# Italy is stretching budget flexibility to the limit, raising a number of issues over EU fiscal rules



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*Italy is currently asking Brussels for more flexibility over its new budget for structural reforms, investments and to help manage the refugee crisis.* **Lorenzo Codogno** *writes that this makes the Italian budget expansionary and, perhaps, also pro-cyclical. Moreover, it raises a number of issues on the proper interpretation of EU fiscal rules, the rules themselves, and the most appropriate fiscal stance given the state of the Italian and EU economy.*

On 18 September, the Italian government presented an update to Italy's Economic and Financial Document, which outlines new macroeconomic projections and sets targets for the country's budget. By 15 October, it will unveil the Stability Law (i.e. the budget).

The key feature of the new budget targets is the flexibility asked of Brussels with respect to EU fiscal rules, worth more than 1.0pp of GDP. 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 stance pro-cyclical, even if flexibility is earmarked for reforms and investments. Finally, it raises some fundamental issues on EU fiscal rules.

**Stretching to the limit**

The Italian 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 the 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.

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 are due to flexibility for structural reforms already granted (via a Council Decision on 14 July). The rest is an additional margin that Italy is asking for from 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 is also asking 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 factor, it would make the total amount of budget flexibility almost 18bn euros, i.e. almost 1.1pp of GDP.

The deficit-to-GDP ratio for 2016 is therefore revised to 2.2 per cent (it was 1.8 per cent back in April, when 0.4pp flexibility was already included), and would rise to 2.4 per cent 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 looks like the overall budget will be about 26-27bn euros. We know that it will have to finance reduced taxation. About 3.5-4.0bn will be needed to abolish the TASI tax on primary residencies.


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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 rulings. 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 the 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 have said many times that this will have to be implemented 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 euros. 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 per cent in 2016 and 0.6 per cent 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 is 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, and subsidies for newspapers (among other benefits). These are all very touchy political issues and it is not clear whether the government will dare to cut tax expenditures substantially.

Financing needs in the budget sum up to about 26-27bn euros and it will not be easy 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 not 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 well defined whether the overall 0.5 per cent 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 per cent 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 may well become true this time for Italy. As a result, such a tricky subject calls for immediate clarification in Brussels.

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 that 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".

The issue here challenges the fundamentals of EU rules, mostly based on cyclical-adjusted, i.e. structural aggregates. The methodology to estimate potential growth, and thus the output gap, developed by the European Commission with contributions from Member States, may tend to underestimate potential and thus the output gap. Although based on a production function approach, estimates based on this methodology almost inevitably turn out behaving like a moving average. After such a prolonged and deep recession, the methodology gives very low values for potential growth.

Estimates are sensitive to the parameters chosen in assessing structural unemployment (NAWRU) and total factor productivity (TFP). Given that the recent economic crisis has nothing to do with normal recessions, fine-tuning these parameters is more of an art than a science. Taking the view that potential growth is significantly below that estimated before the crisis would reconcile with anecdotal evidence suggesting that a number of businesses have gone under and that activity will likely not show up again within national borders.

On the other hand, it would also contrast with the evidence of plenty of slack in the economy, from low capacity utilisation to still very high unemployment, which may argue in favour of the possibility of regaining at least part of the growth lost. It would also be consistent with increasing effectiveness of structural reforms.

Estimating potential growth and the output gap is therefore key to design the proper fiscal stance. However, given the uncertainty over current estimates, it would probably make sense to take a risk management approach. What would be the possible consequences of a tighter-than-necessary fiscal stance? What are the consequences of a too loose fiscal stance, especially if the country has a very high debt-to-GDP ratio? Therefore, assessing the trade-offs is equally important, even beyond what fiscal rules tell us, and the answer is not straightforward.

**Is Italy's mix of spending cuts and tax cuts appropriate?**

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 for Italy's budget are of substance. 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.

The spending cuts for 2016 have declined from 16bn euros 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 per cent year-on-year in real terms, according to the government's estimates, while it had shown a fall of 1.6 per cent in 2014 and 2.1 per cent in 2013.

In 2016, the government expects current expenditure (the overall figure) to grow by 1.4 per cent in nominal terms, i.e. 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, reducing 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 per cent in 2015, 0.1 per cent in 2016 and then rises to 0.6 per cent in 2019, then GDP growth in 2016 would be projected well above trend (1.6 per cent versus 0.1 per cent potential, with the output gap narrowing from -4.0 per cent to -2.5 per cent). 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 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 means 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 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 mid-October 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 and a more prudent approach would be more appropriate. Finally, a number of issues about EU fiscal rules and the overall fiscal stance are raised here. They deserve careful analytical examination in the near future.

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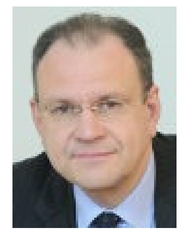
**About the author**

**Lorenzo Codogno** – *LSE, European Institute*

Lorenzo Codogno is Visiting Professor in Practice at the LSE's European Institute. Prior to joining LSE, Lorenzo Codogno was chief economist and director general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). He joined the Ministry from Bank of America where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that we worked at the research department of Unicredit in Milan. He was member of the Board of Directors of ENEL, the EU's second largest power company (June 2006-May 2014) and member of the Board of Directors of MTS (now part of the London Stock Exchange, 1999-2003).

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