

A BIPARTISAN PUBLIC DEBT AGREEMENT FOR ITALY

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The reduction of government debt overhang in Italy remains a key national and European policy priority. In fact, Italy's debt size does not only hamper the country's economic perspectives. The risk and the uncertainty associated with its size tarnish any endeavor to achieve a more closely integrated European economy. Initiatives aimed at increasing risk-sharing are inhibited. At the same time, the lack of mutualization makes Italy's debt even more difficult to contain. A composite solution to reduce and share the risk associated with Italy's public debt needs to be elaborated to break the doom-loop.

This policy proposal intends to advance a three-pronged initiative: the first suggestion is to introduce an institutional innovation increasing the credibility of Italy's political commitment to permanently lower its public debt; the second suggestion designs a way to achieve the reduction of the public debt as required by the compliance with the Euro-area fiscal rules; the third tackles the contradiction of conventional fiscal rules that generally make economic growth more difficult, just when it is needed most.

1) A Bipartisan institution for the control of Public Debt

A political commitment by Italy for debt containment should be preliminary to any common strategy involving the EU institutions. Moral hazard is often cited as a hurdle on the path to risk sharing. Incentives need to be properly designed to prevent a

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country's political system from being tempted to exploit the EU availability for risk sharing.

These pages call for a specific agreement in the Italian Parliament aimed at establishing a permanent Bipartisan Committee for the reduction of Public Debt, whose chair should be assigned to the head of the opposition and with the powers to denounce public debt slippages from the European rules.

The rationale for this committee rests on the idea that European fiscal rules are currently focused on the containment of yearly fiscal deficits rather than on the lowering of fiscal debt. Although the EU's Stability and Growth Pact (SGP) anchors EU countries' decentralized fiscal policies to the Maastricht Treaty's reference values -- government deficit and debt-to-GDP ratios of 3% and 60% of GDP-- its intention was to limit the deficit bias prevalent in many EU countries. The deficit target became even more important after the 2005 reform of the SGP, which introduced, under its preventive arm, medium-term budgetary objectives (MTOs) based on country-specific structural balance targets over the medium term. These were designed to ensure sustainable debt ratios by also taking account of the budgetary costs of pension systems.

As the European Central Bank noted in 2016, "the Pact's debt criterion has effectively not been implemented since the start of EMU"¹. First, monitoring the SGP's deficit criterion had been deemed sufficient by the European Commission and the European Council to steer countries' fiscal policies towards sustainable government debt positions. This was one of the reasons why significant breaches of the 60% of GDP reference value over a prolonged period of time did not lead the Council to take procedural steps to ensure a return towards the Treaty's debt threshold. Second, the "sufficiently diminishing" requirement of the Treaty had not been operationalized prior to the introduction of the debt reduction benchmark in 2011. Third, large deviations from the benchmark structural effort requirement under the Pact's

¹ ECB Bulletin August 2016

preventive arm to ensure sufficient progress towards sound fiscal positions were not penalized. In the absence of a correction mechanism for past fiscal slippages, all of this contributed to a piling-up of government debt.

The substantial difference between fiscal rules targeting the level of government debt rather than deficits is that the former keeps track of past fiscal developments. While each yearly fiscal deficit is analyzed singularly by the EU institutions and command a standard fiscal correction, public debt yearly changes reflect the variations in the primary budget balance, the evolution of interest spending as well as stock-flow adjustments; cumulating into changes in the level of government debt. Effectively enforced debt rules are less prone to a ratcheting-up of government debt than deficit rules that do not entail the correction of past fiscal slippages.

The SGP's debt rule is assessed in three configurations. One configuration is backward-looking over the past three years, one is forward-looking over the coming two years and one is adjusted for the impact of the economic cycle. In principle, only if a country breaches the rule in all three configurations can a debt-based excessive deficit procedure (EDP) be opened. However, for the temporal features that it has, the fiscal debt rules amount to a very different political signaling power. While the yearly correction of fiscal deficits does not depend on the former year deficit, the debt reduction depends on the reduction accomplished in the previous years. It also encompasses forecasts for the coming two years. If a government in charge does not respect its deficit commitment, the political opposition, interested in taking over government responsibilities in the future, is not directly limited in its future fiscal room of maneuver. Differently, if the debt rule is applied, a future government's room of maneuver will be severely limited by the incumbent's lack of discipline.

The Parliamentary opposition has a much stronger interest in avoiding debt slippages by the incumbent.. Increases in the debt position poison the well for the next government. Consequently, the opposition has an inherent interest in preventing this to happen, particularly ahead of general elections when fiscal slippages are more

tempting and the political reward higher. The kind of political dynamics set by the enactment of debt control is completely different from the one triggered by fiscal deficit disputes. While the latter amounts to a conflictual relationship between a national government and the EU institutions, the second internalizes the fiscal disputes in domestic politics, without shifting the blame on the European scapegoat.

To achieve this result, the EU institutions need to attach more relevance to the debt rule in the general assessment of member states' fiscal sustainability. Secondly, Italy needs to set up a Parliamentary institution tasked with the control of fiscal debt developments, which is called to signal any slippage from the agreed path of debt reduction. The chair of the new institution should be assigned to a member of the opposition. The executive board should also be composed prevalently by opposition Members of Parliament. The establishment of an internal control is conceived as a strong political sanction for a country's lack of fiscal discipline.

2) A compromise between conflicting rules for debt reduction

The Treaty on the Functioning of the European Union (article 126.2) foresees that compliance with budgetary discipline in the EU shall be monitored based on "whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace". As a major lesson from the sovereign debt crisis, the EU Treaty's debt criterion was operationalized as part of the "six-pack" reforms which came into force in November 2011. According to Regulation (EU) No 1467/97, as amended by Regulation (EU) No 1177/2011, the debt-to-GDP ratio is regarded as diminishing sufficiently and approaching the reference value at a satisfactory pace if the differential of the government debt-to-GDP ratio with respect to the 60% of GDP reference value declines by 1/20th on average over a period of three years as a benchmark for debt reduction. Countries that do not incur in excessive deficits procedure, like Italy, should ensure both sufficient progress towards the Medium-Term Objective, under the SGP's preventive arm, and comply with the debt

rule to converge towards the Maastricht Treaty's debt threshold. According to EU's calculations, since it entered into force, only for Belgium and Italy has the debt rule been a binding constraint for fiscal policies, requiring at least an additional fiscal correction consistently above 0.5% of GDP over the adjustment benchmark of the SGP's preventive arm. Based on the EU's Commission forecasts, in 2014 and 2015 Italy should have adopted an additional fiscal correction of 1.2% and 2% of GDP, respectively, to comply with the debt rule. Much of the difference is explained by shortfalls in the structural efforts, combined with lower adjustment requirements due to the flexibility provisions acknowledged in 2015. The gap between the debt rule requirements and those necessary to reach the MTO is higher for countries with very high debt. However, had Italy stuck to the original path towards the MTO without adopting "flexibility", the debt rule would not have been more binding than the fiscal deficit rule.

The consequence of the "flexible" compliance with the MTO rules is that Italy's public debt has not declined even though no procedure for excessive deficit or for significant deviation from the fiscal deficit targets has been adopted. Both rules, MTO and debt-rule, have thus lost credibility.

My suggestion is to assign the assessment of fiscal compliance to the EU Commission together with the European Stability Mechanism. The latter, a technical institution less inclined to indulge in political compromises, would play a further critical role in facilitating the reduction of public debt as prescribed by the debt rule, i.e. the reduction of 1/20th of the excess debt above 60% of GDP. In the case of Italy, this reduction would be of about 3,5% of GDP in the first years, a correction which is above the level of adjustment currently required by the MTO.

The compliance with the MTO, tempered by the mitigating factors that the ESM-Commission could deem sensible, would become the premise to access an ESM facility aimed at filling the gap between the MTO correction itself and the reduction of the debt levels as prescribed by the debt-rule. If the MTO correction is 2.0% of

GDP, the ESM would step in for the remaining 1.5%. This would happen via purchases of Italian government bonds currently held by the ECB backed by a special guaranty fund established by Italy, under ESM verification, filled with state properties and frozen in a permanent below the line budget.

If the MTO objective is not achieved, the ESM would not provide for its part of debt reduction. This would obviously sharpen domestic political dynamics with the new Parliamentary institution presiding over debt reduction, stepping in and piling pressure on the government to comply with its fiscal commitments. Then, if a future government walks away from the overall fiscal commitment, the ESM would be legitimated to get the repayment of the frozen bonds. Given the dynamics of the debt-rule, Italy's public debt would decline below 100% in ten years or less.

3) A sanctioning process that does not hamper growth

The application of flexibility margins to the MTO procedure remains exposed to a risk of political interference. Our suggestion is to provide for a further correction in the application of flexibility. More precisely every deviation from the MTO should be sanctioned via an equivalent reduction of current public expenditure and an equivalent increase of public investments.

The contradiction of fiscal sanctions lies in their general depressive effects on growth. Fines, or ex-post corrections of unauthorized violations turn into growth-compressing measures when growth is most needed to reduce the debt-to-GDP ratio. Through the substitution of current expenditures via investments the opposite occurs. The sanction lies in the fact that current expenditures are normally transfers of income that nourish political consensus, while investment enhances growth for the future and potentially could benefit a different government from the incumbent.