

# **WAS RENZI THE REAL WINNER?**

## **Questions about the Italy-EU fiscal dispute**

**SEP Policy Brief No. 8**

**26 October 2014**

**A**fter a hard-nosed negotiation, the EU Commission and the government of Italy have reached an agreement on the level of structural deficit that Italy will have to achieve in the next years as specified in its Stability Law. The agreement is largely provisional, as Italy's economic conditions remain precarious and the fiscal policies on which the agreement is based are uncertain.

In its programmatic budget document for the year 2015 (DPB-2015, the foundation of the budget law) Italy had chosen to produce a correction of its structural deficit far lower than the 0.5% required by the Stability and Growth Pact, Europe's main platform of economic governance. The first Italian proposal was of a thin correction corresponding to 0.1% of GDP. The final compromise, as emerged from Brussels negotiations, was 0.3%, exactly midway.

The formal discussion and the artificial compromise in the middle of May sound hollow if confronted with the substantial issues at stake: on the one hand Italy needs to implement a political economy best designed to overcome its long-lasting predicaments: Italy is completing sixth year of crisis, the last three years of which have been of full recession. On the other hand, Italy, together with France, are stress-testing the first enactment of Europe's new economic governance, based on the revised Stability Pact and on the so called Fiscal Compact. Since credibility in economic governance has a relevant role in firming the ground on which the euro area countries stand, the decisions taken in Brussels could have far reaching consequences.

In this brief, we will analyze the basics behind the Stability and Growth Pact and we will try to apply it to the Italian case in order to understand if the SGP's credibility has been dented or if Italy instead accepted a too restrictive interpretations of the correct rules. Finally we will conclude that at the beginning of next year Italy might be called to clear new doubts on its fiscal position.

*What does the Stability and Growth Pact prescribe?*

The Stability and Growth Pact (SGP) is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all Member States.

The SGP contains two arms – the preventive arm and the corrective arm. The preventive arm seeks to ensure that fiscal policy is conducted in a sustainable manner over the cycle. The corrective arm sets

out the framework for countries to take corrective action in the case of an excessive deficit.

The EU Commission defines the country-specific medium-term budgetary objective (MTO) as the cornerstone of the preventive arm. The medium-term objective is defined in structural terms, i.e. in cyclically adjusted terms and net of one-off and other temporary measures. Member States outline their medium-term budgetary plans in stability and convergence programs (SCP), which are submitted and assessed annually in the context of multilateral fiscal surveillance under the European Semester.

The corrective arm is made operational by the Excessive Deficit Procedure (EDP), a step-by-step procedure for correcting excessive deficits that occur when one or both of the rules that the deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP (or at least diminish sufficiently towards the 60%) defined in the Treaty on the Functioning of the EU (TFEU or Treaty) are breached.

Non-compliance with either the preventive or corrective arms of the Pact can lead to the imposition of sanctions for euro area countries. In the case of the corrective arm, this can involve annual fines for euro area Member States and, for all countries, possible suspension of Cohesion Fund financing until the excessive deficit is corrected.

The legal basis of the Stability and Growth Pact is provided by Articles 121 and 126 of the TFEU. While Art. 121 outlines the preventive arm of the SGP, Art. 126 of the Treaty forms the basis for the corrective arm and the EDP and Protocol 12 defines the reference values of 3% of GDP for public deficit and 60% of GDP for public debt.

*Is the current procedure, under the Six Pack, the Two Pack and the Fiscal Compact, the new normal?*

Secondary legislation governing the Stability and Growth Pact was initially approved in 1997, with significant reforms enacted in 2005, but gaps and weaknesses in the framework were identified more clearly during the recent economic financial crisis. This opened the way to the 2011 reforms, referred to as the "six-pack". These reforms significantly strengthened both the fiscal surveillance and enforcement provisions of the SGP by adding an expenditure benchmark to review countries' fiscal positions, operationalizing the Treaty's debt criterion, introducing an early and gradual system of financial sanctions for euro area Member States, and requiring new minimum standards for national budgetary frameworks. The 2011 reforms also brought the surveillance of both budgetary and economic policies together under the European Semester, to ensure the consistency of the policy advice given. Further details on the implementation of the SGP by Member States are given in a code of conduct, which was last revised in September 2012.

Recognizing the extent and potential consequences of spillovers among euro area Member States' economic and budgetary situations, the Two Pack Regulations, which entered into force on May 30, 2013, build on the Six Pack reforms by introducing additional surveillance and monitoring procedures for euro area Member States.

The Two Pack Regulations support adherence to the SGP's existing fiscal surveillance framework, while at the same time establish a comprehensive surveillance regime for those Member States in the euro area threatened with or experiencing serious difficulties with respect to their financial stability.

This legislation introduces a European assessment of draft budgetary plans on a coordinated timeframe in Autumn for euro area Member States. Furthermore, it improves national budgetary frameworks by

requiring them to set up independent bodies in charge of monitoring national fiscal rules and to base budgetary forecasts on independent macroeconomic forecasts.

For euro area Member States in EDP, a system of graduated monitoring is established in order to secure a timely and durable correction of excessive deficits and to allow an early detection of risks that a Member State does not correct its excessive deficit by the deadline set by the Council. Requirements placed on financially fragile countries are streamlined for countries currently receiving financial assistance while enhancing monitoring that will also enable the Commission to better assess the risks threatening or faced by the Member State in question and thus, in some cases, address vulnerabilities even before a need for financial assistance arises.

To support the effective implementation of the Two Pack legislation, Member States and the Commission have agreed on harmonized frameworks for the draft budgetary plans and for the debt issuance reports, as adopted by the Commission in Communication COM(2013) 490 and contained in a Code of Conduct which sets out all commonly agreed guidelines.

In addition, the form and content of the new regular reporting by Member States in EDP have been set out in a delegated Regulation, adopted by the Commission on 27 June 2013. This delegated act will enter into force if the co-legislators do not object to it by 27 August 2013.

Finally, the Fiscal Compact contained within the inter-governmental Treaty on Stability, Coordination and Governance (TSCG) complements, and in some areas enhances further, key provisions of the SGP. Specifically, the Fiscal Compact requires Member States to enshrine in national law a balanced budget rule with a lower limit of a structural deficit of 0.5% GDP, centered on the concept of the country-specific medium-term objective (MTO) as defined in the SGP. The Fiscal Compact's provisions also increase the role of independent bodies, which are given the task of monitoring compliance with the national fiscal rules, including the operation of the national correction mechanism in case of deviation from the MTO, or the adjustment path towards it (also included in the Two Pack). The TSCG, signed by 25 EU Member States (all but UK and Czech Republic), entered into force on January 1, 2013 and is binding for all euro area Member States that have ratified it, while other contracting parties will be bound only once they adopt the euro or earlier if they signal it.

*Is the medium-term budgetary objective (MTO) Italy's problem?*

The main bone of contention with Italy undoubtedly regards the preventive arm of the SGP. This first arm of the Stability and Growth Pact aims to ensure sound budgetary policies over the medium term by setting parameters for Member States' fiscal planning and policies during normal economic times. Compliance with the preventive arm's provisions should ensure that the Treaty's limits (3% of GDP for the general government deficit and 60% of GDP for gross debt, where debt is also not diminishing at a satisfactory pace) are not breached over a normal economic cycle.

The cornerstone of the preventive arm is the attainment of the medium-term budgetary objective (MTO). The MTO is a country-specific reference value for individual Member States' medium-term budgetary positions, defined in structural terms (that is, cyclically adjusted and net of one-off and temporary measures). All Member States must reach their MTOs or be on an appropriate adjustment path towards it, with an annual improvement of their structural balance of 0.5% of GDP as a benchmark. The MTO is determined to ensure a healthy underlying budgetary position. MTOs are updated every three years or more frequently if a Member State has undergone a structural reform

significantly impacting its public finances. In considering Italy's position we should take into account that Italy emerged last year from the excessive deficit procedure and its deficit is thus below 3%. Moreover it should observe three working principles and methods of interpretation of the reference value for the MTO. MTO should ensure that Member States:

1. have a safety margin against breaching the 3% deficit limit
2. are on course to a sustainable debt position, taking into account the economic and budgetary impact of ageing populations
3. have adequate room for budgetary maneuver, in particular taking into account the needs for public investment.

Member States should either be at their MTO or making rapid progress towards it. Member States faced with a debt level exceeding 60% of GDP or with pronounced risks to overall debt sustainability are required to adjust faster towards the MTO. For all countries, a higher adjustment is required in good economic times in order to have more flexibility in bad times. For euro area Member States and participants of the Exchange Rate Mechanism (ERM) II, the country-specific MTO must be specified within a defined range between -1% of GDP and balance or surplus, in cyclically adjusted terms and net of one-off and temporary measures. Euro area countries that are signatories to the Treaty on Stability, Coordination and Governance (TSCG) have further committed themselves to MTOs of at least -0.5% of GDP, unless the debt-to-GDP ratio is significantly below 60% and there are low risks for the sustainability of public finances.

As part of the 2011 reforms ("six-pack") to strengthen fiscal surveillance, the analysis of the MTO or the adjustment path towards it under the preventive arm of the SGP is judged by an assessment of the structural budget balance, complemented by an analysis of the growth rate of expenditure net of discretionary revenue measures. This requires that for countries at their MTO, any excess growth of new expenditure over a medium-term reference rate of potential GDP growth must be matched by discretionary revenue measures. Countries on their adjustment path must contain their net expenditure growth at a rate lower than medium-term potential GDP growth, again unless matched by discretionary revenue measures. This ensures a gradual strengthening of the underlying budget balance. The information to allow an assessment of these objectives is provided in the Member States' stability and convergence programs (SCPs), which detail budgetary objectives and planned budgetary measures in accordance with the fiscal policy guidelines as contained in the Treaty and the regulations.

As part of multilateral fiscal surveillance, the Commission conducts both an *ex ante* assessment for the current and forthcoming years and an *ex post* assessment for the previous year based on each Member State's stability or convergence program.

The *ex-ante* assessment includes an examination of the medium-term budgetary objectives (MTOs) presented by Member States in their stability and convergence programs, focusing on whether **a)** the MTO is appropriate, **b)** the country is at the MTO or if the adjustment path towards it is appropriate, considering the cyclical conditions and the sustainability risks, and **c)** the economic assumptions on which the program is based are plausible. If the Council considers that the MTO or the adjustment path towards it presented in a stability or convergence program is not appropriate, it will indicate in its

country-specific recommendations that the Member State is invited to adjust its program.

*Additional step for euro area Member states*

The Two Pack Regulation on common provisions for monitoring and assessing draft budgetary plans introduces an additional step in the ex-ante monitoring of budgetary policies for the euro area Member States. Specifically, the Two Pack establishes a common budgetary timeline for euro area Member States which requires these Member States to submit draft budgetary plans to the Commission by October 15 every year, prior to the adoption of the budget.

The Commission will provide two assessments:

- an opinion on each Member State's plan
- an overall assessment of the budgetary situation and prospects of the euro area as a whole.

This exercise mirrors the horizontal assessment of stability and convergence programs taking place in Spring, but with a focus on the forthcoming year rather than on medium-term fiscal plans. The Commission opinion on the euro area Member States' plans will be based on the requirements of the SGP – in particular the country-specific recommendations issued under the preventive arm at the end of the European Semester and the need to comply with the MTO requirements.

For countries under an EDP, progress towards meeting the obligations stemming from the recommendations issued to the Member State will be a central aspect of the assessment. If the Commission identifies particularly serious non-compliance with the European budgetary policy obligations, it can ask for a new plan to be submitted.

In the ex-post assessment, the Commission determines whether a Member State has made sufficient progress towards the medium-term budgetary objective (MTO) compared to the benchmark of an annual improvement of the structural balance equal to 0.5% of GDP. This assessment is further on compliance with the expenditure benchmark. If the Commission finds evidence of significant deviation from the MTO or the adjustment path towards it—which is a conclusion based on an objective, numerical criteria—the Commission shall address a warning to the Member State concerned, which is followed by a Council recommendation within one month (see graph below). If not respected, this can be followed, in the case of euro area Member States, by a sanction equal to an interest-bearing deposit of 0.2% of GDP as a rule

*Does Italy underestimate its macroeconomic risks and overestimate structural reforms?*

In the context of the submission of its programmed budget “Documento Programmatico di Bilancio”, Italy sent to the EU Commission a significantly revised set of forecasts implying a substantial revision in the course of achievement of the Medium-Term Objective.

In the “Nota di aggiornamento” of the “Documento di economia e finanza (DEF), the government estimates a negative variation in Italy's GDP in 2014. Instead of growing by 0.8% this year, Italy's GDP is now expected to decline by 0.3%. For 2015 the estimated growth declines from 1.3% to 0.5%. The

causes are identified in the worsening of the international economic environment, in the reduced impact of past policies and in the delay in the implementation of the reforms approved between 2012 and 2013. The recovery would originate from the domestic demand thanks to the rekindling of investments and to an acceleration of households' consumption. Both domestic demand factors would benefit from the generous financial conditions granted by the ECB monetary policy.

This trend forecasts do not change much once the new “programmed” policy measures for 2015 should be accounted for. Relative to baseline forecasts, GDP would increase by only 0.1% in 2015. Thanks to a set of four significant structural reforms – reforms of the judicial system, of the public administration, of product market regulation and of labor market – the incremental dynamics of GDP would accelerate relative to the trend by 0.2% for each year between 2016 and 2018, hence with a cumulative effect of 0.7%.

According to the Budget Parliamentary Office (BPO), the macroeconomic revision hides factors of risk concerning: the uncertainty about future growth of international trade flows; geopolitical risks in Ukraine and in the Middle East; the potential repercussion of a return to normal condition in the American monetary policy; the lack of a confidence effect on Italian economic agents that might induce households not to cut their precautionary savings if labor market conditions do not visibly improve. Finally a major risk remains the possibility of a deflationary development throughout the euro zone, particularly if concentrated in its most vulnerable countries.

The expected positive effects of structural reforms may be overestimated by Italy's government, weakening the credibility of the fiscal framework submitted to the EU Commission. Notwithstanding the objective difficulty in the estimate of the impact of structural reforms on overall growth, the Italian government measure of their effect corresponds to the 20% of the total expected growth for year 2016 and 30% of growth in 2017 and 2018. Methodologically the measurement is complicated by the fact that structural reforms tend to impact with more certainty the potential output rather than the effective one. This is true in particular if the macroeconomic cyclical position is of muted growth or even of a decline. Quite significantly, the BPO suggests indeed to “exclude the effects of structural reforms from growth forecasts”.

### *Should Italy's Public Finance take into account the macroeconomic risks?*

Given the macroeconomic revisions, the fiscal framework has also been recalculated. Net deficit increased by 3.0% in 2014 relative to a year before instead than 2.8%. The worsening of the economic cycle in 2014 and the resulting reduction in tax revenues have overcompensated the government's effort in cutting public expenditures.

In 2015 net deficit should decline by 0.8% to 2.2%. While fiscal revenues should increase by 0.2%, the improvement is provided for mainly by a decline in government's expenditures, which are planned to decline in absolute terms (-0.3%) for the third time since 1995. In the three following years the net deficit should decline progressively from 2.2% to 0.8% by 2018, through an improvement of the primary surplus that should climb to 3.4% of GDP (+1.1% between 2015 and 2018), thanks to a lower

cost in debt service, but primarily to a new decline in public expenditures that should reach 44.8% of GDP. Once the programmed reforms are taken into account, the expected deficit improves to 0.2% in 2018.

Italy's medium-term objective is represented by the achievement of a structural balance of the public budget. The achievement of the MTO is delayed by one year to 2017. The adjustment is interrupted in 2014 and 2015 and restarted in 2016. The programmed structural deficit is thus higher by 0.3% in 2014, 0.5% in 2015 and 0.4% in 2016. This would allow for an expansive fiscal policy, at least in nominal terms, by 0.7% of GDP in 2015, while the fiscal stance will be neutral in 2016. After that year the fiscal stance will return restrictive.

Net deficit will worsen in 2015 by 11.5bn from the trend set at 2.2% of GDP to a programmed level of 2.9%. The structural surplus will improve by only 0.1% instead of the expected 0.5%. In 2016 the so called safeguard clauses allow for a reduction of the structural deficit by 0.5%.

*Should Italy be allowed to slow the adjustment in 2014?*

The delay in the achievement of the MTO is justified by the Italian government with the necessity of providing stimulative fiscal policy in the current recessionary environment. In particular the government arguments refers to the need of supporting aggregate demand as well as country's competitiveness. The Stability Law goes in the direction of tackling some of Italy's main structural problems – especially the excessive tax pressure where this is most distortionary and puts money on the table to ensure the labor market reform can bring the desired changes in terms of shift towards permanent employment and flex security. The laxer fiscal stance should allow to cut fiscal imposition on firms particularly for what IRAP imposition is concerned; it should also give more room of maneuver to local administrations whose investments are constrained by the internal stability pact; more fiscal space should provide resources to expenditures in education; finally the system of social assistance should be reformulated in accordance with the needs emerging from the labor market reforms.

The slowdown in fiscal adjustment has repercussions on the level of public debt which would indeed increase further from 131.6% of GDP in 2014 to 133.4% in 2015. It should then decline significantly in the three following years reaching a level of 124.6% in 2018. This forecasts is conditioned on a rather ambitious target for the privatization of public properties ranging around 0.7% of GDP in 2014 only.

The main motivation for the revision of the fiscal programs is given by the worsening of macroeconomic conditions. In Italian legislation, such a delay is allowed for exclusively in the case of exceptional events, which are defined as:

- periods connoted by grave recessions in the euro area or in the EU;
- extraordinary events happening beyond the control of the State and exerting severe repercussions on the general financial condition of the State

These are consistent with the definitions of the European norms and in particular with the Stability

and Growth pact. The corrective arm of the SGP defines a grave recession as:

- a period in which the real rate of GDP growth is negative
- a cumulative reduction in production during a prolonged period of very low growth relative to the potential growth rate.

The preventive arm contemplates the case of grave recession as a situation where a waiver can be applied to the achievement of the MTO. The 0.5% of GDP structural improvement in MTO should be considered as a reference value that commands for larger adjustments in good times and admits lower adjustments in bad times.

According to the standard way of interpreting the rules by the EU Commission, it should be admissible that a country does not achieve any improvement if, in a given year, its GDP declines in real terms or if its output gap (the distance between the effective and the potential income) is larger than 4%.

Given the Italian forecasts, Italy's GDP should decline in real terms by 0.3% in 2014, while the output gap should reach -4.3%. So both standard conditions set by the EU Commission allow for a delay in the achievement of the medium-term objective in 2014.

*Is the real controversy in the 2015 postponement?*

None of the two standard conditions apply in 2015 when according to the government's estimates, the GDP should increase by 0.6% while the output gap should remain at -3.5%. In 2015 as reminded, the Italian government wanted to set an objective of structural budget improvement of 0.1%, instead than 0.5%. It is however matter of interpretation whether the bucking of the 4% threshold for the output gap means an automatic discontinuance with the application of mitigating circumstances. In particular the European legislation contemplates factors that can indeed represent mitigating circumstances. In particular the implementation of important structural reforms which can generate direct financial benefits in the long term strengthening the potential rate of sustainable growth, which should have a quantifiable impact on the long term sustainability of public finances.

- The reduction of taxation for low-income households has been made permanent. This will cost about EUR 10bn on a yearly basis, and is essential to maximize the impact on consumption, reducing the risk that the tax benefit will end up boosting household savings.
- The exclusion of labor cost from the tax base of IRAP was a major reform requested by all companies, regardless of their size. The benefit is estimated at 6.5bn a year and is intended to reduce the (high) tax wedge that undermines the competitiveness of Italian firms.
- Firms that will hire people under the “single contract” scheme envisaged by the Jobs Act – i.e. on a permanent basis without the protection of Article 18 for dismissal for economic reasons – will not pay social security contributions for three years.
- The government put on the table EUR 1.5bn for the new, more inclusive, system of

unemployment benefits envisaged by the Jobs Act.

A second mitigating circumstance would be given by the safety margin granted relative to the 3% threshold. This margin is practically minimal in the Italian case since the programmed deficit for 2015 is forecast at 2.9% of GDP. In fact elements of uncertainty cannot be overlooked:

- Details on spending cuts are still missing.
- The government has penciled in almost EUR 4bn of extra revenues from the fight to tax evasion, although the effective collection of these resources tends to be highly uncertain.

*Will eventually the problem come from the public debt, rather than the deficit?*

The Italian government has clearly stated that it does not consider advisable nor effectively realizable the adjustment of public debt as requested by the transition period before the application of the six-pack enters in force. The transition period requests that Italy cuts public debt by 1% in 2014 and 2.2% in 2015. According to the government this fiscal intervention would be self-defeating decreasing the denominator (GDP) and ultimately increasing the debt/GDP ratio. This assessment is evidently based on an estimate of fiscal multipliers which is affected by the structural condition of the economic systems in the euro area.

The significant deviation from the debt rule should imply a report by the EU Commission that could open the way to a new Excessive Deficit Procedure motivated by the level of the debt. Some mitigating factors should however be contemplated here, in particular in reference to the increase of public debt caused by the one-off payment of commercial debts accumulated in the past by the public administration. Nevertheless, the dispute will take place starting from the first months of next year.

### *Conclusions*

The Brussels compromise on October 23 might sound hollow at first. The decision to allow the Italian adjustment to remain exactly midway between the rule and the request might have given the impression that it was the result of the usual low-key bargain or of a tug-of-war in Brussels' style. In fact it was a rationale application of the existing rules. In this sense it responds more to the need of credibility of the European rules than to the Italian needs for an exceptional fiscal stimulus in the deepest recession that the country has experienced in the last 70 years. A structural fiscal adjustment of 0.3% still represent a significant fiscal effort which pays respect to the credibility of the fiscal framework as it is taking place after the relevant innovations of 2012 in the European economic governance.

The doubts concern mainly next year, when the macroeconomic scenario might end being once more disappointing relative to the expected one. The effect of structural reforms may fall short of what is envisaged by the government; the same applies to the spending cuts and to the response of households in terms of increased consumption.

Italy has no margin to absorb in its budget any disappointing news coming from the economy next year. Consequently, it will be monitored closely by the European institutions. A risk of falling again into an excessive deficit procedure should be contemplated by the authorities.