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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

on the Spring 2019 round of fiscal surveillance for Italy

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1. Introduction

The objective of this document is to summarise the outcome of the spring 2019 round of fiscal surveillance of Italy under the Stability and Growth Pact ('SGP').

On 5 June 2019, the Commission assessed, in its report under Article 126(3) of the Treaty on the Functioning of the European Union ('TFEU')[1], that Italy did not satisfy the debt criterion of the Treaty in 2018, and concluded that a debt-based excessive deficit procedure ('EDP') was warranted.

That conclusion was based on the following elements:

- final data for 2018 showed that Italy's public debt-to-GDP ratio increased from 131.4 % in 2017 to 132.2 % in 2018;
- Italy's structural balance deteriorated by 0.1% of GDP in 2018 and was expected to further deteriorate by 0.2% of GDP in 2019 based on the Commission 2019 spring forecast, hence falling short of the fiscal efforts recommended to Italy by the Council by a large margin. Namely, Italy presented a gap to (broad) compliance with the required effort under the preventive arm of the SGP of 0.4% of GDP in 2018 and 0.3% of GDP in 2019;
- the Commission 2019 spring forecast pointed to a headline deficit above the 3% of GDP reference value in 2020, should the VAT hike legislated by the government as a safeguard clause not be activated or should it not be replaced by alternative financing measures.

The conclusion of the Commission report was supported by the Economic and Financial Committee in its opinion adopted on 11 June 2019 under Article 126(4) of the Treaty. The Economic and Financial Committee also invited Italy to "*take the necessary measures to ensure compliance with the provisions of the Stability and Growth Pact in accordance with the EDP process*", and added that "*further elements that Italy may put forward could be taken into account by the Commission and the committee*".

On 1 July 2019, the Italian government adopted, via its mid-year budget for 2019, a fiscal correction for 2019. This document explains how that package was assessed by the Commission and to what extent it affects Italy's compliance status with the SGP based on the Commission 2019 spring forecast.

The document is structured as follows. Section 2 recalls the latest macroeconomic and budgetary developments in Italy. Section 3 outlines the main steps of the 2019 spring round of fiscal surveillance for Italy. Section 4 describes and assesses the new measures put forward by the Italian authorities after the issuance of the 126(4) opinion of the Economic and Financial Committee. Section 5 concludes.

[1] Report from the Commission COM(2019) 532 final "*Italy, Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union*", Brussels, 5.6.2019.

2. Recent macroeconomic and budgetary developments in Italy

Italy's economy slipped into a mild contraction in the second half of 2018. Overall, Italy's real GDP growth reached 0.9% in 2018. The Commission 2019 spring forecast expects real GDP growth to decelerate to 0.1% in 2019, before moderately recovering and reaching 0.7% in 2020.

For 2019, those projections expect aggregate domestic demand to lend only limited support to growth, as a drop in investment demand largely offsets the moderately positive impact from consumer spending; no growth contribution is expected from net trade. In particular, capital spending is set to be hindered by policy uncertainty both domestically and internationally, while the re-introduction of investment-related tax incentives is likely to soften the decline in business investment. Moreover, higher sovereign spreads compared to early 2018 are translating, although with a lag, into tighter credit conditions. Private consumption growth is set to slightly benefit from the positive impact of lower inflation on real disposable income and the new citizenship income scheme, while deteriorating labour market and consumer confidence are likely to dampen consumer spending and divert part of the expected rise in income to savings.

For 2020, based on a no-policy-change assumption, growth is expected to moderately rebound on the back of firming external demand, as Italian exporters limit their losses in market shares, and higher social transfers. The Commission 2019 spring forecast expects consumer price inflation to remain low at 0.9% in 2019, partly due to lower energy prices, and to reach 1.1% in 2020. Nominal GDP growth is projected at 0.8% in 2019 and 1.8% in 2020.

The growth outlook in the Commission 2019 spring forecast is subject to predominantly negative risks, as trade tensions continue to cloud the global outlook and higher-than-expected oil prices could curb consumers' purchasing power. In addition, financial markets remain very sensitive to policy changes and any possible related increases in sovereign yields could affect sentiment and private sector funding conditions. Finally, the rollback of past structural reforms could negatively impact growth potential, for instance to the extent that higher flexibility for early retirement may negatively affect labour supply in a context where Italy is already lagging behind the EU average for the participation of its older workers (55-64 age group) in employment.

On the fiscal side, the Commission 2019 spring forecast expects Italy's general government deficit to increase from 2.1% of GDP in 2018 to 2.5% of GDP in 2019, largely because of the macroeconomic slowdown and the impact of the budgetary measures included in Italy's 2019 budget, with a net deficit-increasing impact of around 0.5% of GDP.[2] More in detail, public expenditure is set to increase in 2019 because of higher flexibility for early retirement, the rollout of a citizenship income scheme and, to a lesser extent, more funds for public investment. Partial financing is provided by a spending review and changes to the tax regime, especially for firms, temporarily supporting revenues. As regards 2020, the Commission forecast is based on a no-policy-change assumption and does not incorporate the impact (1.3% of GDP) of the increase in VAT rates legislated for 2020 as a "safeguard clause" to ensure the attainment of the budgetary targets, given the systematic repeals recorded in recent years and the lack of details on possible alternative measures. The Commission 2019 spring forecast expects Italy's structural balance to have deteriorated by 0.1% of GDP in 2018,

[2] That amount includes the repeal of the VAT hike (worth 0.7% of GDP) legislated for 2019 as a safeguard clause and the activation of the spending-freezing mechanism (worth 2 billion EUR or 0.11% of GDP in 2019) assumed by Italy's 2019 Stability Programme.

followed by larger structural deteriorations of 0.2% of GDP in 2019 and 1.2% of GDP in 2020. The attainment of Italy's current medium-term budgetary objective ('MTO') of a budgetary surplus of 0.5% of GDP in structural terms is not expected over the forecast horizon based on both the government plans and the Commission 2019 spring forecast.

Regarding general government debt developments, the Commission 2019 spring forecast expects that Italy's debt-to-GDP ratio, after reaching 132.2% in 2018, will continue rising to 133.7% in 2019 and 135.2% in 2020, mainly due to a large debt-increasing snowball effect, a declining primary surplus, and the assumption based on past experience 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). The increase in the spot yields at issuance in 2018 and through early 2019 reflects higher risk premia on Italy’s public debt, with sovereign spreads undergoing an upward level shift of around 100 basis points since May 2018. *Table 1* below summarises the main macroeconomic and fiscal variables described so far.

Table 1: Comparison of macroeconomic developments and forecasts

	2017	2018	2019		2020	
	Outturn	Outturn	COM	SP	COM	SP
Real GDP (% change)	1.7	0.9	0.1	0.2	0.7	0.8
Contributions to real GDP growth:						
- Final domestic demand	1.7	1.0	0.3	0.5	0.7	0.9
- Change in inventories	-0.4	0.0	-0.1	-0.2	0.0	0.0
- Net exports	0.3	-0.1	0.0	0.0	0.0	-0.1
Output gap[1]	-0.5	-0.1	-0.3	-0.3	-0.1	-0.2
Employment (% change)	1.2	0.9	0.3	-0.3	0.3	0.2
Unemployment rate (%)	11.2	10.6	10.9	11.0	11.0	11.1
Labour productivity (% change)	0.8	0.1	0.2	0.6	0.2	0.6
HICP inflation (%)	1.3	1.2	0.9	1.0	1.1	2.3
GDP deflator (% change)	0.5	0.8	0.7	1.0	1.0	2.0
Comp. of employees (per head, % change)	0.3	2.0	0.9	1.2	1.0	1.5
General government balance (% of GDP	-2.4	-2.1	-2.5	-2.4	-3.5	-2.1
General government debt (% of GDP)	131.4	132.2	133.7	132.6	135.2	131.3

Note:
[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services using the commonly agreed methodology.
Source:
Italy's Stability Programme for 2019 (SP); Commission 2019 spring forecast (COM); Commission calculations

3. Main steps of the spring 2019 round of fiscal surveillance

According to the data notified by the Italian authorities in April 2019 and subsequently validated by Eurostat,[3] Italy's general government gross debt increased in 2018, reaching 132.2% of GDP (from 131.4% in 2017). As such, in 2018 Italy's debt exceeded the 60% of GDP reference value of the Treaty and, based on outturn data, it did not comply by a large margin (gap of 7.6% of GDP) with the debt reduction benchmark, which requires each year a sufficient reduction in the differential between a Member State's debt-to-GDP ratio and the 60 % of GDP reference value.

Moreover, for 2019, the Commission 2019 spring forecast expects Italy's debt-to-GDP ratio to continue rising, to 133.7% in 2019 and 135.2% in 2020 (see Section 2). As such, based on the Commission forecast, Italy is not expected to comply with the debt reduction benchmark either in 2019 (gap of 9.0% of GDP) or in 2020 (gap of 9.2% of GDP, respectively). This provides evidence of a *prima facie* non-compliance with the debt criterion of the TFEU. In line with the provisions of the TFEU, the Commission analysed all relevant factors in its report under Article 126(3) TFEU of 5 June 2019.

In its analysis, the Commission took the following relevant factors into account: (i) Italy's non-compliance with the recommended adjustment path towards the medium-term budgetary objective in 2018 based on *ex post* data, together with a risk of significant deviation from the preventive arm requirement in 2019 and a headline deficit above 3% of GDP in 2020 based on the Commission forecast; (ii) the macroeconomic slowdown recorded in Italy from the second half of 2018, which only partly explains its large gaps to compliance with the debt reduction benchmark; and (iii) the limited progress made by Italy in addressing the 2018 Country Specific Recommendations, including the backtracking on past growth-enhancing reforms, as well as the lack of details on both content and timeline of the reform commitments in its 2019 National Reform Programme.

Overall, the analysis in the Commission report led to the conclusion that the debt criterion in the TFEU is not fulfilled and that a debt-based EDP was thus warranted for Italy.

The conclusion of the Commission report was endorsed by the Economic and Financial Committee of the Council, in its opinion under Article 126(4) of the Treaty adopted on 11 June 2019. Supporting the Commission, the Member States also invited Italy to "*take the necessary measures to ensure compliance with the provisions of the Stability and Growth Pact in accordance with the EDP process*", and added that "*further elements that Italy may put forward could be taken into account by the Commission and the committee*".

[3] Pursuant 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.

4. New measures put forward by the Italian authorities on 1 July 2019

On 1 July 2019, the Italian government adopted, via its 2019 mid-year budget, a fiscal correction for 2019 amounting overall to around 7.6 bn EUR or 0.42% of GDP in nominal terms and 8.2 bn EUR or 0.45% of GDP in structural terms[4]. Moreover, the spending-freezing mechanism already legislated via the 2019 budget law (worth 2 billion EUR or 0.11% of GDP) has been fully activated for 2019. The new measures put forward by the Italian government, improving Italy's compliance status with the preventive arm in 2019, mainly consist of higher-than-expected revenues and lower-than-projected public expenditure resulting from the budget execution in 2019, with the latter being further guaranteed via a new spending-freezing clause.

More in detail, the government's mid-year budget for 2019, which must now be adopted by the Italian parliament, indicates an overall improvement of the general government deficit of 7.6 bn EUR due to the existence of: (i) additional revenues worth overall 6.2 bn EUR, of which higher tax revenues by 2.9 bn EUR[5], higher social security contributions by 0.6 bn EUR and other revenues, including higher dividends from Bank of Italy and Cassa Depositi e Prestiti,[6] by 2.7 bn EUR; and (ii) additional public spending worth overall 0.1 bn EUR, mainly due to the financing of new provisions included in the "growth decree", only partly offset by lower-than-projected expenditure for deferred-tax-assets and for the servicing of Italy's public debt, given the recent downward shift in the level of sovereign yields.

Moreover, the government adopted a decree-law[7], to be converted into law by the Italian parliament within sixty days, providing for a new spending-freezing mechanism worth 1.5 bn EUR (or 0.08% of GDP) to be activated by 15 September 2019, should the projected savings on the early retirement and citizenship income schemes fail to materialise as projected, thereby putting at risk the attainment of the new fiscal target for 2019.

Overall, the budget adjustment and the new spending-freezing clause ensure that the higher revenues and lower spending that have emerged so far are used for deficit and debt reduction and are not spent for other measures in the rest of 2019. A revision of the legislation implementing the citizenship income and the early retirement schemes, repealing the possibility to transfer unused resources earmarked for those two measures between the two schemes and across budgetary years, provides further reassurances in this respect.

After taking into account the new package of measures, Italy's headline deficit would now reach 2.04% of GDP in 2019 (compared to 2.5% in the Commission 2019 spring forecast), meeting the deficit target adopted by the parliament in December 2018 through the 2019 budget, despite the significant worsening of the macroeconomic outlook recorded since then.

[4] The difference is due to lower-than-expected one-off revenues from tax amnesty ("*rottamazione*") of around 0.6 bn EUR, which worsen the fiscal target in nominal terms but not in structural terms. The allowance of 0.18% of GDP preliminarily granted to Italy for "unusual events" related to the collapse of the Morandi Bridge and to hydrogeological risk is not yet taken into account in these computations, as it will have to be confirmed based on outturn data for 2019.

[5] In particular, the higher tax revenues of 2.9 bn EUR are due to: (i) better-than-expected developments of the personal income tax (IRPEF) by around 0.4 bn EUR; (ii) higher revenues from value-added tax by around 0.35 bn EUR; (iii) higher receipts from lotteries and gambling by around 0.2 bn EUR; (iv) the settlement of past tax liabilities from a large Italian company (Kering Group - Gucci) by around 1 bn EUR; (v) other revenues (e.g. for CO_2 auctions) of around 0.95 bn EUR.

[6] Cassa Depositi e Prestiti is Italy's national promotional institution. The Ministry of Economy and Finance is its majority shareholder.

[7] Decreto legge 1 luglio 2019, "*Misure urgenti in materia di miglioramento dei saldi di finanza pubblica*".

This would correspond to a structural improvement of around 0.2% of GDP (compared to a deterioration of 0.2% in the Commission 2019 spring forecast).

As regards 2020, the Italian government has committed, in a letter sent to the Commission on 2 July 2019, to achieve a structural improvement in line with the requirements of the SGP, by ensuring the full replacement of the VAT hike legislated as a safeguard clause for that year with offsetting fiscal measures, including a spending review and a revision of tax expenditures.

Specifically, the authorities reiterate the commitment, already made on 31 May 2019 in the documents concerning relevant factors transmitted to the Commission in accordance with Article 2(3) of Regulation (EC) No 1467/97, to abide by the parliamentary resolution accompanying the 2019 Document of Economic and Finance. The latter called for the respect of the fiscal targets for 2020 put forward in the 2019 Stability Programme, in compliance with the preventive arm of the SGP, by finding alternative financing measures in case of repeal of the already legislated rise in the reduced and standard VAT rates as of 1 January 2020. To recall, the new fiscal country-specific recommendation to Italy, proposed by the Commission in the context of the European Semester on 5 June 2019 and expected to be adopted by the Council on 9 July 2019, asks Italy to "*ensure a nominal reduction of net primary government expenditure of 0.1% in 2020, corresponding to an annual structural adjustment of 0.6% of GDP"* and to *"use windfall gains to accelerate the reduction of the general government debt ratio*"[8].

In the letter, the government indicates that the abrogation of the VAT hike, while ensuring a structural improvement in line with the requirements of the SGP, will be carried out through an integrated strategy relying on the following elements: (i) a spending review; (ii) a revision of tax expenditures; and (iii) the carry-over to 2020 of the higher revenues and lower public expenditure, especially on citizenship income and early retirement schemes, recorded in 2019.

Finally, the letter indicates that the government's fiscal consolidation will proceed hand in hand with structural reforms aimed at improving the growth potential of the Italian economy, in line with the country-specific recommendations proposed the Commission in the context of the European Semester on 5 June 2019 and expected to be adopted by the Council on 9 July 2019. Those reforms should notably aim at improving the efficiency of the public sector and the legal system, as well as enhancing human capital and productivity.

[8] Recommendation for a Council Recommendation on the 2019 National Reform Programme of Italy and delivering a Council opinion on the 2019 Stability Programme of Italy, Brussels, 5.6.2019 COM(2019) 512 final.

5. Conclusion

On 1 July, the Italian government adopted, via its mid-year budget for 2019, a fiscal correction for 2019 amounting overall to 7.6 bn EUR or 0.42% of GDP in nominal terms and 8.2 bn EUR or 0.45% of GDP in structural terms for 2019. Those measures, improving Italy's compliance status with the preventive arm in 2019, mainly consist of higher-than-expected revenues and lower-than-projected public expenditure resulting from the budget execution in 2019, with the latter being further guaranteed via a newly legislated spending-freezing clause (worth 1.5 bn EUR or 0.08% of GDP) to be activated by 15 September 2019 in case of underachievement of the new fiscal target.

Overall, the budget adjustment and the new spending-freezing clause ensure that the higher revenues and lower spending that have emerged so far are used for deficit and debt reduction and are not spent for other measures in the rest of 2019. A revision of the legislation implementing the citizenship income and the early retirement schemes, repealing the possibility to transfer unused resources earmarked for those two measures between the two schemes and across budgetary years, provides further reassurances in this respect.

With these measures, Italy's headline deficit is expected to reach 2.04% of GDP in 2019 (compared to 2.5% in the Commission 2019 spring forecast), meeting the deficit target adopted by the parliament in December 2018 through the 2019 budget, despite the significant worsening of the macroeconomic outlook recorded since then (with real GDP growth now expected by the Commission at around 0.1% of GDP for 2019, down from around 1% projected last autumn).

This would correspond to a structural improvement of around 0.2% of GDP (compared to a deterioration of 0.2% in the Commission 2019 spring forecast). As such, Italy is now expected to be broadly compliant with the required effort under the preventive arm of the Stability and Growth Pact in 2019, bridging the 0.3% of GDP gap estimated on the basis of the Commission 2019 spring forecast. Moreover, the additional fiscal effort delivered by the government for 2019 is such that it also partially compensates the deterioration in the structural balance recorded in 2018.

As regards 2020, the Italian government has committed, in a letter sent to the Commission on 2 July 2019, to achieve a structural improvement in line with the requirements of the SGP, by ensuring the full replacement of the VAT hike legislated as a safeguard clause for that year with offsetting fiscal measures, including a spending review and a revision of tax expenditures.