Italy: EU Commission sets framework for excessive deficit procedure

As expected, the revised draft of Italy's 2019 budget and its macroeconomic assumptions were severely criticised in the Commission's Opinion. More important was the negative reassessment of the debt criterion benchmark in 2017, which speeds up the time frame for an excessive deficit procedure (EDP)

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Negative opinion confirmed, both on macro assumptions and part of the measures

The publication by the EU Commission of its opinion on Italy's compliance with the preventive arm of the Stability and Growth Pact (SGP) based on the revised 2019 draft budgetary plan provides no surprise. Italy's re-drafted budget for 2019 has had a negative evaluation, which extends from macroeconomic assumptions to planned budgetary measures.

The Commission evaluation deems the changes in the redrafted version as very limited, mainly consisting of a higher privatization target for 2019. The macroeconomic assumptions of the revised draft are evaluated as optimistic: the growth impact of the measures included in the draft is seen as mild both on the consumption and on the investment fronts and projected inflation is thought to be overestimated.

Concerns for lack of structural adjustment...

According to the Commission, the planned deterioration in the 2019 deficit is largely determined by the measures budgeted and the projected adjustment foreseen for 2020 is seen at risk. This is mainly due to the impact of higher VAT rates legislated as a safeguard clause, which so far has never been activated. The 0.8% structural budget deterioration for 2019 and lack of subsequent structural adjustments are seen as optimistic when compared with the Commission's own forecasts.

...and for backtracking on past reforms

Interestingly, the Commission highlights that some of the measures foreseen by the draft budget represent a risk of backtracking on reforms adopted in the past by Italy to comply with country-specific recommendations. This is the case for the pension counter-reform, which could negatively impact labour supply, for the introduction of a tax amnesty which could discourage tax compliance and for measures increasing taxation on banks, which, compounded with the impact of higher sovereign yields could hinder the supply of credit. The opinion also mentions the lack of progress on productivity-enhancing reforms.

Debt rule re-assessment even more important, as it paves the way for an EDP against Italy

Crucially, together with the opinion on the budget, the Commission published a report on the Italian public debt ex-article 126/3 of the Treaty on the functioning of the EU. This was due to the Commission's need to reassess Italy's compliance with the debt criterion benchmark in 2017 (which had been passed in May 2018), taking into account the material change in the relevant factors represented by the 2019 Draft Budgetary Plan. The new assessment deems Italy as currently complying with the deficit criterion (but highlights the risk of a breach in 2020 under a no-policy assumption) but not complying with the debt rule, even allowing for so-called "relevant factors". Macroeconomic conditions are no longer deemed to be a mitigating factor in explaining Italy's gaps to compliance with the forward-looking debt reduction benchmark, nor is the composition of the revised draft, which, backtracking on past structural reforms, does not seem conducive to raising potential growth. Finally, declining public investments cannot represent a mitigating factor, according to the Commission. The report concludes that "the debt criterion ...should be considered as not complied with, and that a debt-based Excessive Deficit Procedure is thus warranted".

By pointing straight to an EDP solution, ie, to the corrective arm of the SGP, the Commission apparently thought that the diluted timing of a Significant Deviation Procedure (within the preventive arm of the SGP) based on Italy breaching the expenditure and the structural adjustment would be incompatible with the need to send a prompt signal on fiscal governance rules before the elections for the European Parliament in May 2019.

EDP unlikely to start before January 2019

It seems now very likely that the EU Commission will start the EDP process. Within two weeks the

Economic and Financial Committee will have to formulate an opinion on the debt report, after which the Commission will be in the position to address an opinion and a recommendation to the Council. Then the Council will have up to three months to decide whether an excessive deficit (or debt, in this unprecedented case) exists. If so, recommendations for corrective measures to be taken will also be disclosed, with a deadline attached. We do not expect the Council to decide before January 2019, thus leaving room for the Italian government to make amendments to the draft in the parliamentary passage of the draft, which will have to be passed by both branches of the Italian Parliament before 31 December.

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