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Assessment of the 2019 Stability Programme for

Italy

(Note prepared by DG ECFIN staff)

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EXECUTIVE SUMMARY

Italy is subject to the preventive arm of the SGP. Since Italy's public debt is above the 60% of GDP reference value of the Treaty, it also needs to comply with the debt reduction benchmark.

After a mild contraction in the second half of 2018, the Italian economy is expected to grow very moderately in 2019 – on the back of firming external demand and higher social transfers – and to slowly regain pace in 2020. The increase in government transfers is expected to support private consumption, although the weak economic sentiment might divert part of the expected rise in income into savings. In light of the weak economic activity, employment growth is expected to grind to a halt in 2019, while unemployment is set to increase also due to a rising labour force. Consumer price inflation is set to decelerate in 2019 and pick up moderately in 2020. According to the Commission 2019 spring forecast, real GDP is expected to grow by 0.1% in 2019 and 0.7% in 2020. This is broadly in line with the scenario underlying the Stability Programme, although in 2020 the projected growth composition differs as the Stability Programme assumes a strong increase in VAT rates which is not considered in the Commission forecast.

According to the Stability Programme, the general government deficit, after declining to 2.1% of GDP in 2018, will increase to 2.4% of GDP in 2019 – due to weak macroeconomic developments and several expansionary measures – and then decline to 2.1% of GDP in 2020, assuming the activation of a VAT hike worth 1.3% of GDP legislated as a "budgetary safeguard clause". In 2021 and 2022, the headline deficit is projected to decline by 0.3 percentage points of GDP per year, supported by a further increase in VAT rates in 2021 and unspecified measures in 2022. The Commission 2019 spring forecast does not take into account the VAT hikes legislated as safeguard clauses, given past repeals and government announcements, pointing to a deficit of 3.5% of GDP in 2020. The latter results from the expansionary measures introduced with the 2019 budget, including a new early retirement and minimum income scheme and higher funds for public investment. The government debt-to-GDP ratio increased to 132.2% in 2018, and is projected by the Stability Programme to decline only from 2020. Based on the Commission 2019 spring forecast, the debt ratio is expected to reach 135.2% of GDP by 2020. The main risks to the fiscal targets of the Stability Programme stem from repealing the sizable VAT hikes assumed in 2020 and 2021 without compensating with adequate financing measures, as often happened in the past. This is particularly relevant as financial markets are very sensitive to Italy's fiscal strategy and possible budget implementation slippages.

Notified data point to non-compliance with the recommended adjustment path towards the MTO in 2018. Based on both the Stability Programme and the Commission 2019 spring forecast, Italy is expected to be at risk of significant deviation from the adjustment path towards the MTO in 2019 and 2020. That conclusion would not change if the allowance for unusual events preliminarily granted for 2019 were subtracted from the requirement of the preventive arm.

In view of the non-compliance with the debt reduction benchmark in 2018, the Commission issued a report under Article 126(3) of the TFEU in order to assess whether an excessive deficit exists in Italy. The report concluded that the debt criterion should be considered as not complied with.

1. INTRODUCTION

On 19 April 2019, Italy submitted its 2019 Stability Programme (hereafter called Stability Programme), covering the period 2019-2022. The government approved the programme on 9 April 2019 and it was submitted to the Parliament on 10 April.

Italy is currently subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium-term budgetary Objective (MTO). As the debt ratio was 132.2% of GDP in 2018, exceeding the 60% of GDP reference value, Italy is also subject to the debt reduction benchmark.

On 5 June 2019, the Commission issued a report under Article 126(3) of the TFEU, as Italy did not comply with the debt reduction benchmark in 2018. The report concluded, following an assessment of all the relevant factors, that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is not complied with.

This document complements the Country Report published on 27 February 2019 and updates it with the information included in the Stability Programme.

Section 2 presents the macroeconomic outlook underlying the Stability Programme and provides an assessment based on the Commission 2019 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

Italy's economy slipped into a mild contraction in the second half of last year, as the slowdown of global trade and weak manufacturing spread to the domestic economy. For the year as a whole, real output expanded by 0.9%, supported by domestic demand, while net exports weighed on real GDP growth.

In compliance with the Code of Conduct, the Stability Programme includes two macroeconomic scenarios, a baseline scenario assuming unchanged policies and a policy scenario incorporating the impact of fiscal measures and structural reforms presented in the National Reform Programme. External assumptions are identical in both scenarios and broadly in line with those in the Commission 2019 spring forecast for 2019 and 2020.

Compared to the updated macroeconomic projections underpinning the 2019 budget of December 2018, the Stability Programme revises real GDP growth in 2019 sizeably downwards from 1.0 % to 0.2 % in the policy scenario. The main reasons for the downward revision are a more negative carryover effect, a worsening external environment also related to the slowdown of the European manufacturing sector, especially in Germany, and some additional factors related to higher uncertainty. These effects imply lower projections for investment, exports and private consumption. Projections for real GDP growth in 2020 have been revised downwards from 1.1 % in the 2019 Draft Budgetary Plan and the 2019 budget to 0.8 %, as the assumed weaker external demand is also expected to have a slightly negative impact next year. In addition, higher oil prices compared to December are assumed to slightly dampen growth in 2020. By contrast, the assumed depreciation of effective exchange rates in nominal terms and the assumptions of lower interest rates are expected to provide some support.

Growth projections for 2019 and 2020 are broadly aligned in the Stability Programme and the Commission 2019 spring forecast. Concerning the composition of growth in 2019, the Stability Programme and the Commission 2019 spring forecast both expect private consumption to underpin growth, albeit moderately, also helped by increasing social transfers. By contrast, the Stability Programme projects a higher from investment compared to the Commission 2019 spring forecast, mostly resulting from positive growth in equipment investment in 2019 projected by the Stability Programme. Projections for export growth in the Stability Programme are broadly in line with the Commission 2019 spring forecast, implying a zero contribution to growth from net trade. For 2020, the Stability Programme projects private consumption to slightly increase, broadly in line with the Commission 2019 spring forecast. However, the Stability Programme assumes a considerably higher fiscal burden due to the VAT hike legislated as a “safeguard clause” (worth 1.3% of GDP) which is not included in the Commission scenario. This notwithstanding, real GDP growth projections remain close to the Commission 2019 spring forecast as the lower positive contribution from domestic demand is expected to be compensated by a positive impact from net trade due to the significantly lower import dynamics. The negative output gap (-0.3 % of potential output in 2019), as recalculated by the Commission based on the information in the programme following the commonly agreed methodology, is expected to almost close in 2020, as actual growth is forecast to exceed potential real GDP growth, estimated at 0.5% in 2020.

As regards the labour market, projections of employment growth and unemployment in the Stability Programme are broadly aligned with those in the Commission 2019 spring forecast. Employment is expected to decline in 2019 in line with weak economic activity. In both forecasts, the jobless rate is driven higher partly due to a statistical effect, as more people who were previously inactive are expected to register as unemployed (and increase the labour force) in order to benefit from the newly introduced citizenship income. Labour productivity (based on full-time equivalent employment) is expected to continue its positive trend and increase, albeit very moderately. The increase in unit labour costs is expected to remain below the rise in the GDP deflator, implying some improvement in profit margins over the programme period.

On balance, the macroeconomic scenario underpinning the Stability Programme appears plausible. However, risks to the growth outlook remain predominantly negative. On the external side, trade tensions continue to cloud the global outlook and higher-than-expected oil prices could curb consumers’ purchasing power. In addition, financial markets remain very sensitive to policy changes and any possible related increases in sovereign yields could affect sentiment and private-sector funding conditions. Furthermore, the lack of detail about fiscal plans for 2020 is likely to result in continuously high policy uncertainty and the impact of the envisaged fiscal path on growth might be more negative than assumed in the Stability Programme. By contrast, a better-than-expected external environment could imply a stronger export-led rebound.

Table 1: Comparison of macroeconomic developments and forecasts

	2018		2019		2020		2021	2022
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.9	0.9	0.1	0.2	0.7	0.8	0.8	0.8
Private consumption (% change)	0.6	0.6	0.6	0.6	0.8	0.7	0.7	0.6
Gross fixed capital formation (% change)	3.4	3.4	-0.3	1.4	0.9	2.0	1.8	1.6
Exports of goods and services (% change)	1.9	1.9	1.9	2.1	3.1	2.3	2.4	2.6
Imports of goods and services (% change)	2.3	2.3	2.2	2.2	3.3	2.7	2.6	2.5
Contributions to real GDP growth:								
- Final domestic demand	1.0	1.0	0.3	0.5	0.7	0.9	0.8	0.7
- Change in inventories	0.0	0.0	-0.1	-0.2	0.0	0.0	0.0	0.0
- Net exports	-0.1	-0.1	0.0	0.0	0.0	-0.1	0.0	0.1
Output gap[1]	-0.1	-0.2	-0.3	-0.3	-0.1	-0.2	-0.1	0.0
Employment (% change)	0.9	0.9	0.3	-0.3	0.3	0.2	0.7	0.6
Unemployment rate (%)	10.6	10.6	10.9	11.0	11.0	11.1	10.7	10.4
Labour productivity (% change)	0.1	0.0	0.2	0.6	0.2	0.6	0.0	0.0
HICP inflation (%)	1.2	1.1	0.9	1.0	1.1	2.3	1.9	1.6
GDP deflator (% change)	0.8	0.8	0.7	1.0	1.0	2.0	1.8	1.6
Comp. of employees (per head, % change)	2.0	2.0	0.9	1.2	1.0	1.5	1.3	1.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.4	2.3	2.5	2.3	2.5	2.2	2.1	2.1

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2019 spring forecast (COM); Stability Programme (SP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2018 AND 2019

This section presents the budgetary developments in the previous and current year as presented by the Stability Programme and compared to the 2019 Draft Budgetary Plan and the budgetary projections underlying the 2019 budget law.

The national statistical institute notified preliminary fiscal outturn data for 2018 on 29 March, which were slightly revised on 3 of April. On 9 April, a new notification introduced substantial revisions to fiscal data for 2017 and 2018, as several companies were reclassified within the general government sector. While the notified general government deficit remained broadly unchanged, both revenues and expenditures were revised upwards, with shifts between revenue and expenditure items. The debt level and nominal GDP have also been revised upwards for the two years. As the historical series before 2017 will be revised only with the 2019 autumn notification, the 2019 spring notification includes a break in the series and is thus not suitable for a backward-looking assessment of government revenue and expenditure trends.

In 2018, the government headline deficit declined to 2.1% of GDP, down from 2.4% of GDP in 2017. The primary surplus increased from 1.4% of GDP in 2017 to 1.6% of GDP in 2018, while interest spending slightly declined by 0.1 percentage points to 3.7% of GDP in 2018. In fact, due to the relatively long average maturity of Italy's public debt, the lower interest rates recorded in recent years more than offset the increase in sovereign yields recorded in the second half of 2018. The outturn deficit is higher than the 1.9% of GDP planned in the 2019 Draft Budgetary Plan. Based on the fiscal data notified on 3 April – which does not include statistical reclassifications and therefore can be better compared with government plans – the higher outturn deficit was due to higher-than-expected government spending. In particular, subsidies to investment and "other current expenditures" exceeded plans by around EUR 1.2 billion and 2.3 billion respectively (0.2% of GDP in total). Conversely, revenues developed slightly better than planned despite the worse-than-expected macroeconomic outcome.

The improvement in the primary surplus in 2018 was mainly due to the strong decline in "other capital expenditures", which had increased significantly in 2017 due to a temporary support to the banking sector. Public investment also declined markedly by 4.3%, reaching 2.1% of GDP, down from 2.2% of GDP in 2017. Overall, capital expenditure declined by 13.1% of GDP in 2018. Conversely, current expenditure increased by 2.3% in nominal terms, driven by spending for the compensation of employees, which increased by 3.1% of GDP as the increase in public wages for the period 2016-2018 was recorded only in 2018 for most sectors. Social transfers in cash, which at close to 20% of GDP represent nearly half of current primary expenditure, increased by 2.2%, with pension expenditure increasing by 2% and other social transfers by 3.1%. The latter increase was partly the result of past measures which increased funds for supporting families and fighting poverty (by extending the scope of the "*Reddito di inclusione*"). Healthcare expenditure increased by 1.6%, remaining stable as a share of GDP at 6.6%. This was the result, on the one hand, of several past measures aimed at containing healthcare expenditure, and, on the other hand, of (i) the increase in public wages, (ii) higher spending for pharmaceutical products by 6.5%, driven by the high cost of innovative products, and (iii) the renewal of public contracts with private healthcare providers, which in several sectors also included arrears. Overall, government spending increased by 1%, declining as a share of GDP by 0.3 percentage points to 48.6% in 2018. On the revenue side, revenues from indirect taxes increased by 2.1%, still supported by the extension of the "split payment" ([1]) to all transactions involving public administrations, which was implemented from 2017. Revenues from direct taxes declined by 0.7%, due to the lower revenues from past measures aimed at collecting unsettled tax liabilities ("*rottamazione cartelle esattoriali*"), extended tax incentives for private investment and the delayed effect of the reduction in corporate income tax rates by 3.5 percentage points implemented from 2017. Social security contributions increased strongly (by 4.2%, compared to 2.2% in 2017), supported by positive labour market developments and by the end of past temporary reductions for new hires with open-end contracts. Overall, government revenues increased by 1.6%, slightly declining as a share of GDP by 0.1 percentage points to 46.4%.

In 2019, the Stability Programme projects the headline deficit at 2.4% of GDP, i.e. above the 2% of GDP targeted by the 2019 budget (which revised the 2.4% of GDP deficit target of the Draft Budgetary Plan and the revised Draft Budgetary Plan, submitted in October and November 2018, respectively). The revision compared to the 2019 budget is due to the lower projected nominal GDP growth (accounting for a higher deficit by 0.4 percentage points) and by different expectations on tax reimbursements (accounting for a higher deficit by 0.1

[1] Under the "split payment" system, payments by public administrations to private suppliers do not include VAT, which is directly paid to the State budget.

percentage points). At the same time, the Stability Programme assumes a cut in government spending by 0.1% of GDP, legislated as a budgetary safeguard clause in 2019. In particular, the projection for revenue growth in 2019 has been revised from 2.5% in the 2019 budget to 1.4% in the Stability Programme. The projection for growth of revenues from indirect taxes has been revised from 2.4% to 1.4%, due the lower projected growth of private consumption in nominal terms and the revised assumptions on tax reimbursements. The lower projection for total compensation of employees, mainly related to weaker employment dynamics, reflects in lower projections for revenues from direct taxes and social security contributions (direct taxes are expected to decline by 0.1% and social security contributions to grow by 2.4%, as opposed to a projected growth of 2.5% and 3.1% respectively based on the 2019 budget). The projection government spending growth is also revised downwards from 2.7% in the 2019 budget to 1.9% in the Stability Programme, mainly due the cut legislated as a safeguard clause and lower interest spending related different assumptions for sovereign yields.

Notwithstanding the projected decline in employment, the Stability Programme projects revenues to increase slightly in 2019 as a share of GDP, to 46.5%, supported by past government measures. Revenues from corporate taxes are expected to temporarily benefit from the provisions included in the 2019 budget, which reduced the possibility to deduct from the tax base several categories of costs, mainly relevant for banks. Social security contributions are expected to further benefit from the end of temporary reductions for new hires with open-end contracts, more than offsetting the reduction of employer contributions to the national insurance institute for accidents on the workplace (*INAIL*). Government expenditure is expected to increase as a share of GDP by 0.3 percentage points, to 48.9%. In particular, social transfers in cash are expected to grow by 4.4%, reaching 20.5% of GDP (+0.6% of GDP), as a consequence of the minimum income scheme and the extended possibilities for early retirement financed with the 2019 budget and legislated in March 2019. Public investment is also projected to increase significantly, by 5.2% (reaching 2.1% of GDP), thanks to the additional funds allocated and the measures taken to address administrative bottlenecks. Spending for compensation of employees is expected to increase only moderately, by 0.4%, due to the expected delay in replacing public employees retiring with the new early retirement scheme. Some arrears for the renewal of public wages for the period 2016-2018 will still be paid in 2019, while the wage increase for the period 2019-2021 is expected to materialise mainly from 2020. Total intermediate consumption is also expected to increase marginally, by 0.2% of GDP, due to the spending review planned at the ministerial level and the reduction in spending legislated as a budgetary safeguard clause. Overall, primary expenditure is expected to increase by 2.2%. Interest spending is expected to slightly decline, from 3.7% of GDP in 2018 to 3.6% of GDP in 2019.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Stability Programme plans a steady reduction of the government headline deficit by 0.3 percentage points of GDP per year over the period 2020-2022, reaching 1.5% of GDP by 2022. According to the national authorities, this corresponds to similar yearly improvements in the structural balance. The MTO set by the Stability Programme – a budgetary surplus of 0.5% of GDP in structural terms – reflects the objectives of the Pact but is not planned to be reached within the programme period.

After remaining stable in 2018, the structural balance is expected to deteriorate by 0.1 percentage point of GDP in 2019 and to improve by 0.2 percentage points in 2020 and 0.3

percentage points both in 2021 and 2022, reaching -0.8% of GDP in 2022. The structural balance recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology shows a somewhat stronger deterioration in 2019. In addition, also due to a different estimate of the level of the output gap over the programme period (-0.1% of potential GDP in 2018 as against -1.5% in the programme at face value) the recalculated structural balance stands at -1.6% of GDP in 2022, pointing to a stronger gap from the MTO at the end of the programme period.

The headline deficit target for 2020 has been revised to 2.1% of GDP, from 1.8% of GDP planned with the 2019 budget, due to the different 2019 base and the worse macroeconomic outlook. Detailed budgetary projections in the Stability Programme (table 2) are based on unchanged legislation trends that incorporate sizable additional revenues related to VAT hikes legislated as a "safeguard clause" to achieve the medium term targets. The positive budgetary impact of the VAT hike would be around 1.3% of GDP in 2020 and 1.5% of GDP from 2021 onwards. As a consequence, the Stability Programme projects revenues from indirect taxes to strongly increase, from 14.5% of GDP in 2019 to 15.6% of GDP in 2020, also supported by additional measures against tax evasion, namely the compulsory electronic transmission of receipts for all commercial transactions with private consumers. Conversely, revenues from direct taxes are expected to decline from 14% of GDP in 2019 to 13.7% in 2020, due to several measures introduced with the 2019 budget, i.e. the extension of the simplified tax regime for self-employed workers, extended tax deductions for building renovations, lower corporate income tax rates for firms increasing investment or hiring and the end of the temporary support from the lower tax deductibility of costs for firms implemented in 2019. These measures are expected to more than offset the temporary revenues from the new possibility to settle past tax liabilities without fines. Overall, revenues are expected to increase as a share of GDP in 2020 by 0.6 percentage points, to 47.1%. Government spending is also expected to increase as a share of GDP, by 0.2 percentage points, reaching 49.1%. Such increase is due to additional funds for public investment and higher spending for the minimum income and the early retirement scheme. At the same time, spending for the compensation of employees is expected to slightly decline as a share of GDP. On the one hand, public wages are expected to rise as part of the renewal of contracts for the period 2019-2021, which will also include arrears for 2019. On the other hand, an increasing number of public employees are expected to retire with the new early retirement scheme, while replacements are expected to take effect with a delay.

In 2021, the budgetary adjustment is planned to be reached through a reduction in spending, with government expenditure projected to decline as a share of GDP from 49.1% in 2020 to 48.8% in 2021. The decline is driven by lower compensation of employees and intermediate consumption, both expected to decline by 0.2 percentage points of GDP. Concerning compensation of employees, the decline is partly due to the fact that the cost of military missions abroad and other expenditure needed to keep current policies unchanged ("*politiche invariate*") is not yet included into budgetary projections beyond 2020. The decline in spending for intermediate consumption partly reflects past measures limiting healthcare expenditure growth. Government revenues are expected to slightly decline as a share of GDP to 47%, despite the additional revenues expected from the VAT hike legislated as a budgetary safeguard clauses.

In 2022, additional unspecified corrective measures with an impact of at least 0.4% of GDP relative to the trend scenario based on unchanged legislation would be necessary to achieve the deficit target, on top of the VAT hike.

Table 2: Composition of the budgetary adjustment[2]

(% of GDP)	2018	2019		2020		2021	2022	Change: 2018-2022
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	**46.4**	**46.7**	**46.5**	**46.3**	**47.1**	**47.0**	**46.6**	**0.2**
of which:								
- Taxes on production and imports	14.4	14.6	14.5	14.4	15.6	15.7	15.6	1.2
- Current taxes on income, wealth, etc.	14.2	14.1	14.0	13.9	13.7	13.7	13.5	-0.7
- Social contributions	13.4	13.5	13.5	13.5	13.4	13.3	13.2	-0.2
- Other (residual)	4.5	4.6	4.5	4.6	4.4	4.3	4.3	-0.2
Expenditure	**48.6**	**49.2**	**48.9**	**49.8**	**49.1**	**48.8**	**48.5**	**-0.1**
of which:								
- Primary expenditure	44.9	45.6	45.3	46.1	45.5	45.1	44.6	-0.3
of which:								
Compensation of employees+Intermediate	15.4	15.4	15.2	15.3	15.1	14.7	14.5	-0.9
Compensation of employees	9.8	9.8	9.7	9.7	9.5	9.3	9.1	-0.7
Intermediate consumption	5.6	5.6	5.5	5.6	5.6	5.4	5.4	-0.2
Social payments	22.5	23.2	23.1	23.5	23.2	23.3	23.2	0.7
Subsidies	1.5	1.5	1.5	1.5	1.5	1.5	1.4	-0.1
Gross fixed capital formation	2.1	2.1	2.2	2.3	2.4	2.4	2.5	0.4
Other (residual)	3.5	3.4	3.3	3.5	3.2	3.2	3.1	-0.4
- Interest expenditure	3.7	3.6	3.6	3.7	3.6	3.7	3.9	0.2
General government balance (GGB)	**-2.1**	**-2.5**	**-2.4**	**-3.5**	**-2.1**	**-1.8**	**-1.5**	**0.6**
Primary balance	**1.6**	**1.2**	**1.2**	**0.2**	**1.6**	**1.9**	**2.0**	**0.4**
One-off and other temporary	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
GGB excl. one-offs	**-2.2**	**-2.6**	**-2.5**	**-3.6**	**-2.2**	**-1.9**	**-1.6**	**0.6**
Output gap[1]	-0.1	-0.3	-0.3	-0.1	-0.2	-0.1	0.0	0.1
Cyclically-adjusted balance[1]	-2.1	-2.3	-2.2	-3.4	-2.0	-1.7	-1.5	0.6
Structural balance[2]	**-2.2**	**-2.4**	**-2.3**	**-3.6**	**-2.1**	**-1.8**	**-1.6**	**0.6**
Structural primary balance[2]	1.5	1.2	1.3	0.2	3.6	1.9	2.3	**0.8**

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Stability Programme (SP); Commission 2019 spring forecasts (COM); Commission calculations.

Over the past years, Italy's stability programmes systematically postponed the achievement of a balanced budgetary position, while the actual deficit did not decline below 2% of GDP. Up to 2017 this was arguably related to weak macroeconomic performance and inflation, but also reflects the practice to include in the fiscal targets ambitious VAT hikes, which are then repealed without adequate alternative measures. Compared to the past, the current Programme

[2] The Stability Programme's revenue and expenditure projections reported in the table over the period 2019-2022 correspond to trend projections based on unchanged legislation.

plans a smaller improvement of the headline balance, due to the weak macroeconomic outlook and the planned expansionary measures.

Figure 1: Government balance projections in successive programmes (% of GDP)

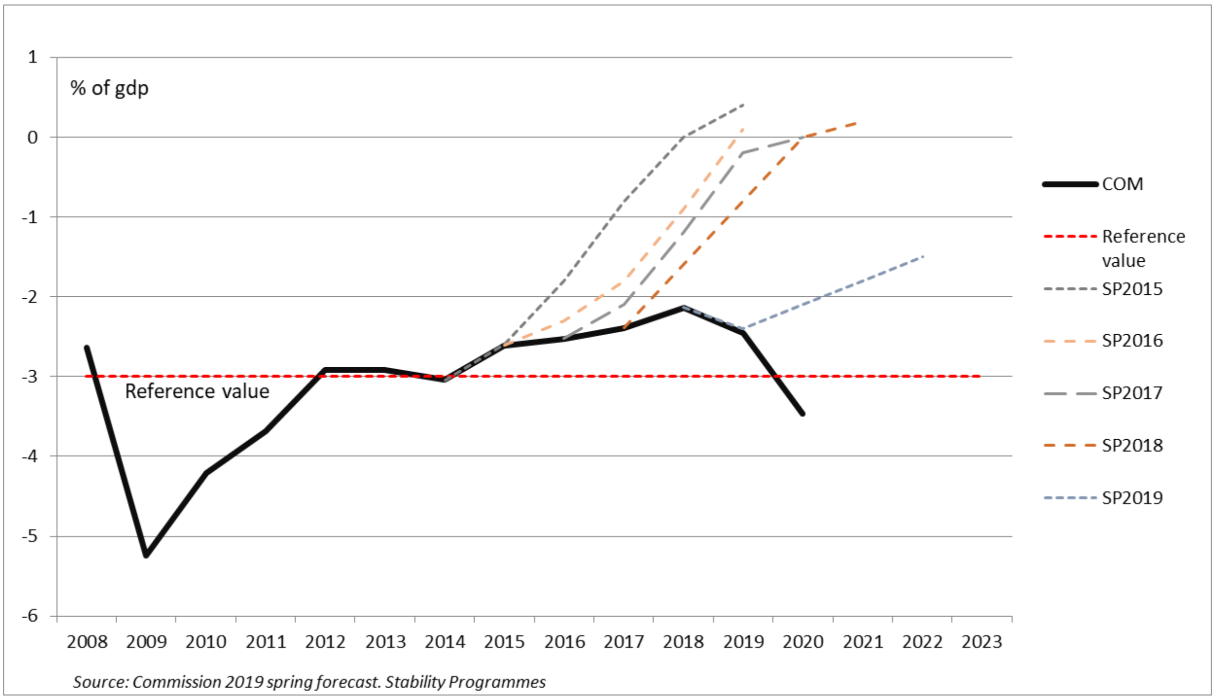
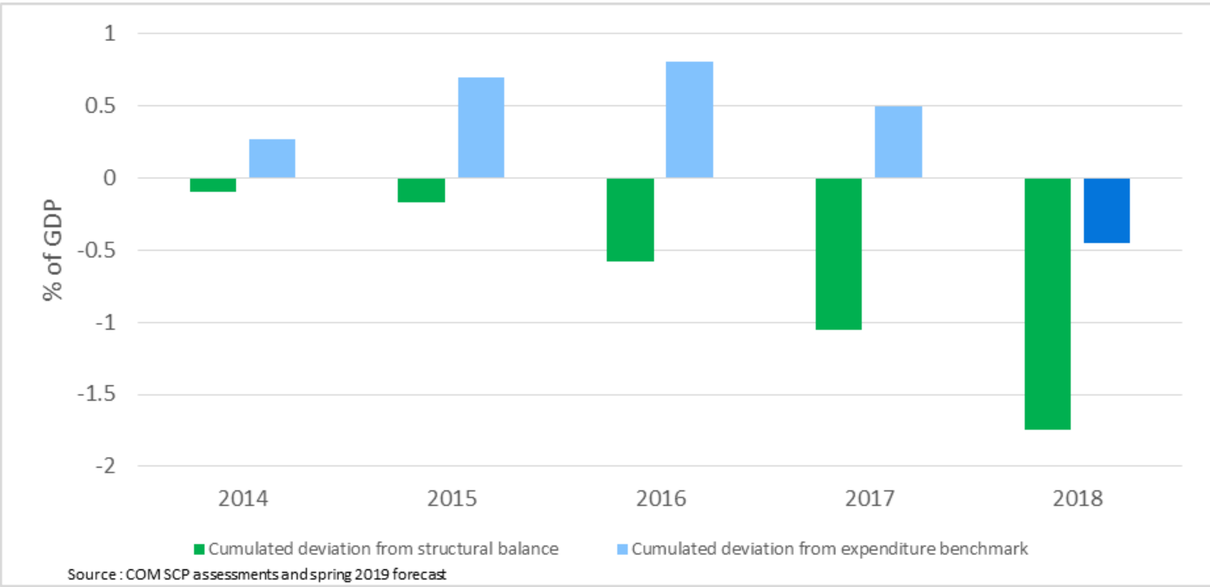


Figure 2: Cumulative deviations of the preceding five years from the upper limit for net growth of government expenditure and from structural effort requirements (in % of GDP)



Since the correction of the excessive deficit in 2013, Italy has been subject to the preventive arm of the SGP and has been recommended to ensure an annual structural adjustment of 0.25% of GDP towards the MTO in 2015, 0.5% of GDP in 2016 and 0.6% of GDP in both

2017 and 2018. These requirements were reduced to 0.22% of GDP in 2015, -0.33% of GDP in 2016, 0.21% of GDP in 2017 and 0.3% of GDP in 2018, due to allowances for unusual events over the period 2015-2017, flexibility for investment and structural reforms in 2016 and the application of the margin of discretion in 2018.

Over 5 years, the constant deterioration of the structural balance – with only a small improvement recorded in 2015 – have led to a stable increase of the cumulative deviation from the requirements, which was particularly sizable over the period 2016-2018. The expenditure benchmark has been less stringent than the structural balance up to 2016, leading to an increasing positive cumulative gap from the requirements. The difference between the two pillars over the period 2014-2016 was mainly due to the higher medium-term potential growth rate and GDP deflator underlying the expenditure benchmark as compared to the structural balance. Furthermore, the structural balance was negatively affected by significant revenue shortfalls, which in 2015 and 2016 more than offset the positive impact of declining interest spending. In 2017 and 2018, the divergence between the cumulative deviation from the requirements for the two pillars narrowed as revenue shortfalls declined and the point estimate of potential growth underlying the structural balance exceeded the medium-term potential growth underlying the expenditure benchmark.

3.3. MEASURES UNDERPINNING THE PROGRAMME

According to the Stability Programme, the 2019 budget (Law 145/2018 and DL 145/2018) entails a worsening of Italy’s headline balance (taken at face value) relative to the trend projections based on unchanged legislation of EUR 11.5 billion (or 0.6% of GDP) in 2019, EUR 14.5 billion (or 0.8% of GDP) in 2020 and EUR 9.2 billion (or 0.5% of GDP) in 2021.

Revenues are reduced relative to trend projections by EUR 3.9 billion (or 0.2 % of GDP) in 2019, and increased by EUR 8.2 billion (or 0.4% of GDP) in 2020 and 11.8 billion (or 0.6% of GDP) in 2021.

Lower revenues are mainly related to: (i) The repeal of the increase in VAT rates and excise duties previously legislated as a budgetary safeguard clause in 2019 (0.7% of GDP). (ii) An extended scope of the simplified tax regime for the self-employed. Currently, self-employed workers with yearly turnover below sector-specific thresholds have the option to pay, as a substitute for the personal income tax, a forfeit 15% tax rate on their yearly turnover adjusted for specific "profitability coefficients". With the new regime, all thresholds for yearly turnover, which currently vary across sectors of activity and range up to EUR 55 000, are harmonised and raised to EUR 65 000. The measure is expected to reduce revenues by 0.1% of GDP from 2020. (iii) A new flat tax rate regime for workers engaged in entrepreneurial activities with a yearly turnover between EUR 65 000 and EUR 100 000, whose corresponding income will be taxed outside the standard personal income tax regime with a forfeit 20% rate. The expected revenue loss amounts to 0.1% of GDP from 2021. (iv) A lower corporate tax rate on firms' profits used to increase investment or to hire new employees, with an expected structural revenue loss of around 0.1% of GDP from 2020. This measure was simplified with a law decree approved in April 2019 (“*decreto crescita*”): the lower corporate tax rate now applies to firms’ retained profits, with similar expected costs for public finances. (v) The extension of past tax deductions for building renovation aimed at fostering energy efficiency, with an expected revenue-loss of slightly less than 0.1% of GDP from 2019.

Measures increasing revenues compared to the baseline scenario based on unchanged legislation trends include: (i) The abrogation of a previously legislated simplified tax regime for small firms ("*Imposta sul Reddito Imprenditoriale*"), entailing higher revenues by around 0.1% of GDP from 2019. (ii) The abrogation of existing tax incentives for firms' capital uplifts ("*Aiuto alla Crescita Economica*"), implying higher revenues 0.1% of GDP from 2020. (iii) The introduction of compulsory electronic transmission of receipts for all transactions with final consumers, expected to yield higher revenues by 0.1% of GDP from 2020. (iv) A new and more advantageous possibility for taxpayers to settle past tax liabilities, by paying in instalments over several years, without fines and with advantageous interest rates, together with smaller provisions curtailing old pending tax liabilities of limited size and reducing incentives for taxpayers to prolong the duration of tax litigations. Overall, one-off revenues amounting to around 0.1% in 2019 and slightly less in 2020 are expected. (v) Lower tax deductibility of specific costs[3] for some categories of firms (especially banks) with a temporary positive effect on revenues by 0.2% of GDP in 2019 and 0.1% of GDP in 2020. (vi) A higher automatic increase in VAT rates, legislated as a budgetary safeguard clause, with additional expected revenues amounting to 0.2% of GDP in 2020 and 0.3% of GDP from 2021. (vii) Other measures increasing yearly revenues by 0.1% of GDP from 2019.

Government spending is increased compared to the trend projections by EUR 7.6 billion (or 0.4% of GDP) in 2019, EUR 22.7 billion (or 1.3% of GDP) in 2020 and EUR 21 billion (or 1.2% of GDP in 2021. In particular, the measures increasing government spending compared to the trend projections include: (i) The introduction of a minimum income scheme ("citizenship income"), guaranteeing – with specific access conditions – a monthly income of EUR 780, corresponding to the relative poverty threshold, with an expected cost of around 0.4% of GDP in 2019 and 0.5% of GDP from 2020. (ii) Extended possibilities for early retirement, including the suspension of the automatic indexation to life expectancy of the minimum contribution years needed to retire independently from age ("*pensione anticipata*") and a new early retirement scheme. The latter (defined "*Quota100*", or "100 threshold") introduces the possibility to retire with at least 62 years of age and 38 years of contributions, for an expected cost of 0.2% of GDP in 2019 and 0.5% of GDP from 2020. (iii) Higher funds for public investment, amounting in total to 0.3% of GDP in 2020 and 0.4% of GDP in 2021. (iv) Other measures amounting in total to close to 0.1% of GDP in 2019 and 0.2% of GDP in 2021. At the same time, government spending is reduced by the following measures: (i) The anti-poverty scheme ("*Reddito di inclusione"*) will be absorbed by the "citizenship income, with annual savings amounting to 0.1% of GDP. (ii) A spending review at the ministerial level, targeting structural savings of slightly less than 0.1% of GDP from 2019. (iii) Other measures reducing spending by around 0.2% of GDP in 2021.
The table below reports the budgetary impact of the main measures included in the 2019 budget, in terms of incremental impact from the previous year.

Besides the measures included in the 2019 budget, the Stability Programme refers to the following planned measures:

[3] More specifically, the tax deductibility of the goodwill and other intangible assets related to past operations is lowered by spreading it over 11 years; the tax deductibility of credit losses incurred in 2018 is postponed to 2026; the tax deductibility of losses due to the implementation of new accounting principles is lowered by spreading it over ten years.

1) Two law decrees adopted by the Council of Ministers in April 2019 ("*decreto crescita*" and "*decreto sblocca cantieri*") aimed at supporting economic growth, including by reintroducing several tax incentives for private investment and revising legal provisions for public investment, respectively. According to the Stability Programme, the two decrees will include measures providing for their financing, with no additional burden for public finances.
2) Additional public investment funds amounting to around 0.1% of GDP per year from 2020, which have been included in the fiscal targets of the Stability Programme.
3) Additional measures that should be taken to reduce the tax burden for middle income households "towards a flat tax", which are not specified and not included in the fiscal targets of the Programme.
4) Additional spending for "unchanged policies" ("*politiche invariate*"), namely the refinancing of military missions abroad and other expenditure needed to keep current policies unchanged but requiring specific financing decisions, estimated in the Stability Programme at around 5 billion in 2021 and 8 billion in 2022 and not yet included in the fiscal targets.
5) On the financing side, the Stability Programme mentions only in general terms additional future measures to reduce public spending and fighting tax fraud.

Main budgetary measures included in the Programme

Revenue	**Expenditure**
2019	
• Repeal of past VAT hikes (-0.7% of GDP) • Abrogation of IRI (+0.1% of GDP) • Tax amnesty measures (+0.1% of GDP) • Lower tax deductibility of firm costs (+0.2% of GDP)	• Minimum income scheme (+0.4% of GDP) • Pension reform (+0.2% of GDP) • Abolition of REI (-0.1% of GDP) • Spending review (-0.1% of GDP)
2020	
• Extended simplified tax regime for self-employed up to EUR 65 000 (-0.1% of GDP) • Lower corporate tax rates on profits used to invest or hire (-0.1% of GDP) • Extended tax deductions for building renovations (-0.1% of GDP) • Abrogation of ACE (+0.1% of GDP) • Compulsory transmission of receipts (+0.1% of GDP) • Higher VAT hike (+0.2% of GDP)	• Minimum income scheme (+0.1% of GDP) • Pension reform +(0.2% of GDP) • Public investment (+0.3% of GDP)

<table>
<tr><th colspan="2">2021</th></tr>
<tr><td>Simplified tax regime for self-employed between EUR 65 000 and 100 000 (-0.1% of GDP)
Higher VAT hike (+0.2% of GDP)</td><td>Public investment (+0.1% of GDP)</td></tr>
<tr><td colspan="2">Note: The table refers to the main measures included in the 2019 Stability Programme that have an incremental budgetary impact over the programme period. The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</td></tr>
</table>

3.4. DEBT DEVELOPMENTS

In 2018, Italy's public debt-to-GDP ratio increased to 132.2%, from 131.4% in 2017, mainly due to a large debt-increasing stock-flow adjustment amounting to 0.9 percentage points of GDP. The latter was due to fluctuations in the Treasury liquidity reserves and to effects on the evaluation of the stock of debt arising from the high sovereign yields recorded in 2018 and the indexation to inflation of several categories of bonds. The difference between cash and accrual accounts also contributed to the stock-flow adjustment in 2018. In 2018, the debt-increasing snow-ball effect, arising by a still positive nominal growth-interest spending differential, was broadly offset by the debt-reducing impact of the primary surplus.

In 2019, the Stability Programme expects the debt ratio to increase to 132.6% of GDP, due to the projected decline in the primary surplus and a stronger snow-ball effect related to the weak economic growth. This projection assumes privatisation proceeds amounting to 1% of GDP, which results in a debt-decreasing stock-flow adjustment. In 2020, the government debt-to-GDP ratio is expected to decline to 131.3%, supported by a higher primary surplus as well as by stronger economic growth and an accelerating inflation, related to the implementation of the VAT hikes. As a consequence, the snow-ball effect is expected to decline to zero. This projection also assumes privatisation proceeds of 0.3% of GDP, which reduces the debt-increasing stock-flow adjustment. In 2021 and 2022 the government debt ratio is expected to continue declining to 128.9% of GDP, supported by an increasing primary surplus. However, the debt-increasing snow-ball effect is expected to progressively increase, due to raising interest spending and a lower inflation effect.

Based on the Commission 2019 spring forecast, Italy’s government debt-to-GDP ratio is expected to increase both in 2019 and 2020, by 1.6 and 1.5 percentage points respectively, reaching 135.2% in 2020. In 2019, the difference from the Stability Programme is explained by lower projections for nominal GDP growth – resulting in a higher debt-increasing snow-ball effect – and different assumptions for privatisation proceeds. The Commission 2019 spring forecast assumes privatisation proceeds worth 0.1% of GDP in 2019, corresponding to specific operations planned for several years and systematically postponed. The ambitious privatisation target included in the Stability Programme for 2019 is not considered in the Commission forecast in light of the limited details provided and the poor track record in meeting privatisation targets in recent years.

In 2020, the debt-to-GDP ratio is expected to further increase based on the Commission 2019 spring forecast, while the Stability Programme projects a reduction. The Commission 2019 spring forecast does not consider additional revenues from the activation of the VAT safeguard clauses, implying lower projections not only for the primary surplus, but also for inflation. This results in a lower projected nominal GDP growth, corresponding to a still debt-increasing and sizable snow-ball effect. Furthermore, the Commission forecast does not take into account the additional privatisation proceeds worth 0.3% of GDP assumed in the Stability Programme.

Table 3: Debt developments

(% of GDP)	Average 2013-2017	2018	2019		2020		2021	2022
			COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**131.0**	**132.2**	**133.7**	**132.6**	**135.2**	**131.3**	**130.2**	**128.9**
Change in the ratio	1.6	0.8	1.6	0.4	1.5	-1.3	-1.1	-1.3
Contributions[2] *:*								
1. Primary balance	**-1.6**	**-1.6**	**-1.2**	**-1.2**	**-0.2**	**-1.6**	**-1.9**	**-2.0**
2. "Snow-ball" effect	**2.5**	**1.5**	**2.6**	**2.0**	**1.4**	**0.0**	**0.4**	**1.0**
Of which:								
Interest expenditure	4.3	3.7	3.6	3.6	3.7	3.6	3.7	3.9
Growth effect	-0.6	-1.1	-0.1	-0.3	-0.9	-1.0	-1.0	-1.0
Inflation effect	-1.2	-1.1	-0.9	-1.3	-1.4	-2.6	-2.3	-1.9
3. Stock-flow adjustment	**0.7**	**0.9**	**0.1**	**-0.4**	**0.3**	**0.3**	**0.4**	**-0.3**
Of which:								
Cash/accruals diff.				0.4		0.0	0.0	-0.8
Acc. financial assets				-0.7		0.0	0.3	0.5
Privatisation				-1.0		-0.3	0.0	0.0
Val. effect & residual				-0.1		0.2	0.2	0.3

Notes:

[1] End of period.

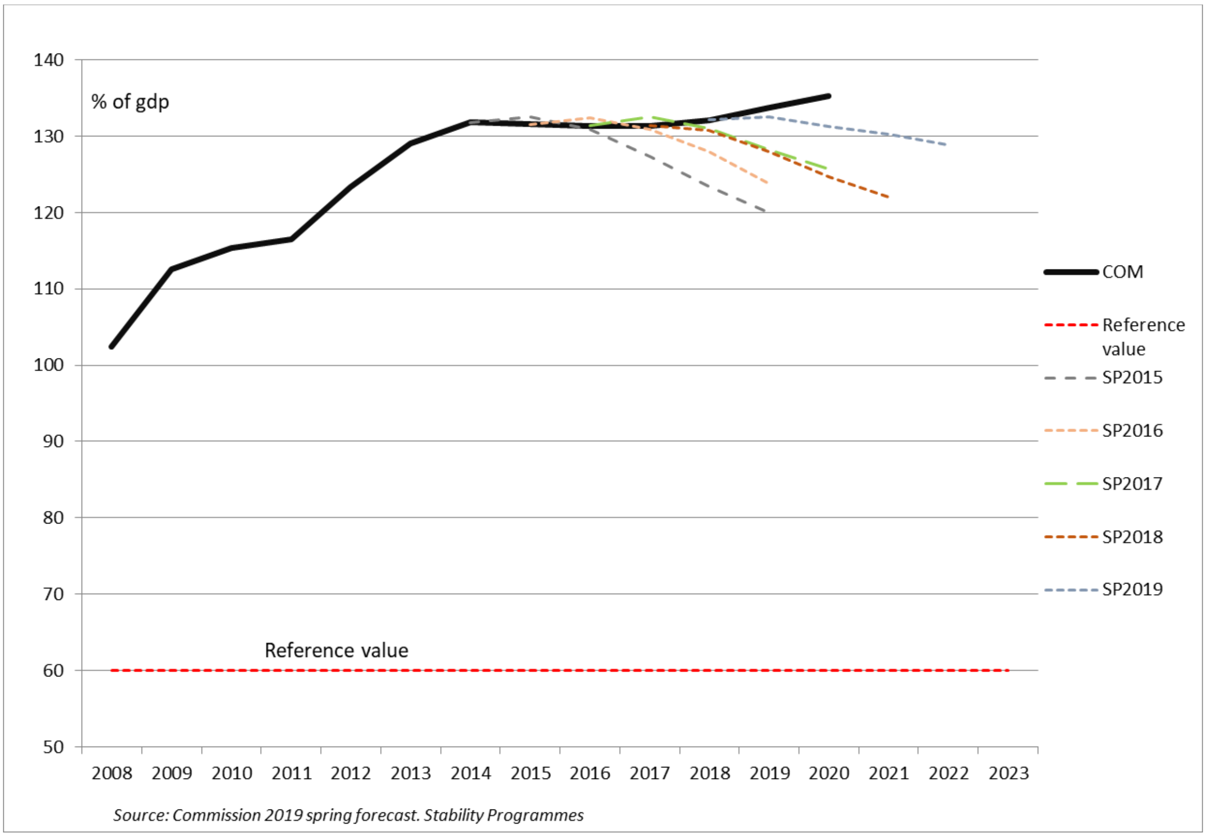
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2019 spring forecast (COM); Stability Programme (SP), Comission calculations.

Over the past years, Italy's stability programmes systematically postponed the reduction of the government debt-to-GDP ratio, reflecting actual deficit developments, relatively weak nominal GDP growth and – to a lesser extent – the constant underachievement of privatisation targets. The debt ratio was also increased by a significant stock-flow adjustment related to the support to the banking sector in 2017, and by the reclassification of several companies within the general government sector in 2017 and 2018 (see Section 3).

Figure 3: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

The Commission 2019 spring forecast projects the 2019 headline deficit at 2.5% of GDP, broadly in line with the 2.4 % deficit target of the Stability Programme. The difference is mainly explained by slightly higher expenditure growth (2.0% y-o-y against 1.9% in the Stability Programme). In the Stability Programme, revenues are expected to increase broadly in line with those projected in the Commission 2019 spring forecast. In fact, despite the more optimistic forecast for nominal GDP growth in the Stability Programme, the projections of the Stability Programme and the Commission forecast are broadly in line concerning the macroeconomic variables most relevant for revenue developments, such as private consumption, employment and wage growth.

In 2020, the Commission 2019 spring forecast points to a deficit of 3.5% of GDP, i.e. significantly higher than the 2.1% deficit target in the Stability Programme despite a similar forecast for real GDP growth. The difference in the deficit forecast is due to the fact that the Commission 2019 spring forecast does not consider the VAT hike legislated as a budgetary "safeguard clause" in 2020 (worth additional revenues amounting to 1.3% of GDP in 2020), due to past systematic repeals in absence of adequate compensating measures. The 2020 deficit target set by the Stability Programme is very demanding, especially because members of the government stated the intention of not activating the VAT hike and the Stability Programme itself mentions the need to find alternative financing measures in the coming months. Nevertheless, no details about such measures are provided in the Stability Programme, and only a general reference is made to possible future measures aimed at containing public spending and fighting tax evasion. However, once social transfers in cash are excluded, current primary expenditure increased only mildly in recent years as a consequence of the measures taken, leaving little room for additional sizeable savings from future spending reviews. Furthermore, although the low level of tax compliance points to a high potential for increasing tax revenues through measures against tax evasion, the related yields are uncertain and do not represent a solid enough basis for prudent budgetary planning. In addition, the often renewed possibility to settle past tax liabilities without fines and at advantageous conditions, systematically implemented in recent years, acts in an opposite direction by implicitly rewarding non-compliant behaviours.

Finally, the Stability Programme indicates the government's intention to find additional room for expansionary measures, such as the reduction of the tax burden for middle-income households "towards a flat-tax". This measure, potentially very costly, would further increase the amount of additional resources needed to achieve the budgetary targets. Risks to the deficit targets are even more pronounced for the outer years of the Programme period. In fact, the projected reduction in the government primary expenditure as a share of GDP appears optimistic in the absence of adequate measures, especially in light of the large additional resources possibly needed to refinance military missions abroad and other expenditure needed to keep current policies unchanged ("*politiche invariate*", see Section 3.3), which are not considered in the targets of the Stability Programme beyond 2020. In this context, the uncertainty on the implementation of the medium-term budgetary strategy of the Stability Programme entails downside risks for both the growth projections and the achievement of the budgetary targets. This is particularly relevant given Italy's high general government debt, which results in a strong market sensitivity to government’s fiscal strategy and possible implementation slippages. Any possible related increase in sovereign yields would negatively affect both the fiscal and – through potential spillovers to the private sector financing costs – the macroeconomic outlook.

The highlighted downside risks for budgetary and nominal GDP growth projections in the Stability Programme are compounded by additional risks for debt-to-GDP projections, concerning the ambitious privatisation targets included in the Stability Programme for 2019 and 2020. Finally, the track record of Italy’s past stability programmes shows that the authorities have been continuously delaying the year of attainment of the MTO (a balanced budget in structural terms), and thus an adequate reduction of the debt-to-GDP ratio (see Figure 3). Up to 2017 this was arguably related to a low growth and low inflation environment. However, a progressively improving fiscal position would help to maintain financial markets' confidence and thus low real interest rates.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council Recommendations addressed to Italy

On 13 July 2018, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended to Italy to "take action in 2018 and 2019 to 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, and to use windfall gains to accelerate the reduction of the general government debt ratio."

4.1. Compliance with the debt criterion

Italy's general government debt-to-GDP ratio increased in 2018 to 132.2% (from 131.4% in 2017), remaining well above the Treaty reference value of 60%. Based on the Commission 2019 spring forecast, Italy was not compliant with the debt reduction benchmark in that year (gap to the debt benchmark of 7.6% of GDP – see Table 5). Italy is not expected to comply with the debt reduction benchmark either in 2019 and 2020, according to both the Commission 2019 spring forecast and the projections of the Stability Programme. Gaps to compliance based on the Commission 2019 spring forecast are particularly large in both years (9.0 and 9.2% of GDP respectively). These gaps would be significantly lower (5.1 and 4.5% of GDP respectively, based on the forward-looking configuration of the benchmark) if the ambitious targets put forward in the Stability Programme for the period 2020-2022 were achieved.

As Italy did not comply with the debt reduction benchmark in 2018 based on notified data and the Commission 2019 spring forecast, there appears to be prima facie a risk of existence of an excessive deficit in Italy in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore prepared a report under Article 126(3) TFEU analysing whether or not Italy is compliant with the debt criterion of the Treaty. The report concluded that the debt criterion should be considered as not complied with.

Table 4. Compliance with the debt criterion

	2018	2019		2020	
		SP	COM	SP	COM
Gross debt ratio	**132.2**	**132.6**	**133.7**	**131.3**	**135.2**
Gap to the debt benchmark [1,2]	7.6	5.1	9.0	4.5	9.2
Structural adjustment [3]	-0.1	-0.2	-0.2	0.2	-1.2
To be compared to:					
Required adjustment [4]	n.r.	n.r.	n.r.	n.r.	n.r.

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (S/CP) budgetary projections for the previous years are achieved.

Source :
Commission 2019 spring forecast (COM); Stability Programme (SP), Commission calculations.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Assessment of requests for deviating from SGP requirements

The Stability Programme invokes an allowance from the adjustment path towards the medium-term budgetary objective in 2019 due to the additional expenditure related to the collapse of the Morandi bridge in Genoa and exceptionally adverse weather conditions that occurred in 2018. In particular, the 2019 Stability Programme indicates that the 2019 budget comprises exceptional expenditure amounting to about 0.2% of GDP in relation to an extraordinary maintenance programme for the road network and a preventive plan to limit hydrogeological risks. The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow catering for this additional expenditure, in that the unusual event is an exceptional event, its impact on Italy's public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the medium-term budgetary objective. However, following close scrutiny, only 0.18% of GDP can be preliminarily considered as expenditure directly linked to the unusual events and thus qualifying for a temporary deviation. A final assessment regarding 2019, including on the eligible amounts, will be made in spring 2020 on the basis of observed data as provided by Italy's authorities.

Adjustment towards the MTO

Italy is subject to the preventive arm of the SGP and has to ensure compliance with the required adjustment towards the MTO. As regards 2018, Italy was recommended to 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. However, the Commission Communication on the 2017 European Semester of May 20174 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. Following the Commission's assessment of the strength of the recovery in Italy while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Italy's 2018 Draft Budgetary Plan, a fiscal structural effort of at least 0.3% of GDP is required for 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth net of primary government expenditure not exceeding 0.5%. Based on notified data, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, because the growth rate of Italy's government primary expenditure, net of discretionary revenue measures and one-offs, was 2%, exceeding that recommended by the Council. In addition, the structural balance deteriorated by 0.1% of GDP in 2018, falling short of the adequate structural adjustment of at least 0.3% of GDP. An overall assessment thus points to non-compliance with the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018.

[4]https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendationscommission-recommendations-communication.pdf

For 2019, Italy is recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP. Based on the Stability Programme, the expenditure benchmark points to a risk of significant deviation both in 2019 (gap of 0.7% of GDP) and over 2018 and 2019 taken together (gap of 0.7% of GDP on average over the two years, after taking into account the "margin of discretion" in 2018), because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, at 1.8%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Stability Programme projects the (recalculated) structural balance to deteriorate by 0.2% of GDP in 2019. That points to a risk of significant deviation both over one year (gap of 0.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 0.6% on average over the two years, after taking into account the "margin of discretion" in 2018). An overall assessment based on the government plans points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2019. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

Based on the Commission 2019 spring forecast, the overall assessment based on the government's plans is confirmed, because the expenditure benchmark also points to a risk of significant deviation both in 2019 (gap of 0.9% of GDP) and over 2018 and 2019 taken together (gap of 0.8% of GDP on average over the two years, after taking into account the "margin of discretion" in 2018), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, at 2.0%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Commission expects Italy's structural balance to deteriorate by 0.2% of GDP in 2019. The structural balance pillar thus points to a risk of significant deviation both over one year (gap of 0.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 0.6% on average over the two years, after taking into account the "margin of discretion" in 2018). That conclusion would not change after considering the preliminarily granted allowance for unusual events in 2019.

For 2020, Italy is recommended to ensure that net primary government expenditure declines by 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP. Based on the Stability Programme, the expenditure benchmark points to a risk of some deviation in 2020 (gap of 0.3% of GDP) and of significant deviation over 2019 and 2020 taken together (gap of 0.5% of GDP on average over the two years), because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, at 0.6%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Stability Programme projects the (recalculated) structural balance to improve by 0.2% of GDP in 2020. That points to a risk of some deviation over one year (gap of 0.4% of GDP in 2020) and of significant deviation over 2019 and 2020 taken together (gap of 0.6% on average over the two years). The indications provided by both the expenditure benchmark and the structural balance pillars suggest that fiscal developments projected by the Stability

Programme, which incorporate the assumed implementation of the VAT hikes, are not sufficient to compensate for the planned significant deviation from the requirements in 2019. An overall assessment based on the government plans thus points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2020. That conclusion would not change after considering the preliminarily granted allowance for unusual events in 2019.

Based on the Commission 2019 spring forecast, the overall assessment based on the government's plans is confirmed, because the expenditure benchmark also points to a risk of significant deviation both in 2020 (gap of 1.5% of GDP) and over 2019 and 2020 taken together (gap of 1.2% of GDP on average over the two years), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, at 3.3%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Commission expects Italy's structural balance to deteriorate by 1.2% of GDP in 2020. That points to a risk of significant deviation both over one year (gap of 1.8% of GDP in 2019) and over 2019 and 2020 taken together (gap of 1.3% on average over the two years). That conclusion would not change after considering the preliminarily granted allowance for unusual events in 2019. Both for the expenditure benchmark and the structural balance pillar, the gaps to compliance in 2020 are significantly larger based on the Commission 2019 spring forecast than based on the Stability Programme, as the Commission forecast does not consider the VAT safeguard clauses and thus projects a worse fiscal outlook for 2020.

In summary, notified data point to a significant deviation from the recommended adjustment path towards the MTO in 2018. That finding would not change after considering the reduced requirement in 2018 following the application of the margin of discretion. Furthermore, an overall assessment based on both the Stability Programme and the Commission 2019 forecast points to a risk of significant deviation from the adjustment path towards the MTO both in 2019 and 2020. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and connections following the collapse of the Morandi bridge in Genoa and of a preventive plan to limit hydrogeological risks following adverse weather conditions were subtracted from the requirement of the preventive arm of the Stability and Growth Pact in 2019.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2018	2019		2020	
Background budgetary indicators[1]					
Medium-term objective (MTO)	0.0	0.0		0.5	
Structural balance[2] (COM)	-2.2	-2.4		-3.6	
Setting the required adjustment to the MTO					
Structural balance based on freezing (COM)	-1.7	-2.4		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
Required adjustment[4]	0.6	0.6		0.6	
Required adjustment corrected[5]	0.3	0.6		0.6	
Corresponding expenditure benchmark[6]	0.5	0.1		-0.1	
Compliance with the required adjustment to the MTO					
	COM	**SP**	**COM**	**SP**	**COM**
Structural balance pillar					
Change in structural balance[7]	-0.1	-0.2	-0.2	0.2	-1.2
One-year deviation from the required adjustment[8]	-0.4	-0.8	-0.8	-0.4	-1.8
Two-year average deviation from the required adjustment[8]	-0.4	-0.6	-0.6	-0.6	-1.3
Expenditure benchmark pillar					
Net public expenditure annual growth corrected for one-offs[9]	2.0	1.8	2.0	0.6	3.3
One-year deviation adjusted for one-offs[10]	-0.7	-0.7	-0.9	-0.3	-1.5
Two-year deviation adjusted for one-offs[10]	-0.5	-0.7	-0.8	-0.5	-1.2
Finding of the overall assessment	**Significant deviation**	**Significant deviation**	**Significant deviation**	**Significant deviation**	**Significant deviation**

Legend

'*Compliance*' - the recommended structural adjustment or a higher adjustment is being observed.

'*Some deviation*' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.

'*Significant deviation*' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.). In case of a SDP, the requirement corresponds to the Council recommendation when available, otherwise it refers to the Commission recommendation to the Council.

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[7] Change in the structural balance compared to year t-1. Expost assessment (for 2018) is carried out on the basis of Commission 2019 spring forecast.

[8] The difference of the change in the structural balance and the corrected required adjustment.

[9] Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source:

Stability Programme (SP); Commission 2019 spring forecast (COM); Commission calculations.

5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

Italy does not appear to face fiscal sustainability risks in the short run. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges, mainly related to the high debt-to-GDP ratio.[5]

Based on Commission 2019 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, projected at 133.7% of GDP in 2019, is expected to steadily rise to 153.4% in 2029, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2029. The sensitivity analysis shows higher risks.[6] Overall, this highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would nonetheless put debt on a slightly decreasing path by 2029, although remaining above the 60% of GDP reference value in 2029.

The medium-term fiscal sustainability risk indicator S1[7] is at 10.2 percentage points of GDP, primarily related to the high level of government debt and the initial budgetary position, contributing 5.2 and 4.1 percentage points of GDP, respectively. This indicator thus signals high risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at 8.3 percentage points of GDP. Based on the debt sustainability analysis and the S1 indicator, overall medium-term fiscal sustainability risks are, therefore, high. Fully implementing the fiscal plans in the Stability Programme would slightly decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 3.2 % of GDP. In the long term, Italy therefore appears to face medium fiscal sustainability risks, primarily related to the initial budgetary position, contributing by 2.1 percentage points of GDP. Full implementation of the programme would nonetheless put the S2 indicator at 0.8 percentage points of GDP, leading to a lower long-term risk.[8] The debt sustainability analysis discussed above points to high risks so that, overall, long-term fiscal sustainability risks are assessed as high for Italy.

[5] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 6 for a definition of the indicator.

[6] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

[7] See the note to Table 6 for a definition of the indicator.

[8] The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report. The fiscal sustainability indicators under the "Stability/Convergence Scenario" take into account the introduction of new provisions on pensions, including a new early retirement scheme, approved by the government in January 2019 (Law n. 26/2019).

Table 6: Debt sustainability analysis and sustainability indicators

Time horizon			Commission Scenario		Stability / Convergence Programme Scenario	
Short-term			**LOW risk**			
S0 indicator [1]			0.4			
	Fiscal subindex		0.5	HIGH risk		
	Financial & competitiveness subindex		0.3	LOW risk		
Medium-term			**HIGH risk**			
DSA [2]			HIGH risk			
S1 indicator [3]			10.2	HIGH risk	8.3	HIGH risk
of which	Initial Budgetary Position		4.1		1.8	
	Debt Requirement		5.2		5.7	
	Cost of Ageing		0.9		0.8	
	of which	Pensions	0.9		0.8	
		Health care	0.3		0.2	
		Long-term care	0.1		0.1	
		Other	-0.4		-0.3	
Long-term			**HIGH risk**			
DSA [2]			HIGH risk			
S2 indicator [4]			3.2	MEDIUM risk	0.8	LOW risk
of which	Initial Budgetary Position		2.1		-0.1	
	Cost of Ageing		1.1		0.9	
	of which	Pensions	-0.1		-0.3	
		Health care	0.7		0.7	
		Long-term care	0.9		0.9	
		Other	-0.4		-0.3	

Source: Commission services; 2019 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2018.

6. FISCAL FRAMEWORK

Italy's national fiscal framework is based on two main legal texts: (i) Law 243/2012, which includes the main implementation provisions of the balanced budget principle pursuant to article 81(6) of the Constitution and can be amended only through a reinforced procedure (i.e. requiring the majority of Members of Parliament). Law 243/2012 inter alia requires consistency of national budgetary targets with the EU legislation; and (ii) Law 196/2009, the Government Accounting and Public Finance Act, which includes all the detailed implementation provisions to manage Italy's public finances at the central and local levels.

In 2016, two remaining enacting decrees of Law 196/2009 were adopted together with a reform of the structure of budget itself. Therefore, the reform of the budgetary process in Italy can be considered formally concluded. In 2017, the administrative steps needed to implement such actuating decrees progressed, namely concerning innovations on the accounting systems. In addition, some corrections to the 93/2016 enacting decree were introduced with the DL 29/2017, in order to improve the accounting and budgetary framework. The 2018 budget encouraged investment at the local level by introducing earmarked quotas within the national budgetary framework. With the aim to further support investment at the local level, the 2019 budget modified the fiscal framework allowing subnational governments to spend their budgetary surpluses without explicit authorisation from the central government.

Overall, based on the information provided in the Stability Programme, the past and planned fiscal performance in Italy over the period 2018-2020 appears not to comply with the requirements of the applicable national numerical fiscal rules, according to the Parliamentary Budget Office (PBO), Italy's independent fiscal council. Despite the requirement by the national legislation, the Stability Programme does not indicate whether the deviation from the structural target in 2018 will affect budgetary developments in the coming years and whether the fiscal targets will compensate for that. Furthermore, according to the PBO the 2019 target does not comply with the expenditure rule or the structural balance rule, while the 2020 target does not comply with the structural balance rule. The targets set for 2021-2022 broadly comply with the expenditure rule and the structural balance rule, according to the PBO. At the same time, the PBO assesses the targets for the period 2019-2022 as not compliant with the debt reduction benchmark.

The Economic and Financial Document, which includes the Stability Programme and the national reform programme, serves as national medium-term fiscal plan in the sense of Regulation (EU) No 473/2013, although there is no statement in this respect in the Stability Programme. The content requirement (referred to in Art. 4.1 of Regulation 473/2013) to list the expected economic returns on non-defence public investment projects that have a significant budgetary impact is only partially complied with. Namely, the Stability Programme indicates that additional resources have been earmarked for public investment and that specific funds have been established to this purpose, providing estimates of the expected economic returns.

The macroeconomic forecast underlying the Stability Programme

In April 2019, the Parliamentary Budget Office (PBO), validated both the baseline and policy scenario of macroeconomic projections of the Stability Programme.[9] The macroeconomic

[9] http://www.upbilancio.it/wp-content/uploads/2019/04/Lettera-di-validazione-QMT-DEF-2019-con-lettera-esplicativa.pdf
http://www.upbilancio.it/wp-content/uploads/2019/04/UPB_Lettera-validazione-QMP-DEF-2019-2022.pdf

projections of the Stability Programme in the policy scenario are positioned within the bounds of the forecast range considered by the PBO for its assessment. However, the PBO stresses that the projections are subject to sizeable downward risks, both external and domestic, and that the government's projections for investment exceed the PBO panel forecast range by a marked margin.[10]

7. SUMMARY

In 2018, Italy's structural balance deteriorated by 0.1 % of GDP and Italy's government primary expenditure, net of discretionary revenue measures and one-offs, grew by 2%, based on the Commission 2019 spring forecast, pointing to non-compliance with the required adjustment towards the MTO. That finding would not change even after considering the reduced requirement in 2018 following the application of the margin of discretion. The ex-post assessment thus suggests that Italy's adjustment path towards the MTO was not compliant with the requirements of the preventive arm of the SGP in 2018.

The debt-to-GDP ratio increased in 2018 to 132.2 % of GDP, thus remaining well above the Treaty reference value of 60 %. Based on notified data and the Commission 2019 spring forecast, Italy was not compliant with the debt reduction benchmark in that year and is not expected to comply in 2019 and 2020 either. Due to Italy's prima facie non-compliance with the debt reduction benchmark in 2018, the Commission has prepared a report under Article 126(3) TFEU analysing whether or not Italy is compliant with the debt criterion of the Treaty. The report concluded that the debt criterion should be considered as not complied with.

As regards 2019, Italy was recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1%, corresponding to an annual structural adjustment of 0.6 % of GDP. The Commission 2019 spring forecast expects Italy's structural balance to deteriorate by 0.2% of GDP in 2019 in line with the (recalculated) projections of the 2019 Stability Programme. An overall assessment based on both the Commission 2019 spring forecast and the Stability Programme points to a risk of significant deviation from the preventive arm requirement both in 2019 and over 2018 and 2019 taken together.

For 2020, Italy is recommended to ensure that net primary government expenditure declines by 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP. The Stability Programme plans a 0.6% increase of primary government expenditure, net of discretionary revenue measures and one-offs, and a (recalculated) structural improvement of 0.2% of GDP, while the Commission expects Italy's structural balance to further deteriorate by 1.2% of GDP. The difference is mainly due to the fact that the Commission 2019 spring forecast does not include a VAT hike (worth 1.3% of GDP) legislated for 2020 as a "safeguard clause" to ensure the achievement of the budgetary targets, as such increase was systematically repealed in recent years. Taking into account the preventive arm requirement, an overall assessment based on both the Commission 2019 spring forecast and the Stability Programme points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2020 and over 2019 and 2020 taken together

[10] http://www.upbilancio.it/wp-content/uploads/2019/04/Audizione-DEF-2019_Pisauro.pdf

8. ANNEXES

Table I. Macroeconomic indicators

	2001-2005	2006-2010	2011-2015	2016	2017	2018	2019	2020
Core indicators								
GDP growth rate	0.9	-0.3	-0.6	1.1	1.7	0.9	0.1	0.7
Output gap [1]	1.2	0.1	-3.4	-2.0	-0.5	-0.1	-0.3	-0.1
HICP (annual % change)	2.4	2.0	1.6	-0.1	1.3	1.2	0.9	1.1
Domestic demand (annual % change) [2]	1.1	-0.1	-1.4	1.5	1.4	0.9	0.1	0.7
Unemployment rate (% of labour force) [3]	8.3	7.1	11.2	11.7	11.2	10.6	10.9	11.0
Gross fixed capital formation (% of GDP)	20.9	20.8	17.8	17.2	17.6	18.0	17.9	18.0
Gross national saving (% of GDP)	20.6	19.0	18.1	20.0	20.1	20.4	20.3	20.3
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.5**	**-3.4**	**-3.0**	**-2.5**	**-2.4**	**-2.1**	**-2.5**	**-3.5**
Gross debt	**101.8**	**106.5**	**126.4**	**131.4**	**131.4**	**132.2**	**133.7**	**135.2**
Net financial assets	**-94.1**	**-94.3**	**-116.4**	**-128.0**	**-125.5**	**n.a**	**n.a**	**n.a**
Total revenue	43.6	45.2	47.4	46.5	46.5	46.4	46.7	46.3
Total expenditure	47.1	48.7	50.5	49.0	48.9	48.6	49.2	49.8
of which: Interest	5.1	4.6	4.7	3.9	3.8	3.7	3.6	3.7
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**0.1**	**-0.5**	**2.0**	**3.4**	**4.0**	**3.6**	**3.9**	**5.0**
Net financial assets; non-financial corporations	**-107.0**	**-130.0**	**-122.6**	**-120.9**	**-119.8**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**-9.3**	**13.2**	**33.1**	**42.7**	**38.0**	**n.a**	**n.a**	**n.a**
Gross capital formation	11.0	10.6	9.4	9.9	9.7	10.1	9.8	9.7
Gross operating surplus	23.7	21.9	20.6	21.8	21.5	21.1	20.9	20.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.9**	**1.8**	**1.3**	**1.4**	**0.9**	**1.0**	**1.1**	**1.0**
Net financial assets	**200.9**	**191.9**	**185.5**	**196.6**	**201.4**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	27.3	28.7	29.1	29.3	29.3	29.7	29.7	29.7
Net property income	14.7	13.3	10.8	9.9	9.7	9.6	9.2	8.7
Current transfers received	20.7	22.2	24.3	24.3	24.1	24.2	25.0	25.4
Gross saving	10.2	9.2	7.3	7.1	6.5	6.6	6.8	6.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-0.4**	**-2.2**	**0.3**	**2.3**	**2.6**	**2.4**	**2.5**	**2.5**
Net financial assets	**11.5**	**22.6**	**25.7**	**14.8**	**10.8**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	0.6	-0.9	1.5	3.2	2.9	2.5	2.3	2.2
Net primary income from the rest of the world	-0.3	-0.1	-0.3	0.2	0.5	0.9	1.3	1.3
Net capital transactions	0.1	0.0	0.2	-0.2	0.0	0.0	0.0	0.0
Tradable sector	44.3	41.6	40.4	41.2	41.6	41.7	n.a	n.a
Non tradable sector	46.0	48.4	49.5	48.6	48.0	47.9	n.a	n.a
of which: Building and construction sector	4.9	5.3	4.6	4.3	4.2	4.2	n.a	n.a
Real effective exchange rate (index, 2000=100)	90.6	99.8	98.9	96.2	95.9	97.9	95.5	94.2
Terms of trade goods and services (index, 2000=100)	104.4	100.3	98.6	105.0	102.9	101.7	100.9	100.8
Market performance of exports (index, 2000=100)	120.8	105.2	99.8	96.1	97.0	96.2	95.4	95.0

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2019 spring forecast

Mandatory variables not included in the Stability Programme

The Stability Programme contains all mandatory variables.