Bringing Domestic Preferences Back Into the Budget:
The Politics of Fiscal Consolidation in Italy (1992-1998)

Benedicta Marzinotto
Florence, September 2002

Abstract

This paper argues that the content of Italy's fiscal consolidation in the 1990s has been largely influenced by domestic socio-political coalitions. Namely, the preference over either spending cuts or revenue increases, at the macro-level, and more so, at the micro-level, the preference over specific spending and revenue items have been affected by socio-economic interests and by partisan Government actors. Here, the colour of Government matters to the extent in which it facilitates or hinders interest groups' access to policy-making, thereby determining their actual political power. The issue of the composition of fiscal consolidation contributes to a better understanding of Italy's significant adjustment. Paradoxically, fiscal austerity has allowed, in a country such as Italy, a more legitimate redistribution of public resources and hence guaranteed their 'social embeddness' (and legitimacy).

1. Introduction

The present paper analyses Italy's European convergence process in the 1990s. Because the inflation, interest and exchange rate criteria - imposed in the Maastricht Treaty as a condition for access into the European Monetary Union (EMU)- had been relatively unproblematic (EMI 1995, 1996), the focus here is on fiscal consolidation in 1992-98. Having Italy's political and economic *elites* accepted and internalised the goal of balanced budgets since the mid-1980s (Verzichelli 1999), one of the most interesting questions relates to the differences in fiscal strategies successive Governments adopted between 1992 and 1998.

It is here argued that the composition of fiscal adjustment in the 1990s –at the aggregate level, the preference over either a revenue- or an expenditure-based consolidation- has been largely influenced by socio-political coalitions. Domestic coalitions have determined both *a priori* and *ex post* Governments' preferences over the content of yearly interventions. Also, the sequencing of fiscal reforms confirms the role played by both partisan government -responsive to specific societal claims- and by interest groups. The 'social embeddness' of Italy's fiscal reforms in the 1990s (Granovetter 1985) is also explanation to the country's extraordinary (and theoretically challenging) success at consolidating with a 6%-of-GDP change in the primary surplus from 1992 to 1997. Paradoxically, fiscal austerity has allowed Italian authorities to better perform the State' redistribution function.

A closer look at the composition of fiscal consolidation reveals some important aspects about the politics of retrenchment in EMU candidates. Already, differences in the content of EMU-induced fiscal reforms contradict recent arguments about the rapid convergence of economic policy-making in the EU. If free movement of capital and the internationalisation of production may have reduced Governments' range of policy options, still cross-national variations persist. So to say, convergence is a rhetoric exercise more than a political reality.

Even when looking at individual countries, preferences over the content of fiscal consolidation seem to vary. If different Governments under the important threat of exclusion from EMU happened to follow different fiscal strategies, then any external constraint, being it economic or institutional, is not powerful enough to completely empty Governments' preferences and hence their room for economic policy manoeuvre. Above all, the main factor affecting the preference over revenue- or expenditure-based adjustments is parties' and interest groups' preference over the role of Government in an economy.

The exercise of identifying the (socio-political) determinants of fiscal consolidation is relevant also for the long-term sustainability of sound public finances. In fact, in recent times, economists have showed that expenditure-based fiscal adjustments –those focusing on cuts to primary transfers and public wages- are likely to be more successful than revenue-based consolidations in the sense that fiscal discipline lasts longer and has greater growth effects ((Alesina and Perotti 1995; Perotti 1996; Perotti, Strauch et al. 1998).

2. Dimensions of Fiscal Consolidation and their Correlation

The Maastricht Treaty provisions imposed that Member States willing to partake of the emerging EMU would have to reach a public deficit and debt not greater than 3% and 60% of GDP, respectively. If the debt criterion was soon left in the background, the interpretation of the 3%-deficit target was extremely strict. By 1997, almost all EMU candidates had succeeded in meeting the 3% reference value. But, they had done so following different fiscal consolidation strategies, some of them cutting primary expenditures, others relying almost exclusively on revenue increases (e.g. Italy).

Fiscal consolidations can be analysed along four dimensions: *timing*, *extent*, *composition* and *sequencing*[1]. In Italy, most significant budget interventions took place first in 1992 and then in 1996 when the Prodi Government succeeded in passing special legislation under the name 'Intervention for Europe'. Namely, the external constraint has been the determinant of the reform *timing*. Indirectly, the Treaty with its imposition of a numerical target has been also responsible for the *extent* of the adjustment[2]. Starting from a precarious fiscal stance in 1992, Italy experienced the largest change in general government structural balance in the EU between 1990 and 1999. In this respect, when looking at the *extent* of the adjustment, 'tying-one's-hands' theories seem to be indeed the best explanation (table 1).

On the contrary, it is here argued that the *composition* of reform is better explained by domestic variables. References to the most appropriate fiscal consolidation strategy were not absent from EU documents (European Commission 2002). European economists and

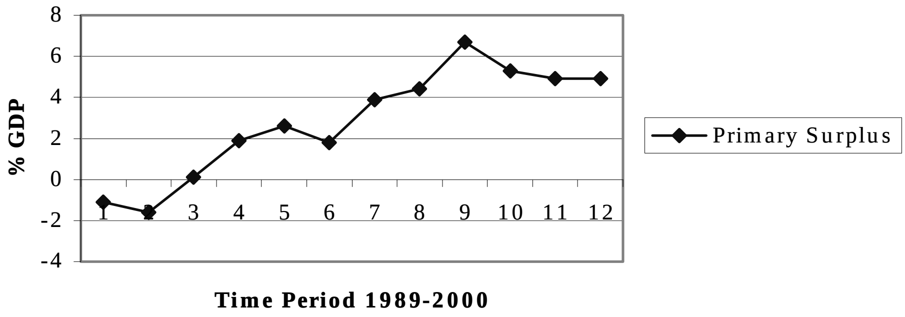
---

[1] Economic literature has investigated also on the *duration* of fiscal consolidations. Economists seem but to agree that this dimension is dependent of the *composition* of consolidation. The more the adjustment tackles primary expenditures, the more likely it is that it will be also protracted (von Hagen et al 2001). The same would actually apply for the *extent* of reform. The same strand of literature argues that expenditure-based consolidations as opposed to revenue-based are likely to register a greater change in primary surplus.

[2] By extent, economic literature means the change in primary structural surplus (Alesina/Perotti 1995).

technocrats seemed generally to agree on the fact that the recipe to balanced budgets had to concern primary expenditures.

Table 1.
Italy 1989-2000: Primary Surplus

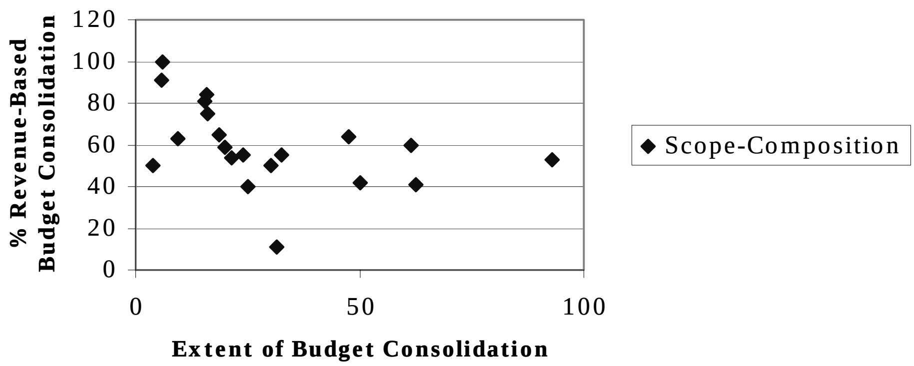


In the case of Italy, this perception was widespread among national *elites* too, and was related had to the origins of the country's fiscal problems. It was believed that its disappointing fiscal performance had been affected by lavish spending due to the incremental nature of spending decisions as they were taking place against an institutional framework in which the Parliament -open to its numerous clienteles- had excessive amendments power over Government budget proposals (Monorchio 1996). But, Italy's budgetary adjustment was concentrated on the revenue side of the budget. New resources contributed to the adjustment for about 6% of GDP, while expenditures' contribution amounted to circa 3% of GDP (BI 1999; European Commission 2000).

The fourth dimension of fiscal reform is its *sequencing*. In 1992-1999, at times, a new Government would follow the strategy of its predecessor; other times, especially in the case of mini-budgets, it would alter both extent and composition. That sequencing diverged is an important proof of the contingent role of socio-political coalitions in affecting the content of reform. Fiscal austerity was characterised, in the short-term at least, by some sort of 'social embeddness'.

But, is there a correlation among these dimensions of fiscal consolidation? The most interesting link would be between extent and composition of the adjustment[3]. It is generally argued that large consolidations tend to concentrate on the revenue side because higher taxation is relatively more politically feasible than spending cuts. This is so because, while pro-welfare coalitions tend to be organized in unions, taxpayers are not represented by an interest organization (Pierson 1998). By correlating extent and composition in 1979-1998, there is no evidence of large fiscal consolidations having been based predominantly on higher taxation. Quite on the contrary, there seem to be evidence that the smaller an intervention, the greater was Governments' reliance on additional resources (table 2.).

Table 2. Correlation between Scope and Composition Italy 1979-1998

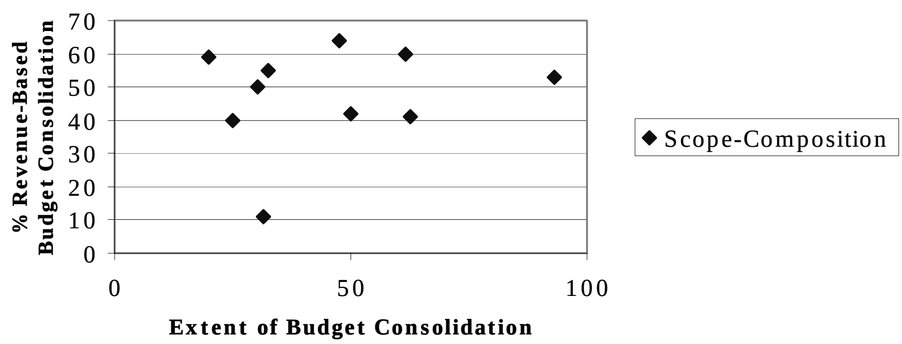


Yet, a recognisable pattern disappears completely if the same exercise is repeated for the time period relevant for the purpose of this study, the years 1989-1998. Hence, the necessary extent of reform –the need to move from a 9.6% to a 2.7% deficit by 1997- bears little explanatory

[3] By extent, it is here meant the programmatic composition of yearly fiscal packages. In fact, final budget outcomes are strongly influenced by economic trends –growth, unemployment, inflation and interest rates- as well as by Governments' capacity to implement them. In that respect, Governments' preferences are not likely to be reflected directly in this type of data. The focus is thus exclusively on fiscal packages as they are described in Governments' yearly Financial Plans.

power as to why Italian politico-economic authorities opted for a revenue-based fiscal consolidation (table 3).

Table 3. Correlation between Scope and Composition Italy 1989-1998



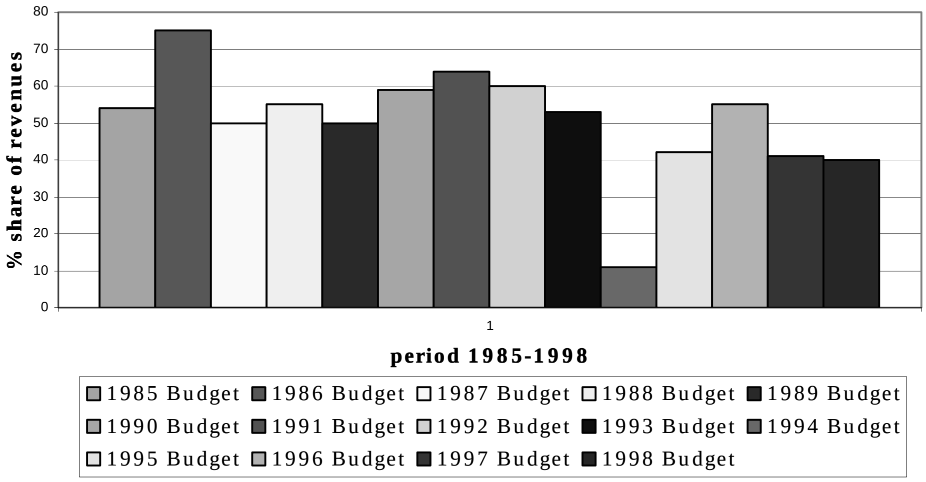
Data Source: Own elaboration from Verzichelli 1999, 304-307.

3.Other explanations to the content of fiscal adjustment

Other explanations, besides the above political-feasibility argument, could help to identify the determinants behind the content of fiscal adjustment. In particular, Institutionalists have investigated on the impact of electoral and budget institutions on fiscal policy outcomes. They have argued that coalition Governments are more likely to resort to revenue-based consolidations because of the high number of veto players. In fact, every single Government partner is committed to defending its constituencies' interests. In Italy, however, in the years between 1992 and 1998, five different coalition Governments followed but their consolidation strategies have not been all revenue-based. In other words, what seems to matter rather than the static institutional framework are the preferences of the actors forming the coalition.

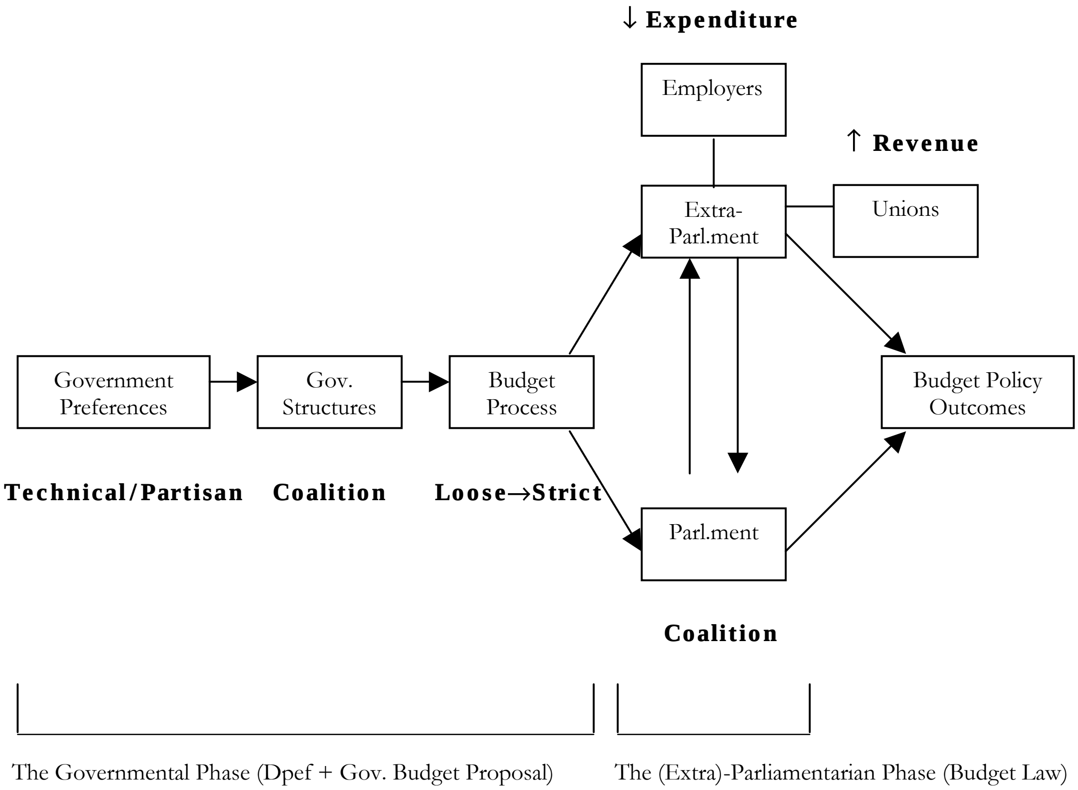
Secondly, some other Institutionalists argued that expenditure cuts become a feasible political exercise only when strict budgetary institutions regulate budget policy-making. In particular, delegation of budget policy decisions to a powerful Finance Minister is said to allow greater fiscal discipline on the spending side of the budget. In the case of Italy, there is no doubt that in particular the 1988 budget reform and Prime Minister Amato's use of the delegation option in the wake of the 1992 crisis may have contributed to reducing the Government's reliance on higher taxation relative to trend (table 4). Yet, there is still a high degree of variation, in the period 1992-1998, in the preference over either revenue- or expenditure-based consolidations. Budgetary reforms would then not explain fully the content of fiscal adjustments. Instead, in the 1990s, changes to the budgetary process seem to have been introduced *ex post*, in particular the reforms in 1997 and 1999, to reflect domestic actors' commitment to fiscal discipline.

Table 4. Budget Composition: % Share of Revenue Increases



In sum, budget policy outcomes in Italy are mainly determined by Government preferences filtered through political structures and budgetary institutions but the most important filter seems to be extra-parliamentarian negotiations with the social partners (Fig. 1). Here, employers' associations have traditionally contested revenue-based consolidations and pledged instead for the introduction of some more dramatic spending cuts. On the contrary, labour unions tended to prefer higher taxation to spending cuts and push for a progressive distribution of the additional fiscal burden.

Fig. 1. The Politico-Institutional Process: From Government Preferences to Budget Policy Outcomes



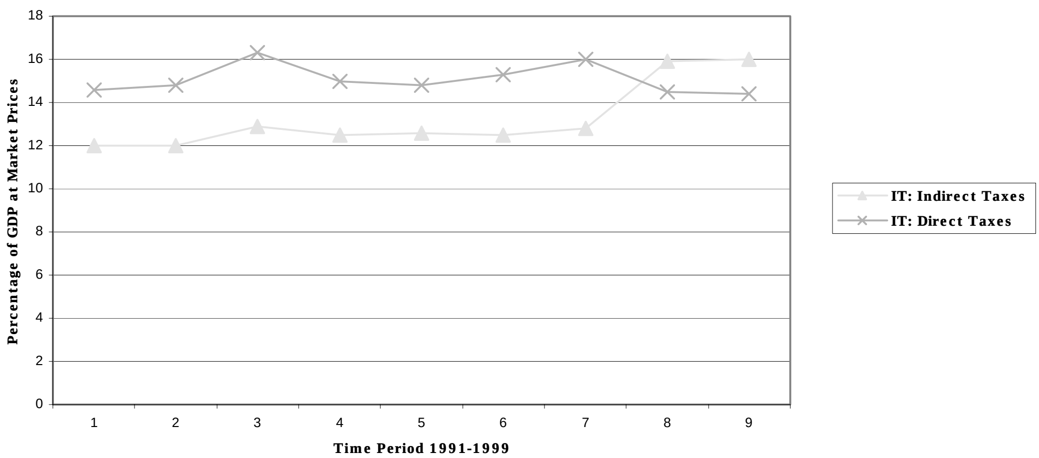
Besides electoral and fiscal institutions, domestic preferences seem to be paramount in the determination of the reform content. It has been argued here that both the partisan preferences of Government actors and those of socio-economic interests have contributed to affecting the composition of Italy's fiscal consolidation. Firstly, parties' positioning on the left-right continuum have different preferences over the content of consolidation because they value differently the role of the State in the economy. In fact, budget consolidation is only a relationship, but at what level should budgets be balanced? The issue refers to the size of Government. Anti-statist (rightist) parties would prefer spending cuts because these reduce the involvement of the State into the national economy. On the other side, the Left (or new-fascist parties) would opt for the second strategy, revenue increases, because this means increasing or, at least, preserving the role of the State.

Secondly, consolidation is about equity[4]. Once a Government has decided to insist either on spending cuts or tax hikes, it will have to establish where to place the burden of the adjustment, i.e. cut spending from whom and impose higher taxation on whom. Here, the role of socio-economic interests is particularly relevant. Italian unions have accepted higher revenues in exchange for greater progressivity, while employers have opposed them and pledged for spending cuts.

4.Public Finances in 1992-1998

By 1997, Italy had succeeded in bringing the public deficit from 9.6% down to 2.7%. The adjustment was concentrated on the revenue side of the budget. In 1997, at the end of the EMU-induced fiscal consolidation, direct taxes increased as a proportion of GDP (table 5).

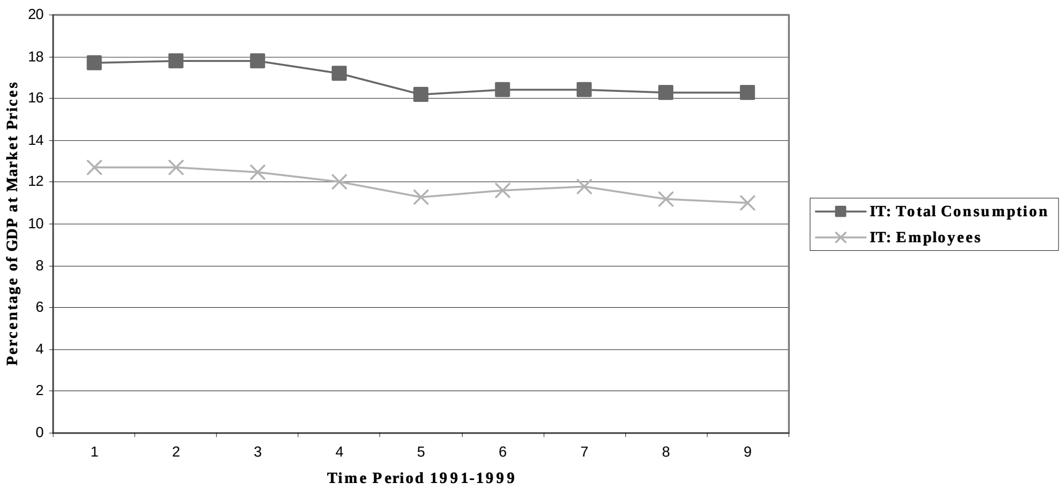
Table 5. Indirect and Direct Taxes; General Government Italy 1991-99



[4] The third important issue is efficiency. Usually, this is measured as Governments' capacity to implement a certain programme. It is about efficient administration. Here, on the contrary, because the interest lies mainly in the governmental and parliamentarian phases of the budget process, efficiency is defined as actors' consideration of the 'efficiency' of an austerity measure in terms of its capacity to fulfil its function. For example, would higher social contributions be an efficient way to increase Government resources? Policy makers would have to construct a realistic prediction about the level of unemployment in the following year.

Revenues from direct taxes had followed an irregular trend largely conditioned by the pressures of socio-political coalitions. In 1997, indirect taxes slightly increased as a proportion of GDP and more so until 1999. While social spending increased slightly until 1997, the most remarkable expenditure restraint has affected Government consumption. The trend in consumption has been mainly determined by the development of compensations for employees (table 6).

Table 6. Total Consumption; General Government
Italy 1991-1999



5.The Programme-Approach

The aggregate composition of fiscal consolidation does not offer a complete picture of the content of fiscal reform and of the role of socio-political coalitions in determining such a content. Public programmes will be studies in detail. Here, the notion of redistributive trade-offs is much more visible. In particular, the thesis will concentrate on the politics of social security contributions (SSC), on the revenue side of the budget, and that of public employment, on the expenditure side. It is argued that different partisan Governments supported by different socio-political coalitions would solve differently the choice between employment creation (private employment stimulated via low SSC) and wage equality (public employment).

6.Conclusion

Italy's choice for higher taxation raises a set of intriguing questions. First, it is interesting to determine why a country where, in the 1990s, external constraints proved so successful in pushing reform through did circumvent external and domestic experts' indications about the most appropriate fiscal consolidation strategy. Secondly, it is quite intriguing that a country suffering from severe competitiveness problems (especially with the lira's real appreciation in 1989-1992) and just about to give up the exchange rate as a competitiveness-boosting policy tool decided to increase taxation which, by pushing labour costs up, may have hindered competitiveness even further.

This paper argues that the composition of fiscal consolidation has been rather determined by domestic socio-political variables and in particular by the preferences of partisan Government actors and of socio-economic interests. The official opening of the budgetary process to the social partners has enhanced the role of specific constituencies, labour unions and employers' associations. Their contribution to the process of budgetary policy has guaranteed the social embeddness of fiscal decisions and allowed a significant fiscal adjustment.

Bibliography

Alesina, A. and R. Perotti (1995). Fiscal Expansions and Fiscal Adjustments in OECD Countries. Washington, Nber.

Monorchio, A., Ed. (1996). La Finanza Pubblica Italiana dopo la Svolta del 1992. I nodi strutturali ed istituzionali della politica di bilancio del nostro paese:approfondimenti e proposte. Bologna.

Perotti, R. (1996). "Fiscal Consolidation in Europe: Composition Matters." The American Economic Review 86(2): 105-110.

Perotti, R., R. Strauch, et al. (1998). "The Sustainability of Public Finances." CEPR Discussion Paper.