Il Ministro
dell'Economia e delle Finanze

PROT. 2878

Rome, 23 October 2019

Dear Vice President, Dear Commissioner,

Valdis Pierre

I am writing in response to your letter dated 22 October 2019, in which you sought clarifications concerning the 2020 Draft Budgetary Plan (DBP) submitted by the Italian Government.

With respect to the fiscal policy targets announced in the DBP, in 2020 we aim to achieve a budget balance of -2.2 percent of GDP, unchanged from this year's updated estimate. While the 2019 outturn implies a 0.3 percentage point improvement in the structural balance, next year may see a slight deterioration in the structural balance (0.1 percentage points). The DBP then foresees a subsequent reduction in the deficit to 1.8 percent of GDP in 2021 and 1.4 percent in 2022, which would entail structural improvements of 0.2 percentage points per annum, marking a clear convergence towards Italy's Medium Term Objective.

While we dutifully take note of the Council recommendation concerning the structural adjustment and net primary expenditure growth, our estimates (which are based on the commonly agreed methodology) indicate that the output gap in 2020 will be wider than -1.5 percentage points and, as such, the Italian economy will be in 'bad times.' In such circumstances, the required structural adjustment for a high-debt country is 0.5 percentage points.

Furthermore, in the DBP the Government has applied for a margin of flexibility for unusual events worth approximately 0.2 percentage points of GDP in 2020. This request follows up on the one presented at the end of last year with reference to hydrogeological and seismic-risk mitigation, infrastructure repair and upgrade. The additional fiscal space requested for 2020 would allow us to focus new projects on hydrogeological risk mitigation and related infrastructure and to involve the private sector via tax incentives. With this additional flexibility in the count, the projected change in the structural balance in 2020 would not constitute a significant deviation.

I would also reiterate the familiar point that although fiscal rules are supposed to adjust for cyclical factors, the estimation of output gaps for countries that experienced sharp double-dip recessions suffers from widely recognised empirical issues. To the extent that the output gap is under-estimated, we may be consistently prescribing overly restrictive fiscal policies.

As concerns the euro area more broadly, employment and output levels remain high, but we face clear cyclical risks and major challenges from international trade relations, geopolitical developments and climate change. Earlier this month, the Eurogroup agreed that in the current conjuncture, the euro area should shun pro-cyclical fiscal policies; if downside risks materialise, the overall fiscal stance should become more accommodative. Our Government agrees with this vision. While mindful of the need to put Italy's debt-to-GDP ratio on a clear downward path, we believe that the key goal is to rekindle economic growth and begin transitioning towards an environmentally sustainable and inclusive growth model. These fundamental considerations underlie our choice of a broadly neutral fiscal stance in 2020 and a gradual improvement in the structural budget balance in the two following years.

The 2020 Budget that we are about to deliver to Parliament will repeal the VAT hike that was due to go into effect next January and refinance the new social policies that were recently introduced. Having successfully rolled out a major income-support scheme, the Government will focus on the implementation of related active labour market policies.

The '100 level' early-retirement option will remain in effect until 2021, as originally planned. Even though this policy entails budgetary costs, it does not alter the key pillars of our pension system, such as a high statutory retirement age and a gradual transition to contributions-based benefits. We believe that frequent changes in early-retirement rules would be damaging and we note that so far the number of applications for the '100 level' retirement option is significantly below the original projections.

The sharp reduction in the poverty rate and the labour market activation engendered by the universal income scheme will lead to significant improvements in Italy's social scoreboard and respond to longstanding Council recommendations.

With the 2020 Budget, Italy will expand support measures in favour of families with children and increase investment on childcare facilities. Furthermore, we have earmarked almost 0.3 percent of GDP for a cut in the tax wedge on labour benefiting in particular the middle class. The cut will go into effect in mid-2020 and will mark a first step towards a comprehensive tax reform. We wish to make Italy's tax system fairer, more efficient and transparent while ensuring a high degree of consistency with ongoing reform processes at the international level, such as the OECD initiative on corporate income tax and the digital economy.

Inclusivity and fair competition also require a balanced distribution of the tax burden. The Budget and the accompanying law decree will include measures to improve tax compliance and combat fraud that will raise tax revenues by approximately 0.2 percent of GDP in each of the next three years. The new measures will complement policies already enacted in recent years with the aim of reducing the tax gap, such as the split payment and reverse charge for VAT and the introduction of mandatory digital invoicing. In January, the requirement of digital transmission of invoices to the Revenue Agency will apply to all non-exempt retailers.

We will promote an increased use of digital payments. The share of cash payments in Italy, though declining, is still higher than in other European countries. The Government will roll out a series of incentives and an education campaign to promote the use of digital means of payment while at the same time working with the relevant industry associations on reducing the cost of POS terminals for retailers and other service providers.

Turning to environmental problems, Italy wishes to be at the forefront of Europe's Green New Deal by starting the transition to a sustainable, inclusive and circular economy. The 2020 Budget includes measures such as a new tax on non-reusable plastic containers and packaging and cuts in environmentally harmful subsidies. Existing incentives on efficiency-enhancing housing renovations will be refinanced and selectively increased.

In addition, we are raising public investment, including by setting up two sustainable investment funds for the central and local governments worth a combined 55 billion euros over fifteen years. The Industry 4.0 program will be refinanced, focusing on environmental sustainability, research and training.

As was illustrated in the recent Update of the Stability and National Reform Programs, and consistent with this year's Council recommendations, the Government plans to undertake structural reforms in key areas such as justice and public sector services. Furthermore, additional financial and human resources will be devoted to education and health care, with the aim to improve the wellbeing of the population while making the economy more productive and attractive for investors.

Having outlined the philosophy and the key goals of the economic strategy of the new Government, let me now add some details concerning the 2020 Budget. Based on updated projections, once next January's VAT hike is repealed the 2020 deficit would reach 2.5 percent of GDP. The refinancing of ongoing policies (e.g. humanitarian missions and various investment funds) adds a further 0.1 percentage point of GDP, while the

continuation of non-recurrent policies such as Industry 4.0 and the cut in the tax wedge on labour will cost a combined 0.3 percent of GDP.

Our starting point is thus a deficit of 2.9 percent of GDP, which will be lowered to slightly less than 2.2 percent of GDP via a financing package worth more than 0.7 percent of GDP. As I mentioned above, new measures to combat tax evasion and fraud will contribute 0.16 percent of GDP in terms of additional revenues. These measures are based on detailed proposals put forth by the Revenue Agency and the Customs and Monopolies Agency. Each measure is accompanied by accurate estimates of the impact on tax revenues based on a highly conservative approach. In order to avoid a lengthy description, I am attaching a technical report drafted by our Finance Department. In addition, the Budget provides for increases in tax revenues from gaming worth 0.04 percent of GDP.

Changes in tax incentives and environmentally harmful subsidies and increases in environmental levies will yield savings in excess of 0.1 percent of GDP. In addition, various tax changes will contribute close to 0.3 percent of GDP. As reported in the DBP, these include a revision of the rules for payments on account by taxpayers subject to the new compliance indicators; changes in the substitute tax on the revaluation of land assets and nontraded shares; a revision of the deductibility rules for deferred tax assets.

Away from the revenue side, a Spending Review by line ministries and other expenditure reductions will improve the budget balance by well in excess of 0.1 percent of GDP. Among the other reductions, we will implement a temporary expenditure freeze equal to the difference between the prudent estimates for the '100 Level' in the baseline 2020-2022 projections and the ones that can be extrapolated from applications received thus far. The corresponding funds will only be released if the mid-year budget review does point to an under-spend in each of the next three years.

In closing, I wish to emphasise that all the estimates contained in the DBP are quite prudent and that we have not pencilled in any impact on tax revenues that may accrue from the promotion of cashless transactions. Our aim is to outperform DBP estimates both in terms

of primary expenditure control and of tax compliance. We are also confident that our fiscal consolidation and structural reform efforts will lead to a further decline in the sovereign spread, yielding budgetary savings on interest expenditure and an additional improvement in the structural balance.

I remain at your disposal should you wish to receive additional information.

Yours sincerely,

Roberto Gualtieri
Economy and Finance Minister

Valdis Dombrovskis
Vice-President of the European Commission

Pierre Moscovici
Member of the European Commission