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Italy-European Union Budget Standoff: A Review

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Italy's proposed budget plans have drawn the ire of the European Union (EU), with the Commission rejecting a member state's proposal for the first time in its history. With EU finance ministries giving the Commission the go-ahead to prepare disciplinary action against Italy for breaching the bloc's fiscal rules, the move has put Italian government on a collision course with the EU. A confrontation between Italy and EU could further destabilize the Italian economy - one of the EU's largest, and potentially push Europe towards a financial crisis. This paper aims to review the proposed Italian budget and how it contravenes EU's fiscal policy. The paper would also look at complexities regarding the budget and the future course of action by the Commission to secure the health of the Eurozone.

What Italy Proposed

Italy has been witnessing recession since 2008 and has the highest a debt-to-GDP ratio of 131.8% in EU, next only to Greece. The Italian government in its proposed expansionary budget seeks to boost welfare spending, cut the retirement age and hike the deficit. One of the most important proposals is pension reform. The government promised to roll back the Fornero pension reform of 2011[1]. It foresees increase in spending by €8bn in 2019 which would allow over 400,000 people to retire once they have reached the age of 62 after contributing to the system for 38 years.[2] Also, the government earmarked €11bn to provide a 'citizen's income' to the unemployed and the poor. It is forecasted that almost six million people would be eligible for this benefit.

Funds have also been allocated to grant an amnesty for unpaid taxes to citizens deemed unable to pay. Further, the budget includes tax cuts for small businesses and self-employed workers. Overall, the government agreed on a budget deficit target of 2.4% of GDP and although

this is comfortably below the EU's 3% threshold, it contravenes its regulations that call on Italy to narrow its deficit steadily towards zero. The budget, the government claimed, would stimulate annual economic growth of 1.5%. It claims that the deficit would rise to 2.4% of GDP over the next two years; it will then decline to 1.8% by 2021.[3] Deputy Prime Minister Matteo Salvini justified the budget by saying that it would lower taxes by 15% for over one million Italian workers and free up around 400,000 jobs for the young by enabling people to retire earlier. Luigi di Maio said that "there is an accord within the whole government for 2.4%, we are satisfied, this is a budget for change".[4]

Reaction of the European Commission

The optimistic view of the Italian government was not shared by the European Commission. The situation was made more complicated by the growth forecast of around 1.0-1.1% according to the Bank of Italy, the International Monetary Fund, and the European Commission.[5] In a letter to the Italian government, Commission's Vice President Valdis Dombrovskis and European Affairs Commissioner Pierre Moscovici said that the 2019 budget was in "serious non-compliance" with EU law. Moscovici further informed the Italian government that its budget plans breached the Stability and Growth Pact.[6]

The Commission, in October 2018, took an unprecedented step of rejecting Italy's budget on following grounds: firstly, the budget proposal emphasized a planned fiscal deviation of an 'unprecedented nature' in the history of the Stability and Growth Pact; Secondly, the budget was not in compliance with Italian fiscal duties as requested in the country-specific recommendations[7] given by the Commission in July 2018; Thirdly, the stated objective in the budget of reduction of the public debt-to-GDP ratio is not credible; Lastly, the decision by the Italian government to raise the public sector deficit raises the question of sustainability of Italy's public debt that could produce negative spillovers on the rest of the eurozone and the Union.[8]

The Commission requested the Italian government to submit a revised draft budget proposal. Italy, in November 2018, re-submitted its draft budget to the European Commission with the same growth and deficit assumptions, stepping up its showdown with the EU over its fiscal policy. The only concession offered by Rome in the revised plan is to sell more state assets and to pay off debt faster. In the revised draft, Italy forecasts that its debt would rapidly fall to 129.2% in 2019, and 127.3% in 2020. The European Commission again rejected the slightly modified draft on the grounds that it violates EU rules.

What Next

EU fiscal rules require highly indebted governments such as Italy to cut their structural deficit and debt every year until government books are in balance or surplus in structural terms and public debt is below 60% of GDP. Italy has a debt of 131.8% of GDP and the euro zone finance ministers are worried that Italy could trigger a debt crisis like the 2008 Greek crisis and could eventually lead to the collapse of euro. The European Commission, in November 2018, took the decision of initiating disciplinary steps against Rome. The EU executive, after reviewing all 28 EU

member states' budgetary plans, said it retains its earlier concerns about Italy's populist-coalition government's plans to boost spending. The commission is said to be planning launch of an excessive-deficit procedure (EDP) - a disciplinary process that could lead to financial penalties, which was approved by the Eurozone finance ministers. They agreed with the Commission's assessment that Rome has failed to respect EU rules and "that a debt-based [excessive deficit procedure] is thus warranted."[9] The Commission may propose Italy's EDP as early as mid-December 2018 to demand "effective action" from Rome to bring its public finances back in line with the rules. Under this timeline, EU finance ministers would vote on the EDP proposal in late-January 2019 when they meet for Economic and Financial Affairs Council gathering. Rome could ultimately face a fine of up to 0.5% of economic output - or €9 billion - if it refuses to comply with the EDP.

The paradox of the problem is that Italy is too big to fail - economically and politically. The euro zone's bailout fund, the European Stability Mechanism, is not big enough to cope with an Italian financial crisis, at least not without help from the ECB. The ECB has been keeping interest rates low for years but successive governments in Rome have not used that leeway to enact necessary reforms.[10] This confrontation is not only the first test for the populist government of Italy, but also the first test of the EU's fiscal compact[11] which was agreed at the height of the euro-zone debt crisis. So far, the populist Italian government's first experiment in challenging Europe reached its conclusion with the most conventional outcome: an agreement with Brussels.

The government agreed to reduce its target budget deficit — from 2.4 to 2.04% of GDP, while lowering the economic growth outlook to 1% from 1.5%.[12] The deal is the result of days of intensive talks between Italy and the Commission, with Rome deciding to seek a negotiated solution. The budget now has to be approved by the lower house of parliament by 31 December 2018 so it can take effect from the start of 2019. Italy backed away from overt confrontation both as a way to avoid financial punishment and because markets were unnerved by the clash. Although, the solution provided is not ideal as it does not deliver a long-term solution to Italy's economic problems. As of now, the commission would monitor closely whether Italy voted through the changed budget draft, as agreed with the EU. If not, Brussels is ready to resume disciplinary steps against Rome, which could eventually mean financial punishment.

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Disclaimer: The views expressed are that of the Researcher and not of the Council.

Endnotes:

[1] Fornero pension reform of 2011 raised the state retirement age to 67 in an effort to secure Italy's public pension system.

[2]Carlo Svaluto Moreolo, Analysis: European Commission rejects Italian budget plan, IPE Real Assets, 25 October 2018, https://realassets.ipe.com/countries/italy/analysis-european-commission-rejects-italian-budget-plan/www.ipe.com/countries/italy/analysis-european-commission-rejects-italian-budget-plan/10027460.fullarticle, Accessed on 6 December 2018

[3] Ibid.

[4] Italy hikes deficit, defying EU, as economy minister caves in, *Reuters,* 27 September 2018, https://www.reuters.com/article/us-italy-budget/italy-economy-minister-buckles-to-party-chiefs-and-raises-deficit-goal-idUSKCN1M70W2, Accessed on 6 December 2018
[5]'Budget of change': Italy announces plans to end austerity and rack up public debt, *The Local Italy,* 28 September 2018, https://www.thelocal.it/20180928/italy-budget-of-change, Accessed on 7 December 2018
[6] Jan Hildebrand, 'Berlin and Brussels can't cope with Italy's budgetary blackmail', *Handelsblatt*, 23 October 2018,
https://www.handelsblatt.com/today/opinion/lose-lose-berlin-and-brussels-cant-cope-with-italys-budgetary-blackmail/23583696.html, Accessed on 7 December 2018
[7] Recommendations like - Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. [Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Italy and delivering a Council opinion on the 2018 Stability Programme of Italy (2018/C 320/11), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018H0910(11)&from=EN]

[8] **Stefano Micossi,** 'Commission rejection of Italian budget may be justified, but what comes next?', CEPS Commentaries, Centre for European Policy Studies, 25 October 2018,
https://www.ceps.eu/publications/commission-rejection-italian-budget-may-be-justified-what-comes-next, Accessed on 10 December 2018
[9] Paolo Pizzoli, Italy: EU Commission sets framework for excessive deficit procedure, *ING*, 21 November 2018,
https://think.ing.com/articles/italy-eu-commission-sets-framework-for-excessive-deficit-procedure/, Accessed on 10 December 2018
[10] Jan Hildebrand, 'Berlin and Brussels can't cope with Italy's budgetary blackmail', *Handelsblatt*, 23 October 2018,
https://www.handelsblatt.com/today/opinion/lose-lose-berlin-and-brussels-cant-cope-with-italys-budgetary-blackmail/23583696.html, Accessed on 10 December 2018
[11] The Fiscal Compact defines a balanced budget as a general budget deficit not exceeding 3.0% of the GDP, and a structural deficit not exceeding a country-specific Medium-Term budgetary Objective which at most can be set to 0.5% of GDP for states with a debt-to-GDP ratio exceeding 60% – or at most 1.0% of GDP for states with debt levels within the 60%-limit.

[12] Italy backs down in its budget standoff with the E.U., *The Washington Post*, 18 December 2018, https://www.washingtonpost.com/world/europe/italy-backs-down-in-its-budget-standoff-with-the-eu/2018/12/18/3cb996f4-f8af-11e8-8642-c9718a256cbd_story.html?utm_term=.639bd938588d, Accessed on 26December 2018