REPORT FROM THE COMMISSION

Italy

Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). That procedure is further set out in Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1], which is part of the Stability and Growth Pact (SGP). Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3%; and (b) whether the ratio of government debt to GDP exceeds the reference value of 60%, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Article 126(3) TFEU provides that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. That report must also "*take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*".

This report, which represents the first step in the EDP, analyses Italy's compliance with the debt criterion of the Treaty in 2017, with due regard to the economic background and other relevant factors. On 29 October 2018, the Commission addressed a letter to the Italian authorities announcing its intention to reassess Italy's compliance with the debt criterion in autumn 2018, taking into account the material change in the relevant factors represented by the 2019 Draft Budgetary Plan.

On 23 May 2018, the Commission issued a report under Article 126(3) TFEU[3], as Italy did not make sufficient progress towards compliance with the debt criterion in 2017. The report concluded that the criterion should be considered as complied with at the time, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. The report also noted a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018, based on both the government plans and the Commission 2018 spring forecast.

[1] OJ L 209, 2.8.1997, p. 6. This report also takes into account the "*Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes*", adopted by the Economic and Financial Committee on 15 May 2017, available at: http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf

[2] Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

[3] 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".

However, Italy's fiscal plans for 2019 represent a material change in the relevant factors analysed by the Commission last May. In particular, on 16 October Italy submitted its 2019 draft budgetary plan[4], entailing a deterioration of the (recalculated) structural balance[5] of 0.9% of GDP in 2019. On 23 October 2018, the Commission adopted an Opinion[6] on the 2019 draft budgetary plan, identifying particularly serious non-compliance with the fiscal recommendation addressed to Italy by the Council on 13 July 2018 and requesting Italy to submit a revised draft budgetary plan. On 13 November 2018, Italy submitted a revised draft budgetary plan for 2019. The changes in the revised 2019 draft budgetary plan were very limited, mainly consisting in a higher privatisation target for 2019 (1% of GDP in lieu of 0.3%). On 21 November 2018, the Commission adopted its Opinion on Italy's revised 2019 draft budgetary plan, confirming the particularly serious non-compliance with the fiscal recommendation for 2019. This justifies a new assessment of compliance with the debt reduction benchmark in 2017.

The data notified by the authorities in October 2018[7] and subsequently validated by Eurostat[8] show that Italy's general government deficit declined to 2.4% of GDP in 2017 (down from 2.5% in 2016), while the debt stabilised at 131.2% of GDP (from 131.4% in 2016), i.e. above the 60% of GDP reference value. For 2018, Italy's revised 2019 draft budgetary plan projects the debt-to-GDP ratio to slightly decrease to 130.9%. In 2019, it projects a further decline (of 1.7 percentage points) in the debt-to-GDP ratio to 129.2%. Based on notified data and the Commission 2018 autumn forecast, Italy did not comply with the debt reduction benchmark either in 2016 (gap of 5.2% of GDP) or in 2017 (gap of 6.6% of GDP) (see Table 1).

Overall, Italy's lack of compliance with the debt reduction benchmark in 2017 provides evidence of a *prima facie* existence of an excessive deficit within the meaning of the SGP before, however, considering all factors as set out below. Moreover, based on both the government plans and the Commission 2018 autumn forecast, Italy is not expected to comply with the debt reduction benchmark either in 2018 (gap of 3.7% and 6.6% of GDP, respectively) or in 2019 (gap of 3.6% and 6.7% of GDP respectively).

The Commission has therefore prepared this report to comprehensively assess the departure from the debt reduction benchmark and examine whether the launch of an excessive deficit procedure is warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the medium-term budgetary objective (MTO). The report takes into account the Commission 2018 autumn forecast, released on 8 November 2018. The Commission forecast is based on the 2019 draft budgetary plan and not on the revised one, but the changes between the two documents are marginal.

[4] https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_it_en_1.pdf

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

[6] Commission Opinion C(2018) 7510 final, 23.10.2018, on the Draft Budgetary Plan of Italy and requesting Italy to submit a revised Draft Budgetary Plan.

[7] According to Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Italy can be found at: http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables

[8] Eurostat news release No 163/2018 of 22 October 2018, available at: https://ec.europa.eu/eurostat/documents/2995521/9328077/2-22102018-AP-EN.pdf/e1b423ef-a337-42ea-90cb-4a6775ba4c07

Table 1: General government deficit and debt (% of GDP) [a]

		2015	2016	2017	2018		2019	
					COM	DBP	COM	DBP
Deficit criterion	General government balance	-2.6	-2.5	-2.4	-1.9	-1.8	-2.9	-2.4
Debt criterion	General government gross debt	131.6	131.4	131.2	131.1	130.9	131.0	129.2
	Gap to the debt reduction benchmark	n.r.	5.2	6.6	6.6	3.7	6.7	3.6
	Change in structural balance	0.1	-0.7	-0.3	0.0	0.2	-1.2	-0.9
	Required MLSA	3.4	n.r.	n.r	n.r.	n.r.	n.r.	n.r.

Notes:

[a] In percent of GDP unless otherwise specified; "n.r." indicates "not relevant"

Source: *Commission services, Italy's revised 2019 DBP and Commission 2018 autumn forecast*

2. DEFICIT CRITERION

Italy made a sizeable fiscal effort between 2010 and 2013, raising the primary surplus to over 2% of GDP and exiting the excessive deficit procedure in 2013 by keeping its headline deficit at a level not above 3% of GDP as of 2012 (down from more than 5% in 2009). However, the fiscal stance eased in recent years. In 2017, the primary surplus decreased to 1.4% and the headline deficit stabilised at around 2.4% of GDP. Yet, both are set to improve in 2018. In 2019 and 2020, both the headline and the primary balance are expected to substantially deteriorate, mainly due to the measures included in the 2019 draft budgetary plan and confirmed in the revised 2019 draft budgetary plan.

Italy's general government deficit was reported at 2.4% of GDP in 2017. According to both the revised draft budgetary plan and the Commission 2018 autumn forecast, it is projected to respect the Treaty reference value of 3% of GDP during the period 2018-2019. However, the reference value will be exceeded in 2020 according to the Commission forecast, under a no-policy change assumption. The revised 2019 draft budgetary plan projects the general government deficit at 1.8% of GDP in 2018 and 2.4% in 2019. Italy's *Nota di Aggiornamento al DEF*, updating the budgetary targets of Italy's 2018 Stability Programme, projects the headline deficit to decline to 2.1% of GDP in 2020. The increase in the general government deficit projected for 2019 largely results from the budgetary measures envisaged in the revised 2019 draft budgetary plan, with a net deficit-increasing impact of around 1.2% of GDP in the government projections. The decrease in the general government deficit projected in 2020 is largely due to the impact (around 0.7% of GDP) of higher VAT rates legislated for 2020 as a safeguard clause. The Commission 2018 autumn forecast projects that Italy's general government deficit will be at 1.9% of GDP in 2018 and rise to 2.9% in 2019. The deficit forecast by the Commission for 2018 is slightly higher than that projected by the revised 2019 draft budgetary plan, and that difference is mainly explained by more prudent assumptions on the size of public spending, including interest expenditure. The deficit forecast by the Commission for 2019 is also higher than that projected by the revised 2019 draft budgetary plan, and that difference is mainly due to lower GDP growth and higher interest expenditure than in the government projections. The Commission 2018 autumn forecast projects that Italy's general government deficit will reach 3.1% of GDP in 2020, under a no-policy-change assumption. The higher deficit forecast by the Commission for

2020 compared to the government's projections is mainly explained by the fact that the Commission does not include the higher VAT rates legislated for 2020 as a safeguard clause, while the other factors are lower nominal GDP growth and higher interest spending.

Thus, Italy currently complies with the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/97, although there is a risk that the deficit criterion will not be complied with in 2020 according to the Commission 2018 autumn forecast, under a no-policy change assumption.

3. DEBT CRITERION

After growing by 5 percentage points per year on average during the double-dip recession of 2008-2013, Italy's government debt-to-GDP ratio continued to increase in 2014-2015 at a slower pace of 1 percentage point per year on average, before peaking at 131.4% in 2016 and slightly declining to 131.2% in 2017. Based on the revised 2019 draft budgetary plan, the debt-to-GDP ratio is expected to progressively decline to 130.9% in 2018, 129.2% in 2019 and 127.3% in 2020. The Commission forecasts projects the debt ratio to remain stable at around 131% over 2018-2020. Up to 2018, favourable – although worsening – financing conditions contributed to underpin the economic recovery and reduce the snowball effect. Thereafter, rising financing costs, a reduced primary surplus and below-target privatisation proceeds are expected to hamper debt reduction. While debt refinancing risks are limited in the short term, the high public debt remains an important source of vulnerability for the Italian economy.

Following the abrogation of the EDP in June 2013, Italy was subject to a three-year transition period towards compliance with the debt reduction benchmark, which started in 2013 and ended in 2015. After the end of the transition period, the debt reduction benchmark became applicable in 2016. Based on notified data and the Commission forecast, the gap to the debt benchmark amounted to 5.2% of GDP in 2016 and to 6.6% in 2017. Moreover, based on the revised 2019 draft budgetary plan, Italy is not projected to comply with the debt reduction benchmark either in 2018 (gap to the debt benchmark of 3.7% of GDP) or in 2019 (gap to the debt benchmark of 3.6% of GDP). This conclusion is confirmed based on the Commission forecast (gap to the debt benchmark of 6.6% and 6.7% of GDP in 2018 and 2019 respectively).

More specifically, the debt-to-GDP ratio reached 131.2% in 2017, i.e. 0.2 percentage points lower than in 2016. The decrease was limited partly due to a still debt-increasing "snowball" effect, as the real implicit cost of debt,[9] while gradually shrinking (to 2.4%, from 2.7% in 2013), remained above real GDP growth (1.6%). In fact, real spot interest rates on new government securities issuances, hovering around zero in 2015-2017, only gradually passed through into the real servicing cost of the outstanding debt stock, given the duration of the Italian debt and the roll-over period combined with low inflation (GDP deflator growth of 0.6%) – see also Table 2 and Graph 1. The positive interest rate-growth rate differential (0.9 percentage points, compared to 0.8 in 2016) implied a still large debt-increasing impact from the "snowball" effect (1.1% of GDP, compared to 1.0% in 2016 – see Table 2). On the other hand, a broadly stable primary surplus at 1.4% of GDP helped to curb debt dynamics in 2017.

[9] The real implicit cost of debt at time *t* can be defined as the nominal yield paid by the government to service the outstanding debt at time *t-1*, net of the impact of inflation at time *t*. In Table 2, the yearly change in debt-to-GDP ratio due to the real implicit cost of debt can be obtained by adding the respective contributions from interest expenditure (debt-increasing) and GDP deflator (debt-decreasing).

The stock-flow adjustment was slightly debt-increasing in 2017 (0.2%), mainly due to the support to the banking sector,[10] partly offset by the reduction in the liquidity buffer, while there were no privatisation proceeds.[11]

In 2018, the revised 2019 draft budgetary plan projects the debt-to-GDP ratio to decrease to 130.9%, down by 0.3 percentage point from the 2017 level. The projected dynamics are mainly the result of a declining although still debt-increasing “snowball” effect (0.5% of GDP),[12] and a small improvement in the primary surplus (to 1.8% of GDP) more than offsetting the debt-increasing stock-flow adjustment (1.0% of GDP). The Commission forecasts the debt ratio to decrease to 131.1% of GDP in 2018, slightly above the revised 2019 draft budgetary plan. The difference is due to a slightly lower projected primary surplus and a higher "snowball" effect, related to marginally higher projections for the real implicit cost of debt.

For 2019, the revised 2019 draft budgetary plan projects a large decline in the debt-to-GDP ratio by 1.7 percentage point to 129.2%. The latter is mainly due to a debt-decreasing stock-flow adjustment (-0.1% of GDP), mainly explained by large privatisation proceeds planned by the government (1% of GDP), and a marginally debt-decreasing "snowball" effect, explained by a strong projected increase in nominal growth as compared to 2018, expected to offset a shrinking primary surplus (at 1.2% of GDP). The Commission forecasts the debt-to-GDP ratio to remain broadly stable in 2019, at 131.0%. The difference is related to significantly lower projections for nominal growth and a higher forecast for interest spending, reflecting in a still sizable debt-increasing "snowball" effect, as well as to a lower projected primary surplus (1% of GDP) and lower privatisation proceeds. Risks to the debt projections in both the Commission forecast and the revised 2019 draft budgetary plan are related to a worse-than-anticipated growth outlook, stronger deterioration of the primary balance, lower inflation or privatisation proceeds, and higher-than-expected interest spending.

The Commission forecasts the debt-to-GDP ratio to remain broadly stable also in 2020, as a further deteriorating primary surplus and increasing interest spending are expected to offset nominal GDP growth.

As shown in Graph 1, the gradual decrease in real implicit debt-servicing cost (*dashed black line*) and the recovery in real GDP growth (*solid blue line*) implied up to 2016 a progressive shrinking of their differential (*yellow shade*), which is set to remain broadly stable over the period 2018-2019, and to slightly increase in 2020 due to the rising real implicit cost of debt. Overall, the debt-increasing “snowball” effect fell in 2017 to 1.1% of GDP, which compares with the pre-crisis average of 1.2% over 2000-2007. Hence, the "snowball" effect offers only a partial explanation for Italy's lack of compliance with the debt reduction benchmark in 2017 and in the coming years.

Overall, this analysis thus suggests that *prima facie* the debt criterion for the purpose of the Treaty and Regulation (EC) No 1467/97 is not fulfilled, whether based on the revised 2019

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[10] In fact, based on notified data, the bank rescue operations related to Banca Monte Paschi and the two Venetian Banks impacted the debt by close to 1% of GDP and the deficit by close to 0.4% of GDP.

[11] Other minor transactions affecting the stock-flow adjustment are not reported. See also the Italian Ministry of Economy and Finance's *Public Debt Report 2017*, at: http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_it/debito_pubblico/presentazioni_studi_relazioni/Rapporto_sul_Debito_Pubblico_2017.pdf

[12] In particular, the “snowball” effect is reduced thanks to much higher inflation and marginally lower interest spending.

draft budgetary plan or the Commission forecast, before consideration is given to all relevant factors as set out below.

Table 2: Debt dynamics [a]

	2015	2016	2017	2018		2019	
				COM	DBP	COM	DBP
Government gross debt ratio	131.6	131.4	131.2	131.1	130.9	131.0	129.2
Change in debt ratio [b] (1 = 2+3+4)	-0.2	-0.2	-0.1	-0.1	-0.3	-0.1	-1.7
Contributions:							
• Primary balance (2)	-1.5	-1.4	-1.4	-1.7	-1.8	-1.0	-1.2
• "Snowball" effect (3)	1.7	1.0	1.1	0.6	0.5	0.7	-0.3
of which:							
Interest expenditure	*4.1*	*3.9*	*3.8*	*3.7*	*3.6*	*3.8*	*3.6*
Real GDP growth	*-1.2*	*-1.5*	*-2.0*	*-1.5*	*-1.5*	*-1.5*	*-1.9*
Inflation (GDP deflator)	*-1.2*	*-1.4*	*-0.6*	*-1.6*	*-1.6*	*-1.7*	*-2.0*
• Stock-flow adjustment (4)	-0.4	0.2	0.2	1.1	1.0	0.2	-0.1
of which:							
Cash/accruals difference	*0.3*	*-0.8*	*1.3*	*0.7*	*0.5*	*0.5*	*0.5*
Net accumulation of financial assets	*-0.7*	*1.0*	*-1.2*	*0.4*	*0.0*	*-0.3*	*-0.7*
of which privatisation proceeds	*-0.4*	*-0.1*			*-0.3*	*-0.2*	*-1.0*
Valuation effect & residual	*0.0*	*0.0*	*0.0*	*0.0*	*0.5*	*0.0*	*0.1*

Notes:

[a] In percent of GDP unless otherwise specified

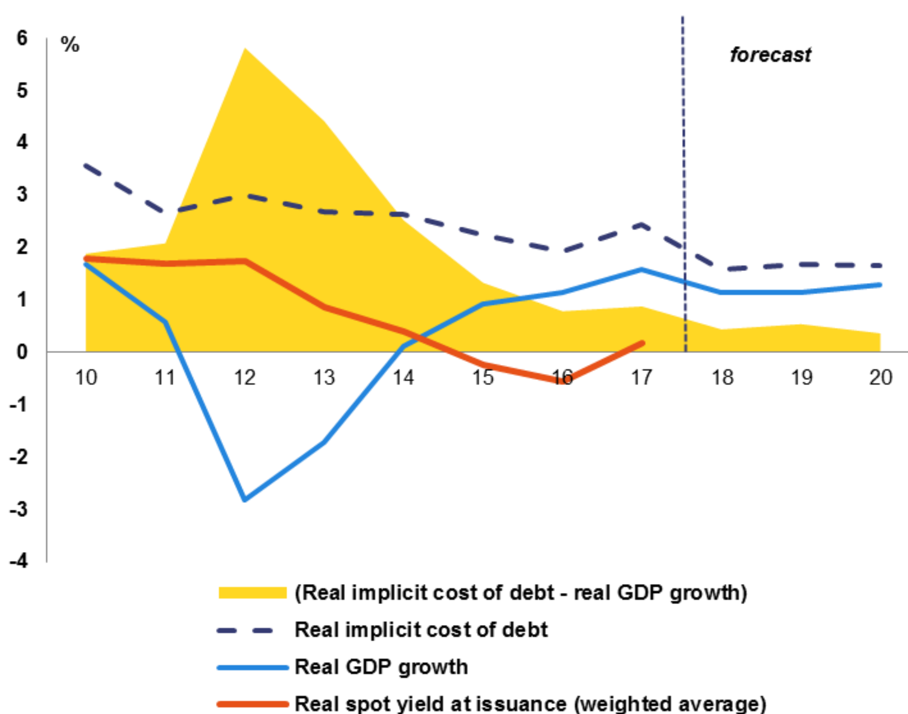
[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t}\right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: Commission services, Italy's revised 2019 DBP and Commission 2018 autumn forecast

Graph 1: Drivers of "snowball effect" on government debt



Source: Commission 2018 autumn forecast

4. RELEVANT FACTORS

Article 126(3) TFEU provides that the Commission report "*shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*". Those factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also provides that "*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and to the Commission*" need to be given due consideration.

In case of an apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted, given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach. In that respect, at least the following three main aspects need to be considered (and have been considered in the past)[13] when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the MTO or the adjustment path towards it, which is supposed to ensure sustainability or rapid progress towards sustainability under normal macroeconomic circumstances. As by construction the country-specific MTO takes into account the debt level and implicit liabilities, compliance with the MTO or the adjustment path towards it should ensure convergence of the debt ratios towards prudent levels at least in the medium term;
2. structural reforms, already implemented or detailed in a structural reform plan, which are expected to enhance sustainability in the medium term through their impact on growth, thereby contributing to bring the debt-to-GDP ratio on a satisfactory downward path. Overall, adherence to the MTO (or the adjustment path towards it), alongside with the implementation of structural reforms (in the context of the European Semester), is expected under normal economic conditions to bring debt dynamics on a sustainable path through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms);
3. unfavourable macroeconomic conditions and, in particular, low inflation, which can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding. A low-inflation environment makes it more demanding for a Member State to comply with the debt reduction benchmark. Under such conditions, adherence to the MTO or the adjustment path towards it is a key relevant factor in assessing compliance with the debt criterion.

In view of those provisions, the following subsections consider: (1) the medium-term economic position, including the state of play in terms of implementation of structural reforms; (2) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and of public investment; (3) the developments in the medium-term government debt position, including its sustainability

[13] See the 126(3) Reports COM(2015) 113 final, 27.2.2015; COM(2016) 305 final, 18.5.2016; and COM(2018) 428 final, 23.5.2018.

prospects; (4) other factors deemed relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term economic position

Macroeconomic conditions, with nominal GDP growth above 2% since 2016 despite recently intensified downside risks, cannot be argued to be a mitigating factor in explaining Italy's large gaps to compliance with the forward-looking debt reduction benchmark. On the other hand, low productivity growth still constrains Italy's potential growth and hampers a faster reduction of the debt ratio. While Italy had made some progress in addressing the 2017 Country-Specific Recommendations (CSRs), the measures included in the 2019 revised draft budgetary plan indicate a backtracking on the past progress as well as with regard to the structural fiscal aspects of the recommendations addressed to Italy by the Council on 13 July 2018.

Cyclical conditions, potential growth and inflation

Italy's real GDP growth reached 1.6% in 2017. Both the revised 2019 draft budgetary plan and the Commission forecast expect it to soften in 2018 (at 1.2% and 1.1% respectively). In 2019, the revised 2019 draft budgetary plan expects real GDP growth to accelerate to 1.5%, while the Commission projects a milder recovery both in 2019 (1.2%) and in 2020 (1.3%). Potential growth is estimated to have finally turned positive in 2017, at 0.3%, (up from -0.2% in 2016) and to further pick up in 2018-2020, while remaining at very low levels. As a result, Italy's negative output gap is estimated by the Commission to close quickly, from -3.6% of potential GDP in 2015 to -0.3% in 2018, before turning positive in 2019 (at 0.3%) and further increasing in 2020 (to 0.8%).

Despite the past progress achieved in important reform areas (e.g. labour market and public administration reforms, fight against tax evasion, banks' balance sheet repair), the legacy of the crisis and remaining structural weaknesses continue to weigh on Italy's potential growth.[14] Italy's GDP is still below the pre-crisis level and has not grown compared to 15 years ago, while annual growth has averaged 1.2% in the rest of the euro area. This is also explained by structural factors that hamper the efficient allocation of resources and constitute a drag on productivity. A still large share of old-age pensions and debt-servicing costs in Italy's overall public spending restrains growth-enhancing spending items like education and infrastructure. The high tax burden on production factors and still low tax compliance continue to hold back economic growth. Employment growth was supported by labour market reforms and hiring incentives, but was largely driven by temporary contracts, while still high levels of long-term and youth unemployment weigh on future economic growth prospects. The business environment continues to hinder entrepreneurship, including due to weak spots in the public administration and very lengthy civil and criminal justice proceedings. Finally, investment, in particular in intangible assets, is still low. In that context, it is important for Italy to pursue the reform effort in order to improve medium-term growth prospects and enhance the sustainability of the country's public finances.

After remaining around 0% in 2015 and 2016, mainly due to low aggregate demand, limited wage pressures and a fall in energy prices, headline Harmonised Index of Consumer Price

[14] See Commission Staff Working Document SWD(2018) 210 final, 7.3.2018, "*Country Report Italy 2018. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

(HICP) inflation increased in 2017, at 1.3%, mainly driven by higher energy prices. Based on the Commission forecast, it is expected to remain stable at 1.3% in 2018 and to further rise to 1.5% in 2019, largely driven by higher oil prices, before slightly moderating to 1.4% in 2020. Core inflation is also set to pick up gradually over the coming years – in line with moderate wage growth – and reach 1.4% in 2020.

Until recently, the possibility for Italy to deliver large fiscal efforts in order to decisively bring down its debt-to-GDP ratio has been hampered by an adverse macroeconomic outlook and the related risk that fiscal policies could turn self-defeating, being the debt ratio and the primary balance negatively affected by subdued price developments. Moreover, low inflation has made it harder for Italy to cut its public spending as a share of GDP by freezing wages and pension entitlements in nominal terms, while implying lower-than-normal tax revenues. Last, unfavourable macroeconomic conditions, including tight financing conditions, have implied higher-than-average fiscal multipliers, amplified by the constrained monetary policy due to the zero lower bound.[15] Real GDP growth accelerated to 1.1% in 2016 and 1.6% in 2017, with nominal GDP growth above 2% (2.3% in 2016 and 2.1% in 2017) for the first time since the global financial crisis. While real GDP growth is forecast by the Commission to sharply decelerate again to 1.1% in 2018 and to only very moderately recover to 1.2% in 2019 and 1.3% in 2020, underlying price developments (GDP deflator) imply an expected acceleration in nominal GDP growth to 2.4% in 2018, 2.5% in 2019, and 2.7% in 2020. Macroeconomic conditions no longer appear to be a mitigating factor in explaining Italy’s large gaps to compliance with the forward-looking debt reduction benchmark, although Italy's growth outlook appears to be subject to intensified downside risks going forward. In particular, a prolonged rise in sovereign yields could worsen banks' funding conditions as well as capital buffers and thereby negatively affect real GDP growth by hampering credit costs and supply. This, in turn, would amplify Italy’s fiscal sustainability risks.

Table 3: Macroeconomic and budgetary developments [a]

	2015	2016	2017	2018		2019	
				COM	DBP	COM	DBP
Real GDP (% change)	0.9	1.1	1.6	1.1	1.2	1.2	1.5
GDP deflator (% change)	0.9	1.1	0.5	1.3	1.3	1.3	1.6
Potential GDP (% change)	-0.1	-0.2	0.3	0.5	0.7	0.6	0.9
Output gap (% of potential GDP)	-3.6	-2.3	-1.0	-0.3	-0.4	0.3	0.4
General government balance	-2.6	-2.5	-2.4	-1.9	-1.8	-2.9	-2.4
Primary balance	1.5	1.4	1.4	1.7	1.8	1.0	1.2
One-off and other temporary measures	-0.2	0.2	0.0	0.1	0.0	-0.1	-0.1
Government gross fixed capital formation	2.2	2.1	2.0	1.9	1.8	1.9	2.1
Cyclically-adjusted balance	-0.7	-1.3	-1.9	-1.8	-1.6	-3.0	-2.6
Cyclically-adjusted primary balance	3.4	2.6	1.9	1.9	2.0	0.8	1.0
Structural balance [b]	-0.5	-1.5	-1.8	-1.8	-1.6	-3.0	-2.6
Structural primary balance	3.6	2.4	2.0	1.8	2.0	0.9	1.0

Notes:

[a] In percent of GDP unless otherwise specified

[b] Cyclically adjusted balance excluding one-offs and other temporary measures

Source : Commission services, Italy's revised 2019 DBP and Commission 2018 autumn forecast

[15] See, for instance, Blanchard O. and D. Leigh (2013), at www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf

Structural reforms

Following the general election of 4 March 2018, the 2018 National Reform Programme[16] adopted in April 2018 by the caretaker government did not propose new legislative initiatives but listed the reforms already adopted at that time in a number of areas such as public administration, judicial system, competition, labour market, education and competitiveness.

In its 2018 Country Report, the Commission assessed that Italy had made some progress in addressing the 2017 CSRs but also that the reform momentum had slowed down and that significant challenges persisted in diverse reform areas. Italy's macroeconomic imbalances – mainly related to a very high public debt and sluggish productivity growth – had stopped deteriorating but remained elevated.[17] As a result, the Commission concluded that Italy still displayed excessive macroeconomic imbalances.[18]

The revised 2019 draft budgetary plan introduced several new policy initiatives, which were further specified in two legislative proposals: the "fiscal decree"[19] of 23 October 2018, and the draft budget law, submitted to the Parliament on 31 October 2018, both currently under discussion.

The "fiscal decree" includes measures aimed at encouraging tax compliance, as well as several measures aimed at collecting past tax liabilities and cleaning tax registers. Concerning the first point, the electronic transmission of invoices will be compulsory also for transactions with final consumers. At the same time, the "fiscal decree" introduced 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. An additional measure will also allow taxpayers – under specific conditions and limits – to disclose past unreported income by paying only 20% of the corresponding tax liability, over several instalments and without interests and fines. The "fiscal decree" also includes several smaller provisions curtailing old pending tax liabilities of limited size and reducing incentives for taxpayers to prolong the duration of tax litigations. Overall, the positive impact on revenues is estimated at around 0.1% of GDP in 2020.

The draft budget law includes numerous measures affecting a wide range of areas including taxation, public investment, social security and the pension system. Concerning taxation, several changes in tax regimes, especially for firms and the self-employed, will partly redistribute the tax burden across sectors, with an overall positive impact on revenues in 2019. The measures reducing the tax burden are the following:

(1) The scope of the simplified tax regime for the self-employed will be extended, by loosening access conditions. Currently, self-employed workers with yearly turnovers 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. In

[16] http://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2018/DEF_2018_-_Sez.3_-_PNR.pdf

[17] See "*Country Report Italy 2018*". Ibidem.

[18] See Commission Communication COM(2018) 120 final, " *2018 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011"*.

[19] Decreto Legge, 23 ottobre 2018, n. 119, *Disposizioni urgenti in materia fiscale e finanziaria*.

addition, several other access conditions are removed. The measure is expected to structurally reduce revenues by 0.1% of GDP.

(2) A similar provision is also introduced 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[20]. The expected revenue loss amounts to 0.1% of GDP from 2021.

(3) The corporate tax rate will be reduced from 24% to 15% on firms' profits used to increase investment or to hire new employees, with an expected structural revenue loss of around 0.1% of GDP.

At the same time, several other existing provisions which lowered the tax burden for firms will be abrogated or reduced in scope. Namely, a previously legislated simplified tax regime for personal income from entrepreneurial activities ("*Imposta sul Reddito Imprenditoriale*") and the existing tax incentives for firms' capital uplifts ("*Aiuto alla Crescita Economica*") will be abrogated (implying higher revenues 0.1% of GDP in 2019 and 0.2% from 2020). The temporary incentives to investment ("*Superammortamento*") will not be extended, while the temporary tax incentives for innovative investment ("*Iperammortamento*") will be extended but reduced in scope. Furthermore, the tax deductibility of specific costs for some categories of firms – especially banks – will be limited, with a temporary positive effect on revenues by 0.2% of GDP in 2019. 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; and the advance payment of the tax on insurances is increased.

The draft budget law also includes several provisions to support public investment. Budgeted resources for public investments will be increased by 0.2% of GDP in 2019 through the creation of two funds, for investments planned at the central level (*Fondo Investimenti Amministrazioni centrali*) and at the local level (*Fondo Investimenti enti territoriali*). Furthermore, two institutional bodies will be created to smoothen administrative procedures: a central office (*InvestItalia*) will coordinate the ministerial work in setting investment strategies at the national level, monitoring the implementation of programmes and addressing bottlenecks; at the same time, an independent office for project planning (*Centrale per la progettazione delle opera pubbliche*) will provide technical support to local and central administrations throughout the implementation of projects.

The two main measures included in the revised 2019 draft budgetary plan are the "citizenship income" and the "100 threshold" ("*Quota 100*"), concerning social security and the pension system respectively. The draft budget law only includes the funds allocated for these measures, which will be designed and implemented with separate laws. However, the revised 2019 draft budgetary plan mentions their main aspects.

The "citizenship income" is a minimum income scheme, which, in the government plans, would aim at guaranteeing a monthly income of EUR 780, corresponding to the relative poverty threshold. However, the exact amount of the allowances and the access conditions remain to be legislated at a later stage. The budgeted fund amounts to EUR 9 billion per year from 2019, including EUR 1 billion for strengthening employment centres. As the fund will

[20] As that measure will be implemented from 2020, it is only included in the draft budget law and not in the revised 2019 draft budgetary plan.

absorb around EUR 2 billion of resources previously allocated to the anti-poverty scheme (*Reddito di inclusione*), the net impact on government spending is 0.4% of GDP.

The "100 threshold" is an early retirement scheme, setting the minimum threshold for early retirement at 62 years of age and 38 years of contributions. The budgeted fund amounts to EUR 6.7 billion in 2019 and EUR 7 billion from 2020 (0.4% of GDP).

The measures included in the revised 2019 draft budgetary plan for 2019 indicate a 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 Recommendation 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. Furthermore, the higher flexibility for retiring early might have a negative impact on labour supply, hampering potential growth.

The strengthened provision for electronic invoicing is expected to help reducing the VAT compliance gap, by providing the tax agency with more timely and accurate information, which will allow targeted inspections with deterrent effects on taxpayers. However, the new possibilities for taxpayers to settle past tax liabilities or report undeclared income at advantageous conditions are expected to produce an opposite effect, by implicitly rewarding non-compliant behaviours.

The planned changes in tax regimes for the self-employed and firms are aimed at better targeting tax incentives to economic growth. However, this change in strategy is subject to downward risks, as some of the measures abrogated had proven successful in supporting investment and firms' capital uplifts. Withdrawing the existing favourable tax regime on reinvested earnings under the ‘allowance for corporate equity’ (*ACE*), which was largely used by firms, could worsen the debt bias in corporate taxation, potentially reducing incentives to alternative forms of financing apart from bank lending. At the same time, the reduced corporate tax rates on firms hiring or investing – although better targeting incentives to economic growth – may prove complex to implement in practice and increase reporting requirements for firms. Furthermore, the reform package overall increases the tax burden on firms in 2019, while having only a broadly neutral impact in 2020.

The measures implying lower tax deductibility of costs, by implicitly increasing the tax burden on banks, could adversely affect credit supply, thus risk worsening the possible negative impact of higher sovereign yields and bank funding costs.

The increased funds and strengthened administrative capacity for public investment is expected to support economic growth, although its impact risks being delayed by implementation lags and administrative bottlenecks.

Overall, the composition of the revised 2019 draft budgetary plan does not seem to be conducive to raising potential growth, as it backtracks on past structural reforms, risks discouraging tax compliance, increases the tax burden on firms at an aggregate level and could lead to reduced credit supply via worse banks' funding conditions from higher sovereign yields.

4.2. Medium-term budgetary position

The ex-post assessment of Italy's compliance with the preventive arm points to some deviation from the adjustment path towards the MTO in 2017, after taking into account the allowances granted under the flexibility clauses and for unusual events. By contrast, as regards 2018, the fiscal adjustment is not expected to be adequate in light of the sustainability challenges that Italy faces. For 2019, the Commission identified in its Opinion of 23 October 2018 on the 2019 draft budgetary plan a particularly serious non-compliance with the fiscal recommendation addressed to Italy by the Council on 13 July 2018. That assessment was confirmed in the Commission Opinion of 21 November 2018 on Italy's revised 2019 draft budgetary plan. The size of the deviation from the recommended adjustment path towards the MTO is expected to further widen in 2020 based on the Commission forecast, under a no-policy change assumption.

Structural balance and adjustment towards the MTO

Box 1: flexibility under the preventive arm

After exiting the EDP in 2013, Italy was broadly compliant with the provisions of the preventive arm up to 2017. However, over the period 2015-2017, Italy's broad compliance was achieved also thanks to the flexibility granted by the Commission, following its Communication on "Making the best use of flexibility within the existing rules of the Stability and Growth Pact" of January 2015, and confirmed by the Council's Country-Specific Recommendations. Italy has largely benefitted from flexibility within the framework of the Stability and Growth Pact. In 2015, 0.03% of GDP of flexibility was granted for unusual events, in connection with the refugee crisis. The same year, the benchmark structural requirement of 0.5% of GDP was reduced by half, to 0.25% of GDP as a result of the enhanced consideration of prevailing cyclical conditions. In 2016, an overall flexibility of 0.83% of GDP was granted in connection with the structural reform clause, the investment clause and the unusual event clause. The latter was granted with reference to the refugee crisis and additional security costs due to the terrorist threat. In 2017, an overall flexibility of 0.35% of GDP was granted under the unusual event clause, due to the refugee crisis and the need to protect the national territory against seismic risks. For 2018, the Commission considered that a fiscal structural effort lower by 0.3% of GDP than the benchmark requirement would be adequate in order to balance Italy's stabilisation needs and existing sustainability challenges. Overall, over the period 2015-2018 Italy was allowed to temporarily deviate from the adjustment path towards the MTO by close to 1.8 percentage points of GDP.

As regards **2017**, Italy was recommended to deliver a structural adjustment of 0.6% of GDP or more, so as to make sufficient progress towards its MTO. However, the 2018 Stability Programme confirmed that the outturn budgetary impact of the exceptional inflow of refugees and of a preventive investment plan for the protection of the national territory against seismic risks was significant in 2017, at around 0.35% of GDP, only slightly higher than the ex-ante estimate. On that basis, the Commission confirmed the allowance preliminarily granted under

the unusual event clause[21]. Therefore, the required adjustment towards the MTO for 2017 has been reduced to take into account those costs.

The overall assessment issued in spring 2018 on the basis of the Commission 2018 spring forecast pointed to some deviation from the recommended adjustment path towards the MTO in both 2016 and 2017. The same assessment is confirmed based on the Commission 2018 autumn forecast.

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 stated in its Communication on the 2017 European Semester of May 2017[22] that it 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 current stabilisation needs and existing 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. This corresponds to a nominal rate of growth of net primary expenditure not exceeding 0.5%.

Based on the revised 2019 draft budgetary plan, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, because the growth rate of Italy's government expenditure, net of discretionary revenue measures and one-offs, will exceed that recommended by the Council. In addition, the improvement in the (recalculated) structural balance planned by the government for 2018 (0.2% of GDP) departs from the adequate structural adjustment of 0.3% of GDP. 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 2018. Based on the Commission 2018 autumn forecast, the overall assessment based on the government plans is confirmed. The Commission forecast projects the structural balance to remain stable in 2018, at -1.8% of GDP. Based on the Commission forecast, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, and the same indication is provided by the structural balance pillar.

Concerning **2019**, the Commission identified in its Opinion of 23 October 2018 on the 2019 revised 2019 draft budgetary plan a particularly serious non-compliance with the fiscal recommendation addressed to Italy by the Council on 13 July 2018. That assessment was confirmed by the Commission Opinion of 21 November 2018 on Italy's revised 2019 draft budgetary plan.

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 revised 2019 draft budgetary plan, the expenditure benchmark points to a risk of significant deviation both in 2019 (gap of 1.3% of GDP) and over 2018 and 2019 taken together (gap of 0.9% of GDP per year, on average, taking into account the adjustment for both years recommended by the Council), because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed that

[21] Namely, the eligible expenditure in 2017 amounts to 0.16% of GDP for the exceptional inflow of refugees and 0.19% of GDP concerning protection against seismic risks.

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

recommended by the Council. The same indication is provided by the structural balance pillar. The revised 2019 draft budgetary plan projects the (recalculated) structural balance to deteriorate by 0.9% of GDP in 2019. The structural balance pillar points to a risk of significant deviation both over one year (gap of 1.5% of GDP in 2019) and over 2018 and 2019 taken together (gap of 1.0% per year, on average, taking into account the adjustment for both years recommended by the Council). That finding would not change after considering the reduced requirement in 2018 following the application of the margin of discretion. An overall assessment based on the government plans points to a particularly serious non-compliance with 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 (around 0.2% of GDP) 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 considered as unusual events outside the control of the Member State concerned for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

Based on the Commission 2018 autumn forecast, the overall assessment based on the government plans is confirmed, because the expenditure benchmark also points to a risk of significant deviation both in 2019 (gap of 1.5% of GDP) and over 2018 and 2019 taken together (gap of 1.3% of GDP per year, on average, taking into account the adjustment for both years recommended by the Council). The same indication is provided by the structural balance pillar. The Commission 2018 autumn forecast expects Italy's structural balance to deteriorate by 1.2% of GDP in 2019, reaching -3.0% of GDP. The structural balance pillar points to a risk of significant deviation both over one year (gap of 1.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 1.2% per year, on average).

Public investment

As regards public investment, Italy's government gross fixed capital formation averaged around 3% of GDP over 1999-2010, but the need to adjust quickly to respond to the sovereign debt crisis led to a substantial reduction in public investment to around 2.4% of GDP on average over 2011-2016. In 2017, public investment-to-GDP ratio reached a new low, at 2% of GDP (-5.3% year-on-year in nominal terms). The ratio is projected by the revised 2019 draft budgetary plan to decline slightly to 1.9% of GDP in 2018 (-2.2% year-on-year in nominal terms). In 2019 and 2020, the revised 2019 draft budgetary plan projects public investment to progressively recover, supported by the additional funds allocated and the measures taken to address accelerate administrative procedures. In summary, given its broad decline over time, public investment does not appear to represent a mitigating factor justifying Italy's lack of compliance with the debt reduction benchmark.

4.3. Medium-term government debt position

Italy's public debt remains a major source of vulnerability for the economy. Newly adopted measures, together with adverse demographic trends, will likely reverse the positive trend achieved by past pensions reforms and weaken long-term fiscal sustainability. Long-term fiscal sustainability was also hampered by the increase in interest rates on government bonds observed in 2018, and could further worsen if real interest rates will rise more than currently expected.

After reaching 131.2% in 2017, Italy's debt-to-GDP ratio is set to broadly stabilise at around 131% over 2018-2020 on the basis of the Commission 2018 autumn forecast. In 2018, a limited increase in the primary surplus, only marginally declining interest spending and below-target privatisation proceeds are expected to continue hindering the pace of debt reduction. In 2019 and 2020, the significant worsening of the primary surplus and rising interest spending are expect to further hamper debt reduction.

According to the European Commission's short-term fiscal sustainability risk indicator "S0", Italy does not appear to face short-term sustainability challenges, although vulnerabilities appear on the fiscal side.[23] In fact, risks from the macro-financial context remain overall limited, also thanks to the ECB's still accommodative monetary policy. However, Italy is exposed to sudden increases in financial market risk aversion due to improving but still large roll-over needs (around 17% of GDP in 2018) related to its public debt. As observed since May 2018, such increases can lead to high volatility in sovereign bond markets and substantially higher debt servicing costs, with the subsequent risk of negative spillovers to the banking sector and to financing conditions of firms and households.

In the medium term, Italy faces marked sustainability challenges. Its structural primary surplus is forecast to further deteriorate to 0.9% of GDP in 2019 and 0.4% of GDP in 2020, down from 3.6% in 2015. This could heighten sustainability risks in the medium term, as a weak fiscal position might further raise risk premia. This is captured by the Commission's medium-term debt sustainability analysis (DSA) and fiscal sustainability risk indicator S1[24], which both point to 'high risk'[25]. The high and increasing projected stock of debt in 2029 in the baseline scenario and its sensitivity to macroeconomic-fiscal shocks contribute to this assessment. Achieving a debt ratio of 60% of GDP by 2033 would thus require Italy to make a large cumulative fiscal effort, amounting to 9.4 pps of GDP over 2021-2025.

In the long-term, Italy is also expected to face marked sustainability challenges, driven both by the sizeable fiscal adjustment required to stabilise the debt-to-GDP ratio, especially in light of the future ageing costs, and to the vulnerabilities linked to the high debt burden. The

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[23] The short-term fiscal sustainability indicator S0 (*an 'early-detection' indicator of fiscal risks in the short term, stemming from fiscal, macro-financial and competitiveness characteristics of the economy over a one-year horizon, based on a range of twenty-five fiscal and macro-financial variables*) is set to be below the 'high-risk' threshold in 2018 but, at 0.36, remains among the highest in the EU, mainly due to Italy's very high public debt. Furthermore, the fiscal sub-index is above its critical threshold.

[24] The medium-term fiscal sustainability indicator S1 shows the additional adjustment effort required, in terms of a cumulated gradual improvement in the structural primary balance over five years (starting from 2021), to reach a 60% debt-to-GDP ratio by 2033, including paying for any future additional expenditure arising from an ageing population.

[25] See forthcoming European Commission Fiscal Sustainability Report 2018. More explanations on the methodology can also be found in the European Commission Debt Sustainability Monitor 2017.

long-term fiscal sustainability risk indicator S2[26] points to significant risks, as a permanent increase in the structural primary surplus of around 2.9 percentage points of GDP would be needed to keep the debt-to-GDP ratio stable over the long term, also due to the costs of ageing. Given the vulnerabilities linked to the high debt burden – captured by the DSA risk assessment – that result also points to 'high risk' in the long-term. In fact, the long-term sustainability ensured by past pensions reforms, by curbing implicit liabilities arising from population ageing, is deteriorating. This is due to worsening demographic trends projected by Eurostat and by recently adopted reforms. In particular, the 2017 and 2018 budgets already contained measures that partially reversed past pension reforms, contributing to increase Italy's old-age pension expenditure over the medium term. In this regard, the revised 2019 draft budgetary plan contains additional provisions that will backtrack on past progress, substantially increasing public spending for old-age pensions. Although the exact design of the reform will be specified in legislative decrees after the adoption of the 2019 budget, based on the information included in the revised 2019 draft budgetary plan the planned reform entails a substantial loosening of conditions for early retirement, by setting the relevant threshold at 62 years of age and 38 years of contributions. The additional cost, estimated at around 0.4% of GDP in 2019, would thus significantly increase Italy's old age pension expenditure, which, at around 15% of potential GDP in 2016, is already one of the highest in the Union and the OECD. Furthermore, the enhanced flexibility for retiring early might have a negative impact on labour supply, in a context where Italy is already lagging behind the EU average for the participation of its older workers (55-64) in employment, thereby hampering potential growth. Overall, further backtracking on the implementation of past pension reforms, could significantly worsen Italy's long-term sustainability risks.

Privatisation proceeds underachieved the 0.5% of GDP target projected by the government in both 2016 and 2017, when they amounted to 0.05% of GDP and below 0.01% of GDP, respectively. Going forward, the revised 2019 draft budgetary plan still projects 0.3% of GDP privatisation proceeds per year over 2018-2020. As regards 2018, the Commission does not incorporate any privatisation proceeds *ex ante* given the track record of privatisations until now and the low progress recorded until late in the year. As regard 2019, in light of the credible and well-specified proposals currently under discussion, half of the projected proceeds are included in the forecast. For 2020, no privatisation proceeds are considered *ex ante* in the forecast for prudential reasons.

Against this background, the planned fiscal deterioration and the possible negative impact on potential growth of the planned pension reform could significantly worsen Italy's fiscal sustainability risks in the medium and long term, endangering an appropriate reduction path of the large public debt.

[26] The long-term fiscal sustainability indicator S2 shows the upfront adjustment to the current structural primary balance (subsequently kept constant at the adjusted value forever) that is required to stabilise the debt-to-GDP ratio over the infinite horizon, including paying for any additional expenditure arising from an ageing population.

4.4. Other factors considered relevant by the Commission

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97). Regarding government support to the financial sector in the course of the financial crisis, contingent liabilities to support liquidity provisions of financial institutions amounted to around 1.5% of GDP at end-2017 (out of a total amount of contingent liabilities of 3.7% of GDP), up from 0.5% of GDP at end-2016.

Support to financial institutions with an impact on the government debt amounted to 1% of GDP in 2017 (up from 0.2% at end-2016). That support was mainly related to the liquidation of two Italian regional lenders (*Banca Popolare di Vicenza and Veneto Banca*) and the precautionary recapitalisation of *Banca Monte dei Paschi di Siena*. The related impact on deficit was around 0.4% of GDP. An additional risk for public finances is related to the possible (one-off) impact from the support to financial institutions also on the deficit for 2019 and 2020, as well as from the considerable stock of trade debt arrears of the public administration.

Article 12(1) of Regulation (EU) No 473/2013 requires that this report consider also "the extent to which the Member State concerned has taken into account the Commission opinion" on the Member State's draft budgetary plan, as referred in Article 7(1) of the same Regulation. In 2017, the Commission Opinion on Italy′s 2018 draft budgetary plan[27] pointed to a risk of non-compliance with the provisions of the SGP and invited the authorities to take the necessary measures within the national budgetary process to ensure compliance. However, despite the flagged risks of non-compliance with the SGP, the 2018 Budget was passed without major changes compared to the draft budgetary plan. In 2018, the Commission Opinion on Italy's 2019 draft budgetary plan identified a serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018 and invited the authorities to submit a revised draft budgetary plan. However, on 13 November 2018, Italy submitted a revised draft budgetary plan confirming the fiscal targets planned for 2019.

4.5. Other factors put forward by the Member State

On 13 November 2018, the Italian authorities transmitted documents concerning relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97 (‘the Italian observations’). The analysis presented in the other sections of this report already covers most of the factors put forward by the authorities.

The Italian observations stress Italy’s solid budgetary performance, witnessed by a consistent track record of sizable primary surpluses which, however, are still too largely offset by intra-euro-area bond yield and growth differentials unfavourable to Italy to ensure compliance with the debt reduction benchmark.

The first relevant factor discussed in the Italian observations is the outlook for nominal GDP growth, marked by recently heightened downside risks, in the face of which too large fiscal

[27] Commission Opinion C(2017) 8019 final, 22.11.2017, on the Draft Budgetary Plan of Italy.

efforts could turn self-defeating and hinder compliance with the debt reduction benchmark through the channel of an adverse denominator effect.

The second, and related, relevant factor is the underestimation of the degree of slack in Italy's economy even after the revision in the "commonly agreed methodology" to estimate the output gap in line with some technical changes proposed by the Italian delegation to the Output Gap Working Group. While those technical changes implied a widening of Italy's output gap for 2017 to -1.2% of potential GDP (from -0.6% based on the Commission 2017 autumn forecast), the revised estimates of the Commission still suggest that the country's economic activity should reach its potential in 2019. In that year, in fact, the output gap is estimated to turn positive, at +0.3% of potential GDP, which is judged by the Italian authorities not to be in line with economic intuition, given Italy's still high unemployment rate of 11% and virtual stability in wages and prices. The Italian observations thus present alternative estimates, suggesting an output gap still around -3% of potential GDP in 2018 based on the government projections, whereby Italy would be virtually at its MTO of a balanced budget in structural terms. Moreover, Italy would satisfy the debt reduction benchmark in its "cyclical-adjusted configuration" under the additional assumption of a "normal" inflation rate (based on the GDP deflator) of 2%.

The third relevant factor highlighted by the Italian observations is the logic of supporting social inclusion and public investment underlying the government fiscal plans in the 2019 draft budgetary plan. In particular, they regard the citizenship income featured in the 2019 draft budgetary plan as in line with the 2018 country-specific recommendations to increase social spending, reform active labour market policies, and raise labour market participation of women by rationalising family-support policies. Moreover, they consider the increase in public investment by 0.2% of GDP in 2019 in line with the 2018 country-specific recommendation to foster research, innovation, digital skills and infrastructure through better targeted investment and increased participation in vocational-oriented tertiary education.

The fourth relevant factor covered in the Italian observations is the wide-range of growth-enhancing structural reforms planned by the government in diverse areas ranging from the judicial system to the public sector.

Other relevant factors put forward by the Italian authorities in relation to Italy's public debt include its sustainability, as the Member State still displays low long-term sustainability risks despite the worsened demographic projections, its affordability, given the downward-trending interest expenditure, and the very low level of contingent liabilities and private sector debt. The Italian observations also stress that risks for Italian public finances, including from the recent rise in sovereign yields, are limited, given Italy’s strong financial position, the long maturity and fixed-rate composition of its public debt, and the recently restored banking-sector profitability.

5. CONCLUSIONS

Italy's public debt-to-GDP ratio, at 131.2% in 2017, is the second-largest in the Union and one of the largest in the world. In 2017, it represented an average burden of EUR 37 000 per inhabitant, in addition to an average yearly cost of servicing it of around EUR 1 000 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. It also 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 spending stood in 2017 at around EUR 65.5 billion or 3.8% of GDP, i.e. broadly the same amount of public resources as are devoted to education. Moreover, a large public debt, in the absence of prudent fiscal policies, exposes the country to market confidence shocks on sovereign yields, with a negative impact on both the interest bill paid by the country as well as the overall financing cost for the real economy, which would, in turn, negatively impact growth. Italy's large public debt is a major vulnerability for the Italian economy and decisively reducing it should remain a priority in the best interest of Italy.

On 23 May 2018, the Commission issued a report under Article 126(3) TFEU[28], as Italy did not make sufficient progress towards compliance with the debt criterion in 2017. The report concluded that the debt criterion should be considered as complied with at the time, having regard in particular to Italy's compliance with the preventive arm.

However, Italy's fiscal plans for 2019 represent a material change in the relevant factors analysed by the Commission last May. In particular, in its 2019 draft budgetary plan Italy planned a large deterioration of the structural balance for 2019, in the order of 0.9% of GDP, while the Council had recommended that Italy should improve its structural balance by at least 0.6% of GDP. Therefore, on 23 October 2018 the Commission adopted an Opinion[29] on Italy's 2019 draft budgetary plan, identifying particularly serious non-compliance with the fiscal recommendation addressed to Italy by the Council on 13 July 2018 and requesting the resubmission of a revised draft budgetary plan. On 13 November 2018, Italy submitted a slightly revised draft budgetary plan, whose fiscal targets remained however unchanged compared to the original version, including the large structural deterioration planned for 2019.

On 21 November 2018, the Commission adopted its Opinion on Italy's revised 2019 draft budgetary plan,[30] confirming the risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018 and the particularly serious non-compliance with the fiscal recommendation for 2019 based on both the government plans and the Commission 2018 autumn forecast. That conclusion justifies a new assessment by the Commission of Italy's *prima facie* lack of compliance with the debt criterion in 2017.

In fact, Italy's general government gross debt reached 131.2% of GDP in 2017, well above the 60% of GDP reference value of the Treaty, and Italy did not comply with the debt reduction benchmark in 2017 based on outturn data. Moreover, Italy is not projected to

[28] 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".

[29] Commission Opinion C(2018) 7510 final, 23.10.2018, on the Draft Budgetary Plan of Italy and requesting Italy to submit a revised Draft Budgetary Plan.

[30] Commission Opinion C(2018) 8030 final, 21.11.2018 on the revised Draft Budgetary Plan of Italy.

comply with the debt reduction benchmark in either 2018 or 2019 based on both the government plans and the Commission 2018 autumn forecast. Those findings clearly suggest that, before consideration is given to all relevant factors, the debt criterion as defined in the Treaty does not appear to be fulfilled by Italy *prima facie*. In line with the Treaty, this report examines the relevant factors in turn.

In particular, while Italy was assessed to have made some progress in addressing the 2017 Country-Specific Recommendations addressed to it by the Council, the measures included in the revised 2019 draft budgetary plan indicate a risk of backtracking on reforms adopted in line with past Country-Specific Recommendations, as well as with regard to the structural fiscal aspects of the latest recommendations addressed to Italy by the Council. Among others, 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 tax compliance. Overall, the revised 2019 draft budgetary plan does not envisage effective measures to tackle Italy's sluggish potential growth and, in particular, its long-lasting stagnation in productivity. In particular, the possibility to retire early may have a negative impact on labour supply. In addition, the newly introduced measures increasing taxation on banks, together with the impact of higher sovereign yields could hinder the supply of credit. On that basis, the growth impact of the policy measures underlying the 2019 draft budgetary plan may be smaller than projected by the government even in the short term.

Last, while the ex-post assessment of Italy’s compliance with the preventive arm made in May 2018 indicated broad compliance with the recommended adjustment path towards the MTO in 2017, once account is taken of the flexibility granted by the Commission for unusual events, an overall assessment based on both the government plans and the Commission 2018 autumn forecast points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018 and to a particularly serious non-compliance for 2019. That conclusion would not change even if the budgetary impact (around 0.2% of GDP) 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 considered, for the purposes of Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97, as unusual events outside the control of the government and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

The analysis presented in this report includes the assessment of all relevant factors and notably: (i) the fact that macroeconomic conditions, despite recently intensified downside risks, cannot be argued to explain Italy's large gaps to compliance with the debt reduction benchmark, given nominal GDP growth above 2% since 2016; (ii) the fact that the government plans imply a backtracking on past growth-enhancing structural reforms, in particular the past pension reforms; and above all (iii) the identified risk of significant deviation from the recommended adjustment path towards the medium-term budgetary objective in 2018 and the particularly serious non-compliance for 2019 with the recommendation addressed to Italy by the Council on 13 July 2018, based on both the government plans and the Commission 2018 autumn forecast. Overall, the analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as not complied with, and that a debt-based EDP is thus warranted.