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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

on the Spring 2019 round of fiscal surveillance for Italy

{SWD(2019) 430 final}

On 5 June 2019, the Commission assessed, in its report under Article 126(3) of the Treaty on the Functioning of the European Union¹, 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 for Italy.

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. As such, Italy presented a gap to (broad) compliance with the required effort under the preventive arm of the Stability and Growth Pact 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 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 terms². Those measures, improving Italy's compliance status with the preventive arm in 2019, mainly consist of higher-than-expected revenues³ 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.

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 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.

³ Additional revenues amount to around 6.2 bn EUR, of which higher tax revenues by 2.9 bn EUR, higher social security contributions by 0.6 bn EUR and other revenues, including higher dividends from Bank of Italy and Cassa Depositi e Prestiti, by 2.7 bn EUR. 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 CO2 auctions) of around 0.95 bn EUR.

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 now 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.

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.

Moreover, the Italian government, in that same letter, commits to have fiscal consolidation 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. The government mentions that 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.

Overall, the Commission is of the view that this package is material enough not to propose to the Council the opening of an EDP for Italy's lack of compliance with the debt criterion in 2018 at this stage. The Commission will keep under surveillance the effective implementation of this package: It will monitor closely the execution of the 2019 budget and will assess the compliance of the 2020 draft budgetary plan with the Stability and Growth Pact. Moreover, progress with structural reforms included in the country-specific recommendations will be key to ensure higher growth and thereby contribute to a decrease in the debt-to-GDP ratio. The Commission will assess the implementation of these reforms within the context of the European Semester.