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France, Italy and the Fiscal Rules

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It is crunch time for the EU's fiscal procedures. October 15, the deadline for the submission of budget plans to the European Commission, is fast approaching. It will be followed, in the course of November, by the assessment of these plans by the new Commission. The dreaded outcome is that of an out-and-out rejection, with a "return to sender" for redrafting. There is a pervasive sentiment that this will be the fate of France, given its avowed violation of the Stability Pact's parameters.

France's brash approach has raised fears that contagion may cross the Alps into Italy. Specifically, the concern is that the opportunity might be seized to castigate both countries' misconduct. Fortunately, EU procedures – for all their faults – do not unfold in this manner. The assessment of whether the fiscal rules are formally observed is carried out by aptly named technocrats. As such, they comb through the complex set of requirements with an essentially legal and technical approach. No doubt, technocrats also internalize the prevailing political constraints, but the specificity of the rules limits their degree of discretion. The political discretion of the Council is in turn contained by the provisions of the "six pack." To avoid episodes such as the notorious Franco-German non-compliance of 2003, the Commission's recommendations are considered approved unless there is a contrary Council decision on a qualified majority vote - a cumbersome and thus unlikely procedure.

This procedural framework provides some safeguards for Italy and sets it clearly apart from France. First and foremost, the two countries are in diametrically opposite situations under the Stability and Growth Pact: France is in the so-called "corrective arm," i.e., subject to an infringement procedure for having long posted a fiscal deficit in excess of the 3% of GDP limit. Italy, in contrast, observes this limit and, while critical of its rationale, declares it intends to continue to do so. It is therefore in the Pact's "preventive arm" - along with all countries seen to be virtuous. This distinction is critical when it comes to applying the margins of flexibility under the Pact's current rules.

In addition, Italy - unlike France - can rightfully claim to be going through "exceptional circumstances." When such circumstances prevail, a country is permitted to breach the 3% limit temporarily, without triggering the Pact's corrective procedures. Exceptional circumstances are defined as "an unusual event outside the control of the member state concerned" or as "periods of severe economic downturn," due to "a negative annual GDP volume growth or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to potential." Italy has, alas, recorded negative growth in 11 of the last 12 quarters, i.e., almost uninterruptedly for three years. Its output gap with respect to potential is estimated by the IMF at 4.3 percentage points. If these are not exceptional circumstances, one wonders what ever will be. France, to its relative good fortune, cannot claim the same justification for the weakness of its public accounts, with GDP expanding every year since 2009.

There is in addition the vexed issue of structural reforms, whose implementation can bring into play another flexibility clause under the Pact. The adoption of pro-growth reforms, and their upfront budgetary costs, are among the factors to be taken into account in the assessment of a country's public finances. In the preventive arm, the "structural reform" clause allows a temporary deviation from a country's proscribed adjustment path toward the medium-term objective (MTO) of structural balance. It is precisely on progress toward the MTO that Italy could be caught out, having announced a slower adjustment pace than the requisite 0.5% per year, thus postponing achievement of structural balance to 2017. But such a deviation would be allowed with the entry into force – rapidly and effectively - of major structural reforms. There furthermore is the specific critique made by Italy's Minister Pier Carlo Padoan on the EU's methodology for calculating potential output, and thus the structural balance, which underestimates Italy's effort. It may be noted in this regard that the IMF puts Italy's structural deficit in 2015 at 0.5% of GDP - clearly not far from the medium-term objective (the corresponding figure for France is a deficit of 2.8 % of GDP).

Clearly, then, Italy is not France, and there are no grounds for similar treatment under the fiscal rules. On the contrary, with a timely implementation of reforms and a rational application of the rules, Italy would be entitled to deviate temporarily from some of the SGP parameters without being subject to corrective procedures. It would do so with full justification (the exceptional circumstances) and for good reasons (the enactment of structural reforms). The Renzi government must place itself in a position from which it can make this case forcefully and unassailably. If it did so, the markets would understand and, hopefully, Europe as well.