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THE ITALIAN PUBLIC DEBT: A PROPOSAL

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The high level of national public debt in Italy represents an impediment to the Italian economy and an element of risk for the stability of the euro area as a whole. This fiscal fragility also prevents Italy from playing a more active role in the determination of the new European rules currently being debated. Italy's lack of stability was and continues to be particularly noticeable when, at the beginning of 2018, the more stable euro-area partners, France and Germany, were beginning to work on the redesign of European common governance while paying special attention to the specific risks represented by Italy and its high public debt. This document contains a proposal to address the problem of the high Italian public debt by changing the way fiscal rules are applied in the euro area.

1. The Italian public debt: the last window of opportunity

Before the international financial-and-'real'-crisis and the crises of the euro area, Italy had failed to exploit favorable economic conditions in order to reduce the weight of its public debt in a measure apt to create a buffer of financial resources to be used during phases of low growth or recession. The decrease in Italy's public debt-GDP ratio, which started in the mid-Nineties, was interrupted in 2007 at the threshold of 100%. Consequently, when the 2007-'09 crisis started, the Italian government found itself ill-equipped on a number of fronts. It was inadequately able to sustain economic growth in the midst of the worst recession in Italian history, remedy the repercussions affecting its financial system, nor mitigate the social and economic costs that were causing

growing mistrust and political instability among the population. Since the beginning of the crisis, the Italian debt-GDP ratio has rapidly increased to exceed 130%.

Ten years later, the Italian economy has recovered a path of growth but the weight of its public debt has not decreased: today it remains over 130% of GDP. Italy is, therefore, still exposed to the risk of being faced with a new recession without having any tools to counter it. Italy could fall anew to similar conditions of 2011 when the need to react to serious doubts about the sustainability of public debt forced the government to enact pro-cyclical fiscal corrections that aggravated the recession and made the debt-to-GDP ratio climb even higher, mainly due to a strong decrease in the denominator of this ratio. Tax increases and significant structural reforms were necessary, paving the way to the stabilizing intervention of the European Central Bank (ECB); first, with the announcement of *Outright monetary transactions*, and then with the realization of *Quantitative easing* (QE) policies. Today, however, the ECB is committed to reducing the use of emergency monetary instruments that were adopted to tackle the crisis. In particular, the ECB wants to reduce the purchasing of government securities, which have mainly benefited countries like Italy that need to sell roughly €400 billion in government bonds annually.

Hence, if faced with serious economic challenges today, Italy would find itself with even lower margins to navigate a crisis than it had in 2007. A new financial crisis, even less severe than the most recent, would find Italy with few resources to mitigate the impact on its economy and citizens, risking a further spiraling of social mistrust. The only financial resources that would be readily available to the Italian government in such a case would be those from the European Stability Mechanism (ESM). However, the ESM assistance programs would be defined by strict conditions set by institutions based in Brussels, a solution rife with economic, social, and political drawbacks.

The urgent need to have resources for counter-cyclical policies is not the only motivation that makes it necessary to reduce the public debt to GDP ratio in Italy. Other reasons have a structural nature. For example, countries with high levels of indebtedness are considered less stable by investors since economic shocks, even extraneous to the indebted countries, can increase their risks of default. Even in the absence of a violent shock, largely indebted countries are condemned to confront increasing constraints in the management of their own budget, and they might

ultimately need to undergo indiscriminate cuts that prevent effective reallocations of public expenditures. As in the case of Greece, the continued high weight of public debt will make it difficult - if not impossible - to safeguard over time the high standard of social protections (pensions, healthcare, combating poverty) that are arguably the most important political and social achievement of the post-war period. This problem tends to be worsened by technological changes that will increase the proportion of those excluded from the labor market for a long transition period. If an adequate fiscal space is not created during a phase of economic recovery like the current one, such as to accommodate for the costs of current and future unemployment, a possible recessionary phase will only further corrode citizens' confidence in the effectiveness of public policies, if not in politics *tout court*.

High public debt to GDP ratios are detrimental to economic growth in the long term. They impose higher interest rates and increase uncertainty, both of which make investors hesitant and discourage capital formation. Moreover, the mounting costs of servicing the debt will eventually erode the margins for long-term public investments in areas such as infrastructure, education, and research. All of this taken together can further create uncertainty that negatively affects households propensity to consume and deepens the distrust and lack-of-confidence over public policy, an already prevalent sentiment among the Italian population. Therefore, reducing the Italian public debt-GDP ratio is essential. Given the current positive economic climate and a current growth rate of 1.5% -- well above the estimated levels of potential growth in Italy -- it is important that efforts on lowering the weight of public debt are undertaken as soon as possible.

2. The "narrow path" of debt relief

The dynamics of public debt depends on several factors. In particular, it depends on the positive or negative imbalances of the public balance sheet, the 'real' rate of economic growth, the level of interest rates paid to service debt, the inflation rate, and the extraordinary operations on debt that have to be neglected in the calculation of the government deficit (such as privatizations or non-recurring revenues). Based on these factors, paths can be taken to gradually reduce the weight of public debt through conventional instruments of fiscal policy that aim to achieve a primary surplus adequate to the desired level of reduction in the public debt/GDP ratio. This is the logic of the

calls for stable and virtuous fiscal behaviors, which are frequently advocated for by the European institutions, the Bank of Italy and the outgoing Italian government. In this regard, the Italian minister of Economy and Finance, Pier Carlo Padoan, coined the effective metaphor of the "narrow path".

The governor of the Bank of Italy, Ignazio Visco, has recently expressed in two public interventions details on accounting equilibria that would be required to reduce the Italian public debt below 100% of GDP within ten years. According to Visco, "with an annual growth rate of around 1%, inflation at 2% (consistent with the ECB's objective) and with the average debt service costs gradually rising to the values observed before the crisis, it would be necessary to maintain the primary surplus to around 4% of GDP. Given the level of interest payments, this basically amounts to achieving the structural equilibrium in the public balance.”[1] In a note updating the Economic and Financial Document (DEF), the Italian Ministry of Economy and Finance drew a similar path of debt reduction, though less demanding.

Maintaining a primary surplus of the public balance at 4% of gross domestic product is not a small commitment. In any case, this "narrow path" is, understandably, the path that the Italian institutions consider rational to pursue by balancing economic principles and their responsibility towards their current citizens, future generations, and partner countries with which they share the European project and commitments.

3. In case the path becomes too narrow: a proposal

It is also advisable to consider a scenario in which the correction of public accounts, to the extent envisaged by the Bank of Italy, proves difficult to implement and, as such, could generate doubts on the commitment of future Italian governments. A cautionary approach on the Italian credibility to meet this long-term commitment is justified, if one observes Italy’s behavior since the start of the monetary union. Since 2000, once the convergence of interest rates was reached, Italy registered deficits near or above 3% of GDP fifteen times.

[1] Our translation from the Italian original version: “Sviluppo dell’economia e stabilità finanziaria: il vincolo del debito pubblico" *21 settembre 2017*, *https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2017/Visco_Varenna_21092017.pdf*

It is true that, previously, Italy had been able to reduce its public debt-to-GDP ratio for a considerable number of years. However, this result was achieved during periods characterized by positive growth that were largely supported by the rapid rapprochement of the Italian interest rates towards the German levels. It follows that the confidence, offered by the monetary union and its frame of stability, mattered more than the economic policies of Italy. Today the conditions seem less favorable. The same Italian yearly revision of DEF shows possible obstacles that characterize the "narrow path". One of those obstacles is the potential rise in interest rates in the near future that would make financing the public debt more onerous while also increasing the cost of private credit for non-financial firms. Higher interest rates would have thus the effect of slowing economic growth, making it more difficult to achieve the desired reductions in the public debt/GDP ratio.

It is under these conditions that we are putting forward a proposal to correct the Italian public balance sheet. This proposal is based on a process that remains ambitious, but less severe than a 4% primary surplus. The opportunity is offered by the reform process that is ongoing in the European Union and euro area with respect to the economic governance rules. Our proposal consists of three initiatives to facilitate the adjustment of Italian public debt to around 90% of GDP within twelve years:

(i) The first initiative aims to strengthen the credibility of the Italian commitment to reducing its public debt, through an institutional mechanism of political incentive.

(ii) The second provides for a scheme that guarantees the reduction of the public debt in twelve years to 90% of the GDP through the signing of a contract with ESM.

(iii) The third introduces a political sanction in the case of opportunistic behavior by Italian governments.

(3i) A tripartisan agreement to control the public debt

A political commitment to the reduction of the weight of public debt should be preliminary to any strategy engaging the European institutions. The problem of opportunistic behavior by some of the EU member states is regularly evoked as an obstacle to European cooperation on the reduction of national risks. It is, therefore, necessary to adequately design incentives to avoid such behavior in Italy. To this end, the proposal is to establish a “Permanent Committee for the Reduction of Public Debt”

within the Italian Parliament, headed by representatives of the opposition parties, that is able to report any deviation of the public debt/GDP ratio from the path established for its reduction[2].

The logic to setting up such a Committee is that the European fiscal rules have been for a long time too focused on containing the government deficit rather than reducing the public debt-to-GDP ratio.

The Stability and Growth Pact provides reference values for both the public deficit-GDP ratio (3%) and for the public debt-GDP ratio (60%). The "Treaty on the Functioning of the European Union" (Article 126.2) adds that, in cases where the ratio of public debt to GDP exceeds the reference value, compliance with budgetary discipline requires that "the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". However, until the euro area crisis, both the European Commission and the EU Council felt that the deficit rule was sufficient in ensuring that the public debt of member states remained sustainable. Moreover the requirement, which states that public debts in excess of the 60% threshold should have to follow a path of sufficient reduction at a "satisfactory pace", has never been specified nor made operational. The objective was to correct slippages of the public deficit year by year (i.e. according to an annual cycle subsequently formalized in the European Semester). The result has been that countries with a public debt above the threshold have not been urged to meet the target.

The problem remained even after the Stability and Growth Pact reforms in 2005, which introduced in the preventive arm medium-term objectives (MTO) based on structural targets specific to each country's public balance sheet. The MTO of each member state with a public deficit above its structural target and/or its excessive public debt specifies an adjustment path to be followed by this country to reach a structural equilibrium in

[2] It should be noted that the competences of this Committee do not overlap with either those of the European Fiscal Board or those of its effective national structure represented, in Italy, by the Parliamentary Budget Office (UPB). As a technical and independent body, the European Fiscal Board cooperates with the European Commission to ensure the correct application of European Union fiscal rules and to assess the European fiscal stance. The UPB is also a technical and independent body. It has the task of checking the congruence of the Italian public budget with respect to the rules of the European Union and of helping the fiscal decisions of the government and of the national parliament. The Committee, here proposed, is instead a national political body that guarantees compliance with the specific methods of managing the public balance sheet that Italy adopts, in agreement with the ESM (see our next point ii), to deal with its high public debt. Therefore, the UPB would retain its original tasks; moreover, respecting its independence, it could offer technical support to the new Committee.

its balance sheet. These changes should have allowed the public surplus/deficit to be consistent with debt reduction but the articulation between the two rules, deficit reduction and debt-to-GDP reduction, has not been fulfilled. Moreover, even the rules governing the structural level of the public balance sheet equilibria have never led to real penalties as past violations have gone unpunished.

All this has inevitably contributed to the accumulation of public debt. It was only after the euro-area crises that the debt criterion was made directly operational as part of the "Six-Pack", approved in November 2011. According to Regulation No 1467/97, as amended by Regulation No 1177/2011, it was established that the public debt would be deemed as sufficiently diminishing and approaching the reference value at a satisfactory pace only if the average differential (calculated over a three-year period) between the public debt-to-GDP ratio and the reference value (60% of GDP) decreases each year by 1/20th. Given the large stock of public debt accumulated by some member states, this rule was too restrictive to be applied in a period of recession or weak growth -- albeit with the mitigating factors envisaged by the Fiscal Compact. Hence, even today, the observations made by the ECB two years ago remain valid (ECB, Economic Bulletin, No. 3/2016): "from the beginning of the economic and monetary union the debt criterion has never been applied."

The substantial feature of an economic system based on a public debt target, rather than on a public deficit target, is that the former needs to take into account the fiscal achievements of the former years. Any budget surplus or deficit is analyzed as an annual figure in its own right or – at most – as an average of the closest years, so that its correction concerns one single year. On the contrary, changes in the level of public debt must be assessed over a multiannual period. Our proposal focuses on this last aspect.

The multiannual commitment of the debt rule, compared to that resulting from the deficit rule, has important political consequences. The correction of the public balance sheet, based on the criterion of the deficit, has a weak and indirect link with the behavior of previous years. On the contrary, the target of public debt reduction to be achieved each year depends directly on the corrections that have been enacted in the preceding years.

If a government in office does not respect commitments on the public deficit, the opposition parties, which hope to govern in the future, do not feel directly limited in

their fiscal leeway as part of a future government. Although the accumulated public debt and the level of the public deficit found at the beginning of its new government appointment determine the setting of the medium-term objective, the new majority will be called upon to assume binding commitments only on the current public deficit and to forecast the deficits for the years immediately following. On the contrary, if the debt rule is applied, the margin to maneuver for the next government will be severely conditioned by the possible indiscipline of its predecessors. For example, if the previous government in office did not comply with the rules laid down, it will be up to the new government to make the whole adjustment in the following year(s). Otherwise, the new government would risk sanctions and corrective procedures by the European institutions.

In other words, the parliamentary opposition has a concrete interest in preventing the incumbent government from poisoning the wells by diverging from the public debt targets. This is particularly true in the imminence of electoral appointments when a strategy of damaging opponents is more attractive for the incumbent and the political reward of fiscal laxity is higher. Moreover, the political dynamics, which is set in motion by activating the control of the public debt, is completely different from that put into motion by the control of the public deficit. In the second case, a conflicting relationship between the national government and the European institutions is established. In the first case, antagonism is instead internal from within the national parliament. The government and the opposition parties of a given country are controlling each other because they are forced to share the same commitment on the public debt, without shifting the responsibilities of budgetary policy to a scapegoat in Brussels.

To achieve this change, the European institutions must first attribute centrality to the public debt criterion in the general assessment of the fiscal sustainability of member states. In addition, countries with high public debt, such as Italy, must create a new parliamentary institution: the Permanent Committee (mentioned above), which will be responsible for carrying out a political check and oversight on the dynamics of the public debt. The presidency of this Committee and the majority of its members should be attributed to parliamentarians of the opposition parties. The new institution would

expose the lack of national fiscal discipline, causing a political sanction on profligate governments.

(3.ii) The Involvement of the European Stability Mechanism

It is reasonable to assume that the consolidation of the European economic recovery and the forthcoming choices of Germany and France on the economic governance of the Union and the Euro area make the application of the debt rule – as introduced by the Six Pack and the Fiscal Compact - more binding. It follows that, even taking into account mitigating factors, after the political elections, Italy will be expected to reduce the weight of its public debt in terms not dissimilar from those set forth by Governor Visco: a reduction below 100% of the GDP in the span of ten years. As previously stated, given the current conditions of the Italian accounts, this public debt reduction would require quite demanding budgetary adjustments: a primary surplus of around 4% of GDP for each of the ten years considered. Therefore, the question becomes the following: is it possible to involve the European institutions in a plan that reduces the Italian annual primary surplus, while leading to the same result indicated by Ignazio Visco? This would imply a less severe impact on the Italian economic and social system.

The second initiative of our proposal aims to positively answer this question. It is based on the assumption that Italy has adopted the "Permanent Committee for the control and reduction of public debt", according to the lines described above, thus indicating in a credible way the will to avoid future opportunistic behaviors.

The positive adjustment differential between the implementation of the debt rule and that of the deficit rule, which is necessary to converge towards the MTO, is much wider when the public debt-to-GDP ratio is higher.[3] For countries with public debt above 100% of GDP, the debt rule tends to be more stringent than the deficit rule. According to the calculations published by the ECB (aforementioned Bulletin 3/2016), the debt rule represented a more stringent fiscal constraint than that of the deficit rule in the case of Belgium and Italy. Based on European Commission estimates, in 2014 and 2015, Italy

[3] In the following, the expression "(country-specific) public deficit rule" implies that we are referring to *the specific adjustment path* that each country would have to pursue to reach a structural equilibrium in its balance sheet (see *3.i*, above). It is well known that, according to the "Six-Pact", the final structural equilibrium implies a 1% of public deficit on GDP as a maximum threshold. The Fiscal Compact maintains that this same threshold must be reduced to 0.5% for member states with a public debt/GDP ratio above 60%. Needless to say, the path to reach the final equilibrium requires softer adjustments than those required by the immediate implementation of this same equilibrium.

would have had to take additional fiscal corrections of about – respectively – 1.2% and 2% of GDP to comply with the debt rule. These estimated gaps include the application of flexibility as granted by the Commission since the beginning of 2015. The flexible application of the MTO rules and additional political compromises have meant that, even without having followed the path towards the structural deficit equilibrium nor decreasing the weight of its public debt, Italy has not incurred either excessive deficit procedures or significant deviation from their debt objectives. The consequence has been that both the deficit rule and the debt rule have lost credibility.[4]

It is worth recalling that, for reasons previously mentioned, in Italy the fulfillment of the country-specific deficit rule could not suffice to comply with the convergence of the public debt towards the threshold of 60% of GDP, as envisaged by the *Six Pack*. In the earlier years, a reduction of Italian public debt towards the 60% threshold would require an annual adjustment of about 3.5% of GDP. In the scheme we propose, the respect of an Italy-specific deficit rule (that is the respect of the trajectory toward its MTO - tempered by the mitigating factors considered reasonable by the Commission) becomes the premise for concluding a contract between the European institutions and Italy (or any other member state with an excessive public debt), aimed at bridging the gap between the fulfillment of the public deficit rule and the fulfilment of the public debt rule.

This contract is based on two elements: the access of the country involved (hereinafter referred to as the debtor country) to financial support provided by the European Stability Mechanism (ESM) on an annual basis; the creation of a National Fund, launched ad hoc by the debtor country, which brings together tangible and intangible national assets (such as real estate and other saleable assets of the national public wealth).

[4] European Commission - Brussels, 21.10.2015 - COM(2015) 600 final - COMMUNICATION FROM THE COMMISSION On steps towards Completing Economic and Monetary Union: "First, the Commission will ensure the consistency of methodology between the debt rule of the Excessive Deficit Procedure and Member States' structural budgetary target, known as the Medium Term Budgetary Objectives. The recent strengthening of economic governance has translated the debt criterion of the Excessive Deficit Procedure into a simple rule for the reduction of government debt in excess of 60% of GDP. What role the rule should play when deciding whether to place a Member State in EDP has however remained unclarified. When updating the lower limits for the Medium Term Budgetary Objectives that Member States can set, the Commission will ensure the consistency of such values with the respect of the debt rule in the medium-term."

Even not considering the possible evolution of European governance, the ESM has the duty of managing public crises and improving stabilization. Hence, in accordance with current rules, the ESM can play a crucial role in facilitating the adjustment of national public debts to reference values. In our proposal, the annual amount of liquid-transfers from the ESM to the debtor country would be equal to the difference between the corrections of the public deficit due, respectively, to the fulfilment of the public debt rule and the fulfilment of the country-specific public deficit rule, until the public debt/GDP ratio of this country becomes equal to or less than 90%. Take the case of Italy for a given year. If the Italian debt were to fall 3.5% of GDP (for that given year) and the annual correction required by the Italy-specific deficit rule was 2% of GDP, the ESM would transfer to Italy an amount of liquidity equal to 1.5% of GDP. The transfers would continue in the following years, following the same criterion, until the Italian public debt fell to a threshold equal to or less than 90%.

The second element of our proposal is that ESM transfers would not take the form of a financial loan (as in the case of traditional European aid programs), but rather a purchase of a share of the country's National Fund (with a unilateral put option to resell: see below).

This purchase should be based on five preliminary steps. First, the main European institutions involved (Commission, Council of the European Union, European Council, and Parliament) should agree that, according to its Treaty, the ESM has the right to purchase (temporarily) non-financial assets.[5] Second, the debtor countries and the ESM make a joint decision on the assets that should be included in each National Fund and on their prices.[6] Third, the ESM is granted by unilateral resell options (either immediate

[5] Article 3 of the ESM Treaty (see also, art. 12, COM. 1) states that the objective of this body "shall be to mobilising funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the Benefit of ESM members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member States. In addition, article 19 of the same Treaty stresses that the Board of Governors has the power to "review the list of financial assistance instruments" used by the ESM. Given that the condition of "strict conditionality" is satisfied by the steps 3-5 listed below, there appears to be no formal impediment to the fact that the ESM enters a contract for the purchase of non-financial assets of a Member State. In principle, there is also no need for a formal approval from other European institutions. The text mentions the opportunity for such assent for political and institutional reasons.

[6] It would be inappropriate to detail the possible contractual transactions between the ESM and each debtor country. The purchases of a National Fund's shares are based on a bargaining in bilateral monopoly; hence, it is analytically impossible to determine the equilibrium prices and the efficient expected returns of the different components of each National Fund.

and complete sale or gradual and partial sales) as an integral part of the original purchase contracts for each share of the Fund of each debtor country. Fourth, the ESM would have to finally stop its annual purchases and could exercise the option of immediate and complete resale of the Fund's shares already acquired, if the debtor country deviated from its specific public deficit rule, even for a single year, as well as if the debtor country unilaterally rescinded the contract before reaching the threshold of 90% of its public debt-to-GDP ratio. Fifth, the debtor country should either increase the assets of its Fund or unilaterally rescind the contract (with the consequences specified in the previous point), if the annual cumulated purchases of National Fund shares by the ESM involved a transfer of more than 95% of this Fund before reaching the 90% threshold of the public debt/GDP ratio.

Again, let us come back to the case of Italy and its 1.5% gap between the debt rule and its specific deficit rule in a given year. Through the purchase of National Fund shares, the annual transfer of the ESM would reduce the public debt of Italy by 1.5% of GDP for the year in question. In total, there would be an annual decrease in the Italian public debt/GDP ratio equal to the annual transaction with ESM, plus the adjustment due to the fulfilment of the specific public deficit rule. The sum would be equal to the reduction of the public deficit required by the debt rule.

However, it could happen that the debtor country does not meet its specific deficit rule -- calibrated according to mitigating factors, or unilaterally rescinds the contract with the ESM before its agreed conclusion. As already mentioned, in the scheme that we propose, the ESM is required to finally stop the annual purchases of shares of the debtor country's Fund. Moreover, the ESM has the right to exercise its option of full and immediate resale of the shares already acquired of this same Fund. Therefore, in the worst case for the debtor country, resale implies an outflow that is equal to the value of all the shares of the National Fund already held by the ESM.

Given that this option is provided for in the initial contract, the debtor country has the obligation to repurchase these shares, thus suffering a sudden increase in its public debt. The increase in public debt could be significant, even if the ESM merely canceled any further purchase of this Fund's shares and decided to hold part of the assets of the debtor country. In such a scenario, there would be a sharpening of the political tensions within the country involved, as all parties have credible incentives to comply with the

multiannual contract that was stipulated with ESM. This applies even more so in the presence of the new parliamentary institution responsible for the control of public debt: the opposition has an interest in exerting an energetic pressure on the government to ensure that the latter fulfills its commitments and avoid shackling a future government with the burden of an unmanageable public debt or the loss of a portion of national assets.

Thanks to the parliamentary controls just mentioned, it is assumed that the debtor country will meet its specific public deficit rule until the annual purchases of shares of the National Fund by ESM have helped bring its public debt to a level equal to or lower than 90% of GDP. To take Italy as an example, this should happen over a period of about twelve years. At that point, the ESM can exercise the other unilateral option in its possession, allowing to gradually sell its shares of the Italian Fund in a period of time and at prices defined by the initial contractual terms. Given the exercise of this option, which is detailed in the contract, Italy would be obliged to make the repurchases decided by the ESM. Such repurchases would have the obvious effect of gradually adding to the Italian public debt. However, Italy could withstand this burden without interrupting convergence to the 60% threshold in its public debt/GDP ratio since it will have triggered a virtuous path of public debt adjustment. In fact, stipulated in the initial contract with ESM, Italy (as well as any other debtor country) could bound the ESM's option of gradual resale to the condition of slowing down but not canceling the adjustment from 90% to 60% in its public debt/GDP ratio.

(3.iii) Sanctions for defaulting to deficit targets.

The last aspect of our proposal concerns the application of flexibility margins to the country-specific public deficit rule. To avoid that the fulfilment of this rule remains exposed to political interference, our recommendation is to introduce a form of sanction in relation to the misuse of the margins of flexibility that are not covered by the European rules currently at work. More precisely: any deviation from the specific public deficit rule – already including the mitigation factors, which is proposed by a member state and approved by the European Commission only after a long bargaining based on contingent constraints with political motivations, should be sanctioned by dictating a

new composition of national public expenditures to be agreed upon with the Commission itself.

The new composition of the national public expenditures would replace the discredited fiscal sanctions that have the inherent contradiction of provoking a generally depressive effect on economic growth. Fines or ex-post corrections of deviations or violations of the rules turn into measures that constrain economic growth when it is needed the most to reduce the public debt/GDP ratio. On the contrary, if the forced coordination with the European Commission leads national governments to support the most effective public expenditures in order to increase aggregate income and the potential production in the medium-long period, the result would be positive. In this respect, the coordination with the Commission would have to allow the strengthening of those public current expenditures, which can help overcome the most evident bureaucratic inefficiencies and inadequacies in the formation of human resources – as well as of those public investments which meet the principle of efficient allocation and can be actually launched in the short period.

These interventions are labelled as sanctions since the public current expenditures, too often preferred by national governments, are income transfers that fuel political consensus in the short term.

4. Summary and Conclusion

We started from the observation that a high public debt, as the case with Italy, can paralyze the economic policies necessary to mitigate future recessions. The excessive Italian public debt can also slowdown economic growth, produce risks that discourage domestic and international investments, and diminish Italy's political impact with respect to the announced phase of redesign and relaunch of the European institutions. This observation, evident to Italian and foreign dispassionate commentators, makes the reduction of our public debt/GDP ratio an absolute priority, which needs to be tackled immediately while the Italian economy is enjoying an expansionary phase. The road to a gradual reduction of the weight of public debt, implemented with adequate and long-lasting primary surpluses, appears to be the most compatible with a full safeguard of the country's economic sovereignty. However, in order to ensure that the "narrow

path" reduces the perception of Italian risk by investors and the European institutions, it is necessary that the latter be convinced that this path will be followed to the end.

This condition is not to be taken for granted, both because of Italy's repeated deviations from shared commitments even in the recent past and – above all – because of the poor predictability of the political events of the country. We have therefore proposed a road to the reduction of the weight of public debt that rests on robust institutional credibility and, at the same time, makes it less demanding in economic and political terms. The proposal is based on three pillars: a) the creation of a parliamentary body, chaired and controlled by members of the opposition who monitor the timing consistency in the reduction of the weight of public debt; b) the shifting of the aggregate aim of fiscal policy from public deficit to public debt; c) a contract engaging the ESM to acquire shares of a National Fund for an annual amount equal to the difference between the adjustments of the public deficit based – respectively – on the public debt rule and the public deficit rule, as defined above.

This third pillar is justified by the fact that the emphasis on the public debt rule would impose on Italy (mainly, at the beginning of the adjustment process) primary surpluses very hard to implement and, in any case, that are more severe than those imposed by the Italian public deficit rule (which, by the way, have never been met in the last years). The shares of the National Fund could be progressively repurchased from ESM by Italy after the achievement of the mutually agreed objective regarding the level of Italian public debt on GDP.

Such a solution makes the adjustment path of public balance sheets politically less expensive, shifting part of this adjustment to years in which the incidence of public debt will decrease and thus become less threatening. This solution would have no impact on the taxpayers of the other European countries. Moreover, it would not affect the economic sovereignty of debtor countries, such as Italy, as long as they are compliant with the commitment to reduce their government deficits.