

Crisis in the Public Finances

1. The increase in public spending

Earlier chapters examined developments in the balance of payments and the lira, leaving the public finances to one side despite their key role in the country's economic life. Beginning with this chapter, however, we will focus on the direct and indirect impact that the public finances, for better or worse, have had on Italy's economic development. The paradox is that government fiscal policy did not achieve this prominence so much for the benefits it generated, which it did, in fact, do for long periods during the post-war period, but rather for its subsequent disarray. Even before the oil crisis in 1973, public spending in Italy had increased more than in any other major country, rising from 32 to 50 per cent of GDP between 1970 and 1979, whereas spending in France, Germany and the United Kingdom, beginning at almost the same level, did not rise above 40 per cent of GDP, while that in the United States remained virtually unchanged at about 30-32 per cent.¹

The rapid rise in public spending placed a considerable burden on the public finances, making it impossible to use fiscal policy to counter cyclical developments in the economy. In recession, budgetary policy consisted of increasing spending; during expansion it involved raising taxes rather than cutting expenditure, increases that did not, however, keep pace with the rise in outlays.

The two main components of the increase in government expenditure were social security spending, whose ratio to GDP increased by 9.1 percentage points between 1957 and 1977, and interest payments on the public debt, which rose by 4.5 points. Social security spending increased more rapidly than any other category of expenditure,² spurred by the belief that government should act as a welfare state, guaranteeing an acceptable standard of living to all. This view was encouraged by mass-based political parties in search of votes and unions seeking to increase their influence with those social groups which had not yet been absorbed into the world of work.

The principal factor in the increase in social-security spending was the decision to make pension rights nearly universal and to link increases in pensions to the cost of living. Until the 1970s there had been no automatic adjustment of pensions to changes in the cost of living: any increases were implemented through special laws enacted in reaction to pressure from pensioners. In 1971,

¹ G. Magnifico, "Recent aspects of monetary policy and models of monetary analysis", in *Review*, XXXVII, 1 (February 1983), p. 11.

² Rolando Valiani, "Italian public finance", in *Review*, XXXIII, 1 (January 1979), pp. 67-68. *Ibid.*, pp. 67-68 *et seq.*

however, pensions were indexed to the cost of living and in 1976 employee pensions were linked to rises in minimum contractual wages in industry. As a result, the minimum pensions of employees began to increase more rapidly than the cost of living and per capita GDP. In addition, pensions slightly above the minimum level in real terms also increased, owing to the automatic adjustment mechanism, thanks to which pensions not only increased considerably as a percentage of GDP but, even more importantly, were poised to rise even more. In 1978 it was calculated that pension outlays would increase from 12 per cent of GDP in 1977 to 14.6 per cent in 1981 if reforms were not introduced.

The main peculiarity of the Italian system was the fact that the "minimum pension" was granted to anybody who had worked for a given number of years, even if the person had not earned enough to qualify for a normal pension. It was essentially a subsidy paid to employees from social security contributions out of wages and paid to the self-employed by the government, i.e. taxpayers. The minimum pension alone accounted for more than 70 per cent of the value of pension payments in 1979. Rolando Valiani advanced a number of criticisms of the minimum pension, especially regarding its redistributive effects, given that the minimum pension was paid to a wide range of beneficiaries that included people with employment or investment income or other pensions.

Another anomaly in the Italian social security system was the disability pension, which had extremely loose criteria for determining eligibility, especially after 1959, and beneficiaries were not always poor. Pensions to the self-employed also benefited from large subsidies. For example, artisans financed only 33 per cent of their pensions, shopkeepers 38 per cent and owner-occupier farmers 6 per cent. The latter placed the heaviest burden on the system. In 1976, they made contributions totalling 156 billion lire but received 2,210 billion lire in benefits. Nevertheless, in 1979 it appeared difficult to alter this ratio, given the mass movement of people out of agriculture and the ageing of those who remained. The situation worsened in 1969 when it was decided that pensions above the minimum would no longer be calculated in relation to actual contributions but rather in relation to beneficiaries' wages at the end of their career. The change rewarded workers with higher wages and those in careers with a more steeply-graded salary scale, a bonus whose cost was borne by the mass of workers paying into the system.³

The other major category of rapidly increasing social spending was expenditure on health care, which in 1977 had grown to more than 5 per cent of GDP, of which half went to meet the cost of stays in hospital. The amount was forecast to rise to 6 per cent if adequate controls were not introduced, with spending on pharmaceuticals, testing, hospital stays and equipment increasing well beyond the level that could be justified as necessary to provide proper health care. The relaxation of controls by the bodies responsible for monitoring

³ *Ibid.* pp. 72 *et seq.*

the system contributed to the rise, as did absenteeism for illness.

Spending on general government also absorbed a considerable portion of the budget. Although the rise in public-sector unit wages was neither rapid nor large, the significant increase in the number of public-sector employees did have a major impact. Between 1970 and 1977 alone, the number of public-sector employees rose by 487,500, a very large figure if compared with the increase of 1,043,000 workers in the economy as a whole over the same period. However, about two thirds of the increase came in the education sector as a result of the increase in the extent of schooling and the reduction in the pupil/teacher ratio.⁴ Nevertheless, "greater fragmentation in salary negotiation and reduced control over these by the central authorities threatened to push spending even higher, hence the argument for "a central strategy for public sector salaries".⁵

Another major item of government expenditure were transfers to public-sector enterprises (state-controlled enterprises, municipal companies, etc.), which, in addition to budget transfers, included other forms of preferential financial treatment such as increases in their endowment funds, advances, subsidies and loans. Such expenditure rose from 4 per cent of GDP in 1970 to 7 per cent in 1975. Moreover, while central and local public-utility companies accounted for only 22 per cent of such spending in 1970, in 1977 the proportion had increased to about half, mainly to cover operating deficits resulting from government-imposed pricing policies.

In short, the increase in spending in this sector was aimed at keeping the price of public services low instead of fostering investment. It was rightly noted that this sort of welfare assistance tended to produce a less efficient allocation of resources and discourage entrepreneurship, dynamism and mobility, which are the basis of the development of a market society. It also tended to lower the average productivity of the system and generate new inflationary impulses.⁶

2. Government revenues and the excessive tax burden

On the other side of the coin, in public finance tax revenues increased from 25.8 to 33.7 per cent of GDP between 1957 and 1977, while total general government revenues rose from 28.3 to 37.2 per cent. As large as the increase was, it did not keep pace with that in government spending, which rose from 29.9 to 47 per cent of GDP over the same period. The gap between the two began to widen significantly in 1970 as Italy recorded considerably larger budget deficits in terms of GDP than the other industrial countries.

⁴ Nevertheless, the increase in the number of public-sector employees did not eliminate the imbalance in the labour market between the supply of white-collar jobs and demand in the productive sector. In any case, the incidence of spending by general government and the broad definition of the public rose from 14.5 per cent of GDP in 1970 to 16.7 per cent in 1972. *ibid.*, p. 75.

⁵ *Ibid.*

⁶ *Ibid.*, pp. 77 *et seq.*

In order to finance these expanding deficits direct taxes increased sharply. Although subsequently amended, the 1973-1974 reform of the tax system had two main effects: a large increase in overall revenues and a change in the composition of total revenue. In 1970 direct taxes raised 28 per cent of revenues, while indirect taxes accounted for the remaining 72 per cent. Following the reform, the ratio between the two changed radically: in 1979 direct taxes generated 51 per cent of revenues and indirect taxes 49 per cent.⁷ Within the absolute and relative increase in direct taxation, personal income taxes came to play a predominant role in the provision of revenue, rising from 16 per cent of total direct taxes raised in 1970 to 57.9 per cent in 1979.⁸

Such a massive increase in income tax produced a variety of effects on household saving and its uses and on the distribution of the tax burden among taxpayers in different economic sectors, in different positions in the productive process or in the household, etc. The majority of income-revenues were collected from employees. Nevertheless, since income tax is imposed on a taxpayer's total income, the existence of multiple sources of income made it difficult to redistribute the tax burden, especially among different types of income.⁹ On the other hand, despite the fact that a variety of closely-linked income sources contributed to the total income of the individual taxpayer, the tax base of Italian income tax was generally felt to be relatively narrow and subject to erosion. The narrowness was a consequence of several factors: the use of criteria for calculating certain types of income that tended to understate their value; the exclusion of certain categories of income from the progressive income tax; tax allowances and credits; and widespread tax evasion.

The erosion of the tax base was due to the criterion used to calculate incomes from land and buildings; together with the exemption of interest on government securities, bank deposits and bonds from taxation. Although justified by a variety of understandable considerations, such exemptions often gave rise to arbitrary treatment of different taxpayers. All of these issues needed to be considered in any discussion of the structure of income tax.¹⁰ However, the issue became even more difficult when inflation was included in the equation, as the problems that a progressive personal income tax posed were accentuated in periods of high inflation.¹¹

3. The problem of the Treasury

In order to meet its treasury needs, the government turned to the Bank of Italy, taking advantage of the fact that, while in the other industrial countries

⁷ A. Pedone, "Aspects and problems of income tax in Italy", in *Review*, XXXIV, 3 (October 1980), p. 424.

⁸ *Ibid.*, p. 418.

⁹ *Ibid.*, pp. 429 *et seq.*

¹⁰ *Ibid.*, pp. 436 *et seq.*

¹¹ *Ibid.*, pp. 446 *et seq.*

such bank financing was limited to a fixed amount, in Italy the government could obtain central-bank credit of up to 14 per cent of planned spending, increased by the amount of subsequent budget revisions. Moreover, the interest rate charged on central-bank financing of the Treasury was a mere 1 per cent, unlike the other countries, where interest was charged at official or market rates.¹²

Once the 14 per cent limit had been reached, the government had no choice but to raise taxes to cover the deficit (a path Italy did not neglect, as we have seen) or, above all, to issue new debt. However, the large increase in issues of government securities made it impossible to ensure that all issues would be fully taken up, so in 1975 the Bank of Italy was required to purchase any unsold securities at the monthly auctions at the auction price, allowing the Bank to place them on the market whenever possible.

The monetary base thus increased steadily. Between 1972 and 1976 the amount of direct and indirect central-bank financing of the Treasury was more than 100 per cent of the net expansion of the monetary base. The situation changed between 1977 and 1979 with the launch of the government's stabilization policy in the autumn of 1976, but the expansion of the monetary base, and with it growth in issues of government securities, resumed in 1980. In 1981 issues totalled 110 trillion lire and were forecast to rise to 140 trillion in 1982.¹³

4. Public spending and private saving

In order to prevent the growing mass of treasury bills from falling entirely, or almost entirely, on the Bank of Italy, thus causing an even greater expansion of the monetary base, efforts were made to encourage households to purchase more government securities so as to reduce and eventually eliminate the need for monetary financing of the treasury's borrowing requirement. However, the public initially showed little interest in purchasing fixed-interest government securities given the level of inflation at the time. In the mid-1970s households preferred bank deposits, in part owing to the speed with which they could withdraw their money if needed. As a result, banks absorbed the majority of annual household savings, accounting for 87 per cent in 1973, 60 per cent in 1975, 66.6 per cent in 1977 and 52 per cent in 1979.¹⁴

In order to persuade savers to purchase treasury bills, these securities began to be offered with interest rates higher than those normally paid on fixed-interest government securities, bringing yields much closer to those on bank deposits. Between 1979 and 1981 the range of maturities at which they were issued was also widened and now included short-term paper. The frequency of auctions was also increased. Treasury bills thus lost most of the classic characteristics of

¹² Magnifico, 'Recent aspects', p. 15.

¹³ F. Parillo, 'Address', in *Review*, XXXVI, 2 (June 1982), p. 257.

¹⁴ Michele Barbato, 'The evolution of monetary policy and its impact on banks', in *Review*, XLI, 2 (May-August 1987), pp. 175-176.

government securities, gradually becoming fully-fledged means of payment. They progressively replaced longer-maturity government securities, coming to account for two-thirds of the issue of government securities,¹⁵ rising to a full 96 per cent in 1980 and about 80 per cent in 1981.¹⁶ Meanwhile the ratio of public debt to GDP rose from 50 per cent at the beginning of the 1970s to about 70 per cent¹⁷ and treasury-bill yields continued to rise.

It was the continuous rise in these rates from 6 to 14 per cent that attracted households and changed their saving behaviour, with a consequent impact on the banks. Deposits declined as a proportion of household financial assets from 52.6 per cent in 1979 to 31.8 per cent in 1981, while that of treasury bills rose from 10 per cent in 1977 to 18 per cent in 1979 and 35 per cent in 1981.¹⁸ It should be noted that the increased preference for government securities was also a result of the sharp fall in share prices, a decline that was not limited to Italy alone.¹⁹

5. Credit controls

While households were demonstrating an increasingly healthy appetite for government debt, inflation began to increase rapidly again after having slowed down since 1976. In the wake of the Khomeini-led revolution in Iran, between 1979 and 1980 a second large rise took place in the price of oil. This increase was also reflected in Italy's balance of payments, causing the lira to weaken even further. Inflation, which had fallen to 12 per cent in 1978, rose above 21 per cent in 1980 before steadying at 17.8 per cent in 1981.²⁰

The decline in inflation in 1981 was the result of the measures taken by the authorities to improve the management of the public debt, facilitating placement with households in order to enable the Bank of Italy to exercise more effective control over the money supply. The first step in this direction was the introduction of repurchase agreements, which enabled the central bank to manage liquidity between the monthly treasury-bill auctions. Measures were then introduced that accelerated the process of banking dis-intermediation by lowering the lending ceiling and, in January 1981, extending the restrictions to loans of less than 130 million lire and those in foreign currency.²¹

The inclusion of loans of less than 130 million lire in the credit restrictions by itself revealed the gravity of the financial and balance-of-payments situation in Italy.

¹⁵ Magnifico, "Recent aspects", p. 28.

¹⁶ *Ibid.* pp. 28-29.

¹⁷ *Ibid.* p. 29.

¹⁸ Barbato, "The evolution of monetary policy", p. 182.

¹⁹ The fall in equity prices was even worse in the United States. Franco Modigliani and R.A. Chon ("Inflation and the stock market", in *Review*, XXXV, 3 (October 1981), pp. 415 *et seq.*) mentioned the sharp decline in the price-earnings ratio in the United States during the period between the mid-1960s to the early 1980s, a period characterized by a variable and rising inflation rate.

²⁰ Barbato, "The evolution of monetary policy", p. 183.

²¹ *Ibid.*, p. 184.

Following the first oil crisis in 1973 the Bank of Italy had set a ceiling on bank lending that was applied only to loans of more than 500 million lire, in order not to harm small and medium-sized enterprises, while the number and amount of loans above 500 million lire could not exceed the forecast growth in total lending.²² Given the acceleration of inflation and the worsening of the balance of payments, in 1974 the ceilings were extended to almost all bank loans, except for those related to energy, cereals and a few other categories and low-value loans.²³ The results were encouraging. The flow of capital was reversed in Italy's favour and stocks were reduced, although, with the fall in inflation achieved, the volume of gross fixed investment also declined. In the following year credit ceilings were not necessary.

In 1976 the Bank of Italy restored the credit ceilings but with a difference, as noted by Antonio Fazio and Stefano Lo Faso: the new restrictions applied to lira-denominated loans, which allowed banks to increase their foreign-currency lending. This was done in order to profit from the abundant liquidity in the international financial markets and channel large amounts of short-term capital into the country through the banking system in order to stabilize the exchange rate of the lira, thereby reducing inflation.

The entire programme was supplemented with a major package of fiscal measures. Once again, there was a sharp improvement in the balance of payments and a further significant decline in inflation, although, as before, economic activity was showing signs of flagging.²⁴ As mentioned above, the oil crisis of 1979-1980 prompted the reimposition of general credit ceilings on loans of more than 130 million lire. In March 1980 the Bank of Italy also modified the system of controls over bank lending, allowing banks to exceed the limits if they deposited a large non-interest-bearing reserve with the Bank, whose amount was a rising proportion of the overshoot. Using this system and the consequent impact on interest rates, the Bank sought to govern the growth of liquidity.²⁵ Its efforts did not end here, however. At the end of 1979 it had begun to use open-market operations to influence the expansion and contraction of market liquidity.²⁶

Financial intermediation with business had become an expensive proposition in Italy, considerably more so than in other industrial countries. In addition to the draining of capital by the large public-sector deficits, this helped to explain the limited formation of capital in the business sector and, conversely, the much greater saving by households.²⁷

²² Antonio Fazio and Stefano Lo Faso, "The control of credit and financial intermediation in Italy", in *Review*, XXXIV, 3 (October 1980), p. 473.

²³ *Ibid.*, pp. 473-474.

²⁴ *Ibid.*, p. 474.

²⁵ *Ibid.*, p. 475.

²⁶ *Ibid.*, pp. 475-479.

²⁷ Franco Cotula and Rainer Masera, "Private savings, public deficits and the Inflation Tax", in *Review*, XXXIV, 3 (October 1980), p. 536. The financial resources of households increased from 1965 to 1972, declined between 1973 and 1979 and again rose in 1978 and 1979, although they remained below the level of 1972.

6. The "divorce" between the Bank of Italy and the Treasury

In July 1981 the Bank of Italy was finally able to free itself of the requirement to act as the residual purchaser of government securities at issue, although this did not imply that the Bank had shifted its policy outlook to a monetarist position. As Maria Teresa Salvemini²⁸ pointed out, the "divorce" was caused by the gradual build up of daily treasury deficits, which the Bank of Italy was called upon to finance, thus expanding the money supply. The Treasury was supposed to absorb all or part of the excess liquidity by auctioning securities, but because the auctions took place at relatively lengthy intervals the central bank was forced to sell treasury bills during the month to absorb the liquidity before it triggered a process of credit creation and to consolidate the compulsory reserves. The Treasury was thus able to sidestep its responsibility.

At the same time, the centralization of the borrowing requirements of the enlarged public sector in the mid-1970s under the Treasury had caused the problem to worsen further, making it impossible to sustain the old treasury management policy, which had sought to regulate the state-sector borrowing requirement in line with monetary-policy objectives. Hence the decision in July 1981 to abolish automatic and unlimited central-bank financing of the Treasury. The Treasury once again became responsible for ensuring the placement of sufficient securities to cover its financing needs, allowing the Bank of Italy to supply an amount of liquidity consistent with its own objectives for monetary control and the general economic aims of the government.²⁹ In other words, the change allowed the central bank to purchase the amount of government securities in the primary or secondary market necessary to produce the desired expansion of liquidity in relation to its credit and deposit targets.³⁰

The divorce between the Treasury and the Bank of Italy did not mean that the behaviour of the two institutions would necessarily diverge. The uncertainty of the deficit made it more important than ever that they coordinate their actions and make sure that this coordination was evident to the market. After the divorce it was clearly necessary to improve the tools and techniques available to the money market, given that the Treasury and the market were now in direct contact. As it was, the post-divorce institutional arrangements would acquit themselves well in the currency crisis of April 1982, demonstrating a significant improvement in the management of the currency and the public debt, ensuring the essential conditions for the transition to a system in which the Treasury would have to go to the market for its funding and therefore one in which the Bank of Italy would return to providing at least temporary financing to the market itself.³¹

²⁸ Maria Teresa Salvemini, "The Treasury and the money market: the new responsibility after the divorce", in *Review*, XXXIV, 1 (February 1980).

²⁹ *Ibid.*, p. 35.

³⁰ *Ibid.*

³¹ *Ibid.*, p. 53.

7. Indexing savings

Household saving continued to be a strength of the Italian economy. Bank deposits did not decline, increasing by 13.2 per cent in 1980, 8.7 per cent in 1981 and 11 per cent in 1982, averaging about 13 per cent per annum for the period between 1979 and 1982. However, the rise did not keep pace with inflation, which averaged 17.5 per cent per annum over the same period.³² Deposits had performed better in the previous four-year period (1975-1978), when they grew at an average annual rate of 23 per cent and inflation averaged 15.7 per cent. In short, deposits increased in nominal terms but contracted in real terms. With their higher rates of interest and shorter maturities, treasury bills continued to attract ever greater attention from the market. However, their spread and the consequent rise in average market interest rates contributed to creating a sort of broad-based indexation of savings, with adverse consequences for controlling inflation.

Owing to widespread expectations of ever-greater issues of treasury bills, the increasing volume of such issues at ever shorter maturities gave rise to instability in the money market. The market became too liquid, with the excessively large volume of short-term securities shunting the money supply and bank deposits aside. Some complained that the delay in implementing the divorce between the Bank and the Treasury made it impossible to change the situation, with policy caught between the deficit on one side and inflation on the other. The cost was also threatening to become excessive, as shown by the rise in bank interest rates and, with them, the cost of credit, increasing the burden on the economy.³³

If the volume of treasury bills issued had continued to grow even greater, no-one could have prevented the intensification of factors distorting the proper evolution of monetary flows and the efficient allocation of financial resources.³⁴

8. The difficulties of financing the Treasury

The widespread concern about the situation was due to the increasing difficulty of containing the budget deficit. It continued to expand each year, and with it the public debt. All attempts to curb it had proved ineffective and the public finances were less and less able to bear the pressure of uncontrollable increases in spending that regularly and predictably led to overshooting spending targets.³⁵ The need to check the growth of the deficit therefore became the focus of discussions and negotiations.

³² G. Guidi, "Opening remarks", in *Review*, XXXVI, 2 (June 1982), p. 192.

³³ G.L. Mengarelli, "The effects of inflation and the public deficit on the flows of saving and credit in Italy", in *Review*, XXXVI, 1 (February 1982), pp. 53 *et seq.*

³⁴ *Ibid.*, p. 54.

³⁵ Giovanni Ruggieri, "The difficult financing of the Treasury", *Review*, XXXIX, 1 (February 1985), pp. 10 *et seq.*

Having abandoned for the moment the option of a municipal tax on buildings, the effort to lower the deficit rested on a remission of construction irregularities and on the reduction of Treasury account. Nevertheless, the package had to be supplemented with a number of additional measures, above all restricting the criteria for spending on health care and pensions, which were to be set in relation to the actual level of services to be provided.

Giovanni Ruggeri, the Accountant General, emphasized with great clarity the difficulties of mining in the deficit. He underlined the problems of quantifying public expenditure and reaching agreement between the government, Parliament and various interest groups on the action to be taken once the readjustment plan was drafted. The country was buffeted by a wave of dissatisfaction. Public-sector employees, pensioners, laid-off workers, first-time job seekers, users of the health service and a host of other groups all had demands that, if even partially met, would inevitably have an impact on public spending, thus widening the deficit. Even this did not include the spending needed to complete "emergency" works that could no longer be postponed, whose costs had increased with time, thanks in part to inflation. Topping it all were natural disasters such as the earthquake that hit Basilicata, Campania and part of Apulia in 1980 (Italy seemed forever afflicted by earthquakes) and the unavoidable costs of implementing Community directives, such as those regarding the steel industry and agriculture.

Owing to the continuous and varied demands of new and old needs, the deficit-reduction measures soon proved to be insufficient, leading to discussions for a "second phase", with an emphasis on rapidly finding new revenues.³⁶ In fact, the difficulties encountered in issuing debt were so serious that the Bank of Italy was quickly criticized for maintaining that its sole task was to defend the currency. Ruggeri replied that "in the absence of an economic constitution laying down, as in other countries, the functions of the central bank, it should be noted that, among the 'institutional' aims and those of 'public interest' attributed to the Bank of Italy in its statute, no mention is made of the regulation of the currency. In reality, however, the high level of professional qualifications in the Bank of Italy enabled it to make a powerful contribution to the performance of this function and signs of this practice are to be found in the preliminary works of the constituent assembly".³⁷

In this situation it appeared that the "divorce" was in need of amendment. It was argued that circumstances could arise in which the Bank of Italy should not be able to avail itself of its safeguards. Ruggeri remarked, "no 'divorce' in an 'operator state' can annul commitments legitimately taken on "even if this leads to the creation of 'hidden deficits', whose existence in some sectors of public finance is well known to have been deleterious".³⁸ Rather, the divorce was to be interpreted as "allowing independent assessment, divergent views and critical

³⁶ *Ibid.*, pp. 16 *et seq.*

³⁷ *Ibid.*, p. 22.

³⁸ *Ibid.*, p. 23.

support with regard to budget policy choices". If, instead, it had been intended to have an impact on government spending "and, in fact, reduce the financial scope for further interventions, the critical voice of the central bank can play a role that goes beyond that implicit in the recognition of its authority".³⁹ The Accountant General's remarks were widely cited to emphasise the seriousness of the impact of government borrowing on the financial market and the fears of failure overshadowing the placement of government securities.

9. The growth of the public debt

Owing to the increasing size of budget deficits, the public debt grew so rapidly after 1980 that at the end of 1984 it was estimated to be equal to about 90 per cent of GDP and forecasts of its future growth were even more dramatic. Rolando Valiani, searching for a solution to the problem, estimated that the debt would rise to 123.4 per cent of GDP at the end of 1988.⁴⁰ Certainly, rising public debt was not a solely Italian phenomenon, being a problem not only in the industrial countries but also the socialist and developing countries, large and small alike. Not all had a public debt like Italy's, most of which was held by domestic investors; except for the industrial countries, the debt of most economies was held by foreigners. Nevertheless, whether held abroad or at home, public debt was especially dangerous in countries where, like Italy, the debt/GDP ratio was very large.⁴¹

The most sensitive aspect of the problem was financing the borrowing requirement, especially owing to its impact on the monetary base. After all, Ruggeri's remarks concerning the central bank focused on financing the deficit. However, Valiani came to the Bank's defence, arguing that in the early 1970s the Bank of Italy had mainly provided monetary financing of budget deficits, so much so that its share of the total debt rose from 25 per cent in 1970 to 40 per cent in 1976. It was only in subsequent years that the Bank significantly reduced its efforts to cover the deficit, with its share of the debt declining to 22 per cent in 1979, 17 per cent in 1983 and an estimated 16.7 per cent at the end of 1984. The proportion of monetized debt also fell: after rising from 11.3 per cent of GDP in 1970 to 24.5 per cent in 1975 and 26.2 per cent in 1976, it declined to about 15 per cent in 1983 and 1984.

According to Valiani, the policy of the central bank initially changed between 1977 and 1978, with the placement of Treasury bills with the banks, an operation that was facilitated by the imposition of the credit ceiling in addition to the securities investment requirement. The new approach continued with the spread of investment in government securities among small investors thanks to the

³⁹ *Ibid.*, pp. 24 *et seq.*

⁴⁰ Rolando Valiani, "What solutions are there to Italy's public debt?", *Review*, XXXIX, 1 (February 1985), p. 75.

⁴¹ *Ibid.*, p. 77. *Ibid.*, pp. 80 *et seq.*

favourable interest rate differential with bank deposits, the exemption of government securities from taxation and the increase in the tax on bank deposits.⁴²

In effect, the Bank of Italy shifted from monetary financing of the public debt to financing it with government securities. However, the change in strategy had raised worries about the difficulty of managing the debt and controlling its growth, especially as it could lead to excessive issues of securities. It was feared that there was a danger that the anti-inflationary rigour of the policy for financing the debt would force Italy to accept a burst of inflation in the future in order to reduce the value of the excessive volume of the government securities. Valiani rejected these fears and the contention that the Bank of Italy had withdrawn from involvement in public-debt policy, arguing that the central bank had sought to prevent the need to finance the deficit and maturing debt securities by forcing it to create new money.⁴³

10. Readjustment policies

The central problem facing the Italian economy was to find an effective policy for readjusting the public finances, a task that could no longer be deferred. Ruggeri offered another long analysis of the issue. On the basis of experience and the findings of specific studies, he calculated that more than 90 per cent of government outlays for interest payments was determined by the stock of existing debt and that only 20 per cent of the impact of interest-rate policy came in the current year, while the largest part affected the deficit in the subsequent year;⁴⁴ that is, high interest rates spurred the growth of the public debt, which in turn pushed up interest rates. It was a vicious circle that had to be broken at all costs.

The debt and the budget deficit were therefore different sides of the same problem and it was not possible to remedy one without acting on the other. The Minister of the Treasury had also addressed the problem in 1984, proposing a "readjustment plan" for the public finances that aimed to stabilize the debt/GDP ratio over four years. The success of the plan depended on annual GDP growth of 3 per cent for the four years and inflation of 7 per cent in the first year and 5 per cent in the remaining three, as well as on measures to reduce the borrowing requirement net of interest payments, increasing revenues and capital spending only at the rate of nominal GDP growth and keeping current expenditure unchanged in real terms.⁴⁵

The conditions necessary for success were neither few nor minor. However, leaving aside the question of the feasibility of achieving them, others argued that meeting the conditions would itself have negative consequences. For

⁴² *Ibid.*, p. 86.

⁴³ G. Ruggeri, "Notes on the control of the public deficit in the medium term", *Review*, XXXIX, 1 February 1985, p. 74.

⁴⁴ Ministero del Tesoro, *Relazione previsionale e programmatica per il 1985* (Camera dei Deputati - Senato della Repubblica, IX Legislatura).

example, Luigi Spaventa argued that, if the conditions were met, adverse trends would be accentuated "and sharply curb the growth of the private sector's disposable income, and especially that of households".⁴⁶ In his view, the possibility of stabilizing the debt/GDP ratio depended not only on reducing the deficit net of interest payments but also, for a given real cost of the debt, on the real growth of the system.⁴⁷

11. The budget deficit and the shift in monetary policy

A further contribution to the discussion of the problem of adjustment came from Mario Arcelli, who noted that Italy had already gone through a monetary policy-shift when the Bank of Italy had switched its priority in 1974 from maintaining stable interest rates to using total domestic credit as an intermediate target.⁴⁸ With the new policy, the Bank of Italy was able to cope with the second oil crisis (1979-1980), tightening the credit ceiling and thus reducing finance to the private sector. However, the continuous increase in the budget deficit had forced the Bank to tighten the ceiling even further in 1980 and 1981, transferring the monetary squeeze to the banks, which reacted by replacing some ordinary lending with an increase in that by the special credit institutions. Caught between the reaction of the banks and the growing budget deficit, the central bank saw its control over total domestic credit gradually decline before its eyes.

With the weakening of direct credit controls and being forced to limit the creation of liquidity, the Bank of Italy had to make a number of changes in the *modus operandi* of monetary policy. Thus, following the "divorce", in 1981 and 1982 it altered its stance with respect to total domestic credit, fostering an increase in both nominal and real interest rates by allowing credit as a whole to expand. That is, the transmission channels of monetary policy were no longer identified almost exclusively with the availability of credit but were now increasingly focused on real interest rates.

The relationship between the budget deficit and monetary policy was emphasised by the Bank of Italy increasing the compulsory reserve ratio to 25 per cent at the end of December 1984 and its extension to repurchase agreements, an instrument that the banks had been using as an irregular form of fund-raising. The measure shifted controls from the asset side of the banks' balance sheets to the liability side.

An additional turning point in monetary policy came in 1983 with the elimination of the credit ceiling. In order to reap the benefits of the change, the

⁴⁶ Luigi Spaventa, "Adjustment plans, fiscal policy and monetary policy", *Review*, XXXIX, 1 (February 1985), p. 24.

⁴⁷ *Ibid.*, pp. 28 *et seq.*

⁴⁸ A year earlier, Arcelli had discussed the significance and limits of total domestic credit as a target in "Is the Total Domestic Credit" intermediate objective still valid?", *Review*, XXXVII, 3 (October 1983), pp. 414 *et seq.*

banks were forced to diversify the forms of their fund-raising and the interest rates they paid, as well as to simplify the bureaucracy required by lending procedures. However, both transformations were affected by the Treasury borrowing requirement, which thus managed to twist the budget deficit, the public debt, credit and money into a single intricate tangle.

12. The road to stagnation

What were the effects of this situation on the real economy? The economists writing in the *Review* between 1979 and 1981 broadly agreed that the direction taken by the Italian economy was the road to stagnation.⁴⁹ They differed only in the accent they placed on this or that factor as the direct or indirect cause of the stagnation. For example, Michele Fratianni emphasized the contrast between public and private ownership, noting that public enterprises were virtually guaranteed against bankruptcy while private-sector firms ceased business when their revenues did not cover variable costs.⁵⁰ Also protected from bankruptcy were large private firms, i.e. those whose labour force was sufficiently large as to make it politically important.

The fact that large firms rarely faced the threat of insolvency was, according to Fratianni, the real reason for the aggressive behaviour of the unions. The latter had little to worry about if their wage demands were not compatible with the survival of the firm as they could be reasonably certain that public funds would be used to save it. Thus, all wage earners were negatively influenced by the gradual replacement of private firms by publicly-owned enterprises.

As the losses of public enterprises mounted and were reflected in increased public expenditure, it became necessary to raise taxes, including social security contributions. It was this increase in the tax burden on firms that fostered the growth of a large "black" economy, especially among small enterprises in labour-intensive industries producing for export or providing services. Fratianni did not himself calculate the number of workers employed in these sectors but did include the assessment presented in the *Government Report on the Economic Situation in 1978*, which estimated that there were 1,640,000 workers with more than one job, 2,600,000 workers with occasional jobs and 400-500,000 foreign workers.⁵¹

Paolo Savona⁵² also viewed the outlook at the beginning of 1979 as being marked by worries and tensions. Although by now an industrial country, Italy "had pre-industrial institutional arrangements". The high and increasing

⁴⁹ Michele Fratianni, "The Italian economy in 1978-79", *Review*, XXXIII, 1 (January 1979), pp. 33 *et seq.*

⁵⁰ *Ibid.*, p. 34.

⁵¹ *Ibid.*, p. 20.

⁵² Paolo Savona, "The Italian industrial structure: problems and prospects", *Review*, XXXIII, 1 (January 1979), pp. 45 *et seq.*

dependence on foreign trade, the concentration of production of manufactured goods in highly competitive sectors, the smallness of the stock of productive capital, the insufficient and often outdated infrastructure, the existence of major sectors in which parasitic rents were prevalent and an ancient territorial dualism were all factors that made planning independently of the dynamics of foreign demand impossible. Prevailing economic philosophies involving the substitution of domestic demand for foreign demand through reforms or "supply-side planning" (i.e., preparing a schedule of individuals' needs) or the "independent variable salary" (setting of the rate of wage growth independently of other economic variables and economic policy objectives), while all had reasonable justifications if considered as policies on their own, became divergent and inconsistent⁵³ once placed within the context of the reality of the development and needs of the country. They were "philosophies" that could only bring "a paralysis to the growth and the employment prospects of the economy, and therefore, a crisis of the whole society".

Savona emphasized the fact that Italy possessed "the most advanced labour legislation in the world – including those areas where the 'proletariat' is dominant – the most extensive pension legislation, preventive and curative medical assistance, which was 'free for everyone', compulsory education up 14 years of age, and substantially free education for all up to a university degree. Moreover, there is an unwritten law ... that inefficient enterprises cannot go bankrupt, so long as they are deemed to have some social relevance". However, at the same time Italy had "the lowest labour participation rate among industrialized countries, and conversely, the highest rate of unemployment. We have about a fifth of the population which enjoys a pension, which is in itself largely insufficient to feed the pensioner". The country also had a generally poor-quality and badly-organized hospital service, inadequate elementary and secondary education, despite the heroic efforts of some, and crumbling universities burdened with responsibilities without corresponding financial resources or consistent legislation. Nevertheless, despite the fact that non-convergent and inconsistent behaviour was rife in the country and its major industries, the Italian economy continued to show unexpected vitality within the ranks of smaller or "unregistered" firms, that is in sectors where economic legislation and union rules were largely absent.⁵⁴ The development of the 'black' economy was an attempt to escape the 'shackles' that were hindering growth.⁵⁵

Valiani argued that it had become difficult to use fiscal policy as an instrument of economic policy. While large social groups desired a welfare state, conflict continued to characterize the distribution of income and those who demanded greater public spending rarely felt obliged to support its cost. The result was an

⁵³ *Ibid.*, pp. 58 *et seq.*

⁵⁴ *Ibid.*, p. 59.

⁵⁵ *Ibid.*, p. 60.

increasingly inextricable tangle of demands for public intervention and "automatic spending mechanisms" and spirited resistance to tax increases.

The fragility of the political equilibrium and competition among parties to win new support tended to ensure protection for all categories of citizens with any social or electoral weight and proposals for making expenditure and revenue policy more efficient had to take account of this reality. Complicating the situation was the lack of cooperation between central, regional and municipal government. The public finances could not be planned without the ability to bind the behaviour of central government and local authorities to the programme.³⁶

13. The crowding out of private finance

An additional difficulty facing the Italian economy was the host of links between the real economy and the public finances, which gave rise to the 'crowding-out' of private spending. In the 1930s the concept of crowding-out had been at the centre of the debate between the Keynesians and neo-quantity theorists. While acknowledging its theoretical importance, Arcelli and Valiani sought to reintroduce the idea by analyzing it within the real-world framework of the Italian economy, where the problem had begun to emerge in the 1970s when the monetary authorities had intervened to regulate the flow of capital and its allocation between the public and private sectors.³⁷ Between 1974 and 1977, private investment was crowded out by the financing needs of the public sector, which was much less economically productive than the private sector. Private investment was also made increasingly difficult by the 'stop-go' nature of government policy, which was at once the cause and effect of the expansion of government spending and the widening of the deficit, as well as being influenced by interest rates pushed up by the volume of government securities being issued and inflation. The flow of credit to the private sector was contained by administrative controls on bank lending imposed to ensure that the increasing demands of the Treasury were met.³⁸

The crowding-out of private investment was worsened by the behaviour of the banks. Mario Monti and Bruno Siracusano showed that lending to the private sector had fallen from 66.1 per cent of total lending in 1972 to 48.4 per cent in 1978, while the banks' purchases of government securities increased from 33.9 to 51.6 per cent of total lending over the same period. In other words, more than half of bank lending was absorbed by government or government-guaranteed securities.³⁹ Banks as well as private firms were being crowded out, since a rising proportion of their assets consisted of government securities. Thus, banks

³⁶ Valiani, "What solutions?", pp. 91 *et seq.*

³⁷ See Section 5 above.

³⁸ M. Arcelli and R. Valiani, "Crowding-out: Some reflections on economic policy" in *Review*, XXXII, 2 (March 1979), pp. 237 *et seq.*

³⁹ Mario Monti and Bruno Siracusano, "The public sector's financial intermediation, the composition of credit and the allocation of resources, *Review*, XXXIII, 2 (March 1979), pp. 237 *et seq.*

replaced lending to business with lending to the government, weakening their direct contacts with firms. In other words, the government and its transfers at least partially replaced banks as a financial intermediary with firms. And although the increase in bank deposits might have prompted the conclusion that this partial exchange of roles allowed the banks and government to expand the scale of their intermediation, the cost to society of government financial intermediation was added to the cost of the banks' financing of government. This had the consequence that efficiency in the use of financial resources was presumably reduced by the greater distance between savings and the use of funds (since speaking of "investment" in certain cases would be a highly euphemistic choice of terms) and by the specific characteristics of the intermediary (the government) making allocation decisions.

Transfers led to the disappearance of what remained of the function of selecting between different entrepreneurial enterprises that the credit market could still perform. What is more, it can be argued that the central bank could not be held responsible for monetary policy since the government essentially required it to restrict bank-lending to firms so that the banks could finance the government, enabling the latter in turn to finance firms.⁶⁰

As we have seen, crowding-out was a consequence of the government's massive recourse to the financial market. Filippo Cavazzuti criticized this policy and, therefore, the budget of the enlarged public sector.⁶¹ Regardless of any other consideration, Cavazzuti argued that households were also penalized in the distribution of the interest being paid on the rising public debt. Beginning in 1974, changes in auction procedures enabled banks to benefit from changes in interest rates. In fact, at the beginning of the 1970s the banks held just 23-25 per cent of Treasury bills issued for investment purposes, compared with about 88 per cent at the end of 1975. The relatively high interest rates available from government securities, which were exempt from income tax, induced the banks to seek to keep the deposit and government-securities markets separate. In many cases this involved refusing to grant non-bank customers access to the treasury-bill market, while in others deposit rates were allowed to rise in order to channel customers away from the treasury bills. At the end of 1978, of the approximately 38 trillion lire of treasury bills outstanding, an estimated 23 trillion were held by the banks, 10 trillion by households and about 5 trillion by the Bank of Italy.⁶²

Interest paid by the enlarged public sector⁶³ grew to 11.1 per cent of the budget in 1976 but rose to 12.1 per cent in 1978. An even larger and growing

⁶⁰ *Ibid.*, pp 244 *et seq.*

⁶¹ Filippo Cavazzuti, "The enlarged public sector budget: a preliminary analysis of its effects on prices and quantities", in *Review*, XXXIII, 2 (March 1979), pp. 255-288.

⁶² *Ibid.*, p. 280.

⁶³ The enlarged public sector included the state sector, the autonomous government agencies, the Southern Italy Development Fund, the Deposits and Loans Fund and other treasury operations, as well as the regions, provinces, municipalities, social-security institutions, hospitals, municipal companies, ENEL and other minor central and local government agencies.

proportion of the budget covered transfers on capital account to firms, especially direct public investment, which rose from 13 per cent in 1976 to an estimated 20 per cent in 1979. However, Cavazzuti argued that the spending had a large multiplier effect, especially considering that it included transfers to the Independent Agency for the Minerals and Metals Industry, the Public Housing Fund, the Central Institute for Medium-Term Credit for export finance and the Fund for Credit to Artisans, funding of credit for shipowners, etc. In short, this expenditure seemed directed at ensuring that firms had finance to improve their debt situation rather than fostering new investment.⁶⁴

⁶⁴ *Ibid.*, pp. 281-282.