Luiss
School of European Political Economy

Will the European deficit procedure determine the future of Italy's political equilibrium?

Carlo Bastasin

Policy Brief

July 24, 2019

On June 5, 2019, the EU Commission assessed, in its Report from the Commission - COM(2019) 532 final "Italy**,** Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union" - that Italy did not satisfy the debt criterion of the Treaty in 2018, and concluded that a debt-based excessive deficit procedure (EDP) was warranted for Italy. The Italian government later added a number of significant tax increases and expenditure cuts that made it possible to suspend the procedure. A verification of Italy's debt position will now be made in the autumn with special regard for the 2020 fiscal perspectives. Next October might thus become another critical juncture for the Italian government, called to adjust its plans via a major fiscal correction. This paper assesses the situation and argues that the size of the fiscal correction might become a powerful factor in undermining the current coalition.

Although excessive deficit procedures have been frequent in the euro area, since the first enactment of fiscal surveillance, the Commission report of June was the first initiative subjecting a large country to a "debt-based" excessive deficit procedure[1]. This peculiar procedure has a distinct technical complexity and a special political character: on one hand, it requires backward-looking as well as forward-looking assessments by the European Commission and by the Economic and Financial Committee (Ecofin) about the direction of the public debt in one country; on the other hand, given the need to correct the trajectory of very large public debts, it may require multi-annual commitments from the affected country, whose governments may find themselves restrained within narrow margins of political discretion for several years and even across different legislatures.

Technically, in case of a debt-based EDP, the European Commission is expected to publicly fix stringent targets for the country's political economy; moreover, Brussels monitors and reports on the progress of the procedure; finally, given the low growth of the economy, Italy may find itself mired in the procedure for more years than any other country before it manages to reduce the debt-to-GDP ratio. Needless to say, the procedure has a special political sensitivity for a government backed by a coalition of Eurosceptic parties inclined to use sovereignist overtones.

Ever since the Fiscal Compact, and in particular the "Two-pack", the piece of regulation introduced in 2013, specified the formalities of this procedure, analysts have been aware of their complexity and difficult applicability. Current or even past data may be revised and forecasted data are anyway subject to a margin of uncertainty. For this reason, it has become more practical to consider abiding by the Medium Term Objective (MTO) trajectory – the correction of the structural deficit toward its target of a balanced budget – a proxy for assessing the debt deviation. In this regard, the deficit deviations from the path towards the convergence to the MTO need to exceed the flexibility margins as defined by the Six Pack and the Fiscal Compact. As far as Italy is concerned this is defined as a deviation from a reduction equivalent to 0.5% of GDP.

Italy's fiscal position has been in the crosshairs of the European Commission for many years. Italy's governments have regularly accepted to adopt the required fiscal targets in their budget laws but have rarely achieved them. However, the final deviation has always remained within the tolerance margins. In October 2018, the new Italian government, elected in March 2018 and composed of two self-defined populist parties, presented a draft budget law that patently deviated from the MTO trajectory and stayed wide of any tolerance margins. Moreover, the fiscal deficit implied the risk of a strong deterioration of the debt-to-GDP ratio. In the following weeks, the European Commission opened an EDP against Italy for the infringement of the deficit and of the debt rules, also motivated by the failed adjustment of the structural deficit in 2017 and 2018 (as agreed with the 2018 Budget Law). The all-evident announcement of a further breach in the deficit rule for 2019 implied that the three-year period

[1] Croatia and Malta have also faced similar procedures

of continued breach – relevant as a criterion for acknowledging the violation of the debt rule - was made public by the Italian government itself.

The European Commission could not do otherwise than open the debt-based EDP. The Ecofin confirmed the findings and the conclusions of the Commission but advised Italy to "continue the dialogue" in the coming months with the auspices that the procedure could be avoided or suspended.

In fact, Italy's government accepted to substantially change its budget law for 2019. In the new law, the target for the deficit was lowered from 2.4% to 2.04%, while the debt-to-GDP ratio was expected to decline, although on the basis of implausible assumptions, primarily revenues from privatizations amounting to 18bn EUR in 2019.

The European Commission accepted Italy's commitments and the EDP could be suspended at least until new estimates of the economic growth were available. This happened with the European Commission spring forecasts in June 2019, conveniently made after the European elections. As said, on June 5th a new opening of the EDP was decided based on four factors: the missed structural adjustment of 2018 (which was finally ascertained after the effective data became available); a slippage from the 2019 target occurring at the beginning of the year, resulting from the comparison of Italy's 2019 Budget Law and the EU Commission spring forecasts; an expected increase in the debt-to-GDP ratio in 2019; serious concerns about the budget dynamics in 2020.

In June, in its formal communication, the European Commission concluded that Italy's debt was out of line and issued a clear statement based on the following elements:

- final data for 2018 showed that Italy's public debt-to-GDP ratio increased from 131.4% in 2017 to 132.2% in 2018;
- Italy's structural balance deteriorated by 0.1% of GDP in 2018 and was expected to further deteriorate by 0.2% of GDP in 2019 based on the Commission 2019 spring forecast. As such, Italy presented a gap in (broad) compliance with the required effort under the preventive arm of the Stability and Growth Pact of 0.4% of GDP in 2018 and 0.3% of GDP in 2019;
- the Commission 2019 spring forecast pointed to a headline deficit above the 3% of GDP reference value in 2020, should the VAT hike legislated by the government as a safeguard clause not be activated or should it not be replaced by alternative financing measures.

The conclusion of the Commission report was later supported by the Ecofin in its opinion adopted on June 11, 2019 under Article 126(4) of the Treaty. The Economic and Financial Committee also invited Italy to "***take the necessary measures to ensure compliance with the provisions of the Stability and Growth Pact in accordance with the EDP process***", and added that "***further elements that Italy may put forward could be taken into account by the Commission and the committee***". Revealingly, the Eurogroup on June 11 and the Ecofin on June 13 did not limit themselves to endorse the European Commission's decision but invited Italy to factually proceed to the fiscal adjustments so as to interrupt the procedure. Italy's European partners thus adopted a clear change of tones, setting aside the auspices of an open dialogue and calling for real facts.

The reaction of the Italian government was twofold: on one hand, the decision of the European Commission triggered a number of anti-EU reactions that were channeled by the national media; on the other, (mostly behind the curtains) the more pragmatic and more technocratic components of the government –first and foremost Prime Minister Giuseppe Conte and Finance Minister Giovanni Tria – worked to smooth the path toward an agreement with the Brussels institutions.

On July 1, 2019, the Italian government adopted, via its mid-year budget for 2019, a fiscal correction for 2019 amounting overall to 7.6bn EUR or 0.42% of GDP in nominal terms and

8.2bn EUR or 0.45% of GDP in structural terms[2]. Those measures, improving Italy's compliance status with the preventive arm in 2019, mainly consist of higher-than-expected revenues[3] and lower-than-projected public expenditure resulting from the budget execution in 2019, with the latter being further guaranteed via a newly legislated spending-freezing clause (worth 1.5bn EUR or 0.08% of GDP), to be activated by September 15, 2019 in case of underachievement of the new fiscal target.

The nature of the correction adopted by Italy's government can be appreciated if the details of the additional revenues, amounting to 6.2bn EUR, are considered: higher tax revenues have been introduced for 2.9bn EUR, higher social security contributions amounted to 0.6bn EUR and other revenues, including higher dividends from Bank of Italy and Cassa Depositi e Prestiti, brought 2.7bn EUR. In particular, the higher tax revenues of 2.9bn EUR are due to: (i) better-than-expected developments of the personal income tax (IRPEF) by around 0.4bn EUR; (ii) higher revenues from value-added tax by around 0.35bn EUR; (iii) higher receipts from lotteries and gambling by around 0.2bn EUR; (iv) the settlement of past tax liabilities from a large Italian company (Kering Group - Gucci) of around 1bn EUR; (v) other revenues (e.g. for CO2 auctions) of around 0.95bn EUR. It is clear that the fiscal burden has been artfully distributed not to be seen or perceived by the electorate and that its character is not structural, as it is mainly built around una-tantum measures.

Although characterized by a less than structural nature, overall, the budget adjustment and the new spending-freezing clause have been accepted by the European Commission as adequate to ensure that the higher revenues and lower spending that have emerged so far are used for deficit and debt reduction and are not spent for other measures in the rest of 2019. A revision of the legislation implementing the citizenship income (Reddito di cittadinanza) and the early retirement schemes (Quota 100), which repeals the possibility to transfer unused resources earmarked for those two measures between the two schemes and across budgetary years, provides further reassurances in this respect.

With these measures, the European Commission concluded that Italy's headline deficit is now expected to reach 2.04% of GDP in 2019 (compared to 2.5% in the Commission 2019 spring forecast), meeting the deficit target adopted by Parliament in December 2018 through the 2019 budget, despite the significant worsening of the macroeconomic outlook recorded since then.

This would correspond to a structural improvement of around 0.2% of GDP (compared to a deterioration of 0.2% in the Commission 2019 spring forecast). As such, Italy is now expected to be broadly compliant with the required effort under the preventive arm of the Stability and Growth Pact in 2019, bridging the 0.3% of GDP gap estimated on the basis of the Commission 2019 spring forecast. Moreover, the additional fiscal effort delivered by the government for 2019 is such that it also partially compensates the deterioration in the structural balance recorded in 2018.

In a letter sent to the Commission on July 2, 2019, the Italian government pledges to achieve a structural improvement in 2020 in line with the requirements of the Stability and Growth Pact by ensuring the full replacement of the VAT hike legislated as a safeguard clause for that year with offsetting fiscal measures, including a spending review and a revision of tax expenditures. The VAT increase has been regularly used as a safeguard clause and never enacted in the past years when governments preferred to renew further VAT commitments rather than actually compensate them with fiscal corrections.

---

[2] The difference is due to lower-than-expected one-off revenues from the tax amnesty ("***rottamazione***") of around 0.6 bn EUR, which worsen the fiscal target in nominal terms but not in structural terms. The allowance of 0.18% of GDP preliminarily granted to Italy for "unusual events" related to the collapse of the Morandi Bridge and to the hydrogeological risk is not yet taken into account in these computations, as it will have to be confirmed based on outturn data for 2019.

Moreover, the Italian government, in that same letter, pledges to have fiscal consolidation proceed hand in hand with structural reforms aimed at improving the growth potential of the Italian economy, in line with the country-specific recommendations proposed by the Commission in the context of the European Semester on June 5. The government mentions that those reforms should notably aim at improving the efficiency of the public sector and the legal system, as well as enhancing human capital and productivity. So far, no such structural reforms have even been discussed by the government.

In its report prepared in accordance with Art. 126(3), the Commission concludes that the package announced by the Italian government is enough ***"not to propose to the Council the opening of an EDP for Italy's lack of compliance with the debt criterion in 2018 at this stage."***

However, the Commission adds that it will ***"keep under surveillance the effective implementation of this package: It will monitor closely the execution of the 2019 budget and will assess the compliance of the 2020 draft budgetary plan with the Stability and Growth Pact. Moreover, progress with structural reforms included in the country-specific recommendations will be key to ensure higher growth and thereby contribute to a decrease in the debt-to-GDP ratio. The Commission will assess the implementation of these reforms within the context of the European Semester."***

In fact, the Italian government refrained from clearing the foggy perspectives of 2020. In its response to the European Commission, Rome did not explain how the 2020 fiscal plans should be designed in the following months to achieve the dauntingly ambitious targets. One explanation might be that the Italian ruling parties indeed expected a major political overhaul from the European elections that could have helped them dismantle the fiscal architecture presiding over the eurozone's economic governance. This option was completely wiped off the table after the election of Ursula von der Leyen as president of the European Commission, which was backed by a coalition of traditional parties and under the influence of France and Germany.

The next months could tell us more about the Italian government's determination to assume a confrontative stance with Europe. So far, it has backed down twice: the first time at the end of 2018 and the second in June 2019. The third time may be the hardest, as the debt-to-GDP trajectory seems to be irreconcilable with the rules. The fiscal correction requires the government to cover for about 23bn EUR of the VAT clauses; plus the unrealistic target of 18bn EUR from privatization this year; plus an estimated 8bn of new unavoidable expenditures; plus other expenditures or lower revenues planned by the government coalition program (primarily, the so-called "flat-tax"). In the best case, the government should find around 60bn EUR to prevent the debt-to-GDP ratio from increasing any further. No such intervention could come in from the backdoor. The question now is whether the fiscal task will be first a matter of disagreement within Italy and within Italy's government, or if it will be a reason for a loggerhead confrontation between Italy and Europe.

Given the fragile domestic political equilibria, a more careful assumption may be to expect the fiscal problem to have a stronger impact on the current precarious coalition. However hard it might be to produce a sizable fiscal correction like the one requested to avoid a breach of the fiscal rules, such measures would be even harder under the current coalition contract. On the contrary, if only one half of the agenda had to be enacted, either the one closer to the League or the one closer to the Five Star Movement, it would not be entirely prohibitive to design a three-year agreement with the European Commission that is broadly compatible with a stable fiscal framework.

In conclusion, next October might turn out to be a decisive juncture for Italian politics and for a framework agreement with the new European Commission.