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Behind the Brussels-Rome Dispute

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The budget showdown between Rome and Brussels came to a head Tuesday. The new Italian government, formed from insurgent political parties, had proposed a deficit equal to 2.4% of gross domestic product next year. The European Commission said that's too high and gave Italy three weeks to submit a new budget. Yet a 2.4% deficit is still well under the 3% ceiling set by the Maastricht Treaty. Why is Brussels imposing a much tighter limit?

Because European bureaucrats have changed the way they measure member states' budgets. The new formula is deeply misleading.

The sovereign debt crises that started in early 2010 prompted Brussels to revisit the Maastricht criteria, on the theory that a crude deficit cap of 3% and a debt limit of 60% might leave too much wiggle room during booms and too little during downturns. The commission instead considered the "structural budget balance," excluding one-off items such as natural-disaster response and the so-called cyclical component of the public budget—meaning both the tendency of social spending to increase in economic downturns and of revenues to rise in booms.

Brussels could then set country-specific targets and impose a plan to meet them. For Italy, the commission demands a reduction in the structural part of the deficit equal to 0.6% of GDP. The Italian government's provides for an *increase* in the structural deficit equal to 0.8% of GDP. That gap is the source of the current controversy.

What the commission won't admit is that this entire method rests on guesswork. To calculate a "structural" deficit, one needs to determine how much of the deficit arises from cyclical factors. To figure out where a country is in the economic cycle, one needs to estimate an output gap—the difference between current GDP and potential GDP at full employment, full capital utilization and no inflationary pressures.

The estimate of this output gap is the source of divergence between Rome and Brussels, and Brussels' estimates make little sense. The commission's spring forecast predicts a positive output gap of 0.5% for 2019, meaning Brussels believes Italy will achieve economic output 0.5% *higher* than a full-employment, full-utilization level next year. That's optimistic, to put it mildly. Brussels believes Italy will perform above potential, even as the unemployment rate has been in double digits for years. The commission's estimate for a positive Italian output gap is nearly the same as its estimate of Germany's positive output gap next year (0.6%), while Germany has experienced annual economic growth around 2% recently and has unemployment below 4%.

The flaw lies in the commission's method for estimating key variables in calculations for the output gap, such as productivity and above all the nonaccelerating wage rate of unemployment, or NAWRU. Brussels is almost certainly taking too dim a view of economic potential when it estimates the NAWRU. The 2018 estimate for Italy's NAWRU is 9.9%, which is less than 1 percentage point below then actual unemployment rate—and suggests that Italy could never hope to reduce its unemployment rate below that high level without significant inflation.

Rome uses different estimates to calculate its output gap in line with unique characteristics of the Italian labor market. Although it hasn't publicly disclosed its NAWRU estimate, it's probably around 8.5%. Brussels has admitted in the past that Italy's own estimates of its output gap might be more accurate, which would argue for giving Rome more fiscal flexibility under the commission's own budget rules.

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How can the EU reject a budget well within the Maastricht Treaty's limits?