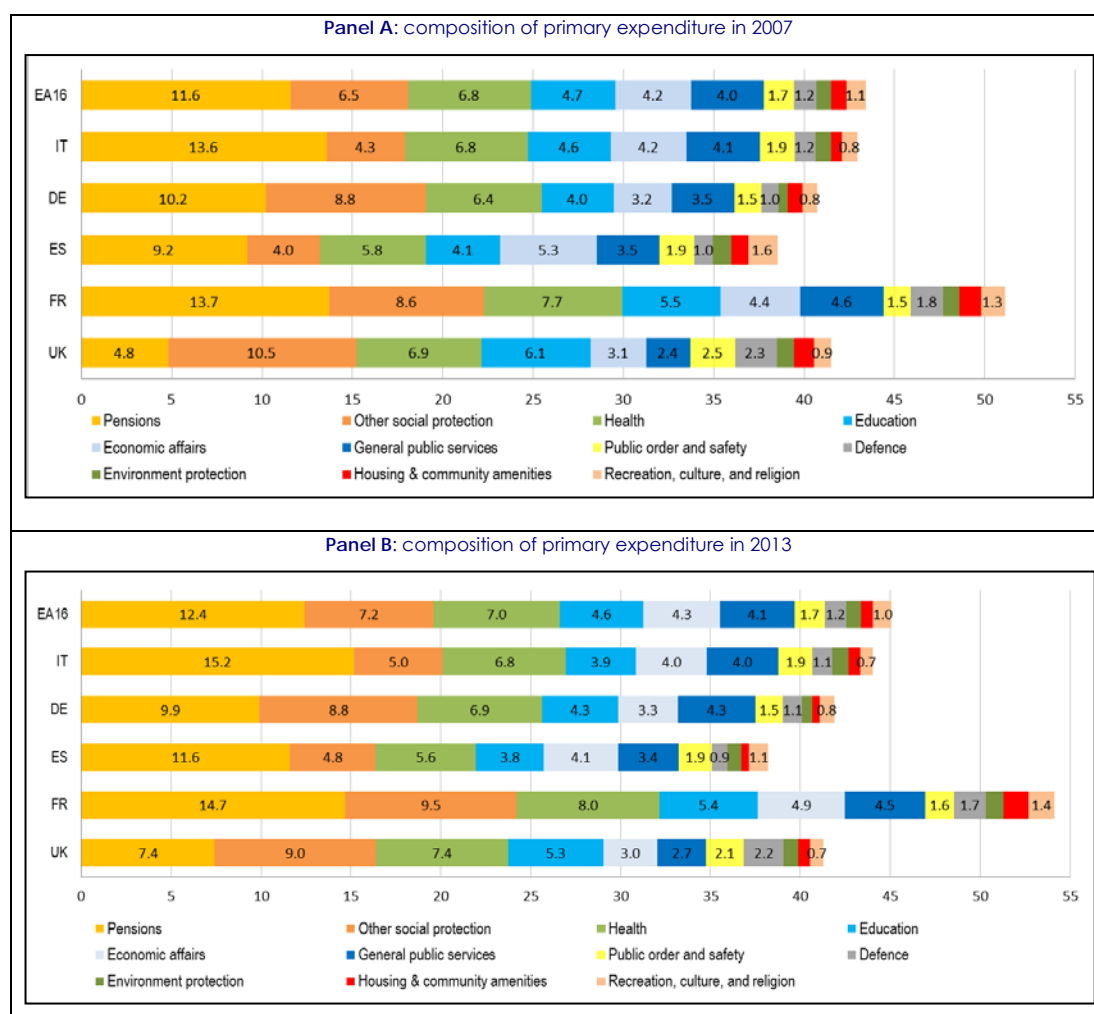
**Driven by pension outlays, Italy's social protection spending is large and increasing.** In terms of composition of primary expenditure by COFOG functions, Italy's pension expenditure as a share of potential GDP in 2013, at 15.2% based on the *Ageing Working Group* definition, was much higher than the EA average (12.4%) and any other big Member State (see Graph 3.1). In contrast, Italy lagged behind in growth-enhancing spending items like education (at 3.9% of potential GDP, the third lowest share in the EA after Spain and Ireland, respectively). This pattern worsened significantly over the crisis, with pension-related expenditure increasing by 1.6 pps of potential GDP

<sup>37</sup> First-level COFOG splits general government expenditure into ten functional groups, whereas second-level COFOG further splits each first-level group into up to nine sub-categories. While the first-level COFOG breakdown is available from national accounts for all EU countries, availability of second-level data is much more limited.

<sup>38</sup> This analysis is based on data available as of December 2015, with historical data disaggregated by COFOG functional classification up to 2013 in ESA2010. Due to data availability reasons, the adopted definition of Euro Area in this Section and the following one refers (unless otherwise specified) to an aggregate excluding Finland, Lithuania, and Slovenia from the EA19. For an explanation of the changes introduced with ESA2010 for general government expenditure, see [http://epp.eurostat.ec.europa.eu/portal/page/portal/government\\_finance\\_statistics/documents/Revisions-gov-deficit-debt-2010-2013.pdf](http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/Revisions-gov-deficit-debt-2010-2013.pdf).

between 2007 and 2013. As opposed to pension expenditure, other social transfers (including, among others, unemployment benefits, disability and sickness benefits, wage supplementation schemes, and severance pay provisions) still represented in 2013 a significantly lower share of Italy's potential GDP (5%) than the EA average (7.2%) and any other big Member State but Spain, despite the increase (by 0.7 pp) registered over the crisis. As regards Italy's health expenditure, this increased from 5.6% of potential GDP in 1999 to 6.8% in 2007, a level in line with the EA average and above all big Member States but France and the United Kingdom. It then remained stable between 2007 and 2013, in contrast with the increasing trend observed in all big Member States but Spain, due to the effective action taken to curb overspending in some Regions. However, health and long-term care outlays are expected to further increase as a share of GDP over the next 50 years (by around 0.8 pp and 1 pp of GDP, respectively) mainly due to demographic projections. <sup>(39)</sup>

Graph 3.1: Evolution of primary expenditure by COFOG functions (% of potential GDP), selected EU Member States



Source: AMECO and AGEING WORKING GROUP data on pensions. Due to data availability issues, the average pension expenditure share in the EA in 2007 is obtained on the basis of 11 MS only (AT, BE, DE, ES, FR, IT, LT, LV, MT, NL, and PT)

<sup>39</sup> See European Commission (2015).

**Several factors explain Italy's relatively high pension outlays, despite recent reforms.** Italy's higher-than-average share of public pension spending in potential GDP is to some extent explained by its broad reliance on public pension schemes as opposed to the private and occupational ones, more widespread in other EA Member States (e.g. Spain and the Netherlands)<sup>(40)</sup> and in the United Kingdom. It also reflects, on the one hand, the fact that Italy is characterised by the highest dependency ratio in the EU (at 32.8% in 2013, vs. 27.8% in the EU28 and 29.3% in the EA), defined as the ratio of people aged more than 64 to the working-age population (see Graph 3.2 – panel A). On the other hand, it is related to relatively high benefit rates per pensioner due to the following factors:

- benefit ratios are well above the EA average. Italy's benefit ratio was around 63% for old-age pensions in 2013, the highest among big Member States and steadily increasing over recent years. In comparison, the average benefit ratio in the EA was around 50% in 2013 and broadly stable in recent years, while in Germany it was much lower (44%) and characterised by a downward trend (see Graph 3.2 – panel B).<sup>(41)</sup> Italy's higher-than-average benefit ratio is mainly due to the generous defined-benefit scheme, abolished only for contributions paid as of 2012;
- the average time spent receiving a pension was longer than the EA average by around two years in 2014.<sup>(42)</sup>

Following the latest reform adopted in 2012 ("Fornero reform"), which accelerated the transition to a full notional defined-contribution system, Italy's pension outlays are expected to stabilise as a share of GDP over the next 30 years<sup>(43)</sup> and the effective retirement age to increase by more than 5 years between 2013 and 2060. This should also have positive consequences on labour supply and thus potential growth.<sup>(44)</sup> Overall, the reform is thus contributing to ensure the long-run sustainability of pension expenditure, as indicated by Italy's positive score in long-term fiscal sustainability indicators.<sup>(45)</sup> Future pensions based on a defined-contribution system are indexed to GDP growth, and an increase in growth potential is thus essential for the adequacy of these entitlements.

**Increasing unemployment has been putting pressure on social spending.** Italy's social protection spending other than pensions amounted to only 4.9% of potential GDP in 2013 and, within this envelope, spending related to the unemployment function<sup>(46)</sup> accounted for less than 1 pp (see Graph 3.3 – panel A). While still relatively low in a cross-country perspective, unemployment-related expenditure has been increasing since 2008 well above the pre-crisis average of 0.3% of potential GDP (between 1999 and 2007), in the context of a general acceleration of overall social protection spending after the trough recorded in 2007 (4.3% of potential GDP). The post-crisis acceleration in unemployment-related social spending was mainly the result of generally increasing unemployment – from a low of 6.1% in 2007 to 12.7% in 2014. It was also driven by the changes in the unemployment benefit system related to the 2012 labour market reform,<sup>(47)</sup> as well as to the ad-hoc extensions of the wage supplementation scheme in the initial years of the crisis. The sharp increase (by around 33% per year on average) in unemployment-related expenditure between 2007 and 2010, well above that of headcount unemployment (at around 11% per year) over the same period, reflects: (i) a more than

<sup>40</sup> At 5.3% and 43.2% of total pension expenditure, respectively, based on European Commission (2015).

<sup>41</sup> According to European Commission (2015a), the same applies to earnings-related public pensions, with a benefit ratio estimated at 59.2% in 2013 (vs 49.6% in the EA) and projected to still increase over the next decade despite the recent pension reforms. The granular picture of pension spending regularly provided by the national statistical office (ISTAT) shows that in 2013 each Italian pensioner received on average EUR 16,638, with over 40% of pensioners receiving a monthly pension income below EUR 1,000.

<sup>42</sup> The average expected duration was about 21 years (vs. 19 in the EA) for men and 25 years (vs. 23 in the EA) for women, calculated on the basis of life expectancy at average effective exit age from the labour market.

<sup>43</sup> *Ibidem*

<sup>44</sup> In 2014, the activity rate in Italy for people aged 20-64 years was only 68.4% (up from 63.3% in 1999), i.e. the lowest in the EU. For the elderly (aged 55-64 years) Italy's activity rate was 48.9% in 2014, significantly up from 29% in 1999 thanks to past pension reforms and with ten Member States in the EU performing worse.

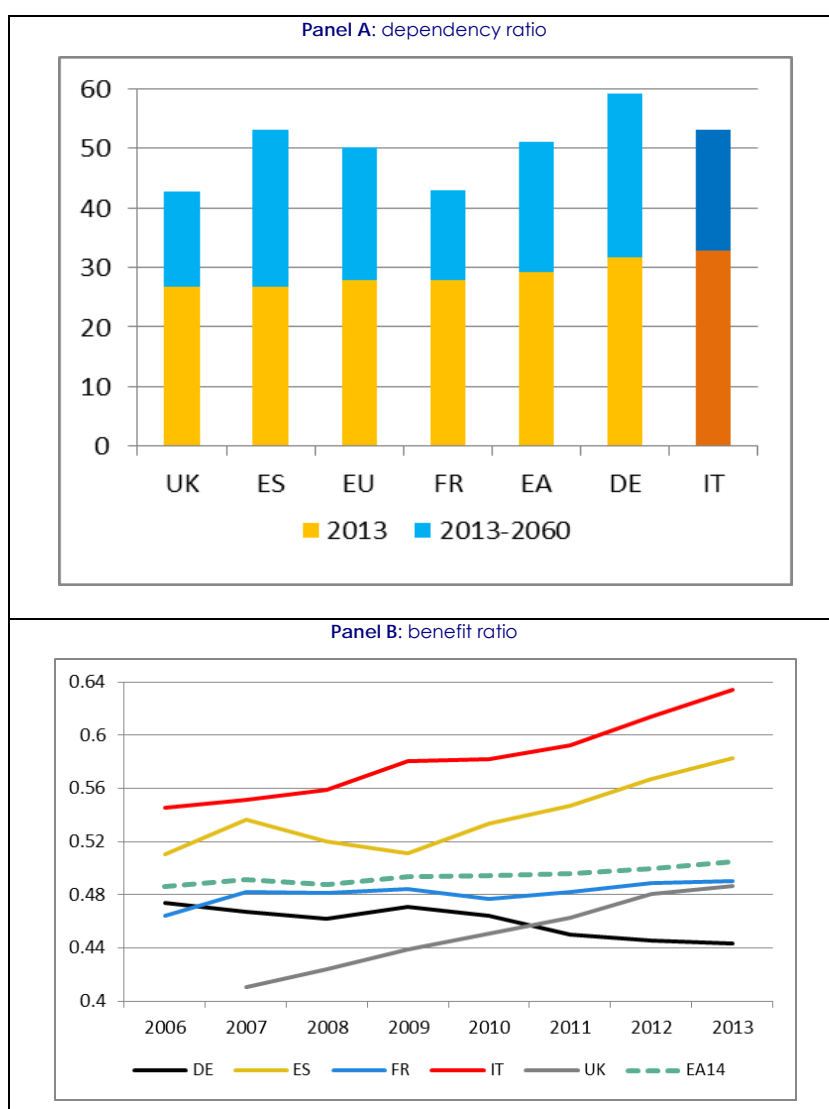
<sup>45</sup> Italy appears to be at low risk thanks to a relatively low value of the long-term sustainability gap indicator S2, conditional on maintaining the SPB forecast for 2017 (2.5% of GDP under a no-policy change assumption) well beyond that year.

<sup>46</sup> Social protection spending on the unemployed (as a percentage of nominal potential GDP) is defined as the sum of unemployment benefits ("*indennità di disoccupazione*") and wage supplementation schemes ("*assegno d'integrazione salariale*").

<sup>47</sup> A further reform has been enacted in the course 2015 but is not captured by available figures yet.

proportional increase (by around 22% per year) in unemployment benefits expenditure, also due to an average yearly increase by close to 10% in the average unemployment benefit (see Graph 3.3 – panel B);<sup>(48)</sup> and (ii) a peak acceleration in wage supplementation scheme spending, growing by more than 95% per year over the same period. Between 2010 and 2014, total unemployment-related spending (growing at an average yearly pace of 8%) failed to keep pace with increasing headcount unemployment (rising by 12% per year), reflecting: (i) a less than proportional increase (by around 9% per year) in unemployment benefits expenditure, due to a contraction by close to 3% per year in the average unemployment benefit; and (ii) the substantial stabilisation of wage supplementation scheme spending after the rapid growth of the previous years, mainly due to the ongoing phasing out of its under-waiver component (“CIGD”).<sup>(49)</sup>

Graph 3.2: Average dependency ratio and benefit ratio for old-age pensions (1)

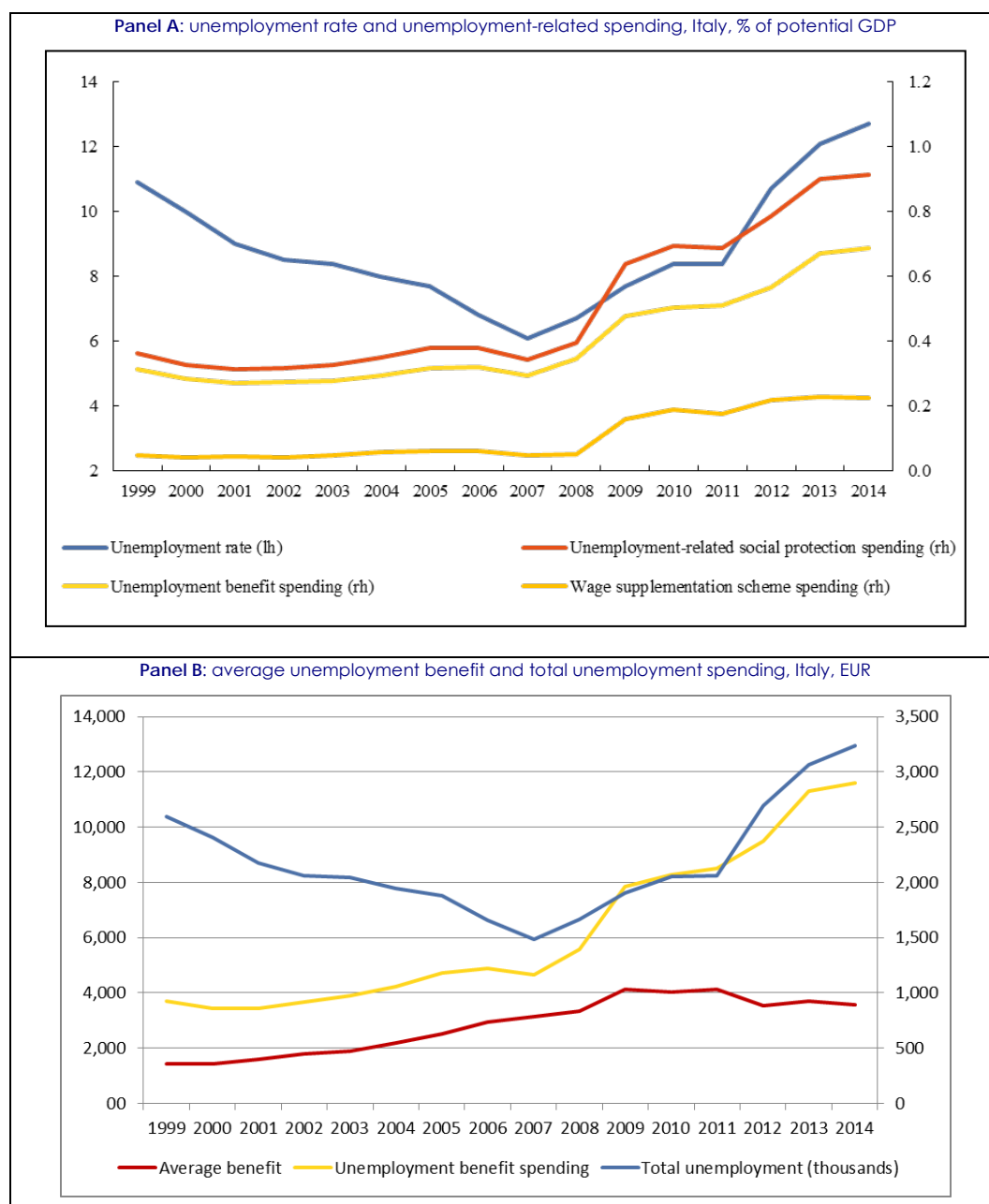


Source: own calculations based on EUROSTAT and AGEING WORKING GROUP projections up to 2060. (1) The benefit ratio is defined as the ratio of average old-age pension to average wage. The dependency ratio is defined as the ratio of ratio of people aged 65 or more to the working-age population (aged between 15 and 64).

<sup>48</sup> Due to data availability constraints, this preliminary analysis of the average unemployment benefit computes it in a simple way as the ratio of total unemployment benefit spending to the total number of unemployed people over a certain year. A more accurate computation should consider the actual number of beneficiaries as reported by INPS.

<sup>49</sup> This is witnessed by an average decrease by close to 11% per year in total amount of authorised hours for the under-waiver component of Italy’s wage supplementation scheme (“CIGD”) between 2010 and 2014.

Graph 3.3: Determinants of unemployment-related social spending in Italy



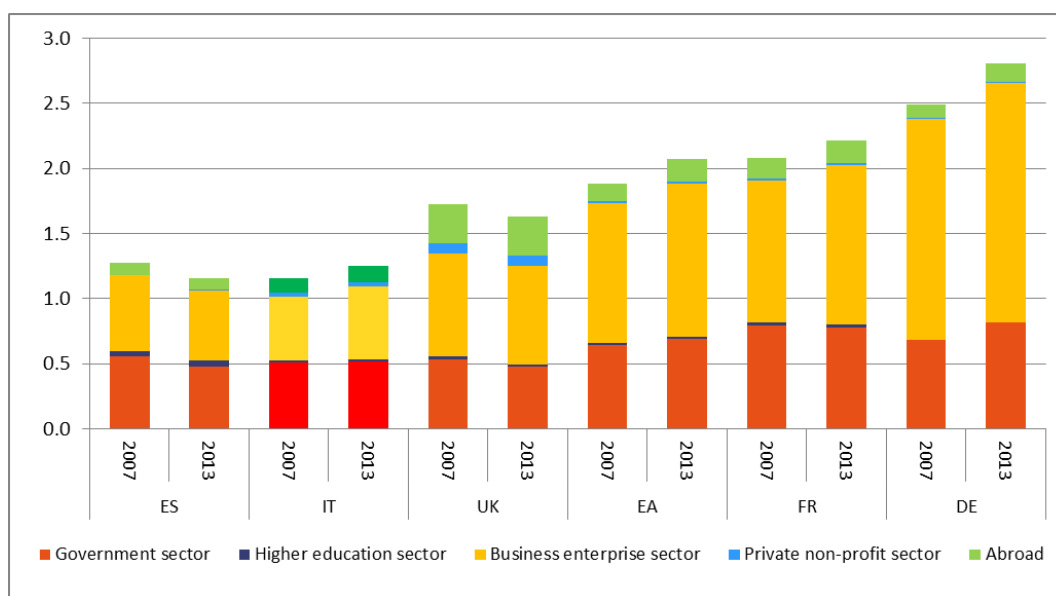
Source: ISTAT and own calculations

### 3.2. Composition of public expenditure: analysis of education and other productive spending

**The share of public resources devoted to social protection is taking an increasing toll on education and other productive spending.** The resources devoted to education in Italy as a share of potential GDP dropped from 4.6% in 2007 to 3.9% in 2013 (see Graph 3.1), resulting in a gap of around 0.7 pp with the average expenditure in the EA. While most countries that experienced fiscal stress such as Ireland, Portugal, Spain, and, especially, Greece have also witnessed declining

resources allocated to this function, Italy is currently the only EA country together with Greece to devote less than 10% of its total primary spending to education. The public expenditure gap is especially concentrated at the tertiary level, as highlighted in OECD (2015). In fact, while Italy's public expenditure per primary and secondary student (in public and private institutions) was in 2012 slightly below the OECD average (by less than 4% and 8% in PPPs, respectively), expenditure per tertiary student was close to one third lower. While the post-crisis decrease in Italy's education spending was due to the fiscal restraint required after the sovereign debt crisis, including the freeze of all public wages since 2010 and the limits imposed on the hiring of new teachers (among other public employees), it must be noted that a sizeable decline in real public expenditure in education had already begun before the crisis. <sup>(50)</sup> Analysis by the OECD (2015) with reference to the period 2000-2012 seems to corroborate this conclusion. As an important *caveat*, it must be noted that this analysis deliberately excludes private expenditure in education, which is however relevant in some Member States. For instance, according to OECD (2015), private educational expenditure in 2012 amounted to 1% of GDP in the United Kingdom, followed by Spain (0.5%), France (0.4%), Italy (0.2%), and Germany (0.1%). In Italy, around half of the 0.2% of GDP private expenditure was on tertiary education, where private funding accounted for more than one third of the total resources. Whereas first-level COFOG classification does not separately include public spending in R&D, the reasoning developed so far applies also to this function, where Italy's public budgetary resources as well as private funding devoted to this essential growth-enhancing item are considerably below the EA average (see Graph 3.4). Namely, public resources amounted to around 0.5% of potential GDP in 2013, broadly stable since the pre-crisis years, i.e. below any other big Member State but Spain and the United Kingdom. However, the latter benefitted however from considerably larger investment in R&D originated from the domestic business sector and from foreign financing sources, while business R&D investment remains particularly low in Italy. <sup>(51)</sup> Following the analysis in Barbiero and Cournède (2013), it seems likely that the severe restraint in Italy's investment in infrastructure, education, and innovation especially during the crisis might have weighed on the country's anaemic potential growth, adding to long-standing inefficiencies.

Graph 3.4: Intramural R&D expenditure in big Member States by source of funding, selected EU countries, 2013



Source: EUROSTAT

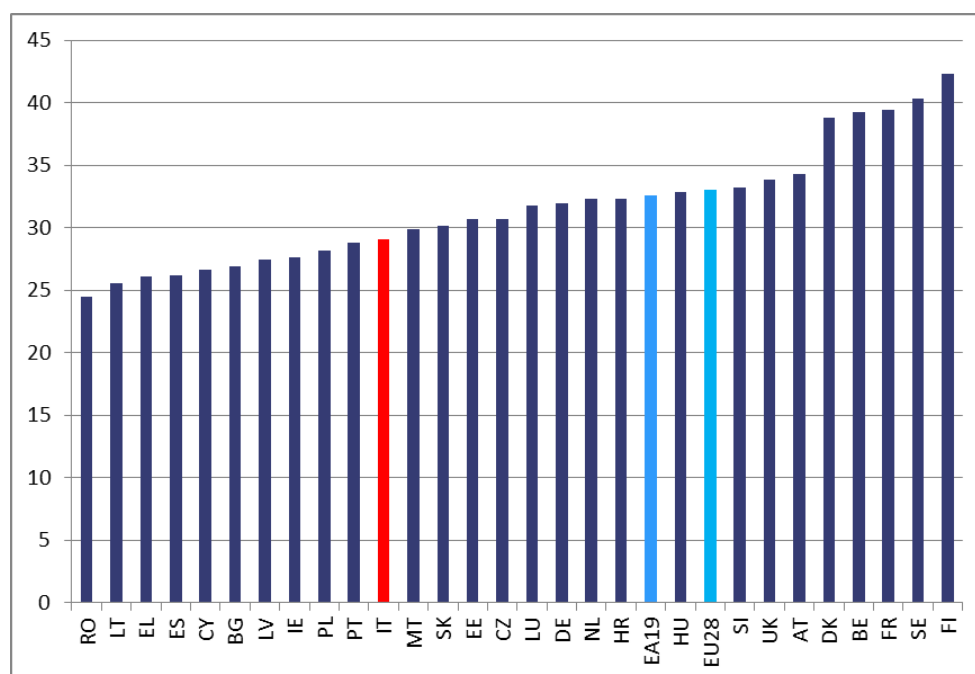
<sup>50</sup> For instance, the Decree Law 112/2208 of June 2008 (converted into Law 133/2008 - see [www.camera.it/parlam/leggi/decreti/08112d.htm](http://www.camera.it/parlam/leggi/decreti/08112d.htm)) had already foreseen (see Article 64) significant cuts to Italy's education spending several months before the failure of Lehman Brothers (September 2008). For more information, see also Montanari *et al.* (2015).

<sup>51</sup> This may also be due to the relatively larger number of SMEs in Italy, which often lack the needed economies of scale to perform this type of investment or might tend to record intramural R&D expenditure under different items. For more information, see also Czarnitzki and Toivanen (2013).

### 3.3. Composition of public expenditure: overall conclusions

**Overall, the evolution of Italy's primary expenditure shares over 2000-2013 suggests a bias towards the elderly.** Overall, analysing the evolution of the shares of Italy's primary expenditure by COFOG functions since the euro adoption (see Graph 3.6), one can conclude that: (i) pension entitlements and health expenditure (two spending items typically devoted to the elderly) have been steadily increasing as a share of total primary spending, from 46.5% in 2000 to 50% in 2013; (ii) in parallel, the share of public resources typically devoted to children and youth, including education, recreation and culture, as well as housing and community amenities, has been steadily shrinking from 14.8% in 2000 to 11.9% in 2013. Overall, there seems to be an increasing bias of Italy's primary spending towards this age group. This pattern could be considered to a certain extent explained by demographic factors common to the EA as a whole, and particularly ageing population, as Italy is characterised by having a relatively large elderly share of the population (namely 21.2% for people older than 64 in 2013 vs. 16.4% in the EA). However, Italy (together with Greece) stands out in this respect, with the largest share of public expenditure mostly devoted to the elderly and the smallest to youth and family. The share of other social expenditure, which includes unemployment benefits and wage supplementation schemes (thus benefiting both the youth and the elderly) increased from 9.7% in 2000 to 11.3% in 2013, mainly as a result of the crisis. The relative importance of the remaining expenditure functions slightly decreased between 2000 and 2013, as notably in the case of defence (by 0.2 pp), public order and safety (by 0.6 pp), general public services (by 0.7 pp), and economic affairs (by 0.5 pp).<sup>(52)</sup> If one excluded public pension outlays, Italy's ranking in the EA by share of primary spending in potential GDP would improve by nine positions (see Graph 3.5), being only higher than Spain among the big Member States and well below the EA average.<sup>(53)</sup> By contrast, the United Kingdom would considerably worsen (by as much as seven positions) due to below-average public pension spending, Spain and Germany remain broadly stable at the bottom of the distribution, and France stably linger at its top. This reinforces the evidence of a bias towards old age expenditure in Italy.

Graph 3.5: Primary expenditure (1) net of pension spending, EU countries, % of potential GDP (2013)



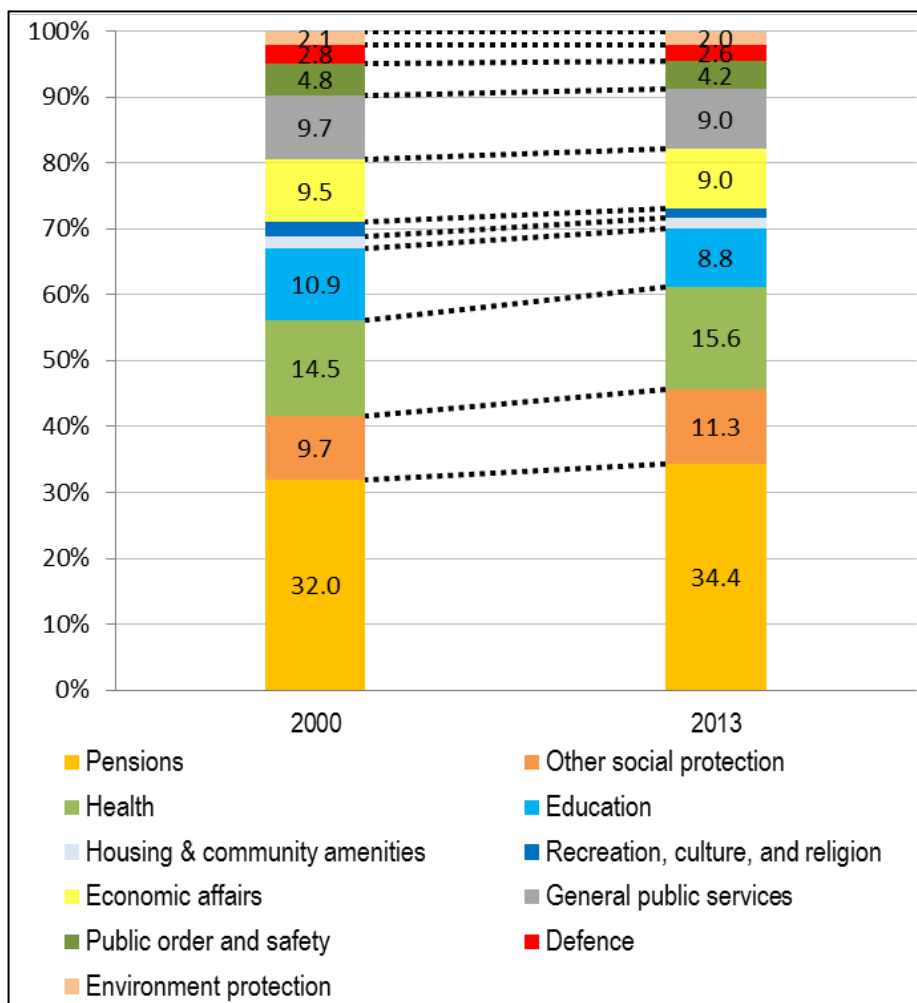
Source: AMECO and AGEING WORKING GROUP data on pensions. (1) Excluding one-off expenditure.

<sup>52</sup> It is worth noting that (negative) one-off expenditures related to the sale of UMTS licences in 2000 have been subtracted to the total resources devoted to the economic affairs function. In the absence, the economic affairs function would have been gaining ground relative to total primary spending.

<sup>53</sup> Similarly, Greece would shift by ten positions and move just after Lithuania among EA countries.



Graph 3.6: Shares of Italy's primary expenditure by COFOG functions in 2000 and 2013



Source: ISTAT

#### 4. PROSPECTS FOR ITALY'S SPENDING EFFICIENCY

**There appears to be scope to enhance the efficiency of public resources allocation in Italy.** A comprehensive analysis of the efficiency and quality of Italy's public spending goes beyond the scope of this paper.<sup>(54)</sup> Nonetheless, this section aims at providing some preliminary evidence that scope exists to enhance the efficiency of public expenditure in Italy both in terms of narrowing the scope of publicly-funded policies (*strategic allocation*) and of reducing the amount of public resources used while broadly maintaining or even improving the quality of public services (*tactical efficiency*). This is followed by a brief account of the policy actions undertaken so far to pursue this objective in terms of the so-called spending review. The literature provides some evidence that efficiency gains are possible. Afonso *et al.* (2010), based on a Data Envelopment Analysis methodology, suggest that Italy is among the advanced economies where, in terms of public spending efficiency, the "room for improvement seems to be large". IMF (2014) also shows Italy's low rank in terms of efficiency of the public administration when compared to other EA countries. This is mainly due to the poor performance, particularly in terms of input-based efficiency (spending as a share of regional GDP), of southern regions in specific spending items including education, social protection (excluding pensions), as well as healthcare spending.<sup>(55)</sup> As regards health expenditure, Medeiros and Schwierz (2015) also show that the output of public spending is lower in southern regions based on health-related variables like life expectancy at the age of 65. Along these lines, Table 4.1 shows Italy's ranking in a set of outcome/output indicators used in Barrios and Schaechter (2009),<sup>(56)</sup> relative to other big Member States. For each "subgroup" of indicators, identifying relevant policy areas such as education and health, it also reports each big Member State's average ranking in the EA19 plus the United Kingdom (twenty Member States overall) across all relevant indicators of that subgroup, which provides a basis idea of output/outcome-based performance. For instance, in 2013-2014 Italy performed worse than any other big Member State except Spain in terms of education and R&D outcome, although the overall score suggests a slight relative improvement since the pre-crisis years. As regards education, this is concluded, for instance, on the basis of Italy's PISA scores being the worst among big Member States, as well as educational attainments and quality of the educational system being poorer than in any other big Member State but Spain. On average, Italy ranked fourteenth among the twenty Member States considered in terms of the chosen education outcome indicators, and its ranking has only marginally improved since then. By contrast, Italy's relative performance appears to be better in health, although it has slightly deteriorated since 2007. By combining the constructed "outcome score" with the level of expenditure in each relevant policy area as a share of potential GDP, Graph 4.1 (Graph 4.2, respectively) allocates all EA Member States and the United Kingdom into four "sectors of efficiency" of health (education, respectively) expenditure and outcome relative to the relevant average both in 2007 (panel A) and in 2014 (panel B). Graph 4.1 suggests that the relative efficiency of Italy's health sector improved over time, being characterised after the crisis years (see Panel B) by a level of spending broadly in line with the EA average but associated with relatively better outcome. Graph 4.2 shows that Italy, together with Spain, was characterised by a systematic underspending in education as a share of nominal potential GDP relative to the EA average, together with a considerably lower-than-average performance, which provides a first indication of the relative inefficiency of Italy's education spending. In contrast, Germany was characterised by lower-than-average spending associated with higher-than-average

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<sup>54</sup> A more detailed/quantitative analysis may be carried out in a forthcoming ECFIN paper. As a starting point, it should be noted that the concept of quality of public spending could be analysed under different viewpoints, including its growth-friendliness and/or distribution. In this section, we constantly refer to "efficiency", which we regard as a narrower and merely economic concept (based on a direct comparison of input and output/outcome dimensions).

<sup>55</sup> This is also due to the lower economic output of southern regions, which thus tend to be more reliant on transfers from the central State to cover the so-called essential levels of medical assistance ("*Livelli Essenziali di Assistenza*").

<sup>56</sup> It should be kept in mind that this choice of indicators is only one of several possibilities, all arbitrary and characterised by relevant caveats. For instance, regarding the education category, one could argue that the use of the total educational attainment mixes older and younger generations, and the use of the PISA mean scores may hide the dispersion within the indicator (especially as regards the "low-achievers"). Moreover, all indicators are given the same weight within the broader policy category to which they belong.

performance. <sup>(57)</sup> However, it should be kept in mind that educational outcomes are affected also by private spending in education, relevant in particular at the tertiary level as mentioned (see Section 3).

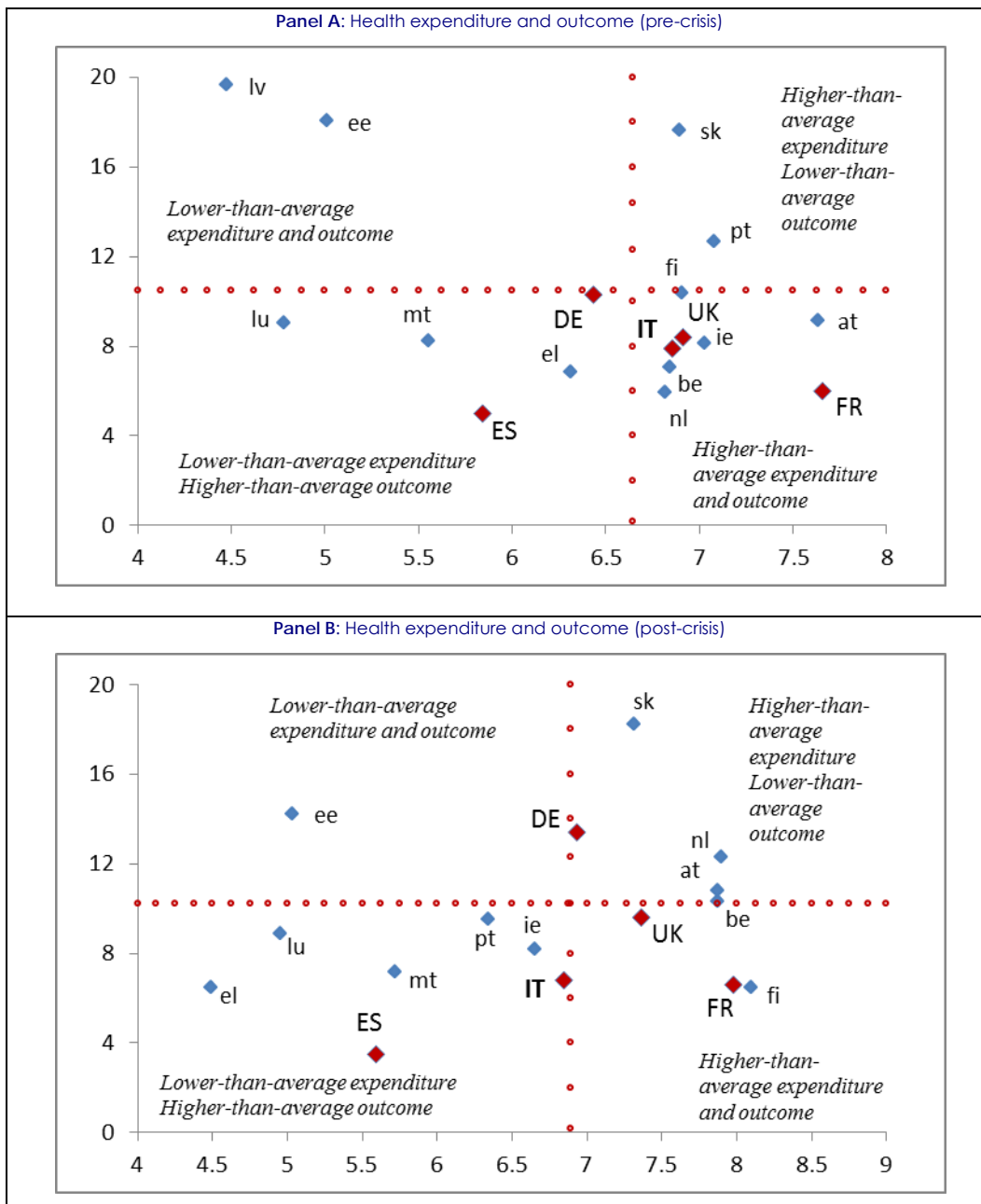
Table 4.1: Relative ranking of five big Member States (average absolute ranking in the EA plus the UK reported) in a selection of output/outcome indicators (1)

Output indicators		pre-crisis					post-crisis				
		DE	ES	FR	IT	UK	DE	ES	FR	IT	UK
Education	PISA total score	Green	Red	Yellow	Orange	Light Green	Green	Red	Yellow	Orange	Light Green
	Educational attainment	Green	Red	Yellow	Orange	Light Green	Green	Red	Yellow	Orange	Light Green
	Youth educational attainment	Orange	Red	Green	Yellow	Light Green	Orange	Red	Green	Yellow	Light Green
	Early school leavers	Green	Orange	Light Green	Red	Yellow	Green	Orange	Light Green	Red	Yellow
	Quality of the educational system	Green	Orange	Light Green	Red	Yellow	Green	Orange	Light Green	Red	Yellow
	<i>Average ranking of the MS in the EA</i>	9.0	14.0	10.0	14.2	9.2	7.9	13.9	10.5	13.2	8.4
Health	Life expectancy at birth	Orange	Light Green	Green	Yellow	Red	Red	Green	Yellow	Light Green	Orange
	Life expectancy at 65	Orange	Light Green	Green	Yellow	Red	Red	Green	Yellow	Light Green	Orange
	Health-adjusted life expectancy - female	Red	Yellow	Light Green	Orange	Green	Red	Yellow	Light Green	Orange	Green
	Health-adjusted life expectancy - male	Red	Yellow	Light Green	Orange	Green	Red	Yellow	Light Green	Orange	Green
	Infant mortality	Orange	Light Green	Green	Yellow	Red	Red	Green	Yellow	Light Green	Orange
	<i>Average ranking of the MS in the EA</i>	10.3	5.0	6.0	5.9	8.4	13.4	3.5	6.6	6.8	9.6
R&D	Number of triadic patents	Green	Red	Light Green	Yellow	Orange	Green	Red	Light Green	Yellow	Orange
	Number of patent applications	Green	Red	Light Green	Yellow	Orange	Green	Red	Light Green	Yellow	Orange
	Technological readiness	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	R&D innovation index	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Quality of scientific research institutions	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Tertiary graduates per inhabitants	Orange	Red	Green	Yellow	Light Green	Orange	Red	Green	Yellow	Light Green
	Quality of math and science education	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	<i>Average ranking of the MS in the EA</i>	5.3	14.1	5.3	12.3	7.1	4.7	13.3	6.8	12.5	6.6
Public Infrastructure	Length of motorways	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Length of railways	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Fixed line and mobile phone subscribers	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Internet users per inhabitants	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Energy infrastructure	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	Overall infrastructure index	Light Green	Orange	Yellow	Red	Green	Light Green	Orange	Yellow	Red	Green
	<i>Average ranking of the MS in the EA</i>	1.7	8.2	3.2	12.3	5.0	4.0	6.7	3.8	10.7	4.5

Source: Barrios and Schaechter (2009) for the selection of output/outcome indicators and relevant sources indicated therein for the update. (1) "Pre-crisis" corresponds to 2007 (2006 for "PISA total score") and "post-crisis" to the latest 2013 or 2014 figure (2011 for "triadic patents" and 2012 for "PISA total score", "patents granted to residents", "number of patent applications", and "tertiary graduates"). Colour labels indicate the relative ranking of the five big Member States among themselves (respectively, from best to worst, dark green, light green, yellow, orange, and red). The reported number indicates the average absolute ranking of the Member State in the specific policy field among the 20 countries of the EA19 plus the United Kingdom.

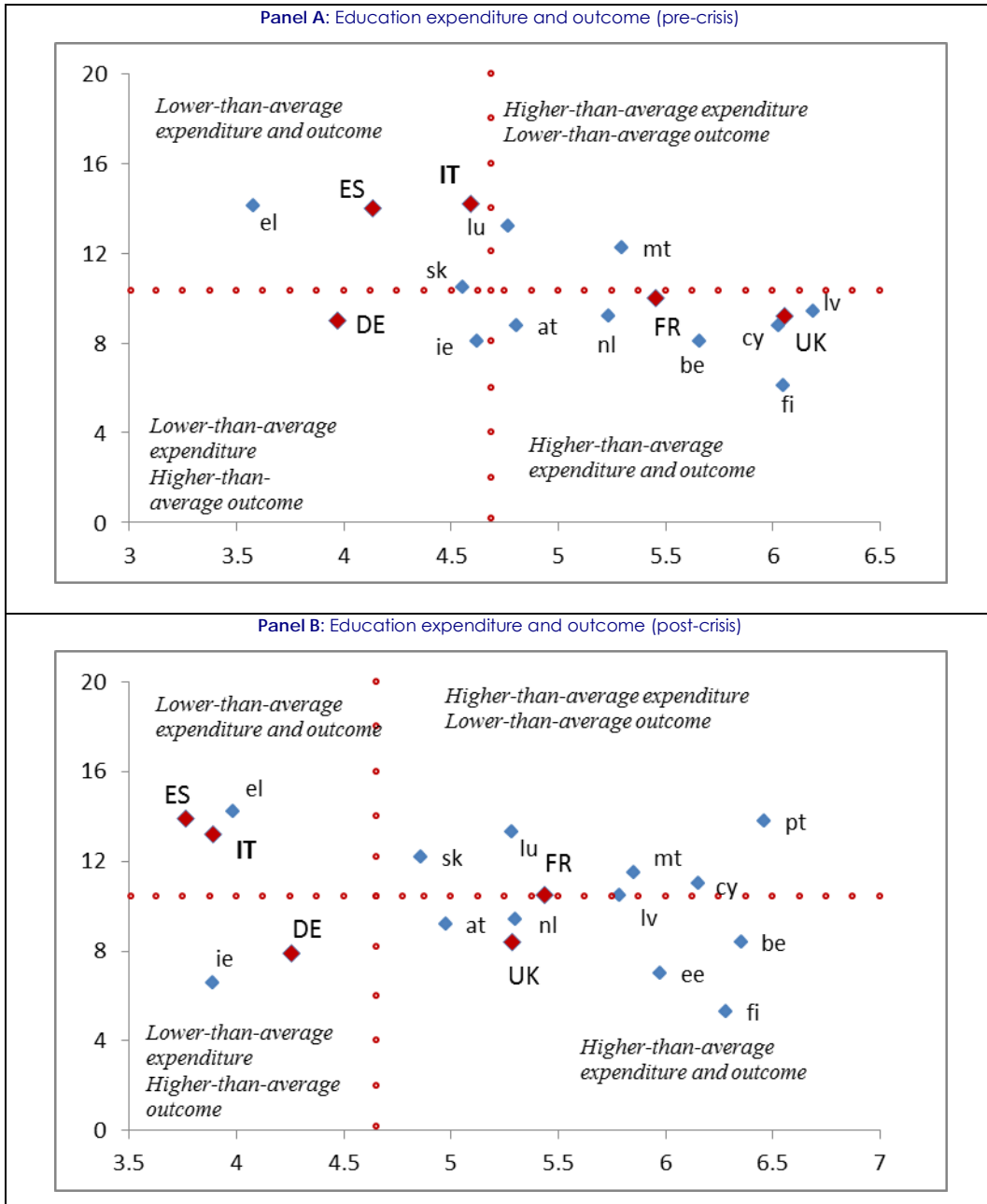
<sup>57</sup> An important caveat is that these simple bivariate analyses cannot be taken to conclude univocally whether the observed worse outcome/output is related to the underspending itself or to lack of efficiency.

Graph 4.1: Basic analysis of expenditure efficiency in health, 2007-2014



Source: own calculations based on AMECO, EUROSTAT and Barrios and Schaechter (2009). The x-axis reports the average public expenditure in the item as a share of the country's nominal potential GDP. The y-axis reports the country's ranking in the EA19+UK in terms of outcome. Dotted lines indicate the EA average for potential GDP share of spending and the EA19+UK average score in terms of outcome indicators (y-axis).

Graph 4.2: Basic analysis of expenditure efficiency in education, 2007-2014



Source: own calculations based on AMECO, EUROSTAT and Barrios and Schaechter (2009). The x-axis reports the average public expenditure in the item as a share of the country's nominal potential GDP. The y-axis reports the country's ranking in the EA19+UK in terms of outcome. Dotted lines indicate the EA average for potential GDP share of spending and the EA19+UK average score in terms of outcome indicators (y-axis).

**In spite of various initiated spending reviews, inefficiencies have persisted.** Spending review exercises were first carried out in Italy on an “experimental” basis in 2007 but rapidly lost momentum in the absence of an adequate steering entity for all involved ministries. Over 2008-2011, under the urgency to achieve fiscal consolidation targets, Italy largely resorted to more immediately effective “linear cuts” to ministerial expenditure – i.e. proportional to the respective allocations over the previous years – in lieu of targeted and gradual spending review actions.<sup>(58)</sup> In April 2012, Italy presented the first comprehensive spending review plan across all public administrations, which was later formalised in the so-called “*Giarda spending review report*”.<sup>(59)</sup> The report identified two crucial features of Italy’s public expenditure to be addressed by any forthcoming spending review: (i) large territorial differences in the production costs of public services across all sectors and government levels;<sup>(60)</sup> and (ii) very diverse territorial scope of the entities to which the same administrative functions are assigned, thereby leading to inefficiencies and high variability of unit costs because of scale economies. On this basis, the report proposed different pathways for expenditure rationalisation, from more radical reforms such as privatising public services on efficiency grounds to more targeted actions aimed at enhancing public spending efficiency, which would form the basis of the first “spending review decree” aimed at starting the so-called “second strand” of Italy’s spending review. Yet it failed to enter into sufficient detail and propose priority spending review actions adequately backed by a clear political strategy. Last but not least, in October 2013, Mr. Cottarelli was appointed spending review commissioner for three years by the Italian government. Before resigning in autumn 2014, he put forward an ambitious spending review plan, aimed to achieve hypothetical savings worth up to 0.4% of GDP in 2014, 1% in 2015, and 2% in 2016 compared to the trend scenario based on unchanged legislation. The so-called “*Cottarelli spending review report*”, made public only in March 2015,<sup>(61)</sup> analysed a broad range of spending items and proposed clear priority actions to rationalise Italy’s public spending, including: (i) more centralised public procurement, including in healthcare; (ii) streamlining and digitalisation of all public administrations, including the abolition of the provincial level of government; (iii) cuts in the number of state-owned enterprises, particularly at the local levels of government; (iv) reduction in specific forms of public support to firms; (v) rationalisation in the provision of certain public services; (vi) interventions on pension entitlements, including de-indexation. Nevertheless, the Italian government failed to endorse the plan, publicly define which priority actions would be implemented, and actively implement the projected savings. Subsequently, these savings were downsized to 0.5% of GDP in 2015 and 0.3% in 2016 according to the 2015 Stability Programme and the 2016 Draft Budgetary Plan.

**The spending review process is progressing, albeit at an irregular pace.** Some positive spending review actions have been recently implemented in Italy, broadly in line with the priority areas of intervention identified by the *Cottarelli report*, yet saving targets tend to be systematically lowered or underachieved. Whereas the 2015 Stability Programme targeted expenditure cuts worth EUR 10 billion (0.6% of GDP), the 2016 Stability Law foresees roughly half of them, while an all-encompassing intervention on tax expenditures and local public enterprises is still pending. In this context, ministers have been directly involved for the second year in a row (Stability Law 2015 and Stability Law 2016) in selecting areas within their own budgets eligible for targeted savings without the recourse to linear expenditure cuts as in the past. Furthermore, the central government is also empowered<sup>(62)</sup> to complete by end-2015 a reform of the budgetary process that could be more in line with a performance-informed budgeting approach over the medium term. This could make the link between public funding and policy priority more transparent than in the current budgetary process. At

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<sup>58</sup> The September 2011 consolidation package contained an attempt to merge the two approaches: ministries were asked to establish, with the Ministry of Finance, standard financing needs to converge to as of 2013, but with the safeguard clause that the budgeted savings (some 0.2% of GDP in 2013 and 0.3% of GDP as from 2014) would have to be ensured by linear cuts in case of insufficient results. However, the December 2011 emergency package did not push this approach forward and enacted, instead, further cuts to transfers to subnational governments as well as the suppression/merging of some administrative bodies.

<sup>59</sup> See “*Analisi di alcuni settori di spesa pubblica*” (March 2013). It can be retrieved at: [www.irpa.eu/wp-content/uploads/2012/07/rapporto\\_spending\\_19.3.13.pdf](http://www.irpa.eu/wp-content/uploads/2012/07/rapporto_spending_19.3.13.pdf)

<sup>60</sup> For instance, considering compensation of employees and intermediate consumption, public expenditure per inhabitant has a coefficient of variation of 67% at regional level, 32% for provinces and 11% for municipalities.

<sup>61</sup> See <http://revisionedellaspesa.gov.it/documenti.html>.

<sup>62</sup> Law 89/2014 of 23 June 2014 (Decree Law 66/2014 of 24 April 2014).

local level, the 2015 Stability Law envisaged savings worth around EUR 4 billion for regions, whose distribution, agreed in February 2015, <sup>(63)</sup> was operationalised by the Parliament in August 2015, with particular regard to the healthcare sector. In this sector, further spending review measures are expected in the near future, particularly by extending centralised public procurement to the regional level as envisaged by the Public Spending Rationalisation Programme. To this end, a decree law is expected to specify the product categories covered and the spending thresholds above which central and local administrations should only resort to centralised procurement. Moreover, some provisions in the 2016 Stability Law further reduce the scope for decentralised procurement by local authorities and other government bodies, particularly for certain categories of goods and services and excluding small Municipalities' purchases. Italy's 2015 Stability Law also foresees the application of the balanced budget rule by Regions as of 2015: in the medium term, if properly implemented, this may help address some shortcomings experienced under the previous Internal Stability Pact, <sup>(64)</sup> such as the strong influence of historical spending on central transfers to sub-national governments. The harmonisation of balance sheets at the local level, after passing an experimental phase, is also gradually being implemented. Furthermore, since March 2015, all public administrations have to regularly update electronic platforms for the reporting of existing liabilities to suppliers of goods and services and only accept electronic invoicing, with sanctions in case of non-compliance. This reform should increase transparency regarding the stock of trade debt, significantly lower the costs faced by firms acting as suppliers to the public administrations, reduce payment delays, and gradually bring Italian practices in line with the requirements of the EU Late Payments Directive. Finally, the ongoing reform of the public administration, if properly implemented, could prove crucial to enhance the overall efficiency of the services provided by Italy's public sector. Overall, while the diagnosis and identification of reform opportunities to make expenditure more efficient at all government levels are available, Italy appears to be still lacking the willingness to push forward the operationalisation of these measures, including through transparent and systematic monitoring of the implemented actions, capability building for the assessment of spending in the administration, and independent ex post assessment of past spending reviews.

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<sup>63</sup> However, the outcome of some legislated cuts in terms of budgetary composition still remains uncertain.

<sup>64</sup> The Internal Stability Pact (ISP) is a set of national rules that bind regional and local bodies in terms of their budgetary targets. These are annually set with the purpose to keep regional and local deficits under control also in order to favour the country's compliance with the EU fiscal rules enshrined in the Stability and Growth Pact.

## 5. CONCLUSIONS

This paper delves into a set of stylised facts concerning the composition and most recent developments of Italy's public expenditure in both a historical and comparative perspective with respect to other big Member States, based on the latest data on general government expenditure by economic classification and function. The underlying objective of the analysis is to draw from it a series of policy implications of relevance for Italy's ongoing spending review effort, including the resource allocation strategy and areas of possible future savings.

The analysis suggests that Italy's total public expenditure as a share of potential GDP has been steadily growing since 1999 due to both insufficient containment of current primary expenditure in the pre-crisis years and exceptionally sluggish potential growth since the onset of the global financial crisis. As a result, Italy's total public expenditure is now above the EA average despite slightly lower-than-average primary expenditure. In particular, debt-servicing costs continue to absorb a considerably larger amount of resources than in the rest of the EA, due to both a much more sizeable debt level and higher interest rates. Furthermore, large differentials between the implicit interest rate paid on it and sluggish nominal potential growth have implied adverse developments for the Italian public debt, especially after the 2010-2011 sovereign debt crisis. Moreover, it must be noted that a higher debt-servicing cost and more demanding fiscal medium-term objective imply that Italy should reduce its primary expenditure below the average in the rest of the EA (by around 2.5 pps) in order to avoid a relatively higher tax burden. At the same time, the debt sustainability challenge remains relevant for Italy, as a very high primary surplus, in the order of 4% of GDP, would be needed to ensure the country's compliance with the debt rule of the *Stability and Growth Pact* even under the assumption of a favourable trend reducing the differential between Italy's debt-servicing cost and potential growth to 0.5 pp in the medium term.

The paper also highlights that Italy's total public expenditure is increasingly biased towards the elderly, while growth-enhancing spending items have been severely restrained during the crisis. In particular, Italy's pension expenditure as a share of potential GDP is the second highest in the EU/OECD after Greece, while investment in infrastructure, education, and innovation has been particularly affected by the crisis. These developments, adding to long-standing inefficiencies, are likely to weigh on the country's anaemic potential growth. In this context, some positive spending review measures, including in particular the so-called "Fornero reform" enacted in 2012, have been contributing to contain pension expenditure and ensure its sustainability in the long run. This is also confirmed by Italy's positive score in long-term fiscal sustainability indicators. However, these reform efforts will require full implementation in the future to be able to continue contributing to the sustainability of the pension system, increase Italy's very low labour market participation, and underpin the adequacy of future entitlements.

Overall, the analysis hints at the fact that it may be difficult to significantly compress Italy's primary expenditure in the future while leaving the current perimeter of State action unchanged. In this context, a systematic spending review process is needed at all government levels to increase the efficiency of public expenditure and make its composition more growth-friendly. This could also help support ongoing structural reform efforts and boost the country's potential growth, particularly in a low-inflation environment, where containing public expenditure might not in itself suffice to keep its growth rate below the sluggish nominal potential GDP growth. This "spending maze runner" challenge is considerably heightened by Italy's need to contain deflator dynamics below the rest of the EA to restore price and cost competitiveness. In any case, a cautious approach is warranted by Italy in projecting future growth on which adjustments on the expenditure side are based, pending a more performance-informed budgeting process as well as a long-needed step-change in the institutional setting, without which other reform efforts might not be able to deliver their impact.



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