COMMISSION OPINION

on the revised Draft Budgetary Plan of Italy

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GENERAL CONSIDERATIONS

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

2. Article 6(1) of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a draft budgetary plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING ITALY

3. Italy is currently subject to the preventive arm of the Stability and Growth Pact. On 13 July 2018, the Council recommended that Italy should ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1% in 2019, corresponding to an annual structural adjustment of 0.6% of GDP.[1] That recommendation had been endorsed by the European Council of 28 June 2018.

4. As its public debt, which stood at 131.2% of GDP in 2017, exceeds the 60% of GDP reference value of the Treaty, Italy also needs to comply with the debt reduction benchmark, which requires an adequate reduction of the debt level towards the 60% of GDP reference value of the Treaty. Italy's public debt-to-GDP ratio is second-largest in the European Union and one of the largest in the world. In 2017 it represented an average burden of EUR 37 000 per inhabitant, plus an annual 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 and represents an inter-generational burden weighing on the standard of living of future Italian generations. The fact that debt-servicing costs absorb a considerably larger amount of public resources in Italy than in the rest of the euro area also takes a toll on the country's productive spending. Italy's interest expenditure stood in 2017 at around EUR 65.5 billion or 3.8% of GDP, which was broadly the same amount of public resources devoted to education. Moreover, a large public debt, in the absence of prudent fiscal policies, could undermine market confidence, with a negative impact on both the interest bill paid by the country as well as the overall financing cost for the real economy.

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

6. By letter of 18 October 2018, the Commission consulted Italy, asking for further information. The reply by Italy of 22 October 2018 acknowledged that "the chosen budget policy approach does not fulfill the rules of the Stability and Growth Pact".

[1] Council Recommendation of 13 July 2018 on the 2018 National Reform Programme of Italy and delivering a Council opinion on the 2018 Stability Programme of Italy, OJ C 320, 10.09.2018, p. 48.

On 23 October 2018, the Commission issued an Opinion on the 2019 draft budgetary plan,[2] identifying a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018 and requesting Italy to submit a revised draft budgetary plan as soon as possible and in any event within three weeks of the date of that Opinion.

7. Italy submitted a revised draft budgetary plan on 13 November 2018 ('the revised 2019 draft budgetary plan'). Pursuant to Article 7(2) of Regulation (EU) No 473/2013, the Commission must adopt a new opinion on the revised draft budgetary plan as soon as possible and in any event within three weeks of its submission. The changes in the revised 2019 draft budgetary plan were very limited, mainly consisting in a higher privatisation target for 2019 (1% of GDP instead of 0.3%). The present Opinion assesses Italy's compliance with the preventive arm of the Stability and Growth Pact based on the revised 2019 draft budgetary plan and the Commission 2018 autumn forecast published on 8 November 2018.

8. The macroeconomic scenario underlying the revised 2019 draft budgetary plan remains unchanged compared to the 2019 draft budgetary plan. Italy's macroeconomic projections appear optimistic compared to the Commission 2018 autumn forecast, which expects lower real GDP growth in 2018 (1.1% instead of 1.2% in Italy's plans), 2019 (1.2% instead of 1.5%) and 2020 (1.3% instead of 1.6%). The Commission's growth forecast is based on more prudent assumptions for consumption and investment growth, including a milder impact of the measures planned by the revised 2019 draft budgetary plan. Administrative bottlenecks and implementation lags are expected to dampen the growth impact of higher public investment planned over the forecast period, in addition to the risk of partly crowding out private investment in the context of large public debt and rising sovereign yields. The planned tax reform is also set to have a negligible impact on growth through private consumption and investment, because the extension of the "flat tax" rate for self-employed is offset by the repeal of previously legislated favourable tax regimes for firms. The Commission 2018 autumn forecast is also more conservative as regards the inflation rate (based on the GDP deflator) than the revised 2019 draft budgetary plan both in 2019 (1.3% instead of 1.6%) and in 2020 (1.3% instead of 1.9%). Part of the difference in 2020 is explained by the fact that the Commission forecast does not incorporate the activation of a "safeguard clause" that would take the form of higher VAT rates legislated for 2020, given past systematic repeals. Overall, the projections in the revised 2019 draft budgetary plans are based on the assumption that nominal GDP growth will pick up to 3.1% in 2019 and 3.5% in 2020, well above the levels expected by the Commission 2018 autumn forecast, at 2.5% in 2019 and 2.7% in 2020.

9. The Parliamentary Budget Office, Italy's independent fiscal monitoring institution, did not endorse the macroeconomic projections underlying Italy's policy scenario for 2019, "as they lie outside the range of acceptable values on the basis of the information currently available"[3] and are therefore subject to significant downside risks. That lack of endorsement means that, as noted in the Commission Opinion of 23 October 2018, Italy does not comply with the requirement established by Article 4(4) of Regulation (EU) No 473/2013, as the macroeconomic forecasts underlying the revised 2019 draft budgetary plan have not been endorsed by an independent body.

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[2] Commission Opinion C(2018)7510 of 23.10.2018.

[3] Letter of 13 October 2018 from the President of Italy's "Ufficio Parlamentare di Bilancio"

10. Italy's general government deficit reached 2.4% of GDP in 2017. 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. Those deficit targets correspond to a planned improvement in the structural balance[4] by 0.2% in 2018, followed by a structural deterioration of 0.9% of GDP in 2019. As a result, the attainment of Italy's medium-term budgetary objective of a balanced budgetary position in structural terms is not projected by 2021, i.e. within the horizon of government's plans.

11. The main provisions included in the revised 2019 draft budgetary plan remain the same as those envisaged by the 2019 draft budgetary plan. In line with the content of the draft budget law submitted by the Italian government to the national parliament on 31 October 2018,[5] the main deficit-increasing measures for 2019 include: the abrogation of the increase in VAT rates previously legislated as a "safeguard clause" (around 0.7% of GDP); the allocation of a fund of around 0.4% of GDP to strengthen public employment services and introduce a citizenship income for inactive or unemployed adults, with the exact amount of the allowance and access conditions to be legislated at a later stage; the allocation of a fund of around 0.4% of GDP to introduce higher flexibility for early retirement, with the exact conditions and minimum threshold to be legislated at a later stage; measures (around 0.2% of GDP) to support public investment, including by creating two funds for investments planned at the central and at the local level and setting up new bodies in charge of streamlining administrative procedures and supporting implementation; a tax reform extending the scope of the simplified tax regime for the self-employed, by widening access conditions to a *forfeit* 15% tax rate on yearly turnover paid as a substitute of the personal income tax, and reducing to 15% the corporate income tax rate on firms' profits used to increase investment or to hire new employees, under specific conditions.

12. In line with the content of the draft budget law submitted by the Italian government to the national parliament on 31 October 2018, the main deficit-reducing measures for 2019 include: the abrogation of previously-legislated favourable tax regimes for firms (around 0.3% of GDP), including a simplified personal income tax regime for entrepreneurial activities ("*Imposta sul Reddito Imprenditoriale*"), existing tax incentives for firms' capital uplifts ("*Aiuto alla Crescita Economica*"), and the tax deductibility of specific costs and budgetary losses for some categories of firms, especially banks;[6] a spending review at different levels of government (around 0.2% of GDP); and various tax amnesty provisions aimed at collecting past unpaid tax liabilities and settling pending tax-related litigation, while encouraging tax

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

[5] As integrated by the Decree Law 119/2018, "*Disposizioni urgenti in materia fiscale e finanziaria*"

[6] More specifically, the tax deductibility of the goodwill and other intangible assets related to past operations is lowered by spreading it over eleven 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.

compliance through the extension of the compulsory electronic transmission of invoices also to transactions with final consumers.

13. The measures included in the revised 2019 draft budgetary plan indicate a risk of backtracking on reforms that Italy had adopted in line with past Country-Specific Recommendations, as well as with regard to the structural fiscal aspects of the recommendations addressed to Italy by the Council on 13 July 2018. In particular, while the Council recommended that Italy should reduce the share of old-age pensions in its public spending to create space for other social spending, the newly-introduced possibility for early retirement backtracks on earlier pension reforms that underpin the long-term sustainability of Italy's sizeable public debt. It may also have a negative impact on the 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. Moreover, the introduction of a tax amnesty could discourage tax compliance, thereby largely offsetting the potential positive effect of strengthened electronic invoicing. Furthermore, while the revised 2019 draft budgetary plan includes provisions lowering the tax burden on firms hiring or reinvesting their earnings in capital goods, the impact of those provisions is largely offset in 2019 by the abrogation of existing favourable tax regimes on firms and on reinvested earnings. Last, the newly introduced measures increasing taxation on banks, together with the impact of higher sovereign yields, could hinder the supply of credit. Taken together, 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. 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.

14. 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 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. The Commission 2018 autumn forecast expects that Italy's structural balance will remain stable in 2018, followed by large structural deteriorations of 1.2% of GDP in 2019 and 0.6% of GDP in 2020.

15. On 11 July 2017, the Council recommended that Italy should ensure a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP.[7] The Commission Communication on the 2017 European Semester[8] stated that the

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

[8] Commission Communication COM(2017) 500 final of 22.5.2017 to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee, the

Commission would stand ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment could be particularly significant. Overall, in order to balance Italy's stabilisation needs and sustainability challenges, the Commission considered that a fiscal structural effort of at least 0.3% of GDP would be adequate in 2018, without any additional margin of deviation over one year. That corresponded to a nominal rate of growth of net primary expenditure not exceeding 0.5%.

16. Based on the revised 2019 draft budgetary plan, the expenditure benchmark[9] 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 structural balance[10] planned by the government for 2018 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, because the expenditure benchmark also points to an inadequate fiscal adjustment in 2018, and the same indication is provided by the structural balance pillar.[11]

17. 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 recommended by the Council. The same indication is provided by the structural balance pillar, which 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 Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

Committee of the Regions and the European Investment Bank: "2017 European Semester: Country-specific recommendations".

[9] Under the preventive arm of the SGP, the so-called "expenditure benchmark" refers to the maximum allowable growth rate of general government primary expenditure, net of discretionary revenues and one-offs, that is consistent with, and conducive to, the fulfilment by the Member State of the improvement in its structural balance as recommended to it by the Council.

[10] The structural balance is defined as the cyclically-adjusted general government balance net of one off and other temporary measures.

[11] The structural balance pillar is based on the yearly change in the structural balance.

18. 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, which 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).

19. The revised 2019 draft budgetary plan expects that the debt-to-GDP ratio will slightly decline from 131.2% of GDP in 2017 to 130.9% in 2018, 129.2% in 2019, and 127.3% in 2020. Italy is not projected to comply with the debt reduction benchmark in either 2018 or 2019 based on the government plans. That conclusion is confirmed on the basis of the Commission 2018 autumn forecast, which expects that Italy's debt-to-GDP ratio will remain broadly stable at around 131% over 2019-2020. The difference with the revised 2019 draft budgetary plan in terms of the underlying debt dynamics is mainly explained by the lower nominal GDP growth and higher general government deficit expected by the Commission in comparison to those projected by the government, as well as by the prudent assumption of an only partial achievement of the ambitious privatisation proceeds planned by the government in 2019 (1% of GDP) and 2020 (0.3% of GDP).

20. On 23 May 2018, in view of Italy's *prima facie* non-compliance with the debt reduction benchmark in 2016 and 2017, the Commission adopted a report under Article 126(3) of the Treaty on the Functioning of the European Union, analysing whether Italy was compliant with the debt criterion of the Treaty.[12] After considering all the relevant factors and in particular Italy's compliance with the preventive arm, the report concluded that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with at that stage. Italy's particularly serious non-compliance identified by the Commission with the recommendation addressed to it by the Council on 13 July 2018 represents a material change in the relevant factors analysed by the Commission on 23 May 2018. That calls for revisiting the Commission's assessment.

21. The Commission Opinion of 23 October 2018 identified in Italy's 2019 draft budgetary plan a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018. Overall, based on an assessment of the government plans in the revised 2019 draft budgetary plan and on the Commission 2018 autumn forecast, the Commission confirms the existence of a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018. The Commission is also of the opinion that the measures included in the revised 2019 draft budgetary plan indicate a risk of backtracking on reforms that Italy had adopted in line with past Country-Specific Recommendations, as well as with regard to the structural fiscal aspects of the recommendations addressed to Italy by the Council on 13 July 2018.

[12] 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".

Done at Brussels,

For the Commission
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