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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.[3]

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 2018, with due regard to the economic background and other relevant factors.

On 23 May 2018, the Commission issued a report under Article 126(3) TFEU[4], as Italy did not make sufficient progress towards compliance with the debt criterion in 2017. The report

[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] The concepts of "*sufficiently diminishing*" and "*satisfactory pace*" are defined in Article 2(1a) of Regulation (EC) 1467/97 as being fulfilled if "*the differential [of the debt ratio] with respect to the reference value has decreased over the previous three years at an average rate of 1/20th per year as a benchmark*". The Regulation also provides that "*the requirement under the debt criterion shall also be considered to be fulfilled if the budgetary forecasts of the Commission indicate that the required reduction in the differential will occur over the three-year period encompassing the two years following the final year for which data is available*". Regulation (EC) 1467/97 further provides that "the influence of the cycle on the pace of debt reduction" should be taken into account. Those elements have been translated into a debt reduction benchmark, as set out in the Code of Conduct on the SGP and endorsed by the Council. Compliance with the debt benchmark is assessed on the basis of three different configurations: the backward-looking, the forward-looking and the debt reduction benchmark adjusted for the impact of the cycle.

[4] 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".

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. The report indicated that the Commission would reassess compliance based on the *ex post* data for 2018 to be notified in spring 2019.

The Commission issued another report under Article 126(3) TFEU in November 2018[5], as it identified in Italy's Draft Budgetary Plan for 2019 a case of "*particularly serious non-compliance*" with the fiscal recommendation addressed to it by the Council on 13 July 2018, thereby justifying a reassessment of Italy's compliance with the debt reduction benchmark in 2017. However, the government put an end to the situation of "*particularly serious non-compliance*" with the preventive arm of the SGP, which had urged the reassessment, through the amendments it introduced in its 2019 budget in the course of December 2018.

The data notified by the authorities in April 2019[6] and subsequently validated by Eurostat[7] show that Italy's general government deficit declined to 2.1% of GDP in 2018 (from 2.4% in 2017), while general government debt increased to 132.2% of GDP (from 131.4% in 2017), i.e. above the 60% of GDP reference value. For 2019, Italy's 2019 Stability Programme projects the debt-to-GDP ratio to continue rising only slightly up to 132.6%. In 2020, it projects a decline (of 1.3 percentage points) in the debt-to-GDP ratio to 131.3%. The Commission 2019 spring forecast expects Italy's debt-to-GDP ratio to increase more markedly, to 133.7% in 2019 and 135.2% in 2020.

Based on notified data and the Commission 2019 spring forecast, Italy did not comply with the debt reduction benchmark in 2018 (gap of some 7 ½% of GDP) (see Table 1). Overall, Italy's lack of compliance with the debt reduction benchmark in 2018 provides evidence of a *prima facie* existence of an excessive deficit within the meaning of the SGP before considering all factors as set out below. Moreover, based on both the government plans and the Commission 2019 spring forecast, Italy is not expected to comply with the debt reduction benchmark either in 2019 (gap of some 5% and 9% of GDP, respectively) or in 2020 (gap of some 4 ½% and 9 ¼% 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). In particular, that section stresses Italy's non-compliance with the recommended adjustment path towards the medium-term budgetary objective in 2018 based on *ex post* data (section 4.1). The report is based on the Commission 2019 spring forecast, released on 7 May 2019, which takes into

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[5] See Commission Report COM(2018) 809 final of 21.11.2018: "Italy - Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union".

[6] 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

[7] Eurostat news release No 67/2019 of 23 April 2019, available at: https://ec.europa.eu/eurostat/documents/2995521/9731224/2-23042019-AP-EN/bb78015c-c547-4b7d-b2f7-4fffe7bcdfad

account Italy's 2019 Stability Programme (SP) submitted to the Commission and the Council on 19 April 2019.

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

		2016	2017	2018	2019		2020	
					COM	SP	COM	SP
Deficit criterion	General government balance	-2.5	-2.4	-2.1	-2.5	-2.4	-3.5	-2.1
Debt criterion	General government gross debt	131.4	131.4	132.2	133.7	132.6	135.2	131.3
	Gap to the debt reduction benchmark	5.8	6.7	7.6	9.0	5.1	9.2	4.5
	Change in structural balance	-1.0	-0.4	-0.1	-0.2	-0.1	-1.2	0.2
	Required MLSA	n.r.	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 2019 SP and Commission 2019 spring forecast

2. DEFICIT CRITERION

Italy made a sizeable fiscal effort between 2010 and 2013, raising its primary surplus to over 2% of GDP and exiting the excessive deficit procedure in 2013, by keeping its headline deficit within the 3% of GDP deficit threshold as of 2012. However, its fiscal stance has gradually eased since 2014, with the structural primary balance deteriorating significantly. In 2018, Italy's primary surplus stabilised at 1.6% of GDP, while the headline deficit reached 2.1% of GDP, the lowest since 2007. However, both the headline and the primary balance are set to deteriorate in 2019 mainly due to the macroeconomic slowdown and the measures included in the 2019 budget, before further worsening in 2020 on a no-policy-change basis.

Italy's general government deficit was reported at 2.1% of GDP in 2018. According to both the Stability Programme and the Commission 2019 spring forecast, it is projected to respect the Treaty reference value of 3% of GDP in 2019. However, the reference value will be exceeded in 2020 according to the Commission forecast, under a no-policy-change assumption.[8] The Stability Programme projects the general government deficit at 2.4% of GDP in 2019 and 2.1% in 2020, before further declining to 1.8% of GDP in 2021 and 1.5% in 2022. The increase in the general government deficit projected for 2019 largely results from the macroeconomic slowdown and the budgetary measures in the 2019 budget, with a net deficit-increasing impact of around 0.5% of GDP.[9] The decrease in the general government deficit planned for 2020 is largely due to the impact (around 1.3% of GDP) of higher VAT rates legislated for 2020 as a safeguard clause.

[8] The no-policy-change assumption departs from the hypothesis of unchanged legislation for instance as regards policy measures that are formally legislated but not included in the Commission forecast to the extent that they are assessed as not credible enough or not sufficiently detailed. As an example, since its 2016 autumn forecast, the Commission does not include higher VAT rates legislated as a "safeguard clause" to ensure the attainment of future fiscal targets, as Italy's budget laws have systematically repealed those hikes for the coming year, mostly without specifying alternative financing measures.

[9] 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.

The Commission 2019 spring forecast projects that Italy's general government deficit will be 2.5% of GDP in 2019 and rise to 3.5% in 2020. Although the net deficit-increasing impact of the measures in the 2019 budget is in line with the projections in the Stability Programme, the headline deficit forecast by the Commission for 2019 is slightly higher than the latter, mainly due to a more prudent underlying trend of public expenditure. The higher deficit forecast by the Commission for 2020 under a no-policy-change assumption compared to the government plans is mainly explained by the fact that the Commission does not include the higher VAT rates legislated for 2020 as a safeguard clause, given the systematic repeals recorded in recent years and the lack of details on possible alternative measures.

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 based on the Commission 2019 spring 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 public debt-to-GDP ratio hovered around 131.5% over 2014-2017 before increasing to 132.2% in 2018. Based on the Stability Programme, it is expected to slightly rise to 132.6% in 2019 and decline to 131.3% in 2020 on the back of rather solid nominal growth, a decrease in the headline deficit thanks to VAT hikes, and ambitious privatisation proceeds. By contrast, the Commission expects the debt ratio to rise in both 2019 and 2020, up to over 135%, due to a large debt-increasing "snowball" effect, a declining primary surplus, and underachieved privatisation proceeds. While refinancing risks remain limited in the short term, the high public debt remains a source of vulnerability for Italy's 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, starting in 2013 and ending 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 7.6% in 2018. Moreover, based on the Stability Programme, Italy does not plan to comply with the debt reduction benchmark either in 2019 (gap to the debt benchmark of 5.1% of GDP) or in 2020 (gap to the debt benchmark of 4.5% of GDP). That conclusion is confirmed, with larger gaps, based on the Commission forecast (gap to the debt benchmark of 9.0% and 9.2% of GDP, respectively).

More in detail, Italy's debt-to-GDP ratio reached 132.2% in 2018, i.e. 0.8 percentage points higher than in 2017. As summarised in Table 2, that increase was mainly due to a large debt-increasing stock-flow adjustment (0.9% of GDP) also related to a marked rise in the Treasury liquidity reserves. The debt-reducing impact of the higher primary surplus (1.6% of GDP, up from 1.4% in 2017) almost entirely offset a debt-increasing "snowball" effect (1.5%). In fact, as shown in Graph 1, the real implicit cost of debt[10] remained above Italy's real GDP growth in 2018 (0.9%), although it slightly shrank (to 2%, down from 2.4% in 2017) thanks to a gradual pass-through of higher spot yields at issuance (1.1% in 2018, up from 0.7% in 2017)[11]

[10] 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).

[11] It was 1.33% on average between January and April 2019

into the servicing cost of the outstanding debt stock[12] and moderately rising inflation (GDP deflator growth of 0.8%). The increase in the spot yields at issuance in 2018 (and in early 2019) reflects higher risk premia on Italy's public debt, with sovereign spreads undergoing an upward level shift in the order of around 100 basis points since May 2018. As such, compared to the projections in the Commission 2018 spring forecast, interest expenditure in 2018 turned out higher by around EUR 2.2 billion (at EUR 65 billion instead of 62.8 billion).

For 2019, the Stability Programme projects the debt-to-GDP ratio to further rise to 132.6%, i.e. by 0.4 percentage points compared to the 2018 level. The projected dynamics are mainly the result of a debt-increasing "snowball" effect (2% of GDP) due to weakening macroeconomic conditions (nominal GDP growth decreasing to 1.2%, from 1.7% in 2018), although the primary surplus (1.2% of GDP) and ambitious privatisation proceeds (1% of GDP) largely offset it. The Commission expects Italy's debt ratio to rise much more markedly in 2019, to 133.7%. The difference is due partly to a larger debt-increasing "snowball" effect (2.6%), related to more prudent assumptions as regards nominal GDP growth (0.8% in lieu of 1.2%) and partly to a debt-increasing stock-flow adjustment largely explained by the assumed underachievement of the privatisations projected by the government (0.1% of GDP in lieu of 1%).

For 2020, the Stability Programme projects the debt-to-GDP ratio to decrease to 131.3% i.e. by 1.3 percentage points compared to the 2019 level. The projected dynamics are mainly the result of a large projected primary surplus (1.6% of GDP) and a neutral "snowball" effect on the back of the assumed marked rise in nominal GDP growth (2.8%), despite a slightly debt-increasing stock-flow adjustment (0.3%). The Commission, instead, expects Italy's debt ratio to keep rising in 2020, to 135.2%. The difference is due to a much lower primary balance (a primary deficit of 0.2% of GDP) as the Commission does not incorporate in its forecast the increase in VAT rates legislated as a safeguard clause, and a much larger debt-increasing "snowball" effect (1.4%), related to more prudent assumptions as regards nominal GDP growth (1.8% in lieu of 2.8%). Moreover, the Commission assumes an underachievement of the privatisations projected by the government (zero in lieu of 0.3% of GDP). Risks to the debt projections in both the Commission forecast and the Stability Programme could be related to a worse-than-anticipated macroeconomic outlook, a stronger deterioration of the primary balance, lower inflation and/or privatisation proceeds, and higher-than-expected interest spending.

Overall, as shown in Graph 1, despite weakening real GDP growth in 2018 (*solid blue line*), the still decreasing real implicit cost of public debt (*dashed black line*) was enough to contain the debt-increasing "snowball" effect (*yellow shade*) to 1.2% in 2018 (up from 0.7% in 2017), i.e. broadly in line with the pre-crisis average (1.2% over 2000-2007), after a couple of years in which it was below the latter (¾% over 2016-2017). While being an *unicum* within the Union at the current juncture, the positive interest-rate-growth-rate differential, leading to a debt-increasing "snowball" effect, thus offers only a partial explanation for Italy's lack of compliance with the debt reduction benchmark in 2018, mainly through its forward-looking configuration. In fact, in 2019 the "snowball" effect is set to rise to 2%, i.e. markedly above the historical average, mainly due to weakening macroeconomic conditions. As such, it represents one of the main factors behind Italy's projected lack of compliance with the debt reduction benchmark in a forward-looking configuration.

[12] That is related to the average duration of the Italian public debt and its rollover period.

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 in 2018, 2019 and 2020, whether based on the Stability Programme or the Commission 2019 spring forecast, before consideration is given to all relevant factors as set out below.

Table 2: Debt dynamics [a]

	2016	2017	2018	2019		2020	
				COM	SP	COM	SP
Government gross debt ratio	131.4	131.4	132.2	133.7	132.6	135.2	131.3
Change in debt ratio [b] (1 = 2+3+4)	-0.2	0.0	0.8	1.6	0.4	1.5	-1.3
Contributions:							
• Primary balance (2)	-1.4	-1.4	-1.6	-1.2	-1.2	-0.2	-1.6
• “Snowball” effect (3)	1.0	0.9	1.5	2.6	2.0	1.4	0.0
of which:							
Interest expenditure	*3.9*	*3.8*	*3.7*	*3.6*	*3.6*	*3.7*	*3.6*
Real GDP growth	*-1.5*	*-2.2*	*-1.1*	*-0.1*	*-0.3*	*-0.9*	*-1.0*
Inflation (GDP deflator)	*-1.5*	*-0.7*	*-1.1*	*-0.9*	*-1.3*	*-1.4*	*-2.6*
• Stock-flow adjustment (4)	0.3	0.4	0.9	0.1	-0.3	0.3	0.3
of which:							
Cash/accruals difference	*-0.3*	*1.4*	*0.2*	*0.4*	*0.4*	*0.4*	*0.0*
Net accumulation of financial assets	*0.5*	*-1.0*	*0.2*	*-0.3*	*-0.7*	*-0.1*	*0.0*
of which privatisation proceeds	*-0.1*	*0.0*	*0.0*	*-0.1*	*-1.0*	*0.0*	*-0.3*
Valuation effect & residual	*0.0*	*0.0*	*0.3*	*0.0*	*-0.1*	*0.0*	*0.2*

Notes:

[a] In percent of GDP unless otherwise specified

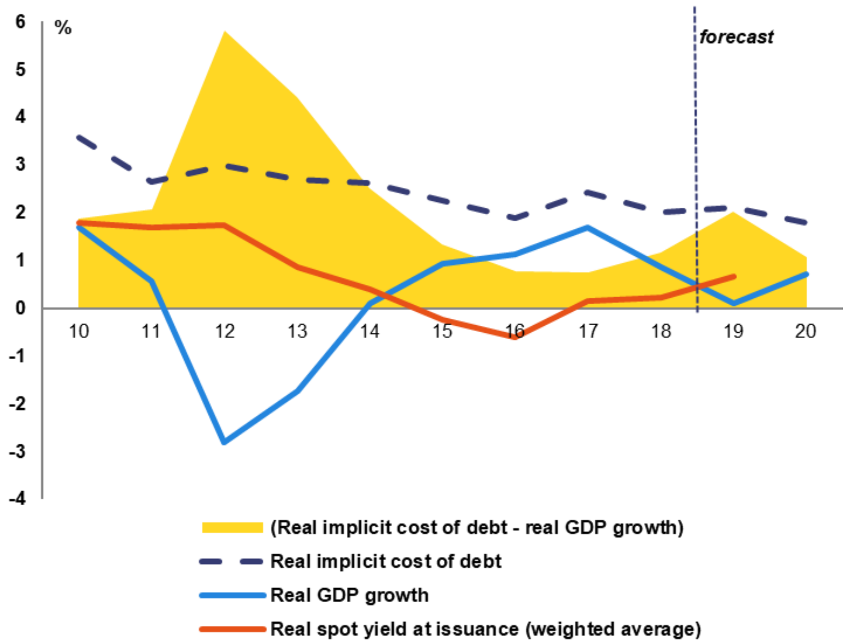
[b] The change in the gross debt ratio can be decomposed as follows:

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

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 2019 SP and Commission 2019 spring forecast*

Graph 1: Drivers of “snowball effect” on government debt



Source: Commission 2019 spring forecast and Ministry of Finance (MEF) data. The real spot yield at issuance for 2019 includes data only up to April 2019

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 influenced to a larger extent 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 based on 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 past reports) when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the Medium Term budgetary Objective (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 Stability and Growth Pact (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 budgetary position, including an assessment of compliance with the required adjustment towards the MTO and of public investment; (2) the developments in the medium-term government debt position, including its sustainability prospects; (3) the medium-term economic position, including the state of play in terms of implementation of structural reforms; (4) other factors deemed relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term budgetary position

An ex post assessment points to Italy's non-compliance with the recommended adjustment path towards the MTO in 2018, even after taking into account the so-called "margin of discretion". Moreover, as regards 2019, Italy is at risk of non-compliance with the preventive arm of the Stability and Growth Pact, even after taking into account the preliminary allowance for unusual events. The size of the deviation from the recommended adjustment path towards the MTO is expected to further widen in 2020 based on the Commission 2019 spring forecast, under a no-policy-change assumption. This represents an aggravating factor.

Structural balance and adjustment towards the MTO

As regards **2018**, on 11 July 2017 the Council recommended that Italy should pursue a substantial fiscal effort in line with the requirements of the preventive arm of the SGP, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of public finances. Based on the commonly agreed adjustment matrix under the preventive arm of the SGP that adjustment translated into the requirement of a nominal rate of reduction of net primary government expenditure of at least 0.2%, corresponding to an annual structural effort of at least 0.6% of GDP. At the same time, the Council stated that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes would need to take due account of the goal of achieving a fiscal stance that contributed to strengthening the ongoing recovery and ensuring the sustainability of public finances. Following the Commission's assessment of the strength of Italy's recovery while giving due consideration to its sustainability challenges, which the Commission carried out in November 2017 in its opinion on Italy's 2018 Draft Budgetary Plan, on 13 July 2018 the Council set for Italy a required fiscal structural effort of at least 0.3% of GDP for 2018 without any additional margin of deviation over one year, corresponding to a nominal rate of growth of net primary government expenditure not exceeding 0.5%.

Based on notified data, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, as the growth rate of Italy's government expenditure, net of discretionary revenue measures and one-offs, at 2%, is expected to have exceeded the 0.5% increase recommended by the Council. Moreover, based on notified data and the Commission 2019 spring forecast, Italy's structural balance is estimated to have deteriorated by 0.1% of GDP in 2018, falling short of the adequate structural effort of 0.3% of GDP. More in detail, the increase in Italy's structural primary expenditure by some 0.45% of potential GDP compared to 2017 was largely driven by compensation of employees and social transfers in cash. That increase was only partly offset by a lower interest bill in the order of 0.1% of GDP[13], resulting in an overall increase in structural expenditure by some 0.35% of potential GDP. On the other hand, Italy's structural revenues improved only by around 0.25% of potential GDP, largely driven by revenues from indirect taxes and social security contributions. An overall assessment thus points to Italy's non-compliance with the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018.

For **2019**, the Council recommended to Italy 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.

[13] However, as mentioned above, interest expenditure in 2018 turned out higher than expected by the Commission 2018 spring forecast based on the 2018 Stability Programme due to a rise in sovereign yields since May 2018.

Based on the Stability Programme, the expenditure benchmark points to a risk of significant deviation both in 2019 (gap of 0.7% of GDP) and over 2018 and 2019 taken together (gap of 0.7% of GDP per year, on average after taking into account the margin of discretion in 2018[14]), as the growth rate of government expenditure net of discretionary revenue measures and one-offs, at 1.8%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Stability Programme projects the (recalculated) structural balance to deteriorate by 0.2% of GDP in 2019. This points to a risk of significant deviation both over one year (gap of 0.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 0.6% per year, on average after taking into account the margin of discretion in 2018). An overall assessment based on the government plans points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2019. That conclusion would not change if the budgetary impact (around 0.18% 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 2019 spring forecast, the overall assessment based on the recalculated government plans is confirmed. The expenditure benchmark points to a risk of significant deviation both in 2019 (gap of 0.9% of GDP) and over 2018 and 2019 taken together (gap of 0.8% of GDP per year, on average after taking into account the “margin of discretion” in 2018), as the growth rate of government expenditure net of discretionary revenue measures and one-offs, at 2.0%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Commission expects Italy’s structural balance to deteriorate by 0.2% of GDP in 2019, reaching -2.4% of GDP. The structural balance pillar thus points to a risk of significant deviation both over one year (gap of 0.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 0.6% per year, on average after taking into account the “margin of discretion” in 2018). That conclusion would not change after considering the preliminarily granted allowance for unusual events in 2019. However, the Italian authorities indicate the existence of upside risks to the 2019 budget balance thanks to higher-than-expected revenues and lower-than-projected public expenditure on measures in the 2019 budget (section 4.5).

For **2020**, Italy is recommended to ensure that net primary government expenditure declines by 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP.

Based on the Stability Programme, the expenditure benchmark points to a risk of some deviation in 2020 (gap of 0.3% of GDP) and to a risk of significant deviation over 2019 and 2020 taken together (gap of 0.5% of GDP per year, on average), as the growth rate of government expenditure net of discretionary revenue measures and one-offs, at 0.6%, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, as the Stability Programme projects the (recalculated) structural balance to improve by 0.2% of GDP in 2020. That points to a risk of some deviation over one year (gap of 0.4% of GDP in 2020) and to a risk of significant deviation over 2019 and 2020 taken

[14] The gap over one year is thus computed with respect to the requirement of 0.6% of GDP in 2019, while the gap over two years (i.e. over 2018 and 2019 taken together) is computed on the basis of the “adjusted” requirement of 0.3% of GDP in 2018, after taking into account the margin of discretion, and of 0.6% of GDP in 2019.

together (gap of 0.6% per year, on average). The indications provided by both pillars suggest that the more positive fiscal developments projected in the Stability Programme for 2020, largely due to the assumed full implementation of a large VAT hike, are not sufficient to compensate for the large planned deviation from the preventive arm's requirement in 2019. 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 2020. That conclusion would not change after considering the preliminarily granted allowance for "unusual events" in 2019.

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

The MTO set by the 2019 Stability Programme, i.e. a budgetary surplus of 0.5% of GDP in structural terms, reflects the objectives of the SGP but is not planned to be reached within the programme period. Namely, after remaining stable in 2018, the structural balance is expected to deteriorate by 0.1% of GDP in 2019 and to improve by 0.2% of GDP in 2020 and 0.3% of GDP in both 2021 and 2022, reaching -0.8% of GDP in 2022.

Box 1: flexibility under the preventive arm

In the context of the fiscal surveillance carried out by the Commission over recent years, Italy has benefitted from different kinds of flexibility clauses and allowances foreseen under the SGP. Specifically, over 2015-2018 Italy benefitted from a cumulated allowance of around EUR 30 billion, or 1.8% of GDP, in addition to an allowance of around EUR 3 billion, or 0.18% of GDP, provisionally granted for 2019. The flexibility granted to Italy was crucial to ensure its (broad) compliance with the preventive arm of the SGP based on outturn data, in particular for 2015, 2016 and 2017. Compliance with the preventive arm was also regarded by the Commission as a key mitigating factor not to trigger an excessive deficit procedure despite *prima facie* non-compliance with the debt reduction benchmark.

Following the "Flexibility Communication" of January 2015, the Council recommended to Italy a fiscal effort of 0.25% of GDP in 2015, instead of 0.5%, due to the greater weight given to cyclical conditions ("*very bad economic times*") it introduced. Moreover, Italy benefitted from an allowance of 0.03% of GDP for additional refugee-related expenditure.

As regards 2016, the flexibility granted to Italy amounted to 0.5% of GDP under the structural reform clause; 0.21% under the investment clause; 0.06% for additional refugee-related expenditure; and 0.06% for exceptional security measures related to the terrorism threat.

As regards 2017, the flexibility granted to Italy amounted to 0.35% of GDP, of which 0.18% for a preventive investment plan for the protection of the national territory against seismic risk and 0.17% for the refugee crisis.

As regards 2018, in its Opinion on Italy's 2018 DBP the Commission made use of its "*margin of discretion*", by considering a structural effort of 0.3% of GDP (instead of 0.6%) as appropriate for Italy, without any further margin of deviation over one year, due to the need "*to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances*".

As regards 2019, in the context of the dialogue between the Italian authorities and the Commission over the 2019 DBP, the Commission assessed that Italy was provisionally eligible for an allowance of around 0.18% of GDP for "*unusual events*" for extraordinary maintenance programme for the road network and for a preventive plan to limit hydrogeological risks. Those amounts will have to be confirmed based on outturn data.

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 2018, the public investment-to-GDP ratio reached a new low, at 2.1% of GDP (growth rate of -4.3% year-on-year in nominal terms). The ratio is projected by the Stability Programme to increase to 2.2% of GDP in 2019 (+5.2% year-on-year in nominal terms) and 2.4% in 2020, supported by the additional funds allocated and measures taken to accelerate administrative procedures. Instead, the Commission expects investment to remain broadly stable at 2.1% of GDP in 2019 (growth rate of 1.9% year-on-year in nominal terms), before more mildly recovering to 2.3% in 2020.

Overall, 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.

4.2. Medium-term government debt position

Italy's public debt remains a major source of vulnerability for the economy. Newly adopted measures and adverse demographic trends partly reverse the positive effects of past pensions reforms and weaken Italy's long-term fiscal sustainability. Fiscal sustainability was also hampered by the level shift in interest rates on government bonds observed in 2018 and through early 2019.

After reaching 132.2% in 2018, Italy's debt-to-GDP ratio is set to further increase up to around 135% in 2020 based on the Commission 2019 spring forecast. In 2019-2020, a marked worsening of the primary surplus, broadly stable interest spending and close to zero privatisation proceeds in a context of weak nominal GDP growth are expected to be the main drivers behind the expected increase in the public debt ratio.

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.[15] 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 still large rollover needs (around 17% of GDP in 2019) related to its large 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 for firms and households.

In the medium term, Italy faces marked sustainability challenges. Its structural primary surplus is forecast to further deteriorate to 1.2% of GDP in 2019 and 0.2% of GDP in 2020, down from 3.5% 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[16], which both point to "high risk"[17]. The high and increasing projected stock of debt in 2029 in the baseline scenario and its sensitivity to macroeconomic-fiscal shocks contribute to that assessment. Achieving a debt ratio of 60% of GDP by 2033 would thus require Italy to make a large cumulative fiscal effort, amounting to 10.2 percentage points of GDP over 2021-2025.

In the long-term, Italy is also expected to face marked sustainability challenges, driven by both the sizeable fiscal adjustment required to stabilise the debt-to-GDP ratio, especially in light of the future ageing costs, and the vulnerabilities linked to the high debt burden. The long-term fiscal sustainability risk indicator S2[18] points to medium risks, as a permanent increase in Italy's structural primary surplus of around 3.2 percentage points of GDP would be needed to keep its 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, the latter points to high risks 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 due both to worsening demographic trends projected by Eurostat and to recently adopted reforms. In particular, with the 2019 budget, the government extended the possibility for early retirement, substantially increasing public spending for old-age pensions. The additional cost, at around 0.3% of GDP in 2019, would further raise Italy's old age pension expenditure, which, at around 15% of potential GDP in 2017, is already one of the highest in the Union and the OECD. Furthermore, the enhanced flexibility for retiring early might 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) in employment, thereby

[15] 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, which allows capturing vulnerabilities stemming solely from the fiscal side, is above its critical threshold, thus suggesting that those vulnerabilities are present in Italy, notably in light of its sizeable government financing needs.

[16] 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.

[17] See forthcoming European Commission Fiscal Sustainability Report 2019. More explanations on the methodology can be found in the European Commission Debt Sustainability Monitor 2018.

[18] 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) needed to stabilise the debt-to-GDP ratio over the infinite horizon, including paying for any additional expenditure arising from an ageing population.

hampering potential growth. Overall, further backtracking on the implementation of past pension reforms could significantly worsen Italy's long-term sustainability risks, endangering an appropriate reduction path of its very large public debt-to-GDP ratio.

Moreover, privatisation proceeds amounted to around zero in 2018, largely underachieving the 0.3% of GDP target planned by the government for that year. For the future, the Stability Programme projects an ambitious 1% of GDP of privatisation proceeds for 2019 and 0.3% for 2020. Given the weak track record of privatisations until now, the Commission forecast incorporates only around 0.1% of GDP of privatisation proceeds for 2019, in light of the credible and specified proposals currently under discussion, and no privatisation proceeds for 2020 for prudential reasons.

4.3. Medium-term economic position

The macroeconomic slowdown recorded from the second half of 2018, with nominal GDP growth falling below 2% in 2018 and over 2019-2020 based on the Commission forecast, can be argued to partly explain Italy's large gaps to compliance with the forward-looking configuration of the debt reduction benchmark. However, policy choices may have contributed to the macroeconomic slowdown through a negative confidence effect and a tighter credit channel. Moreover, Italy made limited progress in addressing the 2018 Country-Specific Recommendations and its National Reform Programme only provides limited details on the few new commitments it contains. Overall, low productivity growth keeps constraining Italy's growth potential and hampering a faster reduction of the public debt-to-GDP ratio.

Cyclical conditions, potential growth and inflation

Italy's economy slipped into a mild contraction in the second half of 2018, as the impact of the slowdown of global trade spread to the Italian economy and was amplified by subdued domestic demand. Namely, higher sovereign yields compared to early 2018 have been translating, although with a lag, into tighter credit conditions, while uncertainty on policies and reform direction has been weighing on investment. Overall, real GDP growth reached 0.9% in 2018. For 2019, ISTAT flash estimates for Q1 support a pick-up of economic activity, although weak domestic demand and subdued business and consumer sentiment suggest that output growth will gain more traction only in the second part of the year (compared to the last two quarters of 2018). As a result, real GDP growth in 2019 is set to remain sluggish at 0.1% based on the Commission forecast, before reaching 0.7% in 2020. The growth projections of the Stability Programme are only slightly more optimistic than the Commission forecast, with real output expanding by 0.2% in 2019 and 0.8% in 2020, where however the government incorporates the VAT hike legislated for 2020 as a safeguard clause.

As regards the GDP deflator growth, the government projections are also more optimistic than the Commission's, with nominal GDP growth at 1.2% in lieu of 0.8% in 2019 (and 2.8% in lieu of 1.8% for 2020 but largely due to the assumed activation of the VAT hike in the Stability Programme). After having risen by 1.2% in 2017, headline Harmonised Index of Consumer Price (HICP) inflation remained broadly stable in 2018 and is expected by the Commission to moderate to only 0.9% in 2019, partly due to lower energy prices, before picking up slightly to 1.1% in 2020. Core inflation, at 0.6% in April 2019, is set to rise above 1% by the end of 2020, in line with moderate wage growth.

Italy's potential growth is estimated to have increased in 2018, to 0.5% (up from 0.2% in 2017), but to slow down again to 0.3% in 2019 before picking up to 0.5% in 2020. Overall, it remains very low. As a result, Italy's negative output gap is estimated by the Commission to have closed in 2018, to -0.1% of potential GDP, from -0.5% in 2017, but to widen again to -0.3% in 2019 due to the starker deceleration in actual GDP growth, before closing again in 2020. Despite progress achieved in some reform areas (e.g. labour market and public administration, fight against tax evasion, banks' balance sheet repair), the legacy of the crisis and persistent structural weaknesses keep weighing on Italy's growth potential.[19] Italy's real GDP has hardly recovered to the pre-crisis level, while real GDP in the rest of the euro area is now 21% higher than in 2004. More in detail, Italy's average annual growth rate was 0.1% over 2004-2018, compared with 1.5% in the euro area excluding Italy.

This is largely 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 public spending limits growth-enhancing spending items like education and infrastructure. A 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 would have been important for Italy to restart the reform effort in order to improve medium-term growth prospects and enhance the sustainability of the country's public finances.

Overall, it can be argued that Italy's ongoing economic slowdown is once again, after the crisis period, calling for a careful modulation of the fiscal adjustment to avoid that large fiscal efforts could turn self-defeating in a context of subdued nominal GDP growth. Low inflation makes 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. At the same time, unfavourable macroeconomic conditions generally imply higher-than-average fiscal multipliers, amplified by the constrained monetary policy due to the zero lower bound.[20] On the other hand, the composition of the fiscal effort also has a major impact on the multipliers, especially in high-debt countries.[21] As such, the macroeconomic slowdown recorded in Italy from the second half of 2018, with nominal GDP growth falling below 2% in 2018 and expected to remain below 2% in 2019-2020 based on the Commission forecast, can be argued to be a mild mitigating factor, only partly explaining Italy's large gaps to compliance with the forward-looking configuration of the debt reduction benchmark. Going forward, risks to the growth outlook remain predominantly negative: trade tensions continue to cloud the global outlook, higher-than-expected oil prices could curb consumers' purchasing power, and any possible increases in sovereign yields could affect sentiment and private-sector funding conditions and amplify Italy's sustainability risks.

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[19] See Commission Staff Working Document SWD(2019) 1011 final, 27.2.2019, "*Country Report Italy 2019. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

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

[21] See, for instance, Blanchard O. and J. Zettlemeyer (2018): "The Italian Budget: A Case of Contractionary Fiscal Expansion?"

Table 3: Macroeconomic and budgetary developments [a]

	2016	2017	2018	2019		2020	
				COM	SP	COM	SP
Real GDP (% change)	1.1	1.7	0.9	0.1	0.2	0.7	0.8
GDP deflator (% change)	1.2	0.5	0.8	0.7	1.0	1.0	2.0
Potential GDP (% change)	-0.3	0.2	0.5	0.3	0.4	0.5	0.7
Output gap (% of potential GDP)	-2.0	-0.5	-0.1	-0.3	-0.3	-0.1	-0.2
General government balance	-2.5	-2.4	-2.1	-2.5	-2.4	-3.5	-2.1
Primary balance	1.4	1.4	1.6	1.2	1.2	0.2	1.5
One-off and other temporary measures	0.2	0.0	0.1	0.1	0.1	0.1	0.1
Government gross fixed capital formation	2.1	2.2	2.1	2.1	2.2	2.3	2.4
Cyclically-adjusted balance	-1.5	-2.1	-2.1	-2.3	-2.2	-3.4	-2.0
Cyclically-adjusted primary balance	2.5	1.7	1.6	1.3	1.4	0.3	1.6
Structural balance [b]	-1.7	-2.1	-2.2	-2.4	-2.3	-3.6	-2.1
Structural primary balance	2.3	1.7	1.5	1.2	1.3	0.2	1.5

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 2019 SP and Commission 2019 spring forecast

Structural reforms

In its 2019 Country Report[22], the Commission assessed that Italy had made limited progress in addressing the 2018 Country-Specific Recommendations. Namely, there has been some progress in fighting corruption, in reducing the stock of non-performing loans in the banking sector, and in implementing the reform of active labour market policies. There has been limited progress in tackling tax evasion, in improving market-based access to finance, in enforcing the framework for publicly owned enterprises, in encouraging women to work, as well as in fostering research, innovation, digital skills and infrastructure and vocational-oriented tertiary education. There has been no progress in shifting taxation away from productive factors, in reducing the share of old-age pensions in public spending (and indeed there has even been some backtracking in that field), in reducing trial length in civil justice, and in addressing restrictions on competition.

The in depth-review published as part of the 2019 Country Report also kept Italy in the "excessive macroeconomic imbalances" category, together with Greece and Cyprus,[23] for the sixth year in a row. Italy's macroeconomic imbalances relate mainly to its high public debt and low productivity growth, while unemployment remains high and the overall stock of non-performing loans in Italian banks' balance sheet remains elevated.

In the first months of 2019, the government approved two law decrees to support investment (so-called "*Crescita*" and "*Sblocca Cantieri*"). The *"Crescita"* decree envisages the strengthening of the regional bodies in charge of public works through the endowment of specialised employees in order to support investment in infrastructure. The decree reinforces State support for firms' financing (e.g. *"Fondo di Garanzia"*, *"Nuova Sabatini"*), in particular for bank credit, and introduces a new vehicle to support venture capital. The

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[22] See "*Country Report Italy 2019*". Ibidem.

[23] See Commission Communication COM(2019) 150 final, "*2019 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*". https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-communication-country-reports_en_0.pdf

"Sblocca Cantieri" decree aims to counter the difficulties faced by firms, especially smaller ones, in participating in public procurement through the implementation of simplified procedures, in order to unlock public investment. The 2019 National Reform Programme also mentions a reform of the public procurement code to be passed within two years.

The 2019 budget and the decree law implementing the new early retirement scheme in January 2019 backtrack on elements of past pension reforms, worsening the sustainability of public finances in the medium term. Those new provisions will further increase pension expenditure in the medium term. Between 2019 and 2021, the new early retirement scheme *("quota 100")* will allow people to retire at age 62 if they have paid 38 years of contributions. In addition, the scope of the existing provisions for early retirement has been extended, including by suspending until 2026 the indexation to life expectancy of the required minimum contribution that past pension reforms had introduced. For those provisions, the 2019 budget earmarked funds worth 0.2% of GDP in 2019 and 0.5% of GDP in 2020 and 2021, but additional costs are also expected in the following years. The high public spending for old-age pensions restrains other social and growth-enhancing spending items like education and investment, and limits margins to reduce the overall high tax burden and the high public debt. Furthermore, broadening the possibility for early retirement might 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) in employment, thereby hampering potential growth and worsening the sustainability of public debt.

Italy's 2019 National Reform Programme[24] builds on the "contract of government" agreed by the government coalition parties in 2018 and its strategy to enhance growth continues to rely essentially on social transfers (e.g. the citizenship income) and to a lesser extent on lowering the tax burden and relaunching public investment. More in detail, Italy's National Reform Programme addresses the structural issues raised by the 2018 Country-Specific Recommendations only partially. In particular: (i) there are no new relevant measures that would foster a "tax shift" away from production factors; instead the National Reform Programme introduces a new possibility to settle past tax liabilities without fines for firms, which may negatively affect tax compliance; (ii) it does not contain major new commitments on justice but essentially confirms past ones such as the pending reform of the civil and criminal trials; (iii) it does not envisage further actions in the area of competition and of the banking sector other than maintaining the effort to support the reduction of non-performing loans and completing ongoing reforms (e.g. of small mutual banks); (iv) it focuses on completing the implementation of the citizenship income and the introduction of a minimum wage, while references to measures favouring female labour market participation are limited, and details on how to boost vocational education are missing.

Overall, Italy's 2019 National Reform Programme only partly addresses the structural issues raised by the 2018 Country-Specific Recommendations, and details on the few new commitments it contains, as well as on the timeline for their adoption and implementation, are often missing. However, its overall reform strategy largely builds on major reforms already in the pipeline in different areas, showing broad continuity compared to past National Reform Programmes.

[24] www.dt.tesoro.it/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2019/03a_-_PNR_2019.pdf

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 0.9% of GDP at end-2018 (out of a total amount of contingent liabilities of 4.2% of GDP), down from 1.3% of GDP at end-2017.

Support to financial institutions with an impact on the government debt amounted to zero in 2018 (down from around 1% at end-2017[25]). 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 2018, the Commission Opinion on Italy's 2019 draft budgetary plan identified a case of "particularly 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. On 13 November 2018, Italy submitted a revised draft budgetary plan confirming the fiscal targets planned for 2019. The authorities amended the 2019 budget in December 2018, which put an end to the situation of "particularly serious non-compliance" with the SGP. Despite those changes, Italy's fiscal targets still point to a risk of significant deviation from the preventive arm in 2019 based on both the government plans and the Commission forecast.

4.5. Other factors put forward by the Member State

On 31 May 2019, 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.

As regards Italy's compliance status with the preventive arm of the SGP, the Italian observations stress the following relevant factors:

(i) as regards 2018, the authorities argue that the non-delivery of the required fiscal effort should not be attributed to the government in office, which they argue just fulfilled the budgetary commitments of the previous government and refrained from any further fiscal expansion. However, the Commission had already assessed Italy's 2018 Stability Programme as being at risk of non-compliance with the SGP in 2018 based on its 2018 spring forecast, calling on the government to restore compliance. Moreover, the worsening of Italy's structural effort based on the Commission 2019 spring forecast compared to the 2018 spring forecast was largely due to higher-than-expected interest spending, which was a consequence of the rise in sovereign spreads recorded since the new government took office in May 2018;

[25] That support (EUR 16.6 billion, overall) was mainly related to the liquidation of the two Italian regional lenders "Banca Popolare di Vicenza" and "Veneto Banca" and to the precautionary recapitalisation of "Banca Monte dei Paschi di Siena". The related impact on deficit was around 0.33% of GDP in 2017.

(ii) as regards 2019, the Italian observations provide indications of upside risks for the budgetary execution which could result in a lower-than-expected headline deficit, around 2.3% of GDP (as compared to 2.4% in Italy's 2019 Stability Programme and 2.5% based on the Commission 2019 spring forecast). That would mainly derive from higher-than-expected revenues and lower-than-projected public expenditure on the citizenship income and the new early retirement scheme, considering the low take up so far. While those upside risks for Italy's 2019 budget balance appear plausible overall, they can only be confirmed later in the year, when more data will be available;

(iii) as regards 2020, the Italian observations contain no new commitments for 2020 and only confirm the 2.1% of GDP deficit target set in Italy's 2019 Stability Programme, while recalling the commitment to find alternative financing measures to reach it without activating the VAT hike legislated as a safeguard clause. However, no details are provided on those alternative measures other than a generic reference to a spending review.

Other relevant factors put forward by the authorities, beyond mere compliance with the SGP, are the following:

(i) Italy's track record of sizable primary surpluses coupled with solid fundamentals and a strong financial position. This is illustrated in particular by a high current account surplus, a positive net international investment position, a long-dated and fixed-rate composition of public debt, low private sector debt, as well as the restored strength of the Italian banking sector, with an overall strong liquidity position, recovered profitability, and the continued reduction of their non-performing loans. In that context, the authorities identify adverse macroeconomic conditions, and in particular the still-high differential between average borrowing costs and nominal GDP growth as the main reason behind Italy's lack of compliance with the debt reduction benchmark in 2018. The consideration of the macroeconomic slowdown as a mitigating factor is reinforced by the fact that, reportedly, the deflationary pressures and downturn in manufacturing experienced by Italy were largely due to external factors. However, the Commission recalls in this report that policy choices may have contributed to the macroeconomic slowdown through a negative confidence effect and a tighter credit channel, not least via higher sovereign spreads recorded since May 2018.

(ii) Italy's commitment to fiscal consolidation and to reducing the debt-to-GDP ratio over the coming years, whereby the headline deficit is projected to decline to 1.5% in 2022 and, correspondingly Italy's structural balance to improve to -0.8% of GDP in 2022, "on the way to a zero balance over the following two to three years". At the same time, however, that argument also reveals Italy's decision to postpone the achievement of its MTO of a structural surplus of 0.5% of GDP;

(iii) the underestimation of the slack in Italy's economy based on the commonly agreed methodology. The narrow estimates of Italy's output gap based on the Commission 2019 spring forecast, at -0.1% of potential GDP in 2018, -0.3% in 2019 and -0.1% in 2020, are argued to be at odds with macroeconomic evidence of relatively high unemployment and very low inflation, as well as debatable on a comparative basis. On that basis, the authorities present alternative estimations of Italy's output gap, at -1.5% of potential GDP in 2018, -1.7% in 2019 and -1.6% in 2020. On that basis, they also argue that Italy is set to be broadly compliant with the preventive arm requirement in 2019, given the reduced effort of 0.25% of GDP that the preventive arm matrix would prescribe based on this larger estimate of Italy's negative output gap, as Italy would be classified in "bad economic times", and growth potential, whereby Italy would grow below potential in 2019. Moreover, the authorities argue that with wider output gap estimates Italy would have also been closer to satisfying the debt rule in its cyclically adjusted configuration;

(iv) Italy's track record of growth-enhancing structural reforms in line with the 2018 Country-Specific Recommendations, starting from the significant resources devoted to improving social inclusion and revitalising public investment. The new citizenship income scheme is argued to respond to the Country-Specific Recommendations by raising income support for individuals and households below the poverty threshold and earmarking additional human, financial and technological resources for active labour market policies. Moreover, the government plans to raise public investment by 0.6 percentage points of GDP by 2021 compared to 2018, and the 2019 National Reform Programme envisages reforms of the judicial system, the corruption prevention system, the public sector, and of tax enforcement. The Italian observations also stress the positive impact on public debt sustainability ensured by the planned policy measures supporting aggregate demand and thereby GDP growth;

(v) Italy's still low fiscal sustainability risks in the long-term, when taking into account national estimates for old-age expenditure, coupled with a low level of contingent liabilities on a comparative basis within the Union.

5. CONCLUSIONS

Italy's public debt-to-GDP ratio, at 132.2% in 2018, is the second largest in the Union and one of the largest in the world. In 2018, it represented an average burden of EUR 38 400 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 2018 at around EUR 65 billion or 3.7% of GDP, i.e. broadly the same amount of public resources that 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.

Italy's general government gross debt reached 132.2% of GDP in 2018, well above the 60% of GDP reference value of the Treaty, and Italy did not comply with the debt reduction benchmark in 2018 based on outturn data. Moreover, Italy is not projected to comply with the debt reduction benchmark in either 2019 or 2020 based on both the government plans and the Commission 2019 spring forecast. In particular, the Commission expects Italy's public debt ratio to markedly increase over the forecast horizon on the back of weak nominal GDP growth, a deterioration of the primary surplus and underachieved privatisation proceeds, reaching 133.7% in 2019 and 135.2% in 2020. 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, the macroeconomic slowdown recorded in Italy from the second half of 2018, with nominal GDP growth falling below 2% in 2018 as well as over 2019-2020 based on the Commission 2019 spring forecast, can be argued to be to some extent a mitigating factor in explaining Italy's large gaps to compliance with the forward-looking debt reduction benchmark. Moreover, low productivity growth keeps constraining Italy's growth potential and hampering a faster reduction of its public debt ratio.

However, Italy has made limited progress in addressing the 2018 Country-Specific Recommendations, and the structural reform agenda outlined by the 2019 National Reform Programme contains only piecemeal measures building upon past reforms in different areas and backtracks on elements of major reforms adopted in the past. 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 and may negatively affect Italy's growth potential.

Moreover, an *ex post* assessment points to Italy's non-compliance with the recommended adjustment path towards the Medium Term budgetary Objective (MTO) in 2018, even after taking into account the so-called "margin of discretion". As regards 2019, Italy is assessed to be at risk of non-compliance with the preventive arm of the Stability and Growth Pact even after taking into account the preliminary allowance granted to it for "unusual events", although the Italian authorities indicate the existence of possible upside risks to the 2019 budget balance thanks to higher-than-expected revenues and lower-than-projected public expenditure on measures in the 2019 budget. The size of the deviation from the recommended adjustment path towards the MTO is set, based on the Commission forecast, to further widen in 2020, when Italy's headline deficit is expected to be above the 3% of GDP deficit threshold under a no-policy-change assumption. This represents an aggravating factor.

The analysis presented in this report includes the assessment of all relevant factors and notably: (i) the 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 can be argued to only partly explain Italy's 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 the commitments included in Italy's 2019 National Reform Programme. 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.