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**Daniel Gros**
CEPS Distinguished Fellow

**Francesco Corti**
CEPS Associate Researcher

**Pietro Regazzoni**
CEPS Intern

# PUBLIC INVESTMENT OR FISCAL CONSOLIDATION AFTER COVID-19?

## THE EXTREME CASE OF ITALY AND GERMANY'S RECOVERY AND RESILIENCE PLANS

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# Public investment or fiscal consolidation after Covid-19?

## The extreme case of Italy and Germany's recovery and resilience plans

Daniel Gros, Francesco Corti, Pietro Regazzoni

With the onset of the Covid-19 crisis, the debate on fiscal policies and the role of deficits in supporting growth has been completely revamped. Through its unprecedented recovery programme, all EU member states have developed comprehensive Recovery and Resilience plans (NRRPs) that will allow them to positively make use of billions of euros worth of economic support to build back stronger after the pandemic. This analysis compares the NRRPs of Germany and Italy, two countries that have very different views and priorities on how their allocation of the recovery funds should be spent and invested over the short, medium and long-term. This paper is a continuation of the CEPS series of assessments of national plans' structural reforms and forms part of the CEPS Recovery and Resilience Reflection Project.

Daniel Gros is a Member of the Board and Distinguished Fellow at CEPS, Francesco Corti is Associate Researcher at CEPS and Pietro Regazzoni is Intern at CEPS. This paper is part of the Recovery and Resilience Reflection Project.

The recent pandemic has revamped the debate on fiscal policies and the role of deficits in supporting growth. In response to the crisis, governments combined traditional automatic stabilisers with *ad hoc* discretionary measures to protect employment, support households, strengthen the healthcare system and guarantee liquidity to businesses. Overall, the package of measures adopted to deal with Covid-19 have produced a sharp increase in the debt-to-GDP ratio. In Italy it grew from 134.6% in 2019 to 159.8% in 2021, whilst in Germany only from 60% to 75% in the same period - half the size of Italy. Germany does not face any fiscal sustainability challenges, whereas the problem remains serious for Italy. In this scenario, the question is how long the current fiscal stimulus should - and can - remain high.

Yet, on this question, Italy and Germany seem to have different views. The reasons why can be found in how they have interpreted the crisis brought on by the pandemic.

In Italy, the crisis has been seen as a confirmation of the need for common debt and supranational automatic fiscal stabilisers to face asymmetric shocks. On the other hand, the Germans feel that their prudent approach to fiscal policy has been vindicated. Years of balanced budgets mean that their government can now spend much more on helping German workers and enterprises to overcome the crisis. For this reason, the way out of the crisis for Italy should include the implementation of structural reforms as well as a public investment plan that can increase growth potential and reduce the debt-to-GDP ratio. For Germany, in contrast, fiscal consolidation remains a priority. This difference is also reflected in the two countries' expected government public balance trends – while Berlin envisages a reduction in the public deficit as early as 2024, Rome still projects a deficit of 3.4% of GDP for the same year.

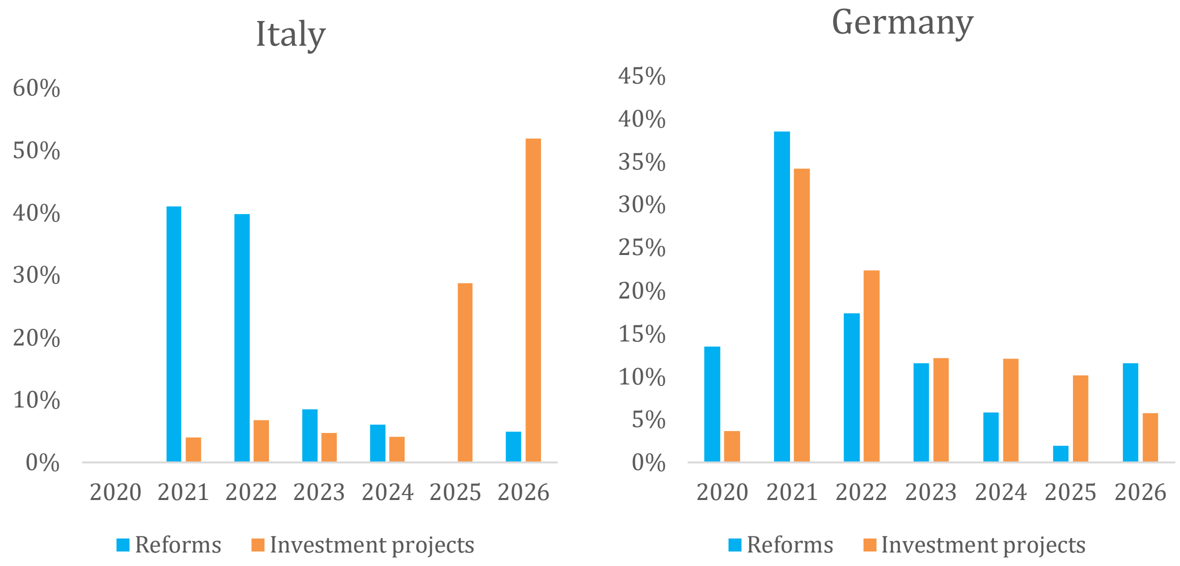
The same divergence of views between Italy and Germany have also emerged in their respective recovery and resilience plans (NRRPs).

## Italy and Germany: plans compared

Italy has presented a plan for €191.5 billion - around 7.4% of GDP - of which €68.9 billion consists of transfers and €122.6 in loans, which includes 142 investment projects and 87 reforms. On top of these, around €13 billion must be added from the REACT-EU programme and €30 billion that the Draghi government has made available through the creation of a Complementary Fund (*Fondo Complementare*), thus bringing the Italian recovery plan to around €233 billion in total.

Germany's plan is much more modest. It amounts to €25.6 billion - around 0.7% of GDP (a tenth of the value of Italy's plan) - based only on transfers and includes 40 investment projects and 27 reforms. Leaving aside the size of the two plans, which reflects the different macroeconomic outlook of the two countries before the crisis and the impact of the latter on employment and GDP (see Alcidi et al. 2020), the first substantial difference between the two NRRPs emerges when looking at the timeline for the completion of the reforms and investment projects indicated within the plans.

*Figure 1. Timeline for the completion of reforms and investments in the Italian (left) and German (right) plans, by year (total %)*




*Source*: Own elaboration, based on data provided in the Italian and German NRRPs.

As shown in Figure 1, Italy prioritises the implementation of reforms, leaving the completion of investment projects to the end of the NRRP. Indeed, four fifths of the reforms are planned to occur in just two years (2021-22), i.e., the likely lifetime of the present government. By contrast, Germany anticipates both reforms and investment projects from the very beginning.

The completion of reforms and investment projects is a necessary condition for obtaining reimbursement from the European Commission regarding expenses incurred within the framework of the Recovery and Resilience Facility (RRF). Consequently, except for the pre-financing of 13% obtained at the time of approval of the NRRP, Italy is likely to obtain the funds later than Germany - provided that the latter implements all the indicated reforms in time. In this respect, the reforms planned by Germany are of a more technical nature (see below) and therefore should not be controversial. Yet, some delays might occur in those policy areas where the Länder have either exclusive competence (e.g., education and healthcare) or concurrent legislative powers[1] (e.g., reform of public administration). This concern applies less to the Italian structural reforms as these are mainly structural and fall within the exclusive competence of the central government (e.g., public administration, justice, bureaucratic simplification, and competition)[2].

Overall, the belated timeline for investments' completion does not mean that Italy will start spending the funding under the RRF only in 2025 and 2026, but simply that it will get its

[1] This means that the Länder have the power to legislate as long, and to the extent that, the Federation has not exercised its right to legislate by Federal Act.

[2] Yet also in the Italian case, delays might emerge in the reforms in those policies areas where regions have concurrent legislative powers (e.g. active labour market policies) (see Corti and Ferrer 2021).

disbursements later. However, the timing of the disbursements should not be important given that even Italy can now sell its short-term government debt at negative rates.

Table 1 summarises below the spending details financed by Italy's and Germany's RRF transfers or loans between 2020 and 2026.

*Table 1. Projected Spending Financed under the RRF, Italy and Germany (2020-2026)*

| ITALY | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | TOT |
|---|---|---|---|---|---|---|---|---|
| Current expenditure financed by RRF transfers (%GDP) | 0 | 0,1 | 0,1 | 0,2 | 0,1 | 0 | 0 | 0,5 |
| Capital expenditure financed by RRF transfers (% of GDP) | 0 | 0,5 | 0,8 | 1,1 | 0,4 | 0,1 | 0 | 2,9 |
| Tax reduction financed by RRF transfers (% GDP) | 0 | 0 | 0 | 0,1 | 0,1 | 0,1 | 0,1 | 0,4 |
| Expenditure financed by RRF transfers (% total) | 0% | 6% | 9% | 14% | 6% | 2% | 1% | 38% |
| Current expenditure financed by RRF loans (%GDP) | 0 | 0,2 | 0,2 | 0 | 0,1 | 0,1 | 0,1 | 0,7 |
| Capital expenditure financed by RRF loans (% of GDP) | 0,3 | 0,6 | 0,7 | 0,7 | 1,2 | 1,1 | 0,9 | 5,5 |
| Tax cuts financed by RRF loans (% GDP) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Expenditure financed by RRF loans (% total) | 3% | 8% | 9% | 7% | 13% | 12% | 10% | 62% |
| Expenditure financed by transfers and RRF loans (% total) | 3% | 14% | 18% | 21% | 19% | 14% | 11% | 100% |
| GERMANY | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | TOT |
| Current expenditure financed by RRF transfers (%GDP) | 0.2 | 0.1 | 0.1 | 0.02 | 0.01 | 0.01 | 0.004 | 0,44 |
| Capital expenditure financed by RRF transfers (% of GDP) | 0.003 | 0.2 | 0.1 | 0.1 | 0.1 | 0.04 | 0.03 | 0.57 |
| Tax reduction financed by RRF transfers (% GDP)) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Expenditure financed by RRF transfers (% total) | 20% | 29% | 20% | 12% | 11% | 5% | 3% | 100% |

*Source*: Own elaboration based on the Stability Programmes.

Two key aspects emerge here.

The first is that capital expenditure in Italy, i.e., expenditure which directly and indirectly finances investment, represents around 84% of the expenditure financed by the RRF, whereas the percentage drops to 57% in the case of Germany.

The second concerns the expected timeline of expenditure: Germany should have already spent half of its total by the end of 2021 whereas for Italy this proportion would only amount to 17%.

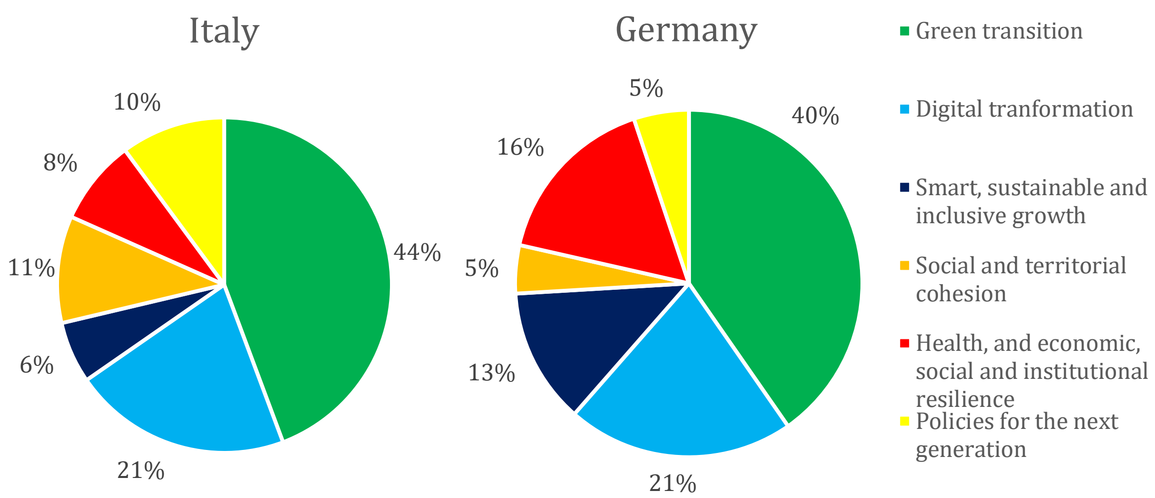
## Explaining the difference

The answer to the above expenditure anomalies is essentially twofold and is linked to both the type of spending that is financed through the RRF and the speed that funds are absorbed.

The kind of projects included in the NRRPs differs. Italy has decided to use European funds to finance additional expenditure, while Germany has preferred to submit projects already budgeted for in 2020. In fact, many of the investment projects presented by Italy (around 71%) are additional, i.e., not included in previous budgets, thus requiring more time for implementation and completion.

In this sense, it is interesting to note that differences between Italy and Germany emerge not only in the type of spending but also in the projects that the two countries will finance through their respective RRF funds. At first glance, as Figure 2 below shows, Italy and Germany seem to have the same priorities for investment projects, both allocating around 40% of RRF funds to the green transition and 21% to the digital transformation. Yet, cloaked behind the same objectives different projects are included with different implementation timelines. One example concerns the green transition spending. Under this label, the Italian plan includes, as a primary investment, around €25 billion for the construction of high-speed rail lines to be completed by 2026. In contrast, Germany's main investment, to be implemented by 2022, consists of €2.5 billion in incentives to support the purchase by private individuals of electric or hydrogen powered vehicles.

*Figure 2. Investment priorities financed through the RRF, Italy (left) and Germany (right).*




Source: own elaboration.

The second factor that explains the postponement of investments with respect to reforms is primarily related to the proverbial Italian difficulty in absorbing European structural funds. As of 30 July 2021, Italy has spent only 51% of the structural funds allocated for the 2014-2020 Multiannual Financial Framework (MFF). In addition to this, the public administration and justice system both suffer from chronic delays and slowness due in part to a numerically insufficient (and often unqualified) staff. Then there is the slowness and sheer complexity of the rules that make Italy a country not only incapable of channeling public investment but also of attracting private investment (Doing Business 2021). For these reasons, Italy only includes two main groups of reforms – 'horizontal' and 'enabling' - to be implemented between 2021 and 2022.

*Horizontal reforms* are defined as structural innovations by the Italian state, including reform of the judicial system and public administration.

*Enabling reforms* are defined as functional interventions to guarantee the implementation of the NRRP and, in general, to remove administrative, regulatory and procedural obstacles that impact economic activities and the quality of services provided to citizens and businesses.

By contrast, the reforms included in the German plan are mostly sectoral, i.e., specific regulatory innovations relating to specific areas of intervention or economic activities, ultimately aimed at introducing more efficient regulatory and procedural regimes.

## Conclusions

The comparison between the Italian and German plans is an interesting exercise to understand how the funds of the Recovery and Resilience Facility can be used to support Europe's recovery from the crisis.

Germany has opted for public financial consolidation, with a modest acceleration in public investment, in line with the past 20 years where public investment cumulative acceleration – measured as net fixed capital formation (NFCF) – has been particularly low.

Italy is betting on an *"all in"* set of reforms and spending, leaving public debt to increase by another 20 percentage points of GDP. After years of low cumulative rates (€1.2 billion between 2016 and 2019), Italy will significantly accelerate its public investments. According to the AMECO forecasts, Italy's NFCF should increase by about 16.4 billion in the period 2019-22, thus accounting for a total acceleration (compared to the period 2016-2019) of around €15 billion, which is half of the euro area's total NFCF acceleration (€32.2 billion).

The Italian bet is based on the hope that the implementation of reforms and investments should produce a positive and, above all, persistent impact on GDP growth. A public debt close to 160% of GDP will only be sustainable if the growth rate increases in a sustained manner, beyond 2026, not just a temporary spurt of growth induced by the country's NRRP spending over the next few years.