ITALY'S BUDGET AND THE EU'S EXCESSIVE DEFICIT PROCEDURE: WHAT'S GOING ON?

The European Commission and Italian government are currently engaged in a power struggle over Italy's draft budget for 2019. The Commission argues the budget is in breach of the 1997 Stability and Growth Pact and has called on Italy to make amendments. The Italian government is resisting and, as a result, risks the Commission commencing an Excessive Deficit Procedure.

This briefing outlines the requirement of Member States to submit their draft budgets to the European Commission, how failing to ensure alignment with EU fiscal policies can result in an Excessive Deficit Procedure and what the implications for Italy could be if such action is taken.

Key issues

- The European Commission has rejected Italy's draft budget for 2019.
- This risks the European Commission opening an Excessive Deficit Procedure ("EDP") against Italy.
- The EDP would see recommendations from the Council being addressed to Italy in a bid to remove the excessive deficit.
- Italy's failure to comply with such recommendations could see additional sanctions being imposed on it.
- The EDP is deliberately long and includes multiple phases to progressively increase the pressure on the Member State and to grant the Member State concerned several opportunities to bring its policies into line.

BACKGROUND: STABILITY AND GROWTH PACT

The Stability and Growth Pact ("SGP") was agreed in 1997, five years after the Maastricht Treaty which established the euro, and was seen as a necessary fiscal counterpart to the euro. It provides Member States, the European Commission and the Council with policy guidelines which strengthen the monitoring and coordination of national fiscal and economic policies[1], and places limits on government deficits of 3% of GDP and on public debt levels of 60%[2].

Regulation (EU) No 473/2013 (the "Regulation") was adopted for the purposes of monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. The Regulation requires that the budgets of EU Member States must be consistent with the economic policy guidance set out in the SGP.

One means of achieving the deficit and debt limits established by the Maastricht Treaty and thereby ensuring consistency with the SGP, is set out in Article 6(1) of the Regulation, which requires each Member State to publish its draft central government budget by 15 October each year. The Commission issues an opinion on whether the draft budget is in compliance with the SGP and under Article 7(2) of the Regulation, the Commission can, in exceptional

The reference values are:

- 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices;
- 60% for the ratio of government debt to gross domestic product at market prices.

(*Article 1 of the Protocol on the excessive deficit procedure, Treaty on European Union)*

[1] See: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=LEGISSUM:l25021&from=EN
[2] See: Article 104c(2) and Article 1 of the Protocol on the excessive deficit procedure https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11992M/TXT&from=EN

cases, request a revised draft budgetary plan where the Commission is concerned that there is "particularly serious noncompliance" with the budgetary policy obligations as set out in the SGP.

REJECTION OF ITALY'S 2019 BUDGET PROPOSAL

This is what has happened with Italy's draft budget for 2019. Italy submitted its draft budget on 16 October 2018. Correspondence between the European Commission and Italy followed, with the Commission raising concerns about the draft and Italy acknowledging in a letter to the EU on 22 October that the Italian Government's "chosen budget policy approach does not fulfil the rules of the Stability and Growth Pact".

On 23 October 2018, the Commission issued an opinion on Italy's draft budgetary plan, in which it stated that the plans deviated "from the recommended adjustment path towards the medium-term budgetary objective" and caused the Commission to identify "a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018"[3]. The Commission requested that Italy submit a revised draft budgetary plan within three weeks of the date of the opinion[4].

Italy published its revised budget on 13 November 2018. However, in the letter submitted to the Commission alongside the budget, the Italian Government stuck by its original proposals and did not reflect the recommendations of the Commission as outlined in their opinion[5].

RECOMMENDATION TO LAUNCH AN EXCESSIVE DEFICIT PROCEDURE

Italy's failure to do so has led the Commission to conclude that an Excessive Deficit Procedure ("EDP") against Italy is warranted. Indeed, in their revised opinion of 21 November 2018, the Commission confirmed the existence of a particularly serious case of non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018. The Commission also stated that it believed measures in the revised budget risked backtracking on reforms that Italy had previously adopted in line with past country-specific recommendations and the recommendations of 13 July 2018[6]. The Commission concluded: "Overall, the analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as not complied with, and that a debt-based EDP is thus warranted."[7]

The Commission's concerns with Italy's draft 2019 budget:

- A nominal rate of growth of net primary government expenditure of 2.7%, which exceeds the recommended maximum increase of 0.1%.
- The (recalculated) structural deterioration in 2019 amounts to 0.8% of GDP, which points to a significant deviation from the structural improvement of 0.6% of GDP in 2019 recommended by the Council on 13 July 2018.
- A fiscal expansion of close to 1% of GDP, while the Council has recommended a fiscal adjustment, and the size of the deviation (a gap of around 1.5% of GDP) are unprecedented in the history of the SGP.
- The plans would not ensure compliance with the debt reduction benchmark agreed by all Member States.
- The Parliamentary Budget Office (Italy's independent fiscal monitoring institution) did not endorse the macroeconomic forecast underlying the 2019 draft budgetary plan.

(*The Commission's letter to Italy, 18 October 2018)*

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[3] On 13 July 2018, the Council of the European Union adopted its 2018 recommendations and opinions to Member States on their economic, employment and fiscal policies. See: http://data.consilium.europa.eu/doc/document/ST-9440-2018-INIT/en/pdf for the recommendations made to Italy. These recommendations, as for all Member States, were also endorsed unanimously by the European Council of 28 June 2018.
[4] See: https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_opinion_it_en.pdf and https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_commission_letter_it_20181023_en.pdf
[5] See: https://ec.europa.eu/info/sites/info/files/economy-finance/draft_bp_2019.pdf and https://ec.europa.eu/info/sites/info/files/economy-finance/tria_letter_to_ec_13_nov_2018_en.pdf
[6] See: https://ec.europa.eu/info/sites/info/files/economy-finance/c-2018-8028-it_en_0.pdf
[7] See: http://europa.eu/rapid/press-release_IP-18-6462_en.htm?utm_source=POLITICO.EU&utm_campaign=c236d257d7-EMAIL_CAMPAIGN_2018_11_21_12_01&utm_medium=email&utm_term=0_10959edeb5-c236d257d7-190383825

The EDP is set out in Article 126 of the Treaty on the Functioning of the European Union[8]. It states that an EDP begins when a Member State has either:

- Breached or is in risk of breaching the deficit threshold of 3% of GDP; or
- Violated the debt rule by having a government debt level above 60% of GDP, which is not diminishing at a satisfactory pace.

Where the Commission considers that an excessive deficit in a Member State exists or may occur, this triggers a multiphase procedure. The reasons for the procedure including several phases are (i) to ensure the Member State concerned is given several opportunities to adjust its policies and (ii) pressure can be progressively increased on the Member State.

The Commission first addresses an opinion to the Member State concerned and informs the Council, who must decide whether an excessive deficit exists. In this scenario, the Council on a recommendation from the Commission, adopts recommendations addressed to the particular Member State in question with a view to "bringing an end to the situation within a given period" (Article 126(7) of the Treaty on the Functioning of the European Union ("TFEU")).

At this stage the recommendations are not made public, although failure to comply with the recommendations can see them publicised as well as the Council applying, or intensifying, a number of measures against the Member State (Article 126(8) TFEU).

If the failure to comply persists, increasingly significant measures can be adopted, including non-interest bearing deposits and / or fines. Article 126(12) makes clear that where, in the view of the Council, the excessive deficit in the Member State has been corrected, it shall abrogate some or all of its decisions or recommendations.

"As its public debt, which stood at 131.2% of GDP in 2017, exceeds the 60% of GDP reference value of the Treaty, Italy also needs to comply with the debt reduction benchmark, which requires an adequate reduction of the debt level towards the 60% of GDP reference value of the Treaty."

(*Commission Opinion on the revised Draft Budgetary Plan of Italy, 21 November 2018)*

INSTITUTIONAL TUSSLE

Back in 2003, the Commission recommended EDPs against France and Germany for violating the limits on government deficits of 3% of GDP for three years in a row. However, the Council (Member States represented by their respective finance ministers) failed to reach the qualified majority threshold, rejecting the Commission's proposal. The Commission went on to state that it deeply regretted that the Council had not "followed the spirit and the rules of the Treaty and the Stability and Growth Pact that were agreed unanimously by all Member States". It subsequently took the case to the European Court of Justice[9] and the Court's July 2004 ruling annulled the Council's conclusions.

EUROPEAN POLITICAL LANDSCAPE

Although EDPs are nothing new, this is the first time that the European Commission has rejected the draft budget of a Member State. If the EDP process is commenced against Italy, and the demands of the Commission to align their deficit and debt with EU standards are ignored, the potential fines

[8] See: https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E126

[9] Case C-27/04, Commission of the European Communities v Council of the European Union. See: http://curia.europa.eu/juris/showPdf.jsf?docid=64022&doclang=EN

on Italy would equate to billions of euros. However, such a decision would not be taken lightly. As the third largest euro zone economy, the Commission will be wary of any ripple effects the sanctions on Italy might have on its neighbouring countries, many of whom are only recently back in the realms of financial stability and there are also broader concerns about the wider market reaction.

The Brexit situation and concerns of stirring up anti-EU sentiments in Italy ahead of the elections for the European parliament in May 2019 will also be on the mind of the Commission. Italy currently has a coalition government, made up of the anti-establishment Five Star Movement and the right-wing League party. Both parties have taken very critical positions on the EU in the past and have disagreed with other "core" Member States on some key issues such as the management of migratory flows and sanctions on Russia. However, since joining the government, both parties have been careful to tone down their fiercest anti-EU rhetoric and government representatives regularly state in the domestic and international media that neither an Italian exit from the EU nor the abandonment of the euro is remotely being considered and underline their commitment to the European project and desire to reform the EU from within. Furthermore, both government parties have commented in an increasingly conciliatory fashion on the budget dispute with the Commission over the last fortnight and leading politicians of the League may very well be keen to find a compromise with the Commission in order to calm the volatile market sentiment with respect to Italian government bonds.

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