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The Growth Dynamics of Europe Today: Economic Divergences, Structural Challenges, and Fiscal Sustainability

Europe has been subject to debates on fiscal sustainability, compounded by growing concerns over its economic growth prospects coupled with divergence – or occasional convergence – among its economies.

This report adopts a multi-dimensional approach to analyze Europe's notable strides, focusing on its current position, key policy interventions, and their future implications.

The analysis is structured around four core dimensions: (1) The growth disparity between Southern European countries and bigger economies in the North, driven by differing structural and macroeconomic factors; (2) The promise of Eastern Europe; (3) Germany's evolving role, currently facing demographic and geopolitical challenges that cloud its future macroeconomic outlook; (4) The complexity of achieving fiscal sustainability in France and Italy amidst EU tightening budgetary constraints and the ongoing debates surrounding reforming fiscal frameworks to suit modern challenges.

Unequal Growth Trends Between Southern and Northern Europe

Fifteen years ago, Southern European countries found themselves at the heart of the eurozone crisis as a result of sovereign debt and banking crises. The crisis and austerity measures taken thereafter exacerbated the disparity in economic growth between Southern European countries and bigger economies in the North such as that of Germany and France. However, recently a surprising trend has occurred as growth has surged in Southern European countries whilst Europe's economic giants like Germany are struggling to keep pace. According to

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the European commission's November forecast, Spain, Greece and Portugal are expected to grow in 2024 by 3.0%, 2.4% and 1.7% respectively, all of which are higher than the Eurozone average of 0.9%. Although Italy is only growing at a rate of 0.7%, this is still much better than many other European economies post-covid. On the other hand France, Netherlands and Germany are looking at growth rates of 1.1%, 0.8% and -0.1% respectively. Southern European countries are now the ones driving growth in Europe. Though there remains a disparity in GDP per capita, Southern Europe's economic success has sparked hopes of economic convergence in Europe. This has important policy implications as it would improve the effectiveness of the ECB's policies.

Consumption-based vs Export-based Models



One of the primary reasons for the unequal growth trend is related to the economic structure of Southern European countries, relying more heavily on domestic consumption rather than exports. Over 60% of GDP in Italy and Spain comes from consumption whereas around 51% of Germany's GDP comes from exports. Exports are significantly influenced by external factors and hence the capability of exports in driving an economy has been reduced post-pandemic because of supply chain disruptions and China's economic slowdown. Southern Europe's economic structure has shielded itself from external economic threats and inflationary trends experienced across other parts of Europe.

In fact, disinflationary trends in the South have emerged due to falling energy prices, the normalization of supply chains post-pandemic, and the effects of monetary policy tightening. Additionally a steady rise in real wages has fueled consumer spending across the region. Labor markets in Southern Europe are currently tight with high labor demand but low labor supply. Higher wages coupled with the disinflationary trends have resulted in increased purchasing power and increased consumption. Given the consumption-based framework, this has resulted in significant economic growth.

Tourism and RRF Allocations: Catalysts for Southern European Growth

The rise of Southern European economies can also be attributed to a rebound in tourism following the lifting of covid-restrictions and the disinflationary trends. Tourism as a percentage of GDP in Portugal, Greece, Spain and Italy stand at 8.1%, 7.7%, 6.9% and 6.2% respectively. Aside from Croatia, these are higher percentages than for any other country in the EU. However there is a disparity between the rate at which tourism has rebounded within the region. Compared to pre-covid levels (2019), tourist night stays are higher in Portugal, Spain and, if we consider only overseas tourist night stays, in Italy. By contrast, the turmoil in Northern Europe's manufacturing industry has impacted tourism in France and Germany.

The heavy dependence on tourism renders these countries particularly susceptible to economic

disruptions, such as interest rate fluctuations and broader economic shocks. Furthermore, the economic deterioration of other European countries and China might negatively impact them since dampened consumer optimism might result in lower spending on tourism.

Another common factor that Italy, Spain, Portugal and Greece have is their status as some of the highest beneficiaries of recovery and resilience funds (RRF). The two highest recipients Italy and Spain have received so far almost 70 billion each. The fund has been allocated to advance sectors like infrastructure, digital transformation and renewable energy development. The most relevant projects include high speed rail expansions, electric vehicle charging stations and solar panel installations. While primarily designed for long-term impact, the RRF funds have already spurred investment, driving growth in Southern Europe.

Fiscal Strategies for Debt Management

With the highest public debt levels in the Eurozone, Portugal, Spain, Italy, and Greece are particularly vulnerable to fluctuations in interest rates. Their progress in reducing public deficits over the past decade offers potential for future credit rating upgrades.

Italy has a high public debt (~140% of GDP) and a significant deficit (-7.2% of GDP) but low private debt at 42% of GDP. While Italian households hold high levels of public debt (about €75 bn borrowed since 2023), they have bought less public debt (BTP Valore) in May 2024 than in the three previous rounds. Therefore, the Italian government will have to turn to institutional investors in order to meet its future borrowing needs. The Italian government plans to finance the budget for 2025 by raising 3.5 billion euros from Italian banks and insurance companies via tax increases and the removal of tax deduction benefits.

Social security, public sector wages and rising costs of serving debt are the main drivers that counterbalance the efforts to reduce the deficit. According to the IMF, Italy's public debt will rise stronger than before the pandemic due to massive spending on the green transition, an ageing population and defence.

Portugal has seen its gross public debt at 95.7 % of GDP in 2024, which is expected to decrease to 90.5 % by 2026, outperforming most other countries in



the Euro zone in their public debt reduction. The public deficit is at 0.6 % of GDP in 2024 and expected to decrease to 0.3 % by 2026. The Portuguese economy recovered from the pandemic-related crisis faster than the average Eurozone, driving tax income up due to growing economic activity. However, public wages, tax cuts and aides meant to absorb high energy prices are counterbalancing the deficit decrease. Specifically, the Portuguese government is planning income tax cuts for young people in order to stop the persistent departure of highly-educated young workers, alongside tax breaks for foreign workers.

The public deficit in Spain is at 3 % of GDP in 2024 and expected to decrease to 2.7 % by 2026, whereas its public debt is at 102.3 % of GDP in 2024.

Spain's nominal GDP growth boosted tax income through direct taxation, aiding in the reduction of the public deficit. This decline is also supported by the removal of tax exemptions, particularly for VAT and electric car taxes. However, reconstruction aid for recent floods in Valencia, ageing costs, climate change, and defense investment remain significant pressures on the deficit.

Spain drew a record in bids for 10-year debt titles during an issuance in January 2024, reflecting growing confidence of investors into the country's economic performance on the one hand, but growing public debt on the other one. The relatively low corporate debt at around 66 % of GDP and a growingly performing economy also drive interest of foreign investors. However, political fragmentation on national and regional levels may undermine structural reforms that remain indispensable to reduce the public debt.

The public deficit in Greece is at 0.6 % of GDP in 2024 and expected to decrease to 0.2 % by 2026, whereas its public debt is at 153.1 % of GDP in 2024 and expected to decrease to 142.7 % by 2026.

Greece has higher growth rates than in the decade following the global financial crisis, after implementing structural reforms that condition the receipt of loans by the IMF. The South-European state has entirely repaid the IMF loan in 2022 and benefits from a favourable debt structure due to low fixed rates and long maturity, particularly regarding ESM loans that are due to be repaid by 2070.

Inflation since 2021 has increased tax income (TVA) and favoured the country's ability to service its debt, and allowed it to reach the pre-pandemic debt-to-

GDP ratio. Also, implemented structural reforms include the digitalisation of the public service and labor reforms allowing the labor market to become more flexible. This evolution can be reflected by the 10-year debt, which yields 3.2 per cent in 2024 (as of today, below Italy and the EU 27 average). However, Greece is still characterised by low household savings and low investment levels in the private sector, the latter being about 10 percentage points lower than the average of the Eurozone.

Finally, the high level of public debt allows governments a merely narrow margin of fiscal manoeuvre, which impedes investment in infrastructure and education, thus slowing regional economic convergence.

Regional Growth Disparities

Alongside high public debt, strong regional growth disparities are considered to be structural impediments to long-term economic development and convergence within the Eurozone.

Regional growth disparities in Southern European countries are also driven by limited infrastructure and public transport access in less developed (often rural) regions, many of which rely on tourism.

In 2021, GDP per capita (PPS), on an index of the average of the 27 EU member states, was above 100 in Northern regions in Italy and between 50 and 90 in Southern regions. In Spain, Castilla-La Mancha, Andalusia and Murcia are below 75, unlike the Northern regions and Madrid, that are between 75 and 125. In Portugal, the Lisbon and Algarve regions reach at least 75. In Greece, the Western regions bordering the Ionian Sea reach the lowest level of GDP per capita.

Lacking access to IT infrastructure and low energy efficiency, low labor productivity, decreasing birth rates and migration of young people to urban areas are all factors of aborted growth potential. Education is concentrated in metropolitan areas, with low tertiary education levels and high unemployment rates in most Southern rural regions. (20% in Ciudad de Ceuta and Andalusia, 54% in Sicily).

The Growth Strategy of Eastern Europe



Eastern Europe's economic growth over the past decades has been remarkable. The transition from centrally planned economies to dynamic market-driven systems has pushed the region into an area of competitive foreign investments (FDIs), innovation, and significant industrialisation.

The Triad of Growth: Investments, Innovation, Industrialisation

The influx of foreign direct investment (FDI) has been the stepping block of Eastern Europe's economic development. The FDI has grown by significant amounts in Serbia (+30%), the Czech Republic (+70%) and Hungary (+70%) in 2023, *largely due to the reorganisation of supply chains towards Eastern Europe* (EY, May 2024). Similarly, the World Bank increased its annual GDP growth forecast for Poland to 3.0% in 2024. (World Bank, April 2024). FDIs have been pivotal in modernising infrastructure, enhancing productivity, and integrating Eastern European economies into global value chains (GVCs).

Eastern Europe has made notable strides in fostering innovation, recognizing it as a key driver of sustainable economic growth. Innovative, high-growth enterprises (IHGEs) play a large role in the definition of long-term economic growth. The United Nations Economic Commission for Europe (UNECE) has supported closer cooperation among its member states to promote innovation and competitiveness, assisting countries in Eastern Europe and the South Caucasus in developing supportive environments for innovative development. The immediate spillover effect is the creation of a *positive buzz* (UNECE) that attracts more companies and people to locate in the area. Prime example of this spillover effect is the growth in car part suppliers in Slovakia following Volkswagen's establishment of manufacturing there. The region is clearly starting to catch up with Western Europe's start-up ecosystems. With Estonia having one of the highest numbers of unicorns (start-up companies that have achieved a \$1 billion valuation) per million inhabitants in the world, there is increasing confidence in the neighbouring countries.

The industrial sector remains a vital component of Eastern Europe's economy, with countries leading in car manufacturing. Slovakia produces over a million

vehicles annually for Volkswagen, Jaguar and Land Rover, with a 2026 Volvo factory and Porsche electric vehicle factory to be built (Sario). This can be attributed to the equivalent number of highly skilled workers in CEE and Western Europe. The region saw a shift from low-skilled, labor-intensive manufacturing to medium and high-tech manufacturing (transport equipment, machinery).

Vision for Future Economic Trends

Eastern Europe's growth outlook is positive, supported by real income reaching pre-pandemic levels (up 10% since Q1 2023) and labor productivity exceeding advanced European economies (EUROSTAT index 118 vs. 103). Among the major factors of future growth in the region is development in human capital. In this context, the results of the OECD's Programme for International Student Assessment (PISA) draw attention in that Estonia, Czech republic, Poland, Slovenia rank higher than Germany, France and the Netherlands, in Mathematics and Science, key skills for domestic technology-intensive innovation.

However, Eastern European countries face lower investment levels than Western Europe, requiring as of today approximately €8 billion in low-carbon energy investments by 2030 and fiscal consolidation to enhance resilience against economic shocks.

The slowdown of the German industry puts a strain on Eastern Europe, especially on Poland, Czech Republic, Slovakia and Hungary, because of their dependence on German manufacturing goods. However, it also presents an opportunity given the prospective of German manufacturing companies relocating or outsourcing to Poland, Czech Republic and bordering countries.

Peculiarly, from the lens of Eastern European intra-regional analysis, the access of firms to bank credit is key for unlocking growth potential and reduce the disparity between Eastern European countries. In 2023, around 80 % of companies in Czech Republic and Bulgaria had access to bank credit, contrary to Lithuania and Estonia (20 %, 10 %).

In terms of geopolitics, we identify three factors to assess in the medium to long term. The tightening of (trade) relations between the EU and the US would directly impact the small and open Eastern European economies of the region because of their dependence on NATO military support. The development of the



Ukraine-conflict will determine investor sentiment, and the Chinese influence stemming from the investments of the Chinese Belt and Road Initiative (BRI), particularly in Hungary and Greece, might result in the US exerting pressure on the region.

Germany in Focus: Economic Stance, Policies, and Future Outlook

Germany has long been one of the world's most resilient economies, known for its high-quality manufacturing and diligent workforce. Yet, the last few years have been marked by economic instability, with the country facing its first two-year recession since the late 1990's, in clear contrast to other EU economies. The modern German economy began after World War II, with West Germany emerging as an economic powerhouse, fueled by the Marshall Plan and the Deutsche Mark. The country witnessed industrial growth, low unemployment, and rising living standards, in line with the principle of *social market economy*. This boom began to slow in the 1960's and was exacerbated by the 1973 oil embargo, determining a large recession that ended in 1975. After the German reunification, the period of recession in the late 1990s and early 2000s had Germany dubbed the *Sick Man of Europe*. However, Germany focused on exports in sectors like automobiles, machinery, and chemicals, turning Germany into the export-driven economy we know today. In addition, this period also saw the introduction of the Euro in 1999, which proved to be vulnerable in face of the 2009 Eurozone debt crisis. Germany performed relatively well, while it covered 25% of the required debt for the other countries. The 2010s were marked by inconsistency, culminating in the global economic upheaval caused by the COVID-19 pandemic. Now, with the country's leading coalition having fallen apart following the dismissing of Finance Minister Christian Lindner, Germany is left with a dysfunctional government. Germany's current recession can be explained by three main causes: industrial weakness, the energy transition, and problems in the labor market.

Industrial Vulnerabilities

Germany's industrial sector is still around 10% below its pre-pandemic output levels and decreasing

month-on-month. This implies that Germany's trade surplus is narrowing, challenging its export-driven economic model. One reason behind this is ECB sustained tight monetary policy stance, leading to an investment and R&D slowdown. The rate hikes also strengthened the Euro, making German exports comparatively more expensive. The Eurozone inflation was partially determined by the supply chain effects from the Russia-Ukraine conflicts, which affected German industry directly because of its heavy reliance on Russian energy and materials. The largest contributor to Germany's industrial weakness is competition from China. Traditionally, German manufacturers produced high-cost, high-quality goods, whilst Chinese manufacturers produced low-cost, low-quality goods, leaving them in entirely different market spaces. However, this has changed rapidly as China has turned to high-tech manufacturing, quickly becoming advancing in spaces like Electric Vehicles (EV's), Green Technology, and semiconductors. China is dominating the production of solar panels and wind turbines for renewable energy, a sector in which Germany once held a strong position.

Modernizing Energy Frameworks

The energy sector is a key contributor to the systemic challenges affecting Germany's industrial framework. Germany has been committed to ambitious sustainability targets within the *Energiewende* program in line with the EU goals. In this view, the German government has recently raised the mid-term renewable energy target in the power sector to a share of 80% in 2030. Such a transition plan implies high costs to be incurred. Germany is expected to face an estimated \$498.4 billion in grid expansion costs by 2045 in its push to achieve climate neutrality by 2045. Those will be passed on to consumers through their energy bills, as it has already been happening in the first half of 2024. Germany's consumer electricity price was 0.40€ per kWh, compared to the EU average of 0.289€ per kWh.

The fundamental drivers of these higher levels in Germany are the heavy reliance on Russian Gas before disruptions occurred and the high implementation costs of the ambitious energy transition plan. This is even exacerbated by the choice to phase out the nuclear energy, reducing



even more the range of allowable sources. As energy costs are expected to remain significantly above pre-pandemic levels, sectors like steel and chemicals are experiencing cost increases of up to 25% year-on-year so far. As a prime example, the German chemical giant BASF, after a huge drop in earnings, announced detailed plans to close sites and slash costs, setting cost cuts of around 1.1 billion euros annually by the end of 2026 Germany with consequent reductions in production. The intrinsic risks in this situation are the likely cuts in production and relocations that may be deliberated by many companies. A survey by Germany's DIHK Chambers of Industry and Commerce shows that out of a total of 3300 companies 37% were considering cutting production or moving abroad, up from 31% (2023) and 16% (2022).

These consequences on German firms make it urgent to accelerate the transition process. Focusing on wind as the most relevant renewable source for Germany, only 60% of planned wind energy projects were completed on time in 2023, with grid infrastructure investments lagging by €10 billion; also, by the end of 2023, the expansion of transmission grids was 7 years behind the schedule. On an aggregate level, there is a clear need for more investments, particularly from the public side. Despite the slight increase in government spending for the energy transition between 2023 and 2024, this level seems insufficient to meet the 2030 goals. Moreover, the draft for 2025 shows smaller earmarks for climate action, with a new level lowered to 34.5 billion, confirming the fears of OECD and analysts about the slow progress in the energy transition.

Labor Market Developments

Today's economy faces an unemployment rate in the German labor market of about 5.5%. This figure does not capture the complete picture, with demographic changes transforming the supply side of the labor market. An expected shrinkage in the working-age population of around 7 million individuals - a 10% decrease - will continue to fuel labor shortages in key industries through 2035. Manufacturing is particularly in a precarious situation, with estimates suggesting a 15% labor gap by 2025. Magnifying the challenges faced, more than 40% of manufacturing workers are nearing

retirement age, and the industry is finding it hard to replace them. Meanwhile, the healthcare sector is increasingly burdened with growing demand due to an aging population. Poor staff-to-patient ratios and almost stagnant improvements in working conditions have determined a situation where more than 200,000 nurses and caregivers will be needed to meet the shortfall by 2025. The tech sector, generally the cornerstone of Germany's push to digitalize, also isn't spared. Some project a shortage of 100,000 IT specialists in 2025, a situation brought about because educational institutions cannot keep pace with the rapid pace of technological change. Computer science graduates have increased, but only about 25% move directly into tech-related jobs. The construction industry faces a looming shortage of 12%, with overregulation, high job turnover, and aging staff setting up a threat to infrastructure and housing projects.

To counter these serious challenges, initiatives have been established by both the government and private sector with a view to stabilizing the labor market such as relaxed visa requirements for immigrants. Additionally, companies are being urged to adopt automation technologies, which a McKinsey & Company report (2023) suggests could fill up to half of the projected labor gaps in manufacturing and logistics. Hybrid work models, popularized during the pandemic, remain a key strategy for retaining and attracting talent, offering flexibility that aligns with modern workforce expectations.

The Role of Government Policies

The most relevant policies put in place by the German government in recent years are set within the above-mentioned long-term energy transition program. Within the implementation of these policies, the main challenges the German government is currently facing are due to the constitutional *debt-brake rule* corroborated by Germany's highest court, stating a maximum limit to the debt-to-GDP ratio currently set at 0.35%. This is inevitably at the basis of the structural lack of spending for the climate action, making the Climate and Transformation Fund unable to properly support the energy transition. Moreover, another threat in this sense is represented by the recent EU fiscal rules, that may force Germany to save additional money, forgoing the still allowed borrowing of 5.2 billion euros more debt. Part of the current



expenditure is within subsidy policies directed to energy-intensive firms, such as the recent *Electricity price package*, lowering these companies' electricity duties to 50 cents per MWh, the minimum rate permitted by the European Union. All these policies are set within the annual Stability Programmes in the context of the recovery from the pandemic and from the Ukraine conflict. Particularly, significant efforts were made in the recent years towards the SMEs, which represent almost the 99% of all companies in the business sector, contributing for more than 49% of value added of all German firms. These companies, falling under the category of *Mittelstand*, will benefit in the next months of additional 11.7 billion euros low-interest loans as established by the German cabinet. Concerning the labor market, German government has launched the Skilled Labor Immigration Act to encourage and facilitate the integration of stranger skilled workers in the German labor market. There has been also an important adjustment, at the end of 2024, to the minimum wage, now set at 12.41€, with other expected increases in 2025. Generally speaking, in view of the still challenging scenario that Germany is facing, the main channel to get out of this situation is represented by a well prioritised and well targeted public investment, funneling more resources towards the energy transition process and more productive sectors, while cutting the overspending in less productive ones, as the OECD suggested in the general guidelines provided to the German government. The maximum debt-GDP ratio could be widened in order to allow for more public investments which can prove to be profitable in a long-term perspective.

At a European level, a more extended phase of lower interest rates would help the recovery of an economy historically driven by a positive trade balance with high exports.

Strategic Forecast: National Forces, Demographics and Geopolitics

Germany's outlook emphasizes the often-overlooked significance of central public policy. Looking ahead to the first half of 2025, the demographic challenges and broader geopolitical dynamics will remain dominant in the German economy. The shrinking labor force that is anticipated poses a risk not only for individual

sectors but also for overall economic output. For the portion of GDP growth driven by technological innovation, cooperation between educational institutions and industry can bridge the current skill gap. Alignment of curricula with the needs of industry could give Germany a proficient labor force for the digital era and reduce the risk of falling behind other nations in digital capabilities. Also, government interventions are essential to ensure the competitiveness of German exports.

To a greter extent, geopolitical uncertainties stand to contribute weightily to export-oriented industries. A new US administration may usher in the tariffs (again), making supply chains even more disrupted. It is these dynamics that policymakers will have to work out carefully while trying to keep their focus on domestic economic stability with prudent fiscal policies. Germany's several demographic and geopolitical challenges call for a proactive and multi-dimensional approach, including strategic investments in education, immigration reform, automation technologies, and flexible work arrangements.

Fiscal Pressures and Policy Reactions in Europe

European governments have faced persistent budgetary challenges over the past decade, driven by a combination of structural and cyclical factors. These include the aftermath of the 2008 global financial crisis, the COVID-19 pandemic, inflationary pressures, and ongoing geopolitical tensions. Key issues include rising public debt levels, funding demands for aging populations, and pressures to invest in the green and digital transitions. The EU's fiscal rules, such as the Stability and Growth Pact, have further complicated budgetary decisions, leading to debates about reforming these frameworks to better suit modern challenges.

France's Path to Fiscal Sustainability: A Fine Line Between Austerity and Social Equity

Recent French political headlines have been dominated by debates over fiscal policy, with concerns about rising public debt and EU warnings about budgetary non-compliance sparking intense



political clashes. These issues, coupled with the fractured results of the 2024 legislative elections, highlight growing divisions in governance and public skepticism toward institutional stability. Different factors explain how France has reached its current fiscal situation. Macron's pro-business policies have been in the spotlight as a factor explaining the French fiscal situation. Corporate tax rates were lowered from 33% to 25%, enhancing France's appeal as a hub for foreign direct investment (FDI), with the country leading Europe in establishing manufacturing facilities. Furthermore, Macron abolished the wealth tax on financial assets, replacing it with a tax on property holdings. Reforms also included labor laws to ease hiring and firing, as well as reducing mandatory social contributions, aiming to reduce unemployment and increase labor market efficiency. Although initially focused on fiscal prudence, the pandemic induced Macron to implement massive state interventions, including job retention schemes, state-guaranteed loans and a €100 billion recovery plan to boost competitiveness, social cohesion and green investments.

However, other factors played a key role in shaping the current situation. France has long run structural budget deficits. This has been driven by high social spending, rigid labor markets and limited flexibility in fiscal adjustment that characterise the French economy. Additionally, France's public debt has steadily risen and is now above 110% of GDP. Finally, the country presents structural economic weaknesses. While it is known for high-quality industries, productivity growth has slowed, impacting economic competitiveness and revenue generation. France's demographics contribute to rising pension costs and a shrinking workforce relative to retirees.

As of today, France's budget reform aims to modernize its fiscal framework, focusing on four main areas: reducing the public deficit to under 3% of GDP by 2027 with €20 billion in cuts for 2024; implementing a 15% global minimum tax for multinational corporations in line with OECD guidelines; introducing a tax credit to incentivize green sector investments; and reinforcing tax enforcement.

The debate surrounding France's new budget reform reveals a sharp divide. The positive view postulates that tax increases and spending cuts are necessary to

stabilize public finances and reduce the risk of inflationary pressure. The focus on controlling public expenditure aligns with broader European fiscal requirements. In some sectors, especially defence and technology, the fiscal policies are seen as potentially fostering growth. By reallocating funds towards defence spending, France may stimulate domestic industries and create jobs. Additionally, tax cuts for businesses could encourage investment, particularly in technology and innovation, which might boost long-term productivity.

On the other hand, this new budget reform has significant social and political risks. The increased burden on companies by tax increases, particularly SMEs, could reduce their ability to invest and hire, leading to slower economic expansion. There's concern that these measures could deepen France's already fragile economic situation, where high taxes and excessive public spending have been persistent issues. Moreover, the austerity measures could also lead to public unrest, as cuts to social services and changes in benefits may exacerbate social inequality, and reduced EU cohesion, affecting budget contributions and collective security cooperation.

Italy's Path to Fiscal Sustainability: The 2025 Structural Budget and the Mattei Plan

In September 2024, Mario Draghi presented a comprehensive report on the European Union's competitiveness, advocating for an annual investment increase of €750 to €800 billion - approximately 4.5% of the EU's GDP - to prevent the EU from lagging behind global competitors such as the United States and China. Investments in green transformation and productivity will surely generate government revenues, but sectors like defence, for instance, may not. Hence, a credible fiscal framework is essential to support this initiative, and while debt-financing can be used, a primary balance is required in the medium-term. This raises concerns about debt sustainability, especially for a country like Italy.

Over the past two decades, the Italian economy has been characterized by sluggish growth, high public debt, and persistent budget deficits. After modest pre-2008 crisis growth of 1.5% annually, Italy's GDP contracted by 6.5% during the 2008 financial



crisis, pushing its budget deficit to 5% and public debt to 118.7% of GDP by 2010. The 2011 sovereign debt crisis peaked in November 2011, when bond yields reached above 7%. Although a €30 billion austerity package in late 2011 rescued Italy from the crisis, Italy's debt-to-GDP ratio had climbed to 132% by 2013 and hovered near 135% through 2019, while the budget deficit remained below the EU's 3% threshold.

Post-2019, Italy's public debt surged due to the COVID-19 pandemic. In 2020, the government introduced over €170 billion in fiscal measures to support healthcare, jobs, and businesses, raising the debt-to-GDP ratio to 155% amid an 8.9% economic contraction. In 2021, GDP rebounded by 6.6% due to eased restrictions and stimulus measures, yet the debt-to-GDP ratio stayed high at 151%, driven by ongoing fiscal support and €191.5 billion from the EU's Recovery and Resilience Facility. From 2020 to 2023, government deficits averaged 8% of GDP annually.

From 2014 to 2021, Italy's longer debt maturities reduced interest costs. However, in the past two years, maturities shortened, stabilising at around 7 years by end-2023, below the euro area's 8-year average.

Italy's 2025 Structural Budget, announced in October 2024, aims to help Italy exit the European Commission's Excessive Deficit Procedure, which was imposed in July 2024. The ambitious 30 billion euro budget primarily seeks to adopt permanent cuts to income tax and social security contributions for low- and middle-income earners. It also plans to raise 4 billion euros from banks and domestic insurers by changing rules related to deferred tax assets and payment of stamp duties by insurers. Additional funds have been earmarked for supporting households and boosting birth rates, renewing public sector wage contracts for the 2025-27 period, as well as for the healthcare sector and public investments.

While the debt-to-GDP ratio has fallen down to around 137% in 2024, it is set to increase over the upcoming years, reaching 139.3% of GDP in 2026, attributed to decreasing but still significant budget deficits and a large debt-increasing stock-flow adjustment due to the delayed impact of tax credits related to the *Super Bonus* scheme for housing renovation. Investments and falling imports have driven modest growth in 2024, expected to be 0.7%.

The balance is set to turn positive again in 2024, at 0.1% of GDP, and is forecasted to increase to 0.5% and 1.1% in 2025 and 2026 respectively under the 2025 Budget Plan. The phase-out of housing tax credits and buoyant revenue are expected to push the government deficit significantly down in 2024, to 3.8% of GDP. The deficit is forecasted to fall further in 2025 and 2026, to 3.4% and 2.9% of GDP respectively, forecasted to be driven by the phase-out of measures to mitigate the impact of high energy prices (1% of GDP) and of tax credits for housing renovations (around 3.5% of GDP).

However, the Budget Plan also emphasises the need to attract private capital, recognising that public investment alone will not be sufficient to meet Italy's long-term needs (especially in areas such as green energy and infrastructure), while at the same time limiting the country's indebtedness. Microsoft announced in a statement that it will invest €4.3 billion (\$4.75 billion) over the next two years to enhance artificial intelligence infrastructure and cloud capacity in Italy. After a recent meeting with Italian Prime Minister Giorgia Meloni, Larry Fink, CEO of BlackRock, reassured investors about *Italy's political stability and its status as an attractive destination for investors*.

Additionally, Italy has also decided to foster relationships with its neighbours in North Africa through the medium of the Mattei Plan, which presents a strategic opportunity for Italy to bolster its energy security while expanding its trade and investment ties, particularly with resource-rich African nations. Over the long term, the plan supports fiscal sustainability by fostering stronger partnerships that can reduce energy import costs, ensuring a more resilient and diversified revenue base for Italy, especially from exports. This addresses recent concerns about the weaknesses observed notably in the German economy, which remains Italy's largest export market, and about the prospective imposition of US tariffs.

Italy's recent growth rates relative to other eurozone members, while encouraging, highlight the pressing need to address structural challenges that continue to hinder its economic potential. Labor productivity, which declined by 4% from 2000 to 2022 while the EU average increased by 20%, remains a critical area of concern, especially given the declining working-age population. Persistent issues such as small firm size, limited innovation capacity, and regional



productivity disparities have curtailed growth, while underinvestment in R&D and lagging educational attainment exacerbate competitiveness gaps. Accelerating much-needed reforms in these matters would boost output and reduce the burden on Italy's finances in the long-term.

By employing a history-based model approach in our analysis, we develop a comprehensive understanding of current key growth dynamics in Europe.

Southern European economies experience a recovery while Northern Europe faces stagnation. Structural challenges, such as the reliance on consumption versus exports in the South and the issue of fiscal sustainability in countries like Italy and France, still present obstacles to convergence. Meanwhile, Eastern Europe's investments, industrialization and innovation offer promising growth prospects, albeit with heavy geopolitical uncertainties. Lastly, Germany's industrial weaknesses, exacerbated by its energy transition and labor market issues, signal a need for urgent intervention.

As of today, it is essential to recognise the far-reaching consequences of fiscal and economic decisions made at both the national and European scales.



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