Strasbourg, 23.10.2018
C(2018) 7510 final

COMMISSION OPINION

of 23.10.2018

on the Draft Budgetary Plan of Italy and requesting Italy to submit a revised Draft Budgetary Plan

EN EN

COMMISSION OPINION

of 23.10.2018

on the Draft Budgetary Plan of Italy and requesting Italy to submit a revised Draft Budgetary Plan

GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area to ensure that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact and the European Semester for economic policy coordination.

2. Article 6(1) of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a draft budgetary plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year. Article 7(2) provides that, where, in exceptional cases, the Commission identifies particularly serious non-compliance with the budgetary policy obligations laid down in the Stability and Growth Pact, the Commission shall request a revised draft budgetary plan.

CONSIDERATIONS CONCERNING ITALY

3. Italy submitted its draft budgetary plan for 2019 ('the 2019 draft budgetary plan') on 16 October 2018.

4. By letter of 18 October 2018, the Commission consulted Italy, asking for further information. The reply by Italy of 22 October 2018 acknowledged that "the chosen budget policy approach does not fulfill the rules of the Stability and Growth Pact". Italy indicated that the government had opted for an expansionary fiscal policy in 2019 so as to support the ongoing economic recovery, doing so in particular through public investment. In that context, Italy also underlined the growth-enhancing structural reform agenda that accompanies the fiscal strategy in the 2019 draft budgetary plan. Italy also indicated that the government's decision not to amend the macroeconomic projections underlying the 2019 draft budgetary plan following the decision by the Parliamentary Budget Office not to endorse them is in line with national legislation. Finally, Italy committed not to further increase its structural deficit after 2019 and to resume the adjustment path towards the medium-term budgetary objective as of 2022, with the possibility to introduce further measures if the projected fiscal targets were not respected. Those observations have been taken into account in the present opinion.

5. Italy is currently subject to the preventive arm of the Stability and Growth Pact. On 13 July 2018, the Council recommended that Italy should 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.[1] That recommendation had been endorsed by the European Council of 28 June 2018. As its public debt, which stood at 131.2% of GDP in 2017, exceeds the 60% of GDP

[1] 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, OJ C 320, 10.09.2018, p. 48.

reference value of the Treaty, Italy also needs to comply with the debt reduction benchmark, which requires a steady reduction of the debt level towards the 60% of GDP reference value of the Treaty.

6. Italy has been so far the main beneficiary of the flexibility applied within the Stability and Growth Pact, for an amount in the order of EUR 30 billion (or 1.8% of GDP), on account of a variety of factors, including bad economic conditions, support for structural reforms and investment, and "unusual events" related to security threats, the refugee crisis and earthquakes. Italy is also the second-largest recipient under the "Juncker Plan", the Investment Plan for Europe which started at the end of 2014. In that context, the total funding in Italy has reached EUR 8.9 billion, which is expected to generate EUR 50.1 billion of new investments. Moreover, Italy is the second-largest beneficiary of the European Structural and Investment Funds, with EUR 44.7 billion of Union support over 2014-2020, which represents an average of EUR 735 per person from the Union budget.

7. The macroeconomic scenario underlying the 2019 draft budgetary plan assumes real GDP growth picking up to 1.5% in 2019 and to 1.6% in 2020, before decelerating to 1.4% in 2021. Investments are projected to expand by 3.7%, while private consumption is set to increase more in line with GDP growth. Exports are set to rebound markedly in 2019 and to further accelerate in 2020 and 2021. Despite the projected decline in the dynamics of unit labour cost, GDP deflator growth is set to pick up to 1.6% in 2019, entailing a marked increase in firms' mark ups. As a result, nominal GDP growth is also assumed to markedly rise to 3.1% in 2019 and 3.5% in 2020, before slightly moderating to 3.1% in 2021. The projected improvement in the macroeconomic outlook is instrumental to the attainment of the government's fiscal targets.

8. Italy does not comply with the requirement established by Article 4(4) of Regulation (EU) No 473/2013, as the macroeconomic forecasts underlying the 2019 draft budgetary plan have not been endorsed by an independent body. The Parliamentary Budget Office, Italy's independent fiscal monitoring institution, did not validate the macroeconomic projections underlying Italy's policy scenario for 2019, "as they lie outside the range of acceptable values on the basis of the information currently available"[2] and are therefore subject to significant downside risks. Italy refers in its letter of 22 October 2018 to the Commission's report of 22 February 2017[3] as not challenging the correctness of the procedure under national law by which in the absence of validation of forecasts by the Parliamentary Budget Office the government can explain to Parliament why it maintains those forecasts. However, that report was drawn up pursuant to Article 8(1) of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, under which Italy and the other Contracting Parties to that treaty gave the Commission a precise and limited mandate to examine if the provisions adopted by them complied with its Article 3(2). As a result, the Commission report of 22 February 2017 could not have covered the compliance with Union law of that national law procedure.

9. Italy's general government deficit reached 2.4% of GDP in 2017. For 2018, the 2019 draft budgetary plan projects a general government deficit at 1.8% of GDP, which is above the target of 1.6% that Italy had planned in the Stability Programme of April 2018. The discrepancy is largely due to lower-than-expected GDP growth and larger-

[2] Letter of 13 October 2018 from Giuseppe Pisauro, President of Italy's "Ufficio Parlamentare di Bilancio".

[3] C(2017) 1201 final.

than-expected interest expenditure following the increase in sovereign yields registered on the back of heightened market volatility since May 2018. The 2019 draft budgetary plan expects the government deficit to markedly increase to 2.4% of GDP in 2019, i.e. significantly above the Stability Programme target of 0.8% of GDP. The difference results from budgetary measures envisaged in the 2019 draft budgetary plan, with a net deficit-increasing impact of around 1.2% of GDP in the government projections. The headline deficit is projected by the 2019 draft budgetary plan to be at 2.1% of GDP in 2020 and at 1.8% of GDP in 2021. In addition to its sensitivity to the optimistic projections for nominal GDP growth, the achievement of those budgetary targets crucially depend on the activation of a "safeguard clause" that would take the form of an increase in VAT rates planned for 2020 (around 0.7% of GDP) and 2021 (around 0.8% of GDP).

10. On 11 July 2017, the Council recommended that Italy should ensure a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP.[4] The Commission Communication on the 2017 European Semester[5] stated that the Commission would stand ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment could be particularly significant. Overall, in order to balance Italy's stabilisation needs and sustainability challenges, the Commission considered that a fiscal structural effort of at least 0.3% of GDP would be adequate in 2018, without any additional margin of deviation over one year. That corresponded to a nominal rate of growth of net primary expenditure not exceeding 0.5%. Based on the 2019 draft budgetary plan, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will clearly exceed that recommended by the Council. The same conclusion can be reached on the basis of the structural balance. The planned improvement in the structural balance for 2018 amounts to 0.1% of GDP, which departs from the adequate structural adjustment of 0.3% of GDP.

11. Based on the 2019 draft budgetary plan, the expenditure benchmark points to a risk of a significant deviation both in 2019 (gap of 1.1% of GDP) and over 2018 and 2019 taken together (gap of 0.9% of GDP per year, on average, taking into account the adjustment recommended by the Council in both years), because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will clearly exceed that recommended by the Council. The same conclusion can be reached on the basis of the structural balance pillar. Italy plans a deterioration in the structural balance[6] for 2019 that amounts to 0.8% of GDP, while the Council recommended a structural improvement of 0.6% of GDP (gap of 1.4% of GDP in 2019 and of 0.9% per year, on average, over 2018 and 2019 taken together). The conclusion would not change after considering the reduced adjustment in 2018 following the application of the margin of discretion. Taking into account the requirement under the preventive arm of the Stability and Growth Pact, an overall

[4] Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Italy and delivering a Council opinion on the 2017 Stability Programme of Italy, OJ C 261, 9.8.2017, p. 46.

[5] Commission Communication COM(2017) 500 final of 22.5.2017 to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank: "2017 European Semester: Country-specific recommendations".

[6] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

assessment based on the 2019 draft budgetary plan points to a planned significant deviation from the adjustment path towards the medium-term budgetary objective in 2019 recommended by the Council.

12. The main deficit-increasing measures for 2019 include the abrogation for 2019 of the VAT hike previously legislated as a "safeguard clause", an increase in public investment, the possibility to retire early, the introduction of a citizenship income for inactive or unemployed adults, and the extension of the scope of the *forfeit* 15% personal income tax rate. The main deficit-reducing measures in 2019 include a spending review at different levels of government, an increase in corporate income tax revenues due to lower deductibility of specific costs for some categories of firms, in particular banks, the abrogation of the previously legislated favourable tax regime for firms ("*Imposta sul Reddito Imprenditoriale*"), and a tax amnesty. However, the tax amnesty is of a one-off nature, and there is a risk that the savings from the spending review could be lower than expected.

13. The attainment of Italy's medium-term budgetary objective of a balanced budgetary position in structural terms is not planned within the forecast horizon of the 2019 draft budgetary plan, as the structural balance, after deteriorating in 2019, is projected to remain broadly stable over 2020-2021, taking into account the impact of the safeguard clauses.

14. The 2019 draft budgetary plan expects that the debt-to-GDP ratio will slightly decline from 131.2% of GDP in 2017 to 130.9% in 2018 and to 130.0% in 2019. The decrease in debt-to-GDP ratio is set to continue thereafter, down to 126.7% of GDP in 2021. Despite the planned reduction of the debt-to-GDP ratio, Italy is not projected to comply with the debt reduction benchmark either in 2018 or in 2019 based on the 2019 draft budgetary plan. Moreover, the planned reduction in the debt-to-GDP ratio is subject to large downside risks, given that it relies on optimistic nominal GDP growth projections, as well as planned privatisation proceeds of 0.3% of GDP per annum over 2019-2021 and the activation of a "safeguard clause" in 2020 and 2021, which was repealed for 2019.

15. Italy's public debt-to-GDP ratio, at 131.2% in 2017, is second-largest in the European Union and one of the largest in the world. In 2017 it represented an average burden of EUR 37 000 per inhabitant. The large stock of public debt deprives Italy of the fiscal space it needs to stabilise its economy in case of macroeconomic shocks and represents an inter-generational burden weighing on the standard of living of future Italian generations. The fact that debt-servicing costs absorb a considerably larger amount of public resources in Italy than in the rest of the euro area also takes a toll on the country's productive spending. Italy's interest expenditure stood in 2017 at around EUR 65.5 billion or 3.8% of GDP, which was broadly the same amount of public resources devoted to education. Moreover, a large public debt, in the absence of prudent fiscal policies, could also amplify the effect of market confidence shocks on sovereign yields, with a proportionally larger negative impact on both the interest bill paid by the country as well as the overall financing cost for the real economy.

16. On 23 May 2018, in view of Italy’s prima facie non-compliance with the debt reduction benchmark in 2016 and 2017, the Commission adopted a report under Article 126(3) of the Treaty on the Functioning of the European Union, analysing whether Italy was compliant with the debt criterion of the Treaty.[7] After considering

[7] Commission Report COM(2018) 428 final of 23.5.2018: "Italy - Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union".

all the relevant factors and in particular Italy’s compliance with the preventive arm, the report concluded that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with at that stage.

17. Italy's economy is characterised by weak growth and productivity dynamics in comparison to the Union average, with adverse employment and social consequences. Boosting potential growth and tackling long-lasting stagnation in productivity require a comprehensive reform strategy. However, the measures included in the 2019 draft budgetary plan indicate a clear risk of backtracking on reforms that Italy had adopted in line with past Country-Specific Recommendations, as well as with regard to the structural fiscal aspects of the recommendations addressed to Italy by the Council on 13 July 2018. In particular, while the Council recommended that Italy should reduce the share of old-age pensions in its public spending to create space for other social spending, the newly-introduced possibility for early retirement backtracks on earlier pension reforms that underpin the long-term sustainability of Italy's sizeable public debt. Moreover, the introduction of a tax amnesty could discourage Italy's already low tax compliance by implicitly rewarding non-compliant behaviour, thereby largely offsetting the positive effect of strengthening electronic invoicing. Furthermore, while the 2019 draft budgetary plan includes provisions lowering the tax burden on firms hiring or reinvesting their earnings in capital goods, those provisions are largely offset by the abrogation of favourable tax regimes on firms and on reinvested earnings under the ‘allowance for corporate equity’.

18. Overall, the Commission is of the opinion that the 2019 draft budgetary plan submitted by Italy plans for 2019 a significant deviation from the recommended adjustment path towards the medium-term budgetary objective, given the large projected deterioration in the structural balance and a growth rate of government expenditure, net of discretionary revenue measures and one-offs, well above the reference rate. Moreover Italy’s independent fiscal monitoring institution has not endorsed the macroeconomic forecast underlying the 2019 draft budgetary plan, because of the significant downside risks to the projections. If those downside risks were to materialise, the nominal budget balance for 2019 could worsen even more than projected in the 2019 draft budgetary plan, which could possibly also entail an even larger structural deterioration. The projected fiscal expansion, coupled with the downside risks to nominal GDP growth, also endangers a sizeable reduction in Italy's still large debt-to-GDP ratio, which remains a major vulnerability for the economy. Finally, given the significant size of the Italian economy within the euro area, the choice of the government to increase the budget deficit, even though faced with the need to tackle issues linked with the sustainability of public finances, creates risks of negative spill-overs for other euro area Member States.

19. On that basis, the Commission has identified in the draft budgetary plan submitted by Italy for 2019 a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018. The Commission also notes that the 2019 draft budgetary plan is not in line with the commitments presented by Italy in its Stability Programme of April 2018. In accordance with Article 7(2) of Regulation (EU) No 473/2013, the Commission requests Italy to submit a revised draft budgetary plan as soon as possible, and in any event within three weeks of the date of this Opinion. The revised draft budgetary plan for 2019 should ensure compliance with the recommendation addressed to Italy by the Council on 13 July 2018.

Done at Strasbourg, 23.10.2018

For the Commission
Valdis DOMBROVSKIS
Vice-President