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ITALY'S BUDGET OUTLOOK: STRETCHING FLEXIBILITY TO THE LIMIT

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- The Italian government will present the Budget by 15 October, following recently announced main fiscal targets. Fiscal policy will become expansionary in 2016. Instead of reducing the deficit by 0.5pp of GDP in structural terms, as required by EU fiscal rules, the structural deficit will increase by 0.4pp (which may become 0.6pp), taking full advantage of EU flexibility clauses.

- The economic scenario is credible, with 0.9% GDP growth projected for 2015 and 1.6% for 2016. The deficit-to-GDP ratio for 2015 is at 2.6% as in April's projections, while that for 2016 moves up from 1.8% to 2.2% (with possibility of 2.4% if extra flexibility is granted). Balanced budget in structural terms moves to 2018 instead of 2017. The debt/GDP ratio starts declining in 2016.

- The Budget will likely contain permanent tax reductions, including abolishment of the TASI housing tax. Spending cuts risk being further reduced versus the already-softened 10bn indicated back in April, and flexibility may be used to fill the gap.

- The Italian government is stretching flexibility of EU budget rules to the limit. The aim to support the still-fragile recovery, and prevent high-multiplier spending cuts to derail it, is understandable. However, the limited progress on spending cuts decreases the leeway for tax reductions, and especially badly needed reductions in the tax wedge on labour. The fiscal stance risks becoming pro-cyclical.

Overview

By 15 October, the Italian government will unveil the Stability Law (i.e. the Budget). On 18 September, it presented the update to the Economic and Financial Document, which outlines the new macroeconomic framework and sets targets for the Budget. Table 1 presents the key figures, with previous figures (April 2015) in brackets.

The key feature of the new budget targets is the flexibility asked to Brussels that is worth more than 1.0pp of GDP, i.e. almost 18bn. Calling for flexibility for reforms and investment is fine, and serves to strengthen the economic recovery, but it risks financing reductions in taxation and becoming a substitute for permanent spending cuts. It also risks making the fiscal strongly pro-cyclical, even if flexibility is earmarked for reforms and investments.

Table 1. Italy's key macroeconomic and public finance projections[1]

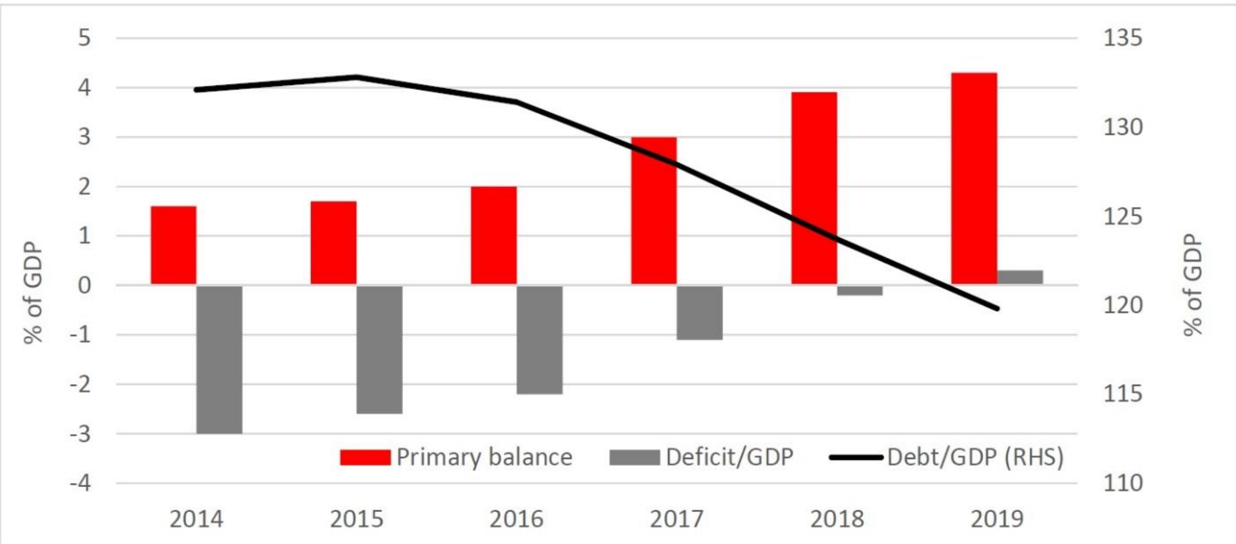
% GDP	2014	2015	2016	2017	2018	2019
Real GDP (% change)	-0.4 (-0.4)	0.9 (0.7)	1.6 (1.4)	1.6 (1.5)	1.5 (1.4)	1.3 (1.3)
Net lending (+)/ borrowing (-)	-3.0 (-3.0)	-2.6 (-2.6)	-2.2 (-1.8)	-1.1 (-0.8)	-0.2 (0.0)	0.3 (0.4)
Primary balance	1.6 (1.6)	1.7 (1.6)	2.0 (2.4)	3.0 (3.2)	3.9 (3.8)	4.3 (4.0)
Interest expenditure[1]	4.7 (4.7)	4.3 (4.2)	4.3 (4.2)	4.1 (4.0)	4.1 (3.8)	4.0 (3.7)
Structural balance[2]	-0.7 (-0.7)	-0.3 (-0.5)	-0.7 (-0.4)	-0.3 (0.0)	0.0 (0.1)	0.0 (0.2)
Change in the structural balance	0.0 (0.0)	0.3 (0.2)	-0.4 (0.1)	0.4 (0.3)	0.3 (0.2)	0.0 (0.0)
Public Debt[3]	132.1	132.8	131.4	127.9	123.7	119.8
	(132.1)	(132.5)	(130.9)	(127.4)	(123.4)	(120.0)

[1] In brackets Economic and Financial Document data presented on 10 April 2015.
[2] Cyclically-adjusted and net of one-offs.
[3] Gross of support to other Eurozone countries and payment in arrears of the public administration.

The planning document is an acrobatic attempt to square the circle. It is certainly not easy to defuse the safeguard clauses introduced in the past (which call for an increase in taxation if spending cuts are not introduced), respond to increased spending needs (also because of Constitutional Court's rulings) and then find the necessary resources for the cuts in taxation announced by the Prime Minister in July.

The government benefits from a slightly improved GDP growth profile (although not in nominal terms) and an interpretation of the rules that in Brussels has become softer and more inclined to avoid further fiscal tightening. The government did not let this opportunity slip by exploiting all the flexibility potentially allowed and reversing the direction of the fiscal stance.

Figure 1. Italy's key fiscal targets



Instead of reducing the structural deficit by 0.5pp of GDP to comply with EU fiscal rules, the government increases it by 0.4pp, i.e. a 0.9pp difference, of which 0.4pp due to flexibility for structural reforms already granted (Council Decision of 14 July). The rest is an additional margin that Italy asks to Brussels: 0.1pp for additional reforms and 0.3/0.4pp for expenses for co-financing projects supported by EU Structural Funds (to be detailed in the Budget). Italy also asks for 0.2pp flexibility as a compensation for the economic and financial impacts of the wave of immigration, although it is not included in baseline projections. Including this latter, it would make the total amount of budget flexibility almost 18 bn.

The deficit-to-GDP ratio for 2016 is therefore revised to 2.2% (it was 1.8% back in April, when 0.4pp flexibility was already included), and would rise to 2.4% if additional flexibility is granted by Brussels for the immigration emergency. If the European Commission accepts all these requests, fiscal policy would become decidedly expansionary.

What will the Budget look like?

Putting together many items leaked in Italian newspapers and statements by various ministers, it look like the overall Budget will be about 26-27bn. We know that it will have to finance reduced taxation. About 3.5-4.0bn will be needed to abolish the TASI housing tax. TASI, is a relatively new local tax levied on residents by city councils to cover the costs of basic services such as street lighting and road maintenance. The tax is related to the value of a residential property (although cadastral estimates are obsolete and there are several distortions at play). Even considering some possible changes in corporate taxation, it looks like there will be no major reduction in the tax wedge on labour in 2016. Even the incentives for new hires introduced in January 2015, which have been effective in supporting employment so far, will likely be refinanced for 2016 in Southern regions only.

There are additional spending needs linked to Constitutional Court ruling. The first ruling is on pensions and the government will have to pay a one-off sum to compensate for past years since the introduction of the pension reform in late 2011. It is a one-off payment, and thus it does not affect structural fiscal projections but only headline figures. From 2016 onwards, the financial effects will have to be included in budget projections, and this should account for less than 1bn per year of extra spending.

There is a huge debate in Italy on making retirement age flexible by allowing workers to retire earlier than normally scheduled with a penalty. The Prime Minister and the Minister of Economy and Finance said many times that this will have to come in a budget-neutral way, effectively meaning that the net present value (NPV) of early retirement pensions must be actuarially neutral versus current pension provisions. However, by making the NPV the same, the cash flow inevitably becomes negative for the government over the first few years, and thus it needs to find proper financing. It is not clear whether and how the government will achieve this.

In the past, the government introduced safeguard clauses by which taxation (notably VAT) increases automatically should spending cuts not be legislated to replace them. This was a way to make the commitment credible, allow deficit projections to include the results and thus respect fiscal rules. For 2016, safeguard clauses amounted to 16bn. Back in April the government reduced this amount to 10bn, as economic growth and interest expenditure were better than expected and thus allowed the government to reduce expected spending cuts. Now there are rumours that the government will announce again a reduction in spending cuts to 6-7bn. This would be quite disappointing. It is true that stronger-than-expected potential growth may reduce the need for spending cuts. However, if potential growth were indeed at 0.1% in 2016 and 0.6% in 2019, as estimated by the government based on the EU methodology, the only way to finance significant cuts in labour taxation would be through spending cuts or shifting away taxation from labour to consumption, property and environment, and reducing tax expenditure.

Tax expenditure in particular proved to be a very difficult political subject. As an example, reducing tax expenditure would mean eliminating tax benefits on fuel for lorry drivers, tax benefits for agriculture, subsidies for newspapers etc. These are all very touchy political issues.

Financing needs in the Budget sum up to about 26-27bn. It will certainly not be easy for the government to find adequate financing. The key thing to watch is whether the government will finance permanent tax cuts with temporary budget flexibility. If this happens, it would not be appropriate and bode well for future public finance trends.

There are many critical points in the interpretation of budget rules

There are a number of critical points in Italy's fiscal scenario and the call for flexibility.

First, it is not clear whether flexibility clauses can add up, i.e. flexibility for reforms, plus that for investments and possibly for the immigration crisis. It appears that the prevailing interpretation is indeed that they can add up, but it is not clear whether the overall 0.5% of GDP limit can apply to the flexibility for reforms only or to overall flexibility. In fact, January's Commission communication says, "under the preventive arm of the Pact, some investments deemed to be equivalent to major structural reforms may, under certain conditions, justify a temporary deviation from the MTO of the concerned Member State from the adjustment path towards it". The reference to structural reforms may imply that the flexibility for investments must be considered together with that for structural reforms, and thus be limited by the 0.5% ceiling. In this case, Italy would find itself in violation of the rules and would have to revise budget projections. Economic rationale would say that these are two different matters and that the two flexibility clauses can add up. Still, if there is no limit, the fiscal stance could completely change and even become pro-cyclical, as it may well become true this time for Italy. As a result, such a tricky subject calls for immediate clarification in Brussels.

Among the conditions to get access to the so-called 'investment clause', there is a requirement that the country makes the request in the Stability Programme published in April. Italy did not ask back in April. However, this is a minor procedural issue. As the application of this flexibility provision is in its infancy, probably a late request in the Draft Budgetary Plan to be presented in mid-October would be deemed acceptable. Public investments must have a "positive, direct and verifiable long-term budgetary effect on growth and on the sustainability of public finances" and Italy's planning document makes a good simulation. Investment plans also need to be sufficiently detailed, and this again will have to be done in the Draft Budgetary Plan. Finally, a Member State can benefit from the 'investment clause' if its GDP growth is negative or GDP remains well below its potential, resulting in a

negative output gap greater than 1.5% of GDP. According to the Italian government, the output gap in 2016 is estimated at -2.5%. Although, the difference versus the -1.5% threshold appears to be sufficiently large, some changes in the coefficients and revision of data by the European Commission in November may well produce an output smaller than the limit. This risk is probably small, but not negligible.

Flexibility is not a 'discount' allowed for the time being. It is a temporary deviation from the adjustment path towards the Medium-Term Objective (MTO) or a temporary deviation if the country is already there. It is like borrowing fiscal space on a temporary basis. The 'loan' must be compensated and the MTO reached within the four-year horizon. The adjustment path depends on the cyclical position and the debt-to-GDP level. Italy should have included already in 2017 a structural adjustment greater than 0.6pp of GDP in view of the reduction of the output gap. The government stresses the fact that the "gap of almost 20 points compared to pre-crisis output trend [...] does not emerge properly using the output gap methodology followed by the European Commission". This would be equivalent to saying that the true output gap is wider and that Italy can recover the output potential lost during the crisis, or at least more than what implied by merciless estimates based on the European methodology. Italy's planning document also says, "substantially larger reduction in the 2017 structural deficit would be counterproductive".

Finally, in order to achieve a reduction in the debt-to-GDP ratio sufficient to comply with the debt rule, the government sets an ambitious goal for privatisation, i.e. almost 2pp of GDP between 2015 and 2018. It would certainly be possible, but very ambitious, especially without giving up direct or indirect control of the two major state-owned companies (ENI and ENEL) and speed up dismissals at local level.

There is also a tricky domestic issue: balanced budget provisions embedded in the Constitution

In theory, the government cannot modify budget targets, according to the new balanced budget Constitutional rules, unless there are very good reasons, e.g. periods of severe recession and extraordinary events, such as natural disasters. It is not among these exceptional events the lower-than-expected inflation indicated by the government. In fact, the government calls for article 6 of the law for the implementation of the balanced budget principle, which is a sort of nuclear option. This article says that the government can make changes if they are related to the position in the economic cycle, effectively introducing a loophole ready for any eventuality. However, the Italian Parliament could challenge the interpretation of this clause and potentially reject the revised targets.

Will these projections and the forthcoming Budget get Brussels' blessing and Parliamentary approval?

Overall, the above-mentioned problems are all venial sins. With a little luck, the estimates of the European Commission out in November will not be too far from those of the government and allow Italy to pass the test of the preventive arm of the Pact. Moreover, ex post budget results may turn out being within the margins of error accepted in Brussels.

Yet, the fundamental questions are of substance and go beyond the EU rules. They concern the direction and policy priorities of intervention. In my view, the number one budget priority should be the reduction of the tax wedge on labour, financed by permanent cuts to current expenditure and not only by taking advantage of flexibility.

Is the mix of spending cuts and tax cuts appropriate?

The spending cuts for 2016 declined from 16bn a year ago to 10bn in April and risk declining further in the Budget. The government document says, "The spending review will continue in

2016 and the following years, providing much of the coverage of the tax cuts". However, in 2015 the reference aggregate for current spending (the aggregate used by the European Commission to check compliance with the spending rule) is forecast to grow by 0.8% yoy in real terms, according to government's estimates, while it had shown a fall of 1.6% in 2014 and 2.1% in 2013. In 2016, the government expects current expenditure (overall figure) to grow by 1.4% in nominal terms (close to flat in real terms). This development is not sufficient to allow a breakthrough in the reduction of the tax wedge on labour, which in Italy is well above the European average.

Is the overall fiscal stance appropriate?

The government spent a 3-page box in the document to review the literature on fiscal multipliers and the message seems clear: be prepared for further reductions in spending cuts as they have the highest multiplier effect on the economy, and it would be appropriate to reduce them to allow aggregate demand to strengthen. Therefore, the government appears to be willing to take flexibility as a way to reduce high-multiplier expenditure cuts while, at the same time, reduce taxation.

In theory, the budget should earmark the amounts allowed by flexibility for reforms and investments, but they may end up financing the overall Budget. This would lead the overall stance into clear expansionary territory. Would it be appropriate? Well, it depends. If potential growth is the one estimated by using the European methodology, i.e. potential growth goes down to 0.0% in 2015, 0.1% in 2016 and then rises to 0.6% in 2019, than GDP growth in 2016 would be projected well above trend (1.6% versus 0.1% potential, with the output gap narrowing from -4.0% to -2.5%). Fiscal policy would turn pro-cyclical. If however, as claimed by the Italian government, potential growth is underestimated and thus the output gap is much wider, then fiscal policy would be less, although still, pro-cyclical.

Then, the next issue would be on risk management. Would it be better to be more cautious and reduce the deficit more rapidly or make sure the economy takes sufficient momentum to avoid deflationary traps and lacklustre growth by mean of a pro-cyclical policy? This is a very difficult question as the recession has been unprecedented and the risk of a fresh downturn in global growth, driven by emerging markets, is a real. As highlighted by the government, GDP growth is about 9pp below the pre-crisis peaks, but the output gap versus pre-crisis trend growth is almost 20pp.

The bottom line

My taking is that the composition of the Budget is key. If the government is bold enough and increases permanent spending cuts while reducing taxation on labour and increasing public investment, then the near-term effect on growth would likely be slightly recessionary and it would fully justify the call for flexibility and temporary pro-cyclical policies.

If, however, the government uses flexibility to reduce the housing tax (not a good way to enhance potential growth) and reduces structural spending cuts, then pro-cyclical policies would not be justified. A more prudent approach would be much better.

I am not very optimistic, but let us see what we get in the Budget in mid-October.