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Budgetary Planning Report

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SUMMARY

The 2019 *Budgetary Planning Report* is devoted to analysing the 2019 Economic and Financial Document (EFD) and expands, with additional analysis, the text of the parliamentary hearing of 16 April conducted as part of the preliminary examination of the EFD.

The report is organised into four chapters. The first is devoted to an analysis of the EFD's macroeconomic forecasts for the period 2019-2022. The second analyses the trend and policy scenarios for the public finances. The third chapter discusses issues concerning the short/medium-term sustainability of the public finances, while the fourth examines the policy objectives set out in the EFD in the light of national and European fiscal rules.

As regards the macroeconomic forecasts, in light of the information available and a broad reconstruction of the budget package outlined in the EFD, the PBO validated the 2019-2022 policy scenario, highlighting however the risks associated with the international context (a slowdown of the Chinese economy, uncertainty about Brexit, intensification of geopolitical tensions, increasing financial imbalances and investors' risk aversion), the domestic situation (weak economic activity) and the high degree of uncertainty that characterises, in this phase, the specification of the fiscal policy sketched out in the EFD.

The slowdown in the world economy, which in 2018 had mainly involved exporting countries, is continuing with the involvement of a larger number of economies. World trade is weakening, despite some easing of tensions over protectionist policies. The reduction in global demand has prompted the oil-producing countries to reduce their output of oil, thereby supporting oil prices. In Italy, economic activity remains weak. GDP decelerated last year and according to the latest national accounts estimates, the slowdown originated with domestic demand and, to a slightly lesser extent, net foreign demand. Private consumption has been held back by purchasing power, while at the end of the year investment had recouped only a small part of the large contraction registered in the summer. The uncertainty of households and firms also continues to rise. However, the picture delineated by the most recent economic indicators seems to signal, despite highly mixed developments, the first modest signs of recovery for the first quarter of the current year.

The EFD's policy macroeconomic forecasts were broadly consistent with those of the PBO panel. However, the estimates reflect slightly higher assessments of the expansionary impact of the budget than those of the panel of forecasters. The policy scenario contains more optimistic projections for gross fixed investment in 2019 and those of the PBO panel, particularly for the machinery and equipment component. General government expenditure for 2020 also amply exceeds the upper bound of the PBO panel's range, likely due to the different assessments made by the PBO panel and the EFD of the price/quantity breakdown of nominal public consumption. In 2021, however, it is the increase in household consumption that exceeds the upper bound of the panel's estimates as a result

of the different assessments of the impact of the safeguard clauses providing for increases in indirect taxes. The policy growth in nominal GDP falls within the forecasting interval, thanks in part to the deflator, which remains below the upper bound forecast by the panel.

In addition to the downside risks already mentioned, the scenario is still subject to a degree of uncertainty concerning the assessment of the impact that the possible increase in VAT rates would have on prices and on the level of economic activity.

In the EFD estimates, the output gap remains negative for the entire forecast horizon. It narrows slightly in 2018, before widening again in 2019 and stabilising at just below 2 points over the remainder of the forecast period. These estimates, based on the methodology agreed at European level, differ significantly from those of both the Update to the 2018 EFD and the European Commission formulated in its Autumn Forecasts 2018 in November (which expected a positive output gap already this year and further growth in the next). The uncertainty associated with measuring the output gap represents an additional risk factor in the budget policy scenario. The PBO is developing a procedure for estimating the output gap and the potential output of the Italian economy that is based on multiple estimated models combined into a composite measure with a plausibility range.

For the public finances, the report emphasises that the autumn budget package, as set out in the EFD, resembles a complex puzzle, which will require a clear identification of policy priorities. As already noted, this uncertainty over the design of budgetary policy is an important risk factor for the country's economic prospects.

In the EFD, the Government acknowledges that the deficit for 2018 exceeded forecasts and that the trend public accounts are on a less favourable trajectory as a result of the deterioration in the economy. According to official forecasts, without corrective measures net borrowing will rise to 2.4 per cent of GDP in 2019 (retaining the freeze on €2 billion of the appropriations for the ministries, provisioned as part of the amendments to the budget package at the end of December 2018), before decreasing to 2 per cent in 2020 and to 1.8 and 1.9 per cent in the two subsequent years.

The EFD itself indicates that the deficit with unchanged policies and excluding the increase in VAT envisaged with the safeguard clauses (€23.1 billion in 2020 and €28.8 billion from 2021) would rise as a percentage of GDP from 2.4 per cent in 2019 (€42 billion), 3.4 per cent in 2020, 3.6 per cent in 2021 and 3.8 per cent (€73 billion) in 2022. In this scenario, and also excluding proceeds expected from privatisations that seem difficult to achieve, the debt/GDP ratio would continue to rise after 2019 to reach over 135 per cent in 2022, up from 132.2 per cent in 2018.

The resources that need to be found to ensure a gradual decline of the deficit in the EFD policy scenario are: i) alternative measures replacing the VAT increases already provided for in existing legislation, which amount to €23.1 billion in 2020 and €28.8 billion starting from 2021; ii) resources to finance unchanged policies, amounting to €2.7 billion in 2020, €5.2 billion in 2021 and €7.8 billion in 2022 and to increase investment (about €2 billion a year); and iii) those necessary for a further correction of the deficit in order to achieve the policy targets, amounting to €6.5 billion in 2022 (conversely, in 2020 and 2021 the policy targets consist in an increase compared to the trend forecasts and therefore in a reduction in funding needs compared to the existing legislation of €2.5 billion and €0.1 billion respectively). Overall, it is therefore necessary to identify resources of about €25 billion for 2020, rising to about €36 billion in 2021 and €45 billion at the end of the period.

Additional initiatives announced in the EFD, such as the plan to continue the process of reforming income taxes (the "flat tax") and the overall simplification of the tax system, to be implemented "in compliance with the public finance objectives specified in the document", would require the identification of further compensatory measures.

On the basis of the limited indications provided in the EFD on the budget measures, finding the resources needed to achieve the policy objectives will be based on four main pillars, in addition to the "activation" of the "safeguard clauses" involving increases in indirect taxes as described above: the reduction and rationalisation of tax expenditures, countering tax evasion, the spending review and privatisation receipts. Each of these approaches has critical aspects.

The reduction of tax expenditures raises a number of issues that need to be addressed. Their elimination should be preceded not only by a quantification of the overall financial impact and the beneficiaries involved, but above all by an *ex post* analysis of the redistributive effects that the elimination of each subsidy mechanism would generate. Furthermore, some tax relief measures that are spread out over multiple years (for example, those for building renovations or for mortgage interest on primary-residences) would continue to cause revenue losses in future years and would therefore not immediately make resources available to fund other measures.

The resources needed to achieve the net borrowing targets for 2021 and 2022 amount to 0.1 per cent and 0.4 per cent of GDP, respectively, mainly generated by measures to fight tax evasion. Overall, the magnitude of the increase in revenue expected in 2022 seems rather ambitious when assessed in the light of the results currently achieved by the Revenue Agency. More specifically, just over €19 billion were collected in 2018, of which €16 billion deriving from "ordinary" control activities (i.e. as a result of assessments issued by the Revenue Agency, promotion of compliance and enforced collection) and the remaining €3 billion from "extraordinary" recovery measures (for example, the facilitated settlement of tax disputes and outstanding assessments, voluntary disclosure, etc.). It would therefore be a question of significantly increasing (by up to 50 per cent or so) the amount of revenue recovered from "ordinary" collection activity.

Taking account of developments in primary expenditure in nominal and real terms since 2010 (primary expenditure has increased by a total of €50.4 billion in nominal terms, while it has decreased by €14.7 billion in real terms), recourse to expenditure cuts is challenging for a number of reasons. More specifically: 1) in the area of public employment, measures to contain expenditure such as a new freeze on turnover would run up against the already reduced number of staff and the aging of employees. These factors have inevitable repercussions for the overall efficiency of government administration and the use of technological innovation, unless reforms of the functioning of the public administration are implemented, whose effects nevertheless take a considerable time to unfold; 2) the risk that further cuts in healthcare spending will affect the quality of the services delivered or the scope of public involvement in this sector; 3) the welcome commitment of the Government to increase the financial resources for investment available to central and local governments, including addressing the critical issues connected with the application of the new legislation governing public tenders; and 4) the Government's recent increase in pension expenditure with the introduction of the *quota 100* mechanism (sum of age and years of contributions) and the Citizenship Income.

The 2019 EFD retains the assumption, adopted in the 2019 DBP, of privatisation receipts equal to 1 percentage point of GDP in 2019 and 0.3 points in 2020, equal to about €17.8 and €5.5 billion respectively. Comparing the disposals envisaged in the 2015-2018 EFDs and the corresponding actual figures, however, it is clear that the only year in which the results met expectations was 2015 (when disposals implemented amounted to €6.6 billion). Before 2015 disposals of more than €10 billion were recorded on only three occasions (1997, 1999 and 2003), while in those following 2015, the results obtained were significantly below expectations: in 2017-2018, with forecast disposals of 0.3 points of GDP per year, actual receipts amounted to €58 million in 2017 and €2 million in 2018. In light of the increase in the forecast for privatisation receipts, the PBO therefore reiterates even more strongly its previously expressed conclusion that the public finance policy scenario is exposed to the real risk that the privatisation programme may prove to be totally or partially unfeasible.

As regards the public debt, the report presents a number of simulations to analyse the sensitivity of the debt to GDP ratio in the EFD policy projection in alternative scenarios. In the extreme case in which trend net borrowing increased by the effects of unchanged policies is not financed through the activation of the safeguard clauses and the budget measures envisaged in the EFD, and in the absence of privatisation proceeds, the debt ratio would increase to 134.7 per cent in 2021 and 135.4 per cent in 2022.

The final chapter of the report focuses on compliance with national and European fiscal rules and on the new medium-term objective (MTO) for Italy as from 2020.

Despite the more unfavourable nominal deficit targets than previously indicated, the policy scenario in the 2019 EFD envisages, due to more pessimistic macroeconomic assumptions, a slightly more ambitious structural adjustment path towards the MTO compared with the policy scenario in the *Aggiornamento del Quadro Macroeconomico e di Finanza pubblica* published in December 2018. Nevertheless, deviations from the adjustments required by the fiscal rules persist for almost the entire planning horizon in addition to 2018, both for the structural balance rule and the expenditure benchmark. The European Commission, using its Spring 2019 forecasts, will conduct an overall evaluation to determine whether the preventive arm of the Stability and Growth Pact has been complied with and assess the possibility of opening a significant deviation procedure for the deviation estimated for 2018. In addition, there is no compliance with the debt reduction rule in 2018 or in the planning period, despite the decline in the debt to GDP ratio envisaged by the Government for the 2020-2022 period. The failure to comply with the debt rule in 2018 makes it possible that the Commission could prepare a new report to evaluate the possible opening of an excessive deficit procedure against Italy for non-compliance with the debt criterion.

Italy's new MTO starting from 2020 is indicated in the EFD. It is equal to a structural surplus of 0.5 percentage points of GDP, a more stringent target than that declared in previous policy documents, which called for a zero structural budget balance. Note that previous documents, in specifying the structural balanced balance as the MTO, set a more ambitious MTO than the minimum determined using the EU methodology, which until the recent revision produced an MTO for Italy equal to a structural deficit of 0.5 per cent of GDP. The revision of the MTO according to the European method is therefore equal to 1 percentage point of GDP and is due both to the deterioration in the public finance scenario and to the increase in the forecast for long-term developments in public expenditure linked to the ageing of the population ("ageing cost").

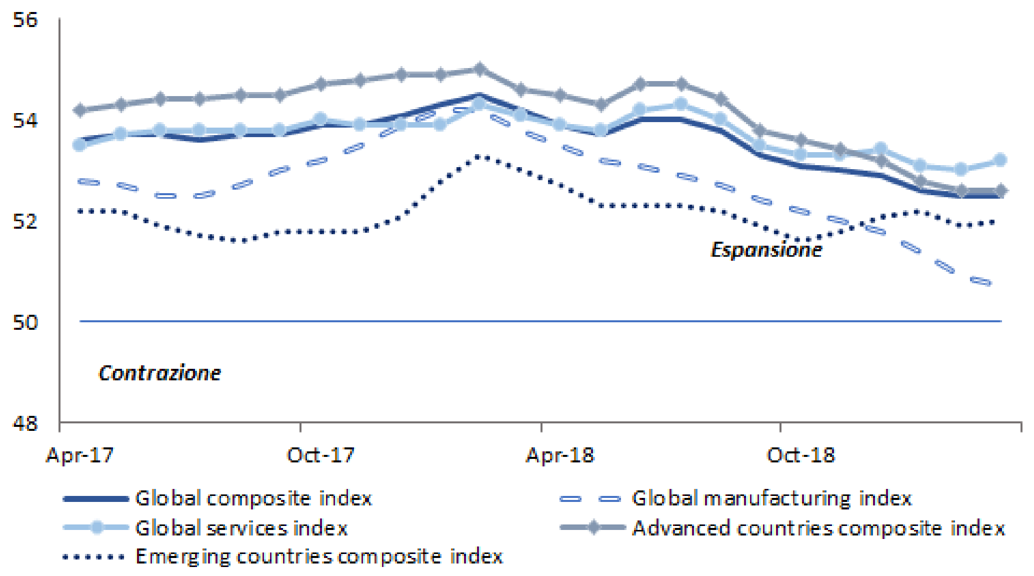
1 THE MACROECONOMIC ENVIRONMENT

1.1 *The world economy and the EFD's assumptions for international variables*

The slowdown in the international economy, which in 2018 mainly regarded the advanced countries, spread in the first part of this year to also include the emerging economies, including China. In addition to temporary factors, such as the government shutdown in the United States and the change in emissions standards in the automotive sector in Europe, the weakening of the global economy was also attributable to uncertainty regarding restrictions on free trade. International economic indicators, such as purchasing managers' indices (e.g. the Markit PMI), immediately reflected the developments, showing a clear downward trend since mid-2018 (Figure 1.1).

The projections of the leading forecasters point to a further deterioration in the global economy in 2019, with the projections for that year having already been revised downwards in the autumn. In April, the International Monetary Fund (IMF) again revised its expectations, especially for this year, when growth in global GDP is expected to decelerate to 3.3 per cent (from 3.6 per cent in 2018); during the next three years, growth should return to the pace seen in 2018.

Figure 1.1 – JP Morgan Global PMI (1)
(three-month moving average)



Source: IHS Markit.
(1) Confidence indicators based on the assessments expressed by corporate purchasing managers. A value of more than 50 indicates an expansion.

Compared with the IMF's scenario, the 2019 Economic and Financial Document (EFD) is more cautious in its expectations for growth in world GDP and trade (Table 1.1). It sets out separate growth forecasts for world GDP excluding the European Union (EU) and GDP for the EU only, which represents about 16 per cent of the total on a purchasing power parity basis. In comparing the data, we see that the EFD incorporates growth expectations for world GDP that are almost half a percentage point lower than those of the IMF across the entire forecast horizon.

The foreign trade projections also appear to be more prudent than those of the IMF. Compared with last September's Update to the Economic and Financial Document (the Update), international trade growth has been revised sharply downward for the current year (last September it was projected to grow by 3.9 per cent in 2019) and marginally in the three subsequent years; while in the Update GDP was expected to decline over the forecast horizon, in the EFD it appears to increase.

Between the summer and the end of last year the price of oil went through two major phases. The first, in which prices rose, was mainly driven by the cut in supply caused largely by the collapse in production in Venezuela and fears of US sanctions on Iran. Starting in the autumn, supply expanded owing to the limited effectiveness of the sanctions against Iran and the increase in US production capacity. At the same time, the increasingly marked slowdown in the world economy restricted demand, contributing to depress the prices. With the new year, the leading oil producing countries reacted, agreeing to cut production below the levels already agreed, thereby supporting prices. In recent days, the price of Brent has hovered at just over $70 per barrel.

The EFD's assumptions are slightly lower than those that could be drawn from the most recent information. More specifically, using that latest data available, based on futures contracts, this year the price of oil is about $3 dollars per barrel higher than indicated in the EFD and about $1 higher for 2020-2022 (Table 1.2).

Table 1. 1 – World GDP and trade forecasts

	2018	2019	2020	2021	2022
World GDP					
EFD - excluding EU	3.9	3.3	3.5	3.6	3.6
IMF	3.6	3.3	3.6	3.6	3.6
World trade					
EFD	3.8	2.5	3.7	3.8	3.9
IMF	3.8	3.4	3.9	3.9	3.9

Source: 2019 EFD and IMF (2019), *World Economic Outlook,* April.

Table 1.2 – Oil prices (Brent) in dollars

	2018	2019	2020	2021	2022
EFD					
Price, dollars per barrel	71.3	64.8	64.6	62.9	61.7
% change		-9.1	-0.3	-2.6	-1.9
Forward prices observed in last 10 business days of April					
Price, dollars per barrel	71.3	67.5	66.4	63.7	62.3
% change		-5.3	-1.6	-4.1	-2.2

Source: 2019 EFD and Thomson Reuters Datastream.

The dollar/euro exchange rate between October of last year and the first half of April was essentially stable, with small fluctuations in the range of 1.12-1.16 dollars/euro, in the absence of significant surprises in the monetary policy and announcements of the two major central banks. However, at its last meeting the European Central Bank (ECB) announced that as from next September it will begin a new programme of longer-term refinancing operations (TLTRO-III) in order to preserve favourable conditions for bank lending and the orderly transmission of monetary policy, granting loans on attractive conditions

The EFD uses the technical assumption that exchange rates will remain unchanged over the entire forecast horizon, projecting the average rate for a recent short window of time. This gives in a dollar/euro exchange rate of 1.135 in 2019 and 1.134 in the three subsequent years. Using the values for the last two weeks, the exchange rate would be 1.131 for 2019 and 1.123 in 2020-2022, a small divergence with respect to the figures in the EFD (Table 1.3). Compared with forward exchange rates, the divergence is even greater since they incorporate a stronger euro (up to about 1.22 dollars/euro).

The interest rate developments contained in the EFD are consistent with expectations of a gradual increase in the money policy reference rates. The yield estimates of the Ministry of the Economy and Finance (MEF) are based on internal forecasts of the yields at issue of government securities, which are not directly comparable with market figures. In terms of trends we can observe that: *i)* the direction of both short-term and long-term rates is that expected by the markets; *ii)* long-term rates for 2019 are close to market values and the acceleration in subsequent years is gradual; *iii)* short-term interest rates are slightly higher than current market rates for 2019, but appear to accelerate sharply starting in 2020. However, in the last four EFDs the short-term rate forecasts for 2019 were heavily revised downward *ex post*, signalling that the MEF perhaps takes a cautious approach in estimating interest expenditure.

Table 1.3 – Dollar/euro exchange rate

	2018	2019	2020	2021	2022
EFD	1.181	1.134	1.134	1.134	1.134
Constant exchange rate at level in 10 days ending on 11 April	1.181	1.131	1.123	1.123	1.123
Forward rates in last 10 days of April	1.181	1.124	1.158	1.190	1.219

Sources: 2019 EFD and Thomson Reuters Datastream.

Overall, given that a uniform external reference scenario must be used to formulate the trend (which is prepared in advance) and policy macroeconomic forecasts, the assumptions underlying the EFD seem to be broadly consistent with the most recent developments. The prudence of the projections for foreign demand and short-term interest rates is offset, at least in part, by a more favourable profile for oil prices.

1.2 The Italian economy

In 2018 Italy's GDP decelerated to 0.9 per cent, from 1.7 per cent the previous year. According to the updates to the annual revenue and expenditure accounts released on 9 April, the role of domestic demand in the slowdown was slightly greater than that of net foreign demand. The quarterly pace of growth declined during the year, becoming slightly negative in the third and in the fourth quarters. In the latter quarter, growth fell by 0.1 per cent on the previous quarter (from -0.2 per cent during the summer period).

Economic activity in the final part of 2018 was primarily slowed by inventory building, which subtracted 0.4 percentage points from the change in GDP. By contrast, slightly positive contributions came from domestic demand net of inventories (0.1 percentage points) and net foreign demand (0.2 percentage points). On the supply side, value added in agriculture and industry contracted with respect to the previous period (by -1.1 and -0.5 per cent respectively) and was barely positive for services.

The picture delineated by the most recent economic indicators seems to signal, despite highly mixed developments in survey findings, the first modest signs of recovery for the first quarter of the current year.

Industrial production rose in the first two months of this year and, according to PBO estimates, increased by around 1 percentage point for the quarter as a whole. However, signs of a deterioration in the outlook for industry are evident in qualitative indicators, including the PMI and the Istat index of manufacturing confidence. After having weakened in the summer, output in construction is recovering at a moderate pace. The increase in January (1.3 per cent on the previous period), which reached levels last seen at the end of 2017, was followed by a jump in February (+3.4 per cent).

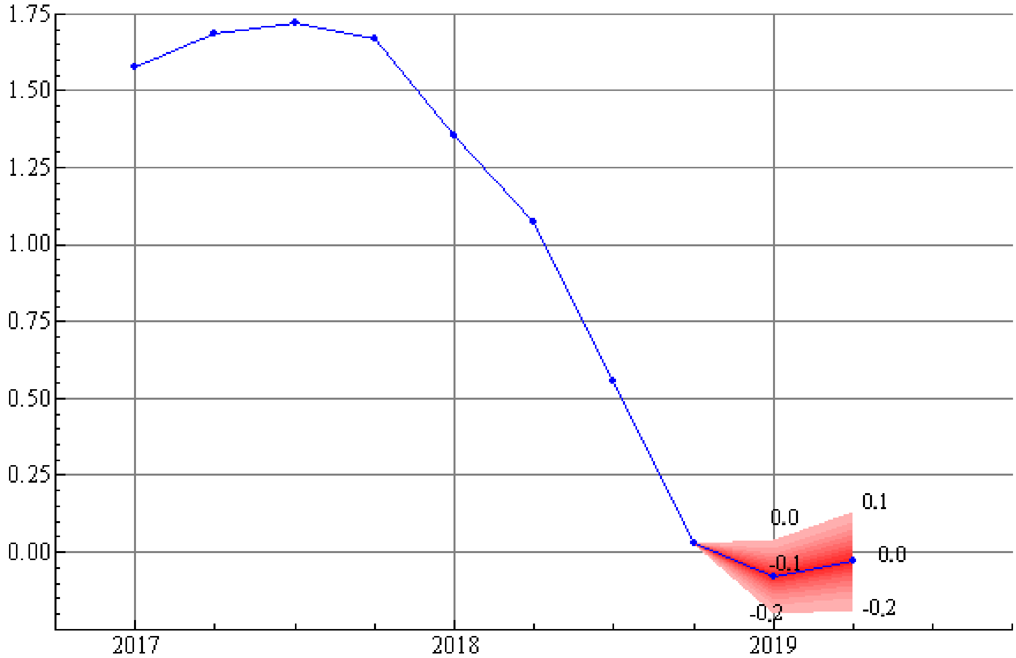
The value added in the services sector rose moderately in the fourth quarter of the year after having stagnated in the summer. However, the most recent qualitative indicators provide mixed signals about the outlook: the PMI for services jumped in March, while the Istat confidence index for the market services sector registered its fifth consecutive average decline in the first quarter, despite a slight recovery in March.

The composite index of business confidence, obtained as the weighted average of sectoral indices, decreased last quarter. The uncertainty of households and firms also continued to grow. Although still below the highs registered in 2013-2014, the PBO uncertainty indicator began to deteriorate from the end of 2018, mainly driven by the construction and manufacturing sectors.

The softness of current economic conditions is lessening. According to the PBO's short-term forecasts, economic activity expanded at the start of the year, albeit modestly. It is estimated that GDP increased by 0.1 per cent in the first quarter compared to the previous three months (the year-on-year change, however, was marginally negative), reflecting continuing uncertainty about the domestic and international environment. In the second quarter, GDP is expected to continue to grow at a quarterly pace similar to that of the preceding period, but with a greater degree of uncertainty (Figure 1.2).

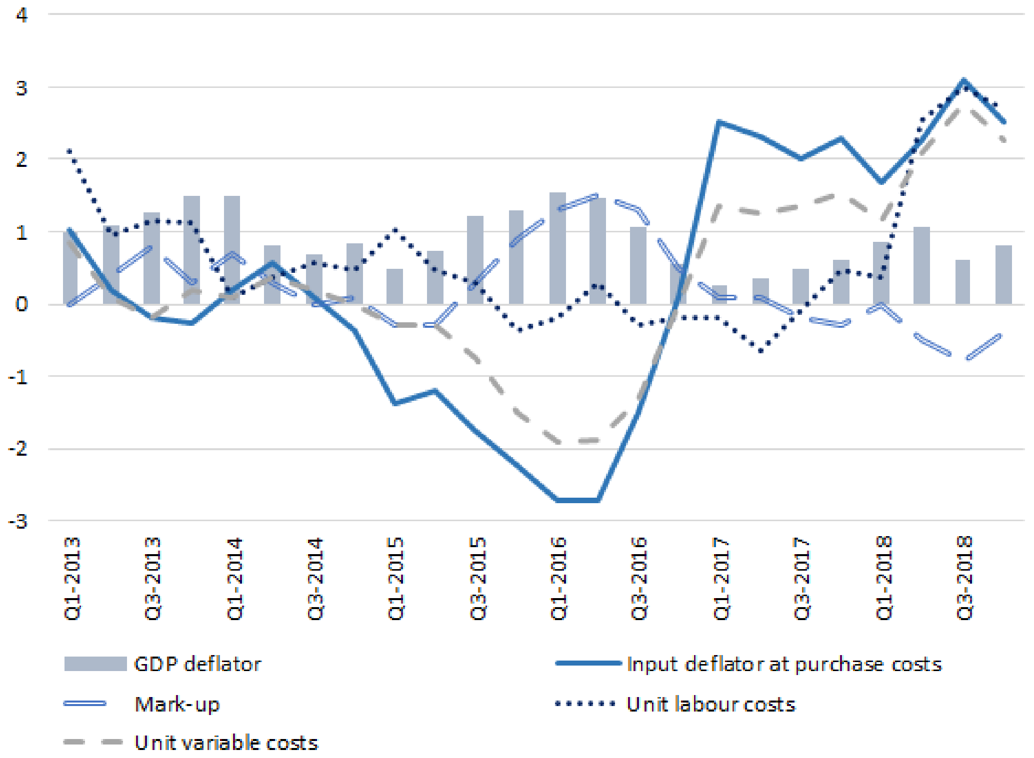
Consumer price inflation in the early months of the year was slightly lower than the average for 2018 (1.1 per cent), for both the general index for the entire population and core inflation. According to provisional Istat data, consumer price inflation in March (national consumer price index) remained stable at the previous month’s level (1.0 per cent year-on-year), while core inflation, which excludes the prices of energy and unprocessed food, increased marginally (to 0.5 per cent). Inflation is still not very widespread among the components of the index. In the first two months of the year, 88 per cent of the items in the basket of the harmonised consumer price index saw year-on-year increases of less than 2 per cent (compared with an average of 82 per cent in the fourth quarter). The GDP deflator (Figure 1.3) continues to show a year-on-year change of around 1 per cent. In 2018 the rise in the prices of producer inputs and unit variable costs increased, but at the same time margins were squeezed even further.

Figure 1.2 – Forecasts for year-on-year GDP growth (1)



(1) The error bands show a confidence interval of 90 per cent around the central scenario.

Figure 1.3 – GDP deflator, production costs and margins
(percentage change on year-earlier period)



Source: Istat.

The inflation expectations of businesses and households as measured by Istat's confidence surveys remain cautious. In the first three months of the year, more than half of households expect stable prices and only 13.8 per cent forecast price increases in the following 12 months. Business expectations for sales prices also remain moderate, having already been revised downwards since the autumn.

In the second half of 2018 the labour market was adversely impacted by the slowdown. Labour inputs, measured by hours worked in the national accounts, decelerated in the third quarter compared with the previous period (to 0.3 per cent, from 0.7 per cent in the second), followed by a contraction in the fourth (-0.3 per cent). Labour demand, measured in terms of payroll jobs (on the basis of existing employment contracts), stagnated in the second half of the year, with the decline in employment in services being partially offset by a recovery in manufacturing and construction. According the Labour Force Survey, the number of persons in employment decreased in both the third and fourth quarters (-0.2 per cent in both periods) due to the fall in both payroll employment and self-employment. The reduction in the number of payroll workers in the third quarter was due both to the decline in the number of workers on permanent contracts (-0.5 per cent on the previous period, from 0.2 per cent in the second quarter) and the slowdown in fixed-term employment, which subsequently contracted (-0.3 per cent in the fourth quarter) for the first time since the beginning of 2016.

Employment growth at the start of this year remained weak. Preliminary information data for January-February show a slight expansion (0.1 per cent compared with the fourth quarter of 2018), driven by open-ended employment (0.3 per cent), while fixed-term employment contracted in the same period (-0.7 per cent). According to INPS administrative data, the slowdown in fixed-term employment under way since the summer mainly reflects the considerable growth in transformations of temporary positions to open-ended contracts. This trend is estimated to have intensified in the final months of 2018 and in January of this year.

Wage growth has gradually slowed down after the temporary increase in the first half of 2018. In the fourth quarter, hourly productivity recovered slightly (0.2 per cent compared with the previous period), as value added declined by less than the number of hours worked. The recovery in productivity was driven by the services sector, while the decline in manufacturing and construction continued, albeit more moderately. The cost of labour decreased significantly starting in the third quarter and the increase in unit labour costs slowed.

1.3 *The macroeconomic forecasts in the EFD*

The macroeconomic scenario in the EFD shows a significant slowdown in growth this year, from 0.9 per cent in 2018 to 0.1 per cent in the trend scenario and just above that (0.2 per cent) in the policy scenario; a recovery will follow, more marked in 2020 and modest in 2021-2022 (Table 1.4). Compared with last December's *Aggiornamento del Quadro Macroeconomico e di Finanza Pubblica* [Update of the macroeconomic and public finance scenario], there is a considerable downside correction of the forecast for GDP for 2019, equal eight-tenths of a point in the policy scenario (Table 1.5). The analysis of the EFD, conducted using the Treasury's econometric model, demonstrates that about half of the revision of the GDP forecast for this year derives from the assumptions about exogenous international variables and from the inclusion of recent national accounts data (each would have had an impact of 0.2 percentage points). In the MEF's assessment, the remainder of the revision (0.4 percentage points) would depend upon other factors not directly connected with changes in the international situation and in economic conditions in Italy.

Table 1.4 – Comparison of the Government's trend and policy scenarios (1)

		MEF policy scenario				MEF trend scenario				Differences			
	2018	2019	2020	2021	2022	2019	2020	2021	2022	2019	2020	2021	2022
INTERNATIONAL EXOGENOUS FACTORS													
World trade	3.8	2.5	3.7	3.8	3.9	2.5	3.7	3.8	3.9	0.0	0.0	0.0	0.0
Oil price (Fob, Brent)	71.3	64.8	64.6	62.9	61.7	64.8	64.6	62.9	61.7	0.0	0.0	0.0	0.0
Dollar/euro exchange rate	1.181	1.135	1.134	1.134	1.134	1.135	1.134	1.134	1.134	0.0	0.0	0.0	0.0
ITALIAN MACRO VARIABLES (VOLUMES)													
GDP	0.9	0.2	0.8	0.8	0.8	0.1	0.6	0.7	0.9	0.1	0.2	0.1	-0.1
Imports	2.3	2.2	2.7	2.6	2.5	2.2	2.5	2.5	2.5	0.0	0.2	0.1	0.0
Final domestic consumption	0.5	0.4	0.7	0.6	0.5	0.4	0.6	0.6	0.6	0.0	0.1	0.0	-0.1
Household consumption	0.6	0.6	0.7	0.7	0.6	0.6	0.6	0.7	0.8	0.0	0.1	0.0	-0.2
Expenditure of general government and non-profit institutions serving households	0.2	-0.4	0.8	0.1	-0.1	-0.3	0.4	0.1	0.0	-0.1	0.4	0.0	-0.1
Investment	3.4	1.4	2.0	1.8	1.6	0.7	1.2	1.3	1.5	0.7	0.8	0.5	0.1
Exports	1.9	2.1	2.3	2.4	2.6	2.1	2.3	2.5	2.6	0.0	0.0	-0.1	0.0
CONTRIBUTION TO GDP GROWTH													
Net exports	-0.1	0.0	-0.1	0.0	0.1	0.0	0.0	0.0	0.1	0.0	-0.1	0.0	0.0
Inventories	0.0	-0.2	0.0	0.0	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand net of inventories	1.0	0.6	0.9	0.8	0.7	0.5	0.7	0.7	0.8	0.1	0.2	0.1	-0.1
PRICES													
Import deflator	2.9	1.7	1.8	1.7	1.5	1.7	1.8	1.7	1.6	0.0	0.0	0.0	-0.1
Export deflator	1.7	1.4	1.7	1.7	1.6	1.4	1.7	1.6	1.6	0.0	0.0	0.1	0.0
GDP deflator	0.8	1.0	2.0	1.8	1.6	1.0	1.9	1.7	1.5	0.0	0.1	0.1	0.1
Nominal GDP	1.7	1.2	2.8	2.6	2.3	1.2	2.6	2.5	2.4	0.0	0.2	0.1	-0.1
Consumption deflator	1.1	1.0	2.3	1.9	1.6	1.0	2.3	1.8	1.5	0.0	0.0	0.1	0.1
LABOUR MARKET													
Unemployment rate	10.6	11.0	11.1	10.7	10.4	11.0	11.2	10.9	10.6	0.0	-0.1	-0.2	-0.2

Source: 2019 EFD.
(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

Table 1.5 – The Government's macroeconomic scenario (2019 EFD and December 2018 estimates) (1)

	MEF 2019 EFD				MEF December 2018			Differences		
	2019	2020	2021	2022	2019	2020	2021	2019	2020	2021
Growth and demand										
GDP	0.2	0.8	0.8	0.8	1.0	1.1	1.0	-0.8	-0.3	-0.2
Imports	2.2	2.7	2.6	2.5	2.3	2.8	2.8	-0.1	-0.1	-0.2
Final domestic consumption	0.4	0.7	0.6	0.5	0.7	1.0	0.8	-0.3	-0.3	-0.2
Consumption of households and non-profit institutions serving households	0.6	0.7	0.7	0.6	0.8	0.8	1.0	-0.2	-0.1	-0.3
General government expenditure	-0.4	0.8	0.1	-0.1	0.4	1.3	0.1	-0.8	-0.5	0.0
Investment	1.4	2.0	1.8	1.6	2.4	2.3	2.0	-1.0	-0.3	-0.2
Exports	2.1	2.3	2.4	2.6	2.4	2.5	2.5	-0.3	-0.2	-0.1
Contribution to GDP growth										
Net exports	0.0	-0.1	0.0	0.1	0.1	0.0	0.0	-0.1	-0.1	0.0
Inventories	-0.2	0.0	0.0	0.0	-0.1	0.0	0.0	-0.1	0.0	0.0
Domestic demand net of inventories	0.6	0.9	0.8	0.7	1.0	1.2	1.0	-0.4	-0.3	-0.2
Prices										
Import deflator	1.7	1.8	1.7	1.5	2.0	1.7	1.7	-0.3	0.1	0.0
Export deflator	1.4	1.7	1.7	1.6	1.8	1.6	1.6	-0.4	0.1	0.1
GDP deflator	1.0	2.0	1.8	1.6	1.4	1.8	1.6	-0.4	0.2	0.2
Nominal GDP	1.2	2.8	2.6	2.3	2.3	2.9	2.6	-1.1	-0.1	0.0
Consumption deflator	1.0	2.3	1.9	1.6	1.4	2.2	1.6	-0.4	0.1	0.3
Labour market										
Unemployment rate	11.0	11.1	10.7	10.4	10.3	-	-	0.7	-	-
Assumptions for international variables										
Italy's key foreign markets	2.3	3.9	3.8	3.7	3.6	-	-	-1.3	-	-
Oil, dollars per barrel	64.8	64.6	62.9	61.7	61.5	-	-	3.3	-	-
Exchange rate, dollars for 1 euro	1.14	1.13	1.13	1.13	1.14	-	-	0.00	-	-

Source: 2019 EFD and *Aggiornamento del Quadro Macroeconomico e di Finanza pubblica*, December 2018.
(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

With regard to the MEF's trend scenario, the composition of growth is almost entirely attributable to the domestic components of demand, since the contribution of net exports remains essentially nil across the entire forecast horizon. Foreign trade for this year incorporates a slightly larger increase in exports than that for 2018, partly attributable to the weaker exchange rate, despite the slowdown in world trade. Consumer spending should repeat the growth reported last year (0.6 per cent) in 2019-2020 but during the subsequent two years it is expected to accelerate slightly. As for capital formation, the MEF forecasts no growth in machinery and equipment spending and a less marked slowdown in construction investment for 2019. Over the rest of the horizon, investment in capital goods is projected to strengthen, while the moderate pace of growth in the construction component is projected to continue.

With regard to nominal variables, the MEF's trend macroeconomic scenario forecasts a change of 1.0 per cent in the private consumption deflator this year. Starting in 2020 the scenario incorporates the increase in indirect taxation envisaged by the safeguard clauses, with inflation rising to 2.3 per cent, followed by a decline to 1.5 per cent in 2022. As a result, the GDP deflator accelerates slightly this year (to 1.0 per cent), more sharply next year (1.9 per cent) and then slows. Given the forecasts for real GDP growth and its deflator, nominal GDP grows by 1.2 per cent in 2019, accelerates sharply in 2020 (to 2.6 per cent), driven by the price component, and slows slightly in the subsequent two years.

This trend scenario forms the basis of the EFD policy forecasts, which raises the deficit by 0.1 per cent of GDP in 2020 as a result of higher expenditure, confirms the deficit for 2021 (owing to comparable increases in expenditure and revenue) and improves it significantly (0.4 per cent of GDP) in 2022. That year also includes a spending review, mainly to fund increased outlays for unchanged policies, and greater revenue deriving largely from measures to counter tax evasion.

The overall impact on growth estimated by the MEF is moderately expansionary. This year, the economy benefits from additional measures for supporting investment, which contribute for 0.1 percentage points to GDP. For the next three years, the measures increase GDP growth compared with the trend macroeconomic scenario by 0.2 percentage points in 2020 and 0.1 points in 2021. In the final year of the forecast, by contrast, real growth is 0.1 percentage points lower than in the trend scenario as a result of budget tightening. Overall, GDP grows by 0.2 per cent in 2019 and 0.8 per cent over the next three years in the policy scenario.

As regards the components, the increase in growth over the trend macroeconomic scenario is mainly attributable to domestic demand thanks to stronger recovery in investment, especially construction, across the entire forecast horizon, and in 2020 in public consumption as well. Net foreign demand is unchanged from that projected in the trend scenario except for 2020, when stronger domestic spending stimulates an increase in imports. In the last year of the forecast horizon, the slower GDP growth than in the trend scenario is mainly attributable to household consumption, which is affected by the loss of purchasing power springing from higher taxes; in 2022, public consumption also contributes slightly to the restriction.

The GDP deflator increases just slightly more than in the trend scenario for 2020-2022. Nominal GDP, which mainly reflects the volume component, is barely higher than indicated in the trend scenario for 2020-2021 and barely lower in 2022. Overall, nominal GDP in the policy scenario rises by 1.2 per cent this year, accelerates to 2.8 per cent in 2020 and subsequently slows (respectively to 2.6 and 2.3 per cent in 2021-2022).

Employment benefits from the faster growth in 2019-2021 but increases just slightly less than that under the trend scenario in 2022. The unemployment rate is slightly more favourable, reaching 10.4 per cent at period-end (10.6 per cent under the trend scenario).

1.3.1 *Estimate of potential output and the output gap*

In the EFD's projections, the output gap remains negative for the entire forecast horizon, narrowing slightly in 2018 (-1.5 per cent, after the -1.8 per cent registered in 2017), before widening again this year and stabilising (at -1.6 per cent) over the rest of the forecast horizon. These estimates, based on the methodology agreed at EU level, differ significantly from those in the 2018 Update, formulated in September, in which the gap narrows over the forecast horizon (to -0.2 per cent in 2021). In its Autumn Forecasts 2018 the European Commission projected a positive gap as early as this year (0.3 per cent) and further expansion next year (0.8 per cent).

The comparison with the 2018 Update, which covered a time horizon similar to that of the EFD, certainly reflects the differences in the macroeconomic scenario. The EFD incorporate slower growth and a different labour market structure, brought about in part by measures involving the Citizenship Income and pensions. However the revision of the output gap in the EFD is also the result of differences in the initialisation parameters used in the total factor productivity (TFP) model. In this regard, the PBO demonstrates that, all other conditions being equal, with the TFP parameters used in the Update, the output gap would have been less negative across the entire forecast horizon, with the difference being greater the further along the forecast horizon.

The estimate of the output gap, which is crucial for the application of EU rules, is nonetheless surrounded by a high degree of uncertainty due to the fact that, since it is not observable, it varies considerably based on the specific econometric model used. In addition, the quantification of the potential gap and the actual gap has become especially uncertain in recent years, reflecting rising macroeconomic volatility, which makes it more difficult to distinguish the temporary and permanent components of economic activity. Different processes for extracting the trend in the same model can produce a very broad range of estimates.[1]

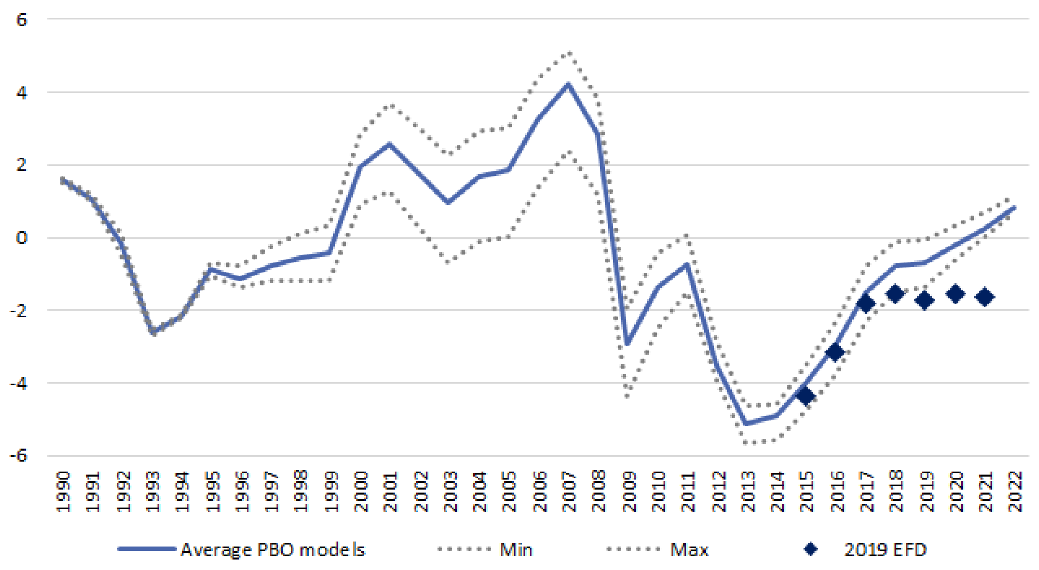
The PBO is developing a procedure for estimating the output gap and the potential output of the Italian economy that is based on multiple estimation models combined into a composite metric with a plausibility range. The approach adopted is that of the

[1] See the Parliamentary Budget Office (2017), "Which gap? Alternative estimations of potential output and the output gap in the Italian Economy" Working Paper No. 2, July.

unobserved components in the time series, which are identified using different econometric specifications.[2]

Using the PBO's policy forecasts, produced for the endorsement of the EFD, as the macroeconomic scenario, the PBO's new output gap models would point to a gap in 2019 (Figure 1.4) that is still negative (-0.7 per cent in a range of between -1.4 and -0.1 per cent), which tends to close over the forecast horizon at a convergence rate that varies based on the model. The following year the gap is expected to remain negative but approach equilibrium in the average of the estimates (-0.2 per cent, with a range of between 0.3 and -0.6 per cent). The gap would turn moderately positive on average in 2021 (0.3 per cent) before strengthening at the end of the forecast horizon, thanks to the gradual recovery in growth. As expected, there is considerable variability in the estimates of the different models, about 1 percentage point over the entire forecast horizon.

Figure 1.4 – Estimates of the output gap according to the new PBO models (1)



Fonte: based on Istat and Ameco data and 2019 EFD.
(1) The figure shows the output gap (average, minimum and maximum) obtained using the new estimation models of the PBO and that given in the 2019 EFD.

2 Beginning with the most conservative model, with a bivariate GDP and inflation structure, we consider models that also include estimates of unemployment and are based on production function. Also included is a statistical filter, similar to that of Hodrick and Prescott but with specific parameters that reflect the cyclical characteristics of Italy's GDP in the given reference period. Finally, intervention variables are considered to capture some changes in the characteristics of the economic cycle following the global crisis (more details will be provided in a forthcoming PBO Working Paper).

1.4 Endorsement of the macroeconomic scenario

The PBO assessed the macroeconomic scenarios published in the EFD for the 2019-2022 forecasting period. Although European legislation only requires endorsement of policy forecasts, in agreement with the MEF, the PBO extends its endorsement process to comprise the forecasts in the trend macroeconomic scenario.

The PBO sent its letter endorsing the trend macroeconomic forecasts for 2019-2022 on 25 March.[3] The endorsement of the trend scenario occurred after the PBO had previously communicated its comments on a preliminary version of the MEF forecasts, which was followed by the definition of a new trend macroeconomic scenario by the MEF.

The PBO then conducted an endorsement exercise for the policy macroeconomic scenario, sending its endorsement letter to the MEF on 16 April.[4]

Briefly, the methodology adopted in the endorsement exercise involved the following aspects. It was based on a comprehensive analysis of the macroeconomic scenarios proposed by the MEF using: a) the PBO estimates for short-term developments in GDP and the main components of demand; b) the annual forecasts obtained by the PBO with Istat's forecasting model (MeMo-It), used under the terms of the framework agreement signed with that institute; c) the annual forecasts produced separately and specifically by the independent forecasting institutes (CER, Prometeia, and REF.ricerche) that form part of the PBO forecasting panel. In addition, the PBO also monitored the forecasts of other national and international institutions and conducted an analysis of the internal consistency of the scenarios developed by the MEF. To ensure the consistency of the comparison with the MEF forecasts, the projections of the PBO panel forecasters (including the PBO forecasts) were formulated on the basis of the same assumptions for the exogenous international variables used by the MEF (world trade, oil prices, exchange rates, interest rates). In addition, for the policy scenario, the PBO panel based their assessments on general hypotheses about public finance measures developed by the PBO based on the EFD and in consultation with the MEF.

The trend macroeconomic scenario of the 2019 EFD – which reflects the increases in indirect taxes provided for in the safeguard clauses for 2020-2021 – appears consistent with the forecasts of the PBO panel, although some of the variables subject to the endorsement diverge slightly from the upper bound of the forecasts prepared by the PBO panel. The MEF's trend forecast for GDP growth lies below the upper bounds of the PBO panel projections in each year of the forecast horizon (Figures 1.5 and 1.7). However, there are differences in some demand components. The PBO panel expects household consumption to decelerate in 2021-2022, reflecting the increase in indirect taxes, while

[3] The letter was published on the PBO site, with an accompanying note explaining the endorsement exercise and process and discussing the risks inherent in the estimates (http://en.upbilancio.it/wp-content/uploads/2019/04/Validazione_QMT_DEF_19_-lett_espl_EN.pdf).

[4] The endorsement letter can be found on the PBO site at: http://en.upbilancio.it/wp-content/uploads/2019/05/PBO_Lettera-validazione-QMP-DEF-2019_EN.pdf.

the MEF forecasts an acceleration. Furthermore, according to the PBO panel, the slowdown in total investment is expected to be more pronounced this year than estimated in the EFD. The MEF's export projections are consistent with those of the PBO panel and indicate a slight acceleration in 2019; over the next three years the panel expects a convergence towards the pace of external demand, while the EFD sees a contraction in market shares. The forecasts for employment (measured in terms of full-time equivalent units) are very similar to the PBO panel median projections for 2019-2020 and only slightly higher in the subsequent two years. The unemployment rate is also virtually identical with the panel's median projections through next year and more favourable thereafter. It should be noted that the panel forecasts regarding the labour market are mixed, since the difference between the upper and lower bounds is around 1.5 percentage points over the next three years, due to the complex and uncertain assessment of the impact of the Citizenship Income on the labour supply, both in economic terms and in the official statistics.

The PBO conducted an endorsement exercise of the multiplier effect of the Citizenship Income for the years 2019-2020, using the MeMo-It structural macroeconometric model.[5] The main elements underlying the PBO's simulation are similar to that of the analogous simulation of the EFD. The only appreciable difference concerns the increase in the labour force, estimated in the PBO exercise at 300,000 in 2019 and 600,000 the year after (compared with an estimated 470,000 across the entire horizon in the EFD). The effects on GDP in the first two years of the simulation are similar (0.2 percentage points in 2019 and 0.4 points in 2020) to those set out in the EFD. The increase in employment caused by this growth would be smaller than the rise in labour participation, at least in the short term; the unemployment rate would therefore rise by an even more pronounced extent than in the EFD's estimation. The multiplier effects on economic activity and the increase in the labour supply lead to a slight improvement in the economy's potential growth, estimated with the European Commission's production function model. For the 2019-2020 period the PBO's analysis agrees with that of the MEF in forecasting an increase in the potential growth rate of a few tenths of a percentage point. Beginning in 2021 the MEF's simulation instead shows a further strong push in potential growth, which is difficult to interpret on an economic basis.

With regard to the nominal variables, the MEF trend macroeconomic scenario forecasts a change in the GDP deflator that is within the range of the forecasts of the PBO panel and not very different from the median values. Given the forecasts for real GDP growth and its deflator, nominal GDP growth in the EFD scenario is broadly in line with the forecasts of the PBO panel.

The impact of the activation of the safeguard clauses on the economic system is uncertain with regard to both prices and quantities. The extent of the transfer of the increase in indirect taxation to consumer prices can in fact vary greatly depending on a variety of factors, such as cyclical conditions, the expectations of firms that set prices, the level of spare capacity and developments in labour costs and commodity prices. There are also important structural aspects, such as competitive pressures on domestic and international markets, as well as the characteristics of distribution channels. The PBO estimated the macroeconomic impact of the safeguard clauses, as provided for by the 2019 Budget Act, on the main nominal and real variables through the

[5] See the testimony of Chairman Pisauro before Parliament on 5 February 2019 on Decree Law 4/2019 "Urgent provisions on the Citizenship Income and pensions".

macroeconomic simulations of the MeMo-It model, which differ based on the assumptions about the transfer of increases in indirect taxes on prices.

Four possible scenarios are considered: *a*) *full pass-through*, in which it is assumed a full and immediate impact of the increase in indirect tax rates on the consumption deflator; *b*) *partial pass-through*, in which the indirect tax changes partially translate (around 75 percent, as in the PBO's trend scenario) into growth in consumption deflator; *c*) *no pass-through*, in which, although the safeguard clauses have been activated, it is assumed that no impact on final prices will occur because the increase in tax rates will be fully absorbed by firms; *d*) *deactivation of the safeguard clauses*, in which indirect taxes are not increased and deficit funding is used instead.

Compared with case *d*), deactivation of the clauses, consumer inflation would increase by about 1.5 percentage points in the first year of the simulation of the case of full pass-through and about 1 percentage point in that of partial pass-through. The effect would tend to gradually diminish over the subsequent three years.

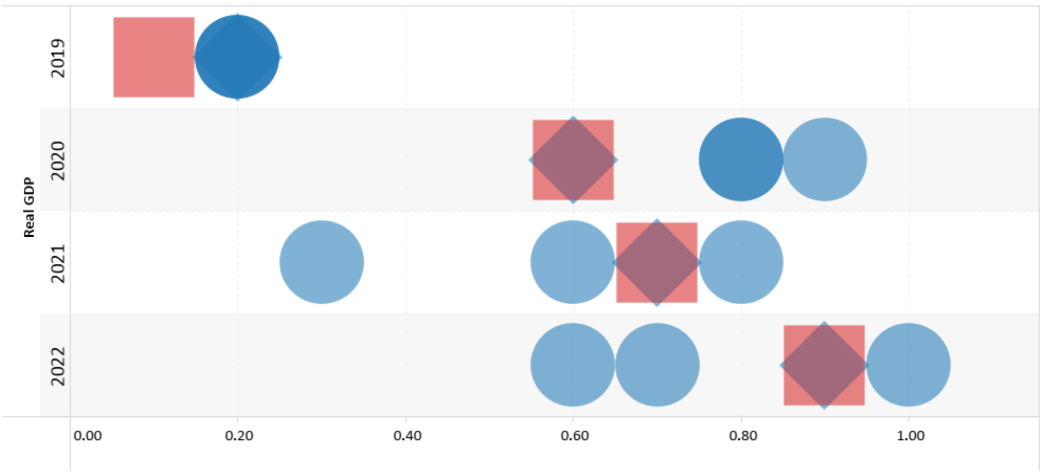
The uncertainty associated with the impact of changes in indirect taxes to prices also has an effect on economic activity. The most expansionary scenario for real GDP is, by construction, that of the deactivation of the clauses. The internal components of demand would benefit both from greater purchasing power and growth in profits. The development of the economy could be less in the two cases of indirect tax pass-through (partial or full) to prices. Growth would be hampered primarily by weaker consumer spending, which would result from the loss of purchasing power by households owing to higher prices in relation to disposable income. Even the rate of profit and expenditure on capital goods would be slightly lower than in the simulation of the benchmark. It is estimated that GDP growth will decrease by about 0.2 percentage points in the first year of the simulation (in both of the indirect taxation pass-through scenarios), with relatively more obvious effects in subsequent years in the case the tax increase fully translates into growth in prices. In the no-pass-through scenario, the growth of the economy would be marginally slower than that in the baseline scenario. The weaker growth in disposable income in nominal terms, because of the reduction in the non-labour components, would be to a large extent offset by the weaker increase in consumer inflation.

The endorsement exercise for the policy scenario considers the proposed budget for the 2020-2022 period. The PBO performed a tentative reconstruction – shared with the panel forecasters – based on the general guidelines set out in the EFD and discussions with the MEF. There continues to be, however, a very high degree of uncertainty in the fiscal policy scenario, especially due to the possible deactivation of the safeguard clauses in 2020, which are instead fully considered in the policy scenarios.

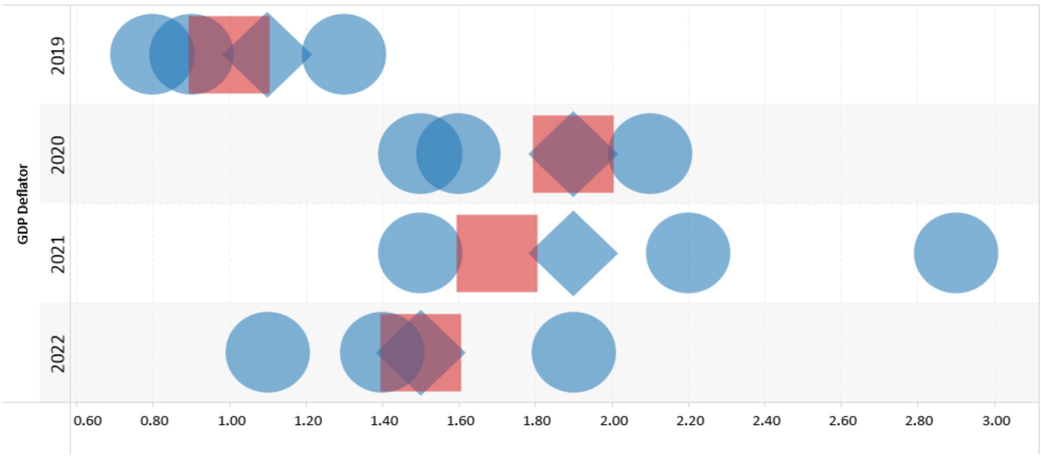
The MEF's macroeconomic policy forecasts and those of the PBO panel are consistent overall (Figures 1.6 and 1.7). The increase in real GDP lies within the panel's forecast interval and it only reaches the upper bound in 2021. By comparison with the median of the PBO's estimates, the EFD's growth projection is slightly more cautious in 2019-2020 and just a little more optimistic in the final two years of the forecast horizon. However, these estimates imply that the measurements of the expansionary effects of the budget measures are slightly greater than those of the PBO panel.

Figure 1.5 – Comparison of the Government's trend scenario with the PBO panel forecasts

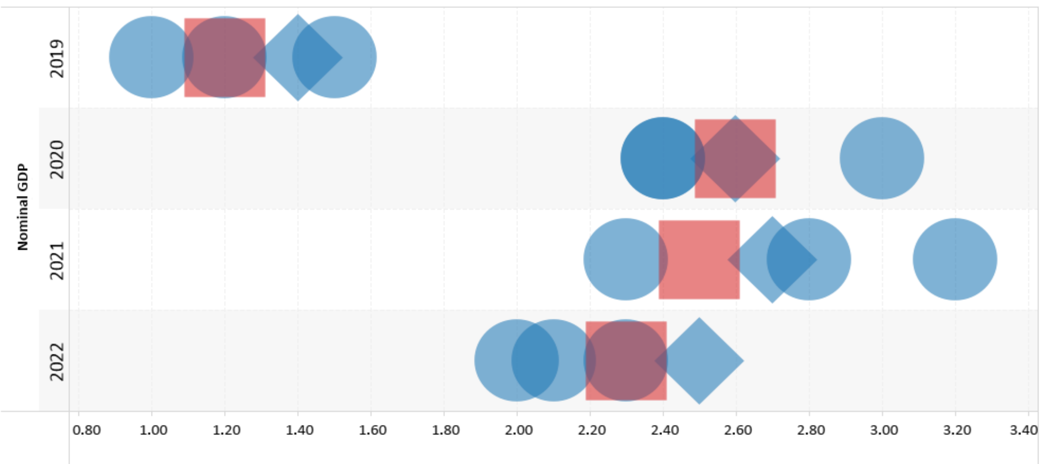
GDP (trend scenario)



GDP DEFLATOR (trend scenario)



NOMINAL GDP (trend scenario)



Government forecasts PBO panel forecasts PBO forecasts

Figure 1.6 – Comparison of the Government's policy scenario with the PBO panel forecasts

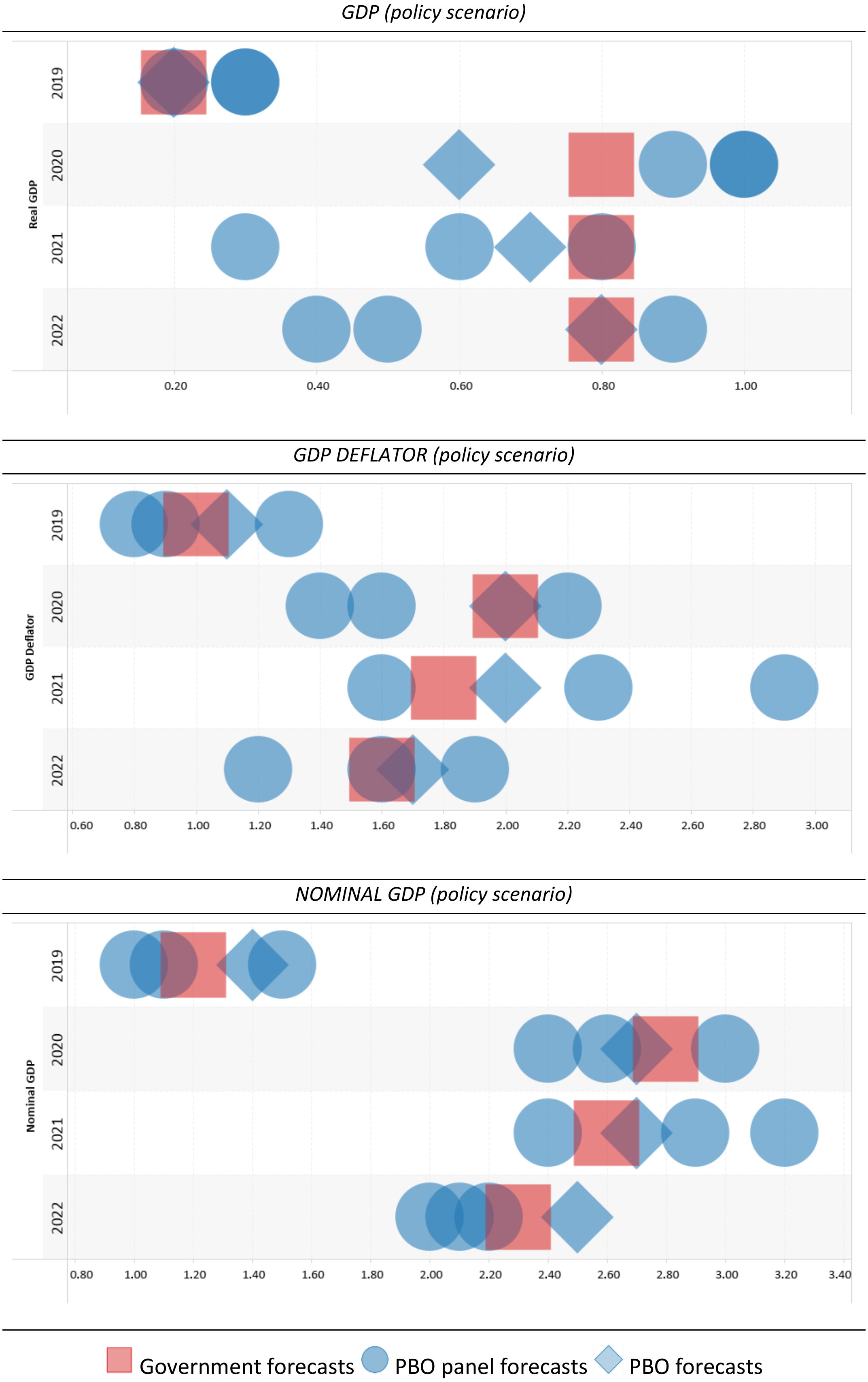
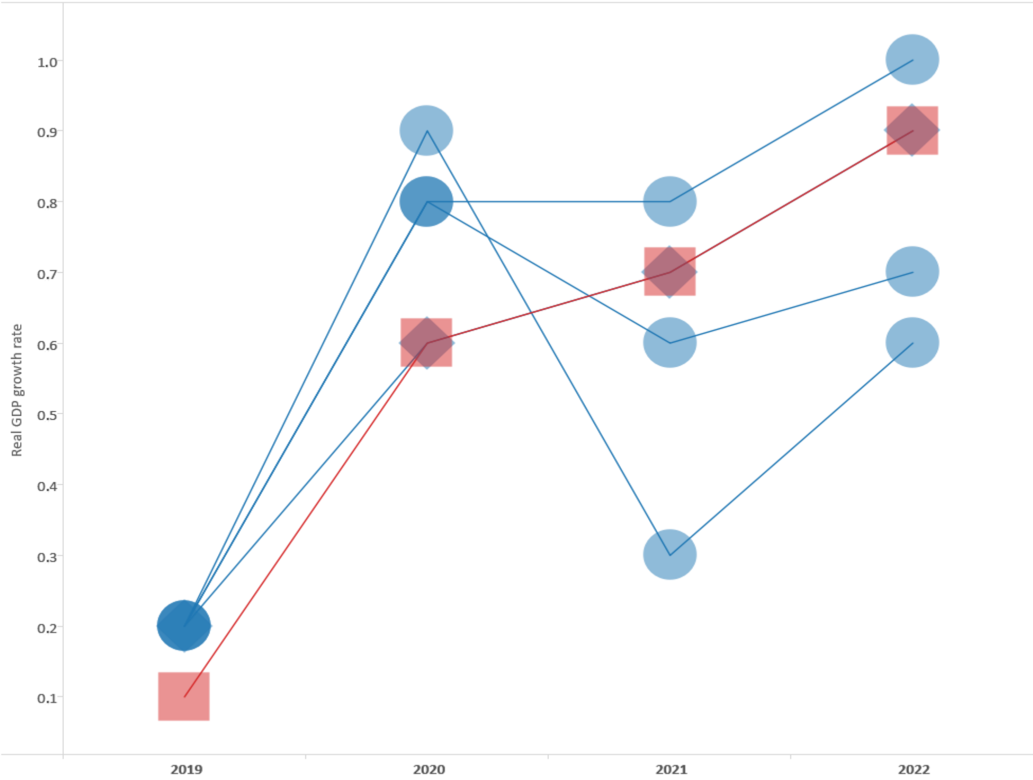
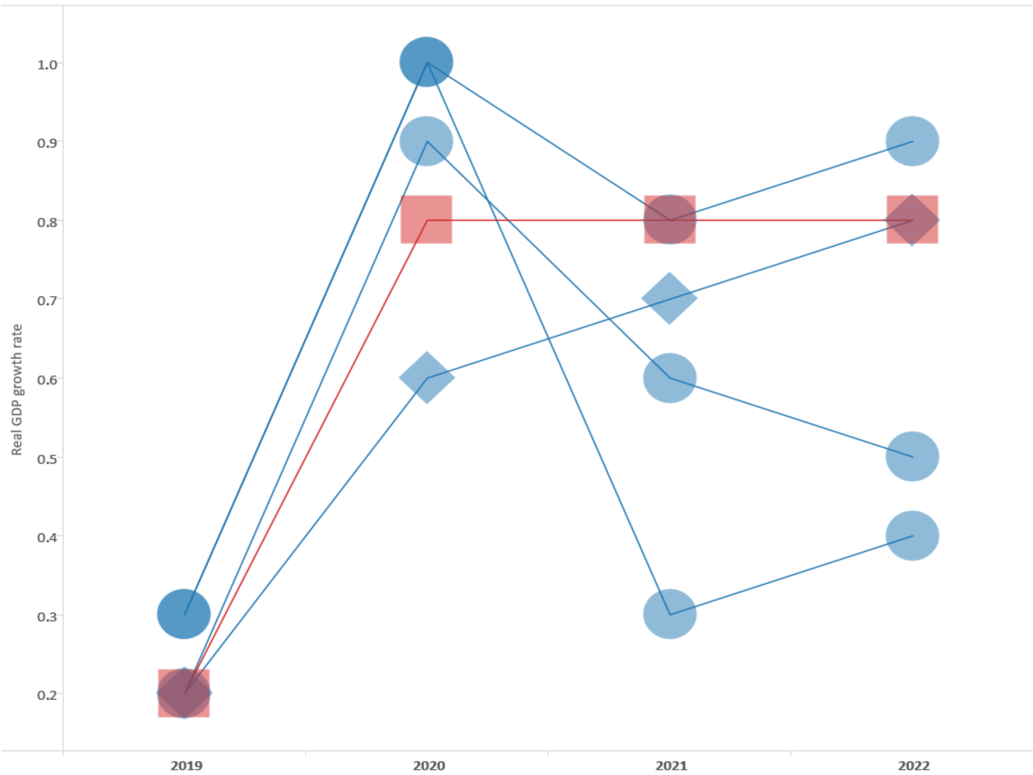


Figure 1.7 – Trend and policy developments in real GDP

Trend



Policy



Government forecasts PBO panel forecasts PBO forecasts

With regard to the demand components, in the EFD's policy scenario there is a marked divergence (already observed in the trend scenario) between its projections for gross fixed investment in 2019 and those of the PBO panel, particularly for the machinery and equipment component. General government expenditure for 2020 also far exceeds the upper bound of the PBO panel's range, as do the different assessments made by the PBO panel and in the EFD of the price/quantity breakdown of developments in nominal public consumption. In 2021, however, it is the increase in household consumption that exceeds the upper bound of the panel's estimates, just as in the trend scenario, as a result of the different assessments of the impact of the safeguard clauses.

The growth in nominal GDP in the policy scenario falls within the forecasting interval, owing in part to the deflator, which remains below the upper bound of the panel's estimate. Based on these comparisons, a definitive profile of the EFD's policy forecasting, with regard to both real and nominal GDP, can be created that complies with the criteria for acceptability adopted by the PBO panel. The real growth in the EFD is, especially in the final two years of the policy scenario, close to the upper bound of the PBO panel forecasts. This constitutes a potential adverse risk for the EFD forecast, especially in light of the various sources of uncertainty, both international and domestic.

1.5 *Risks to the forecast*

The medium-term macroeconomic scenario for the Italian economy is exposed to substantial downside risks, both from the international and financial sector and of domestic origin. The following outlines some categories of risks, which taken as a whole prompt caution in the forecasts.

Risk of a further deterioration in international economic conditions. – Although the macroeconomic scenario already appropriately reflects a slowdown in foreign demand variables, for a variety of reasons the results could prove to be more pronounced. The Italian economy could end up exposed, given that its productive structure has a high propensity to export. Despite the recent resumption of dialogue between the US and China, fears of a global trade war remain high, which has had an impact on investment decisions. This is accompanied by the specific risk represented by China, which has a significant role in buoying German industry, given the fact that the measures taken by the Chinese authorities to counter the slowdown under way may not be sufficient. Furthermore, uncertainty over Brexit continues to weigh on Europe since the deadline for concluding an agreement between the United Kingdom and the EU continues to be pushed back. Other potential global risk factors are represented by economic downturns (Argentina, Venezuela, Turkey) and local geopolitical tensions (in North Korea, Syria, Iran and the Middle East in general), the unpredictable stance of the US administration and the European elections.

Financial imbalances and investor risk aversion. – Economic and monetary policies remain very expansionary at the global level, fuelling financial excesses in both stock prices and in public and private borrowing. In this environment, negative shocks would be difficult for authorities to accommodate and could induce a sudden increase in investors' risk aversion. The increase in risk premiums demanded by international investors would penalise economies with public and private issuers with low credit ratings, such as Italy.

Uncertainty about economic policies. – According to PBO’s indicator, the uncertainty of Italian households and firms is continuing to rise, particularly in the industrial sector. The uncertainty, which impacts consumption and investment decisions, may also derive from economic policy guidelines and programmes. In Italy, an example of a specific risk factor is the composition of the announced consolidation of the budget and the procedures for implementing additional measures indicated in the EFD. This uncertainty is widely perceived and can discourage expenditure by private actors, with a considerable impact on the national economic activity.

2 THE PUBLIC FINANCES

2.1 The trend scenario

The EFD acknowledges that the deficit for 2018 exceeded previous forecasts and that the trend public accounts are on a less favourable trajectory as a result of the deterioration in the economy. The forecasts on a current legislation basis point to a halt in the decline of the deficit/GDP ratio, with a sharply increasing deficit in 2019 followed by a decrease the next year to the level of 2018, and a further decline in the two years 2021-2022, partly a result of the current-legislation estimation method, which does not consider the effects of the unchanged policies.

Furthermore, this would only be possible thanks to the substantial increases in VAT rates and excise duties on mineral oils provided for in the safeguard clauses, which would be activated as from 2020 and provide the largest contribution to the primary surpluses, i.e. net of interest expenditure. In the absence of such clauses, the deficit would rise and exceed 3 per cent of GDP in each of the years in the 2020-2022 period.

The expected deficit for 2019, equal to 2.4 per cent of GDP, incorporates the impact of the decision to freeze €2 billion of the appropriations for the ministries, provisioned as part of the amendments to the budget package at the end of December 2018, following the agreement between the Government and the European Commission.

In 2018 the deficit was lower than the previous year due to both an increase in the primary surplus and a decrease in interest expenditure. General government net borrowing, as reported by Istat on April 3, 2019, fell in absolute terms (from €41.5 billion to €37.5 billion) and as a percentage of GDP, from 2.4 to 2.1 per cent (Table 2.1), reflecting an increase in the primary surplus (+€3.3 billion) from 1.4 to 1.6 per cent of GDP and a reduction in interest expenditure (-€0.6 billion) from 3.8 to 3.7 per cent of GDP. The improvement in the deficit is due to the one-off measures to rescue the banking sector implemented in 2017, for which outlays on capital account had amounted to about 0.4 percentage points of GDP. The reduction in primary spending as a percentage of GDP of 0.3 points (to 44.8 per cent) – attributable solely to capital expenditure (which fell from 3.9 to 3.3 per cent of GDP) as primary current expenditure increased (from 41.2 to 41.5 per cent of GDP, due in part to contract renewals for personnel in the various segments of public employment) – was accompanied by a slight reduction in total revenue (to 46.3 per cent). The fiscal burden also declined by one tenth of a percentage point, to 42.1 per cent of GDP, reflecting a reduction in the proportion of direct taxes – with virtually no change in the burden of indirect and capital taxes – partially offset by an increase in the weight of social contributions. Spending on interest decreased for the sixth consecutive year, including in absolute terms, standing at around €19 billion less than the peak reached in 2012. The deficit for 2018 was higher than that forecast in the Technical Note to the 2019 Budget Act – at 1.9 per cent of GDP – mainly due to higher capital expenditure, largely deriving from an increase in investment grants and, in particular, those associated with the significant tax credits for research and development, provided for under legislation passed in previous years, which were concentrated in 2018.

Table 2.1 – General government consolidated revenue and expenditure account *(millions of euros)*

	2017 figures				Difference between 2017 figures		2018 figures 3 April 2019		2018-2017	
	Oct. 2018	% of GDP	3 Apr. 2019	% of GDP	Abs. Value	% of GDP	Abs. Value	% of GDP	% change	Change as % of GDP
	(1)	(2)	(3)	(4)	(3) - (1)	(4) - (2)	(5)	(6)	(7)	(8)
Compensation of employees	164.231	9,5	164.993	9,6	762	0,0	170.064	9,7	3,1	0,1
Purchases of goods and services produced by market producers	45.285	2,6	44.913	2,6	-372	0,0	45.888	2,6	2,2	0,0
Intermediate consumption	94.928	5,5	95.123	5,5	195	0,0	95.985	5,5	0,9	0,0
Social benefits in cash	341.408	19,8	341.258	19,8	-150	0,0	348.893	19,9	2,2	0,1
Other current expenditure	62.485	3,6	63.567	3,7	1.082	0,1	66.819	3,8	5,1	0,1
TOTAL CURRENT PRIMARY EXPENDITURE	**708.337**	**41,1**	**709.854**	**41,2**	**1.517**	**0,1**	**727.649**	**41,5**	**2,5**	**0,3**
Interest expenditure	65.515	3,8	65.497	3,8	-18	0,0	64.879	3,7	-0,9	-0,1
TOTAL CURRENT EXPENDITURE	**773.852**	**44,9**	**775.351**	**45,0**	**1.499**	**0,1**	**792.528**	**45,2**	**2,2**	**0,2**
Gross fixed capital formation	34.041	2,0	34.354	2,0	313	0,0	33.043	1,9	-3,8	-0,1
Other capital expenditure	32.870	1,9	32.580	1,9	-290	0,0	24.881	1,4	-23,6	-0,5
TOTAL CAPITAL EXPENDITURE	**66.911**	**3,9**	**66.934**	**3,9**	**23**	**0,0**	**57.924**	**3,3**	**-13,5**	**-0,6**
TOTAL PRIMARY EXPENDITURE	**775.248**	**44,9**	**776.788**	**45,1**	**1.540**	**0,1**	**785.573**	**44,8**	**1,1**	**-0,3**
TOTAL EXPENDITURE	**840.763**	**48,7**	**842.285**	**48,9**	**1.522**	**0,1**	**850.452**	**48,5**	**1,0**	**-0,4**
Direct taxes	250.192	14,5	250.642	14,5	450	0,0	248.876	14,2	-0,7	-0,3
Indirect taxes	249.405	14,5	248.384	14,4	-1.021	-0,1	253.607	14,5	2,1	0,1
Social contributions	225.671	13,1	225.566	13,1	-105	0,0	234.964	13,4	4,2	0,3
Actual social contributions	*221.659*	*12,9*	*221.405*	*12,8*	*-254*	*0,0*	*230.822*	*13,2*	*4,3*	*0,3*
Imputed social contributions	*4.012*	*0,2*	*4.161*	*0,2*	*149*	*0,0*	*4.142*	*0,2*	*-0,5*	*0,0*
Other current revenue	69.525	4,0	69.537	4,0	12	0,0	71.770	4,1	3,2	0,1
TOTAL CURRENT REVENUE	**794.793**	**46,1**	**794.129**	**46,1**	**-664**	**0,0**	**809.217**	**46,1**	**1,9**	**0,1**
Capital taxes	2.324	0,1	2.318	0,1	-6	0,0	1.478	0,1	-36,2	-0,1
Other capital revenue	2.586	0,1	4.297	0,2	1.711	0,1	2.214	0,1	-48,5	-0,1
TOTAL CAPITAL REVENUE	**4.910**	**0,3**	**6.615**	**0,4**	**1.705**	**0,1**	**3.692**	**0,2**	**-44,2**	**-0,2**
TOTAL REVENUE	**799.703**	**46,4**	**800.744**	**46,4**	**1.041**	**0,1**	**812.909**	**46,3**	**1,5**	**-0,1**
NET PRIMARY BORROWING (-) / LENDING (+)	**24.455**	**1,4**	**23.956**	**1,4**	**-499**	**0,0**	**27.336**	**1,6**		**0,2**
NET BORROWING (-) / LENDING (+)	**-41.060**	**-2,4**	**-41.541**	**-2,4**	**-481**	**0,0**	**-37.543**	**-2,1**		**0,3**
Nominal GDP	1.724.954		1.724.205		-749		1.753.949			

Source: Istat (2018), *Conti e aggregati economici delle Amministrazioni pubbliche*, October and (2017) *Conto economico trimestrale delle Amministrazioni pubbliche*, 3 April.

On 9 April 2019, Istat published a new version of the accounts in which, for the years 2017-2018 only (the revision extended to the previous period will take place on the occasion of the October 2019 notification), a change has been incorporated in the list of institutions included in the general government sector[6] agreed with Eurostat. This change produced a small improvement in the deficit – which was nevertheless unchanged as a percentage of GDP – due to the similar effects of increases in revenue and expenditure. The latter, which rose by €2.6 billion in 2017 and €3.2 billion in 2018, included increases in costs recognised in the account of the new units included in the general government sector for compensation of employees, intermediate consumption, interest, and capital formation, as well as reductions in production and investment grants. On the revenue side, which expanded by €2.9 billion in 2017 and €3.2 billion in 2018, increases were posted for other current revenue and, in particular, market production. The changes increased the public debt by around €6 billion. The increase in the debt as a proportion of GDP was only one tenth of a percentage point of GDP, thanks to the increase in the latter (€3 billion in 2018) produced by the changes.

Without additional measures, the deficit would increase from 2.1 to 2.4 per cent of GDP in 2019, decline to 2 per cent in 2020 and then to 1.8 per cent and 1.9 per cent in the following two years (Tables 2.2a, 2.2b, and 2.2c). These developments would on the one hand reflect a significant decrease in the primary surplus in 2019 (by four-tenths of a point, to 1.2 per cent of GDP), followed by a gradual increase to 2 per cent in 2022 and, on the other, interest expenditure as a proportion of GDP that, after seven consecutive years of decline from 2012 to 2019, would increase in 2021-2022, reflecting an assumption of a rise in interest rates. Of the total primary surplus, about 77 per cent in 2020, about 81 per cent in 2021 and about 77 per cent the following year would be attributable to the increase in revenue expected from the safeguard clauses, which is quantified by the Government at €23.1 billion in 2020 and €28.8 billion from 2021.

Compared with the public finance scenario indicated in the Technical Note, the EFD trend forecasts reflect the final figures for 2018 as updated by Istat on 9 April this year, the deterioration in the macroeconomic scenario and the financial impact of legislative measures approved through March 2019. These include the effects of the amendments introduced with the ratification of Decree Law 119/2018, which were not incorporated in the estimates in the Technical Note, and, for 2019, of the setting aside of the €2 billion in provisions noted earlier.

6 The new units included in the general government sector are: Rete ferroviaria italiana (RFI) S.p.A., FerrovieNord S.p.A., Agenzia nazionale per l'attrazione degli investimenti e lo sviluppo di impresa (Invitalia), Cassa del Trentino S.p.A., Finanziaria per lo sviluppo della Lombardia S.p.A., Finanziaria regionale abruzzese S.p.A., Finpiemonte S.p.A., Finanziaria regionale Valle d'Aosta S.p.A., Acquirente Unico S.p.A., and Ricerca sul sistema energetico S.p.A..

Table 2.2a – General government consolidated revenue and expenditure account: a comparison of trend forecasts *(millions of euros)*

	Technical Note					2019 EFD					
	2017 (10/2018)	2018	2019	2020	2021	2017 (9/4/2019)	2018 (9/4/2019)	2019	2020	2021	2022
Compensation of employees	164,231	169,633	171,523	172,576	171,587	166,683	171,826	172,594	174,018	173,751	174,859
Intermediate consumption	140,213	142,398	144,636	146,739	146,443	141,744	143,855	144,123	147,640	148,417	149,968
Social benefits in cash	341,408	349,780	365,181	379,758	389,393	341,258	348,893	364,120	376,990	387,900	397,090
Pensions	*263,661*	*269,230*	*278,137*	*290,362*	*298,302*	*263,641*	*268,839*	*277,430*	*287,350*	*297,070*	*305,180*
Other social benefits	*77,747*	*80,550*	*87,044*	*89,396*	*91,091*	*77,617*	*80,054*	*86,690*	*89,640*	*90,830*	*91,910*
Other current expenditure	62,485	65,630	67,662	67,638	68,055	62,417	65,700	67,792	68,085	68,312	68,478
TOTAL CURRENT PRIMARY EXPENDITURE	**708,337**	**727,440**	**749,002**	**766,711**	**775,477**	**712,102**	**730,274**	**748,629**	**766,733**	**778,380**	**790,395**
Interest expenditure	65,515	64,476	66,019	69,292	72,924	65,598	64,979	63,984	65,983	69,659	73,739
TOTAL CURRENT EXPENDITURE	**773,852**	**791,916**	**815,021**	**836,002**	**848,401**	**777,700**	**795,253**	**812,613**	**832,716**	**848,039**	**864,134**
Gross fixed capital formation	33,787	33,000	34,981	40,980	43,723	38,765	37,081	38,991	42,999	45,690	47,171
Investment grants	13,903	15,077	12,551	15,335	13,505	9,649	13,899	12,192	13,494	13,371	13,205
Other capital expenditure	19,221	6,832	6,799	6,592	6,061	18,781	7,385	5,928	5,765	5,118	4,636
TOTAL CAPITAL EXPENDITURE	**66,911**	**54,910**	**54,331**	**62,907**	**63,289**	**67,195**	**58,365**	**57,111**	**62,258**	**64,179**	**65,012**
TOTAL PRIMARY EXPENDITURE	**775,248**	**782,350**	**803,334**	**829,619**	**838,766**	**779,297**	**788,639**	**805,740**	**828,991**	**842,559**	**855,407**
TOTAL EXPENDITURE	**840,763**	**846,826**	**869,352**	**898,909**	**911,690**	**844,895**	**853,618**	**869,724**	**894,974**	**912,218**	**929,146**
Total tax revenue	501,921	503,177	515,046	543,188	556,148	501,344	503,961	506,859	535,263	550,374	559,317
Direct taxes	*250,192*	*248,960*	*255,083*	*256,277*	*260,042*	*250,642*	*248,876*	*248,619*	*250,184*	*255,118*	*259,290*
Indirect taxes	*249,405*	*252,848*	*258,929*	*285,867*	*295,050*	*248,384*	*253,607*	*257,273*	*284,107*	*294,278*	*299,042*
Capital taxes	*2,324*	*1,369*	*1,034*	*1,045*	*1,056*	*2,318*	*1,478*	*967*	*972*	*978*	*985*
Social contributions	225,671	234,161	241,426	245,866	249,844	225,566	234,964	240,592	244,194	248,335	253,644
Actual social contributions	*221,659*	*230,197*	*237,382*	*241,740*	*245,648*	*221,405*	*230,822*	*236,359*	*239,869*	*243,926*	*249,168*
Imputed social contributions	*4,012*	*3,964*	*4,044*	*4,126*	*4,196*	*4,161*	*4,142*	*4,233*	*4,325*	*4,409*	*4,476*
Other current revenue	69,525	73,139	72,801	72,207	73,093	72,403	74,974	76,953	77,155	76,733	77,162
TOTAL CURRENT REVENUE	**794,793**	**809,109**	**828,239**	**860,217**	**878,028**	**796,995**	**812,421**	**823,437**	**855,640**	**874,464**	**889,138**
Other capital revenue	2,586	2,181	3,324	3,627	3,635	4,297	2,214	3,196	2,436	2,703	2,772
TOTAL REVENUE	**799,703**	**812,659**	**832,597**	**864,889**	**882,719**	**803,610**	**816,113**	**827,600**	**859,048**	**878,145**	**892,895**
Fiscal burden	*42.2*	*41.9*	*42.0*	*42.5*	*42.3*	*42.1*	*42.1*	*42.0*	*42.7*	*42.7*	*42.5*
NET PRIMARY BORROWING (-) / LENDING (+)	**24,455**	**30,309**	**29,264**	**35,272**	**43,952**	**24,313**	**27,474**	**21,861**	**30,057**	**35,586**	**37,488**
% of GDP	1.4	1.7	1.6	1.9	2.3	1.4	1.6	1.2	1.6	1.9	2.0
NET BORROWING (-) / LENDING (+)	**-41,060**	**-34,167**	**-36,755**	**-34,019**	**-28,972**	**-41,285**	**-37,505**	**-42,123**	**-35,926**	**-34,073**	**-36,251**
% of GDP	-2.4	-1.9	-2.0	-1.8	-1.5	-2.4	-2.1	-2.4	-2.0	-1.8	-1.9
Nominal GDP	*1,724,954*	*1,761,208*	*1,802,525*	*1,855,483*	*1,903,388*	*1,727,382*	*1,756,982*	*1,777,899*	*1,823,329*	*1,868,945*	*1,914,457*

Source: based on data from the Technical Note to the 2019-2021 Budget Act (Table 3.2-5) and the 2019 EFD (Table II.2-1).

Table 2.2b – General government consolidated revenue and expenditure account: a comparison of trend forecasts *(percentage of GDP)*

	Technical Note					2019 EFD					
	2017 (10/2018)	2018	2019	2020	2021	2017 (9/4/2018)	2018 (9/4/2018)	2019	2020	2021	2022
Compensation of employees	9.5	9.6	9.5	9.3	9.0	9.6	9.8	9.7	9.5	9.3	9.1
Intermediate consumption	8.1	8.1	8.0	7.9	7.7	8.2	8.2	8.1	8.1	7.9	7.8
Social benefits in cash	19.8	19.9	20.3	20.5	20.5	19.8	19.9	20.5	20.7	20.8	20.7
Pensions	*15.3*	*15.3*	*15.4*	*15.6*	*15.7*	15.3	*15.3*	*15.6*	*15.8*	*15.9*	*15.9*
Other social benefits	*4.5*	*4.6*	*4.8*	*4.8*	*4.8*	4.5	*4.6*	*4.9*	*4.9*	*4.9*	*4.8*
Other current expenditure	3.6	3.7	3.8	3.6	3.6	3.6	3.7	3.8	3.7	3.7	3.6
TOTAL CURRENT PRIMARY EXPENDITURE	**41.1**	**41.3**	**41.6**	**41.3**	**40.7**	**41.2**	**41.6**	**42.1**	**42.1**	**41.6**	**41.3**
Interest expenditure	3.8	3.7	3.7	3.7	3.8	3.8	3.7	3.6	3.6	3.7	3.9
TOTAL CURRENT EXPENDITURE	**44.9**	**45.0**	**45.2**	**45.1**	**44.6**	**45.0**	**45.3**	**45.7**	**45.7**	**45.4**	**45.1**
Gross fixed capital formation	2.0	1.9	1.9	2.2	2.3	2.2	2.1	2.2	2.4	2.4	2.5
Investment grants	0.8	0.9	0.7	0.8	0.7	0.6	0.8	0.7	0.7	0.7	0.7
Other capital expenditure	1.1	0.4	0.4	0.4	0.3	1.1	0.4	0.3	0.3	0.3	0.2
TOTAL CAPITAL EXPENDITURE	**3.9**	**3.1**	**3.0**	**3.4**	**3.3**	**3.9**	**3.3**	**3.2**	**3.4**	**3.4**	**3.4**
TOTAL PRIMARY EXPENDITURE	**44.9**	**44.4**	**44.6**	**44.7**	**44.1**	**45.1**	**44.9**	**45.3**	**45.5**	**45.1**	**44.7**
TOTAL EXPENDITURE	**48.7**	**48.1**	**48.2**	**48.4**	**47.9**	**48.9**	**48.6**	**48.9**	**49.1**	**48.8**	**48.5**
Total tax revenue	29.1	28.6	28.6	29.3	29.2	29.0	28.7	28.5	29.4	29.4	29.2
Direct taxes	*14.5*	*14.1*	*14.2*	*13.8*	*13.7*	14.5	*14.2*	*14.0*	*13.7*	*13.7*	*13.5*
Indirect taxes	*14.5*	*14.4*	*14.4*	*15.4*	*15.5*	14.4	*14.4*	*14.5*	*15.6*	*15.7*	*15.6*
Capital taxes	*0.1*	*0.1*	*0.1*	*0.06*	*0.06*	0.1	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Social contributions	13.1	13.3	13.4	13.3	13.1	13.1	13.4	13.5	13.4	13.3	13.2
Actual social contributions	*12.9*	*13.1*	*13.2*	*13.0*	*12.9*	12.8	*13.1*	*13.3*	*13.2*	*13.1*	*13.0*
Imputed social contributions	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	0.2	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*
Other current revenue	4.0	4.2	4.0	3.9	3.8	4.2	4.3	4.3	4.2	4.1	4.0
TOTAL CURRENT REVENUE	**46.1**	**45.9**	**45.9**	**46.4**	**46.1**	**46.1**	**46.2**	**46.3**	**46.9**	**46.8**	**46.4**
Other capital revenue	0.1	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.1	0.1	0.1
TOTAL REVENUE	**46.4**	**46.1**	**46.2**	**46.6**	**46.4**	**46.5**	**46.4**	**46.5**	**47.1**	**47.0**	**46.6**
NET PRIMARY BORROWING (-) / LENDING (+)	**1.4**	**1.7**	**1.6**	**1.9**	**2.3**	**1.4**	**1.6**	**1.2**	**1.6**	**1.9**	**2.0**
NET BORROWING (-) / LENDING (+)	**-2.4**	**-1.9**	**-2.0**	**-1.8**	**-1.5**	**-2.4**	**-2.1**	**-2.4**	**-2.0**	**-1.8**	**-1.9**
Nominal GDP	*1,724,954*	*1,761,208*	*1,802,525*	*1,855,483*	*1,903,388*	*1,727,382*	*1,756,982*	*1,777,899*	*1,823,329*	*1,868,945*	*1,914,457*

Source: based on data from the Technical Note to the 2019-2021 Budget Act (Table 3.2-5) and the 2019 EFD (Table II.2-1).

Table 2.2c – General government consolidated revenue and expenditure account: a comparison of trend forecasts *(growth rates)*

	Technical Note				2019 EFD				
	2018	2019	2020	2021	2018	2019	2020	2021	2022
Compensation of employees	3.3	1.1	0.6	-0.6	3.1	0.4	0.8	-0.2	0.6
Intermediate consumption	1.6	1.6	1.5	-0.2	1.5	0.2	2.4	0.5	1.0
Social benefits in cash	2.5	4.4	4.0	2.5	2.2	4.4	3.5	2.9	2.4
Pensions	*2.1*	*3.3*	*4.4*	*2.7*	*2.0*	*3.2*	*3.6*	*3.4*	*2.7*
Other social benefits	*3.6*	*8.1*	*2.7*	*1.9*	*3.1*	*8.3*	*3.4*	*1.3*	*1.2*
Other current expenditure	5.0	3.1	0.0	0.6	5.3	3.2	0.4	0.3	0.2
TOTAL CURRENT PRIMARY EXPENDITURE	**2.7**	**3.0**	**2.4**	**1.1**	**2.6**	**2.5**	**2.4**	**1.5**	**1.5**
Interest expenditure	-1.6	2.4	5.0	5.2	-0.9	-1.5	3.1	5.6	5.9
TOTAL CURRENT EXPENDITURE	**2.3**	**2.9**	**2.6**	**1.5**	**2.3**	**2.2**	**2.5**	**1.8**	**1.9**
Gross fixed capital formation	-2.3	6.0	17.1	6.7	-4.3	5.2	10.3	6.3	3.2
Investment grants	8.4	-16.8	22.2	-11.9	44.0	-12.3	10.7	-0.9	-1.2
Other capital expenditure	-64.5	-0.5	-3.0	-8.1	-60.7	-19.7	-2.7	-11.2	-9.4
TOTAL CAPITAL EXPENDITURE	**-17.9**	**-1.1**	**15.8**	**0.6**	**-13.1**	**-2.1**	**9.0**	**3.1**	**1.3**
TOTAL PRIMARY EXPENDITURE	**0.9**	**2.7**	**3.3**	**1.1**	**1.2**	**2.2**	**2.9**	**1.6**	**1.5**
TOTAL EXPENDITURE	**0.7**	**2.7**	**3.4**	**1.4**	**1.0**	**1.9**	**2.9**	**1.9**	**1.9**
Total tax revenue	0.3	2.4	5.5	2.4	0.5	0.6	5.6	2.8	1.6
Direct taxes	*-0.5*	*2.5*	*0.5*	*1.5*	*-0.7*	*-0.1*	*0.6*	*2.0*	*1.6*
Indirect taxes	*1.4*	*2.4*	*10.4*	*3.2*	*2.1*	*1.4*	*10.4*	*3.6*	*1.6*
Capital taxes	*-41.1*	*-24.5*	*1.1*	*1.1*	*-36.2*	*-34.6*	*0.5*	*0.6*	*0.7*
Social contributions	3.8	3.1	1.8	1.6	4.2	2.4	1.5	1.7	2.1
Actual social contributions	*3.9*	*3.1*	*1.8*	*1.6*	*4.3*	*2.4*	*1.5*	*1.7*	*2.1*
Imputed social contributions	*-1.2*	*2.0*	*2.0*	*1.7*	*-0.5*	*2.2*	*2.2*	*1.9*	*1.5*
Other current revenue	5.2	-0.5	-0.8	1.2	3.6	2.6	0.3	-0.5	0.6
TOTAL CURRENT REVENUE	**1.8**	**2.4**	**3.9**	**2.1**	**1.9**	**1.4**	**3.9**	**2.2**	**1.7**
Other capital revenue	**-15.7**	**52.4**	**9.1**	**0.2**	**-48.5**	**44.4**	**-23.8**	**11.0**	**2.6**
TOTAL REVENUE	**1.6**	**2.5**	**3.9**	**2.1**	**1.6**	**1.4**	**3.8**	**2.2**	**1.7**

Source: based on data from the Technical Note to the 2019-2021 Budget Act 2019-2021 (Table 3.2-5) and the 2019 EFD (Table II.2-1).

Compared with the Technical Note (Table 2.2a), whose comparison with the EFD is made more complex by the effects of the change in the scope of general government, it is possible to find various differences. On the revenue side, there is a clear deterioration in absolute terms in both tax revenue and social contributions due to the revision of forecasts for economic growth. On the expenditure side, which was impacted more by the change in scope, the following should be noted: a significant reduction in the level of interest expenditure; a decrease, especially in 2020, in pension expenditure linked to differences in inflation adjustments resulting from the postponement of the activation of safeguard clauses (this shift was not applied in the Technical Note, so inflation had a larger impact than in current projections); the reduction in intermediate consumption in 2019, partly attributable to the setting aside of the appropriations noted earlier; the containment of investment spending in 2020-2021, which is nevertheless planned to increase in the policy scenario through the budget package for next year.

In the EFD forecasts, revenue as a proportion of GDP is greater than that registered in 2018 in each of the four years from 2019 to 2022. The fiscal burden rises considerably in 2020-2021 (from 42 to 42.7 per cent) due to VAT increases, while the decline in 2022 (to 42.5 per cent) is mainly connected with the greater impact on that year of recent measures reducing direct taxes.

Direct taxes reflect the application of tax relief measures for sole proprietors and professionals introduced with the last budget and the extension and changes in the timing of the deduction of depreciation for so-called Industry 4.0 assets and for software. In addition to the effects of the safeguard clauses noted above, indirect taxation reflects increases in, among other things, taxes on gaming and tobacco products. Social contributions rise slightly in relation to GDP in 2019 and then decline steadily, reflecting slower growth in gross wages for the entire economy than the growth in nominal GDP, due in part to the provisions of current legislation.

After being forecast to increase in 2019 and 2020, primary expenditure as a percentage of GDP is expected to decline subsequently and in 2022 falls to just under the level of 2018, reflecting developments in current spending and capital expenditure that increases as a proportion of GDP in 2020 and then stabilises. The evolution of primary expenditure essentially reflects that of its most important component, namely spending on social benefits in cash, which incorporates the effects of the measures concerning the *quota 100* mechanism (sum of age and years of contributions) and the Citizenship Income. Net of social benefits, primary spending, after falling just under half a percentage point of GDP in 2018 (to 25 per cent), continues to decline until it is a percentage point lower than the 2018 level at the end of the period, also reflecting the nature of the current-legislation measure, which does not consider spending on an unchanged policy basis.

Examining the main items of the general government account, spending on compensation of employees – after the sharp increase recorded in 2018 – is expected to gradually decrease as a percentage of GDP in the subsequent four years (from 9.8 per cent in 2018 to 9.1 per cent in 2022), essentially reflecting expenditure increases connected with the contract renewals for the 2019-2021 period starting from 2020, the funds to finance new permanent hiring and those for the reorganisation of the careers of police and armed forces personnel and, on the other hand, the effects of cost reductions due to retirements prompted by the *quota 100* scheme and the financing of peace-keeping missions until 2020 only.

Intermediate consumption already declines as a percentage of GDP in 2019 due to the frozen appropriations for current spending by ministries and, from 2021, the activation of the measures to correct healthcare spending provided for in the 2019 Budget Act.

Social benefits also increase considerably as a percentage of GDP, rising from 19.9 per cent in 2018 to 20.7 per cent in 2022, reflecting the effects of the measures mentioned earlier. In particular, pension expenditure will be impacted by the rules governing the *quota 100*, partly offset by the limitation of indexation of larger pensions and the reduction of pensions greater than €100,000 for five years. Expenditure on other social benefits will also increase due primarily to the Citizenship Income and, to a lesser extent, to the refinancing provided for in the second section of the Budget Act of, among other things, the funds for social policies, the non-self-sufficient persons and families.

Capital expenditure is expected to decrease as a proportion of GDP in 2019 due to the substantial cuts envisaged – especially for investment grants to the State Railways – in the budget package drafted in December last year, as well as a doubling of public property sales (which have a negative accounting impact on public investment) and the freezing of a significant amount of capital account appropriations. The ratio of this expenditure to GDP would increase in 2020 and then stabilise as a result of the planned measures, in particular those for investment, impacting the two funds for central and local government entities respectively. More specifically, local authorities will be able to use surpluses released by the recent legislation, which according to PBO estimates[7] amount to about €11.5 billion in liquid resources, of which about €4 billion for entities that, despite having significant free resources, were constrained by the restrictive effects of the budget-balance rule deactivated by the 2019 Budget Act. It is therefore more likely that these entities will take advantage of the loosened constraints to increase investment spending.

2.1.1 One-off measures

As foreseen by legislation, Section II of the EFD sets out a list of one-off measures, identified on the basis of the methodology defined by the European Commission.[8] The effects of these

[7] See Ufficio parlamentare di bilancio (2019), "Spendable surpluses of local authorities under the new budget balance rules", Focus Paper no. 3, April (text in Italian).
[8] European Commission (2015), Report on Public Finances in EMU, Part II, Chapter 3. For a summary of the methodological criteria, see the Box on page 17 in Ufficio parlamentare di bilancio (2016), "The 2016 Stability Act in the public finance policy scenario", Focus Paper no. 1, February (text in Italian).

measures, which correspond to provisions already incorporated in current legislation, are summarised in Table 2.3.

One-off measures as a proportion of net borrowing are positive and equal to a constant one-tenth of a percentage point of GDP for both 2018 and the entire forecast period considered by the EFD. That amount is also assumed for the policy scenario in the construction of the structural public finance indicators. This implies that, at present, the policy projections do not envisage the introduction of further measures with net one-off effects.

It should be noted that some measures indicated in the National Reform Programme (NRP), included in the "Growth Decree", such as the extension of the third facilitated settlement of tax arrears to local authorities or the participation of those authorities in the plan for the disposal of public buildings, could theoretically increase the effects of the one-off measures, but this can only be verified following the actual presentation of the legislation, depending on the effects that may be attributed to the measures in question.[9]

Table 2.3 – One-off measures
(millions of euros)

	2016	2017	2018	2019	2020	2021	2022
Balance of one-off measures as a % of GDP	**0.2**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
One-off revenue measures as a % of GDP	*0.3*	*0.5*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*
One-off expenditure measures as a % of GDP	*-0.2*	*-0.6*	*-0.1*	*-0.1*	*-0.1*	*0.0*	*0.0*
Balance of one-off measures in absolute value (= a + b + c)	**3,430**	**-685**	**1,665**	**1,860**	**2,307**	**2,402**	**2,375**
a) Revenue, of which:	5,539	8,848	3,040	2,279	2,375	1,762	1,885
Sundry in lieu taxes	*1,067*	*1,070*	*1,359*	*1,128*	*648*	*248*	*0*
Adjustment of budget values to IAS	*394*	*250*	*202*	*202*	*202*	*202*	*202*
EU solidarity fund for Amatrice earthquake	*0*	*1,167*	*0*	*0*	*0*	*0*	*0*
Resolution Fund for banks	*0*	*1,526*	*0*	*0*	*0*	*0*	*0*
Repatriation of capital held abroad (voluntary disclosure)	*4,078*	*956*	*264*	*0*	*0*	*0*	*0*
Facilitated settlement of tax arrears, including extension to 2017 and readmission of rejected applications	*0*	*3,879*	*1,215*	*949*	*1,525*	*1,312*	*1,683*
b) Expenditure, of which:	-3,045	-10,289	-2,200	-2,239	-1,048	-340	-340
Natural disaster response	*-2,127*	*-2,326*	*-1,900*	*-2,239*	*-1,048*	*-340*	*-340*
Resolution Fund (4 banks)	*0*	*-1,000*	*0*	*0*	*0*	*0*	*0*
Measures to support MPS and Veneto banks	*0*	*-6,343*	*0*	*0*	*0*	*0*	*0*
One-off outlay for 2014 EU own resources decision	*-888*	*0*	*0*	*0*	*0*	*0*	*0*
Reclassification of Alitalia loan	*0*	*-600*	*-300*	*0*	*0*	*0*	*0*
Dividend outlays	*-30*	*-20*	*0*	*0*	*0*	*0*	*0*
c) Real estate disposals (decrease in expenditure)	936	756	825	1,820	980	980	830

Source: 2019 EFD, Section II.

[9] Certain measures, such as tax amnesties and property sales, could be included in the one-off measures even if their revenue effect (regardless of their use) does not exceed the threshold of 0.1 per cent of GDP generally adopted to identify the minimum level of one-off measures to be included in the estimates of structural balances.

On the revenue side, the measures considered mainly concern sundry in lieu taxes and amnesties, both of which were increased in the budget package for 2019, from which total revenue is expected to reach about €2 billion and €5.5 billion, respectively, in the forecast period from 2019-2022 .

On the expenditure side, a revision is conducted for past fiscal years, including the effects of the loan granted by the State to Alitalia, reclassified under capital transfers, to the one-off measures for 2017-2018.

This is a bridging loan granted by the State to the special administrators of Alitalia in 2017, in an initial amount of €600 million, which was disbursed in 2017. It was then increased by a further €300 million, which was disbursed in 2018.[10] The initial funding should have been repaid within six months, in compliance with the rules governing State aid for rescuing and restructuring non-financial undertakings in difficulty, pending the identification of a buyer who would take over the company from the special administrators. The subsequent repeated extension of the loan repayment terms, with an increase in the related amount, and the continuing special administration of the company have prompted the reclassification of the item as a State transfer to a company in crisis, with effects reflected in the general government account. This item was not included in the one-off measures indicated in the 2018 Update to the EFD.

With regard to the forecast period, the only one-off measure considered under expenditure concerns the interventions in favour of areas hit by natural disasters, equal to about €4 billion over the entire forecast period, of which €3.3 billion in 2019-2020. This is a reduction compared with the amounts previously indicated in the 2018 Update to the EFD. This reduction, equal to about €2.2 billion, does not reflect expectations of lower spending on measures in the areas still needing to be rebuilt, but rather the convention of not including spending for disasters too distant in time under one-off measures. The spending currently included in the table of one-off measures only regards the seismic events that occurred in central Italy in 2016-2017.

Moreover, given that the methodological criteria adopted by the European Commission provide for a maximum period of two years starting from the occurrence of the disaster (or in any case, as an exception, from the year in which the reconstruction efforts effectively begin), the expenditure forecast for the years after 2019 should not be included in one-off measures.

Finally, one-off measures include revenue from property disposals, which are expected to be around €1.8 billion in 2019, €1 billion per year in 2020-2021 and €830 million in 2022. These amounts represent a significant upward revision of the estimates presented in the 2018 Update, attributable to two factors:

- an increase in trend receipts, which are forecast on the basis of the average of those achieved in 2016-2018 (about €830 million), while in previous forecasts they were smaller (about €600 million);

[10] See, respectively, Decree Laws 50 and 148 of 2017.

- the inclusion of additional receipts from the disposal plan envisaged in the 2019 Budget Act, amounting to €950 million for 2019 and €150 million for both 2020 and 2021.

The one-off effects do not include the revenue expected from the placement of the shares of the units of the Invimit Sgr real estate investment fund, amounting to around €1.4 billion in 2019, as these are financial operations that are not registered in the general government (economic accrual) account.

2.2 The policy scenario

The EFD envisages substantially no change in the deficit/GDP ratio provided for under current legislation, with a further improvement in the budget balance only in the last year of the programming period. More specifically, for 2020 the deficit deteriorates by 0.1 percentage points of GDP compared to the trend scenario, for 2021 the expected deficit/GDP is that envisaged in the trend scenario and for 2022 net corrective measures equal to 0.4 per cent of GDP would reduce the deficit from 1.9 per cent to 1.5 per cent of GDP (Table 2.4).

The projections of the policy scenario are affected by the net effects of measures whose details are not provided in the EFD. The document contains only general indications about measures that are currently considered in the policy forecasts (Table 2.5).

Table 2.4 – Public finance indicators (1)
(percentage of GDP; plus sign = improvement in balance)

	2018	2019	2020	2021	2022
Trend net borrowing (a)	**-2.1**	**-2.4**	**-2.0**	**-1.8**	**-1.9**
Change (a')		*-0.2*	*0.4*	*0.1*	*-0.1*
Trend one-off measures	0.1	0.1	0.1	0.1	0.1
Net measures (b) (2)			**-0.1**	**0.0**	**0.4**
Policy net borrowing (c=a+b)	**-2.1**	**-2.4**	**-2.1**	**-1.8**	**-1.5**
Change (c')		*-0.2*	*0.3*	*0.3*	*0.3*
Interest (d)	-3.7	-3.6	-3.6	-3.7	-3.8
Change (d')		*0.1*	*0.0*	*-0.1*	*-0.1*
Cyclical component of policy budget balance (e)	-0.8	-0.9	-0.8	-0.9	-0.9
Policy net borrowing adjusted for cycle (f=c-e)	-1.3	-1.4	-1.2	-0.9	-0.7
Policy one-off measures (g)	0.1	0.1	0.1	0.1	0.1
Structural primary surplus (h)	2.3	2.1	2.2	2.6	3.1
Change (h')		*-0.2*	*0.2*	*0.4*	*0.4*
Policy structural balance (i=f-g)	**-1.4**	**-1.5**	**-1.4**	**-1.1**	**-0.8**
Change (i')		*-0.1*	*0.2*	*0.3*	*0.3*
Flexibility clauses (l)	0.0	0.2	0.0	0.0	0.0
Change in policy structural balance including flexibility clauses (m)		***0.1***	***0.2***	***0.3***	***0.3***

Source: based on 2019 EFD data.
(1) Totals may not match due to rounding of decimals. – (2) The net measures are calculated as the difference between policy net borrowing and trend net borrowing.

Table 2.5 – The budget measures provided for in the EFD
(millions of euros)

	2019	2020	2021	2022
Trend net borrowing (a)	**-42,123**	**-35,926**	**-34,073**	**-36,251**
as % of GDP	-2.4	-2.0	-1.8	-1.9
VAT increases		23,072	28,753	28,753
Unchanged policies		2,721	5,170	7,767
Net borrowing on unchanged policy basis with exclusion of VAT increases	**-42,123**	**-61,719**	**-67,996**	**-72,771**
as % of GDP	-2.4	-3.4	-3.6	-3.8
EFD budget measures				
Resources to raise				
Alternatives to VAT increases		23,072	28,753	28,753
Increased revenue (1)			2,000	8,000
Spending review		2,000	5,000	8,000
Total		25,072	35,753	44,753
Uses				
Deactivation of VAT increases		23,072	28,753	28,753
Maintaining unchanged policies		2,721	5,170	7,767
Increased investment (2)		1,800	1,900	1,700
Deficit correction (=b-a)		-2,521	-70	6,533
Total		25,072	35,753	44,753
Policy net borrowing (b)	**-42,123**	**-38,447**	**-34,143**	**-29,718**
as % of GDP	-2.4	-2.1	-1.8	-1.5

Source: information in the 2019 EFD.
(1) Approximately 0.1 per cent and 0.4 per cent of GDP in 2021 and 2022. – (2) Approximately 0.1 per cent of GDP in each year. Amounts calculated residually as the difference between the overall net value of the budget measures and the value of the other known components of the budget measures.

First, we examine the impact of so-called unchanged policies on the deficit. In the EFD the increase in the deficit is expected to accelerate, going from about €2.7 billion in 2020 to about €5.2 billion in 2021 and to almost €7.8 billion in 2022 (as indicated in Section II[11]). These amounts include the financing of international peace-keeping missions from 2021, additional expenditures for public employment including part of those for the renewal of public employment contracts from 2022, and other current and capital expenditure. Increases in public investment are planned, with the objective of increasing them as a proportion of GDP from 2.1 per cent in 2018 to 2.6 per cent in both 2021 and 2022.[12]

These effects are offset by funding measures – defined in the EFD as being "substantial"[13] – which are planned to include, starting from the first year, cuts in current expenditure with increasing effects over time (€2 billion in 2020, €5 billion in 2021 and €8 billion in

11 See pages. 28-30, Section II of the EFD.
12 See page 7, Section I of the EFD.
13 See page VI, Section I of the EFD.

2022[14]), with the aim of reducing that spending as a proportion of GDP,[15] as well as revenue increases of 0.1 per cent of GDP in 2021 and 0.4 per cent in 2022, which would mainly stem from measures to fight tax evasion.[16] The financial resources would be divided similarly between revenue increases and spending cuts at the end of the period.

The EFD also confirms current legislation on fiscal matters pending definition of alternatives to the safeguard clauses and tax reform measures in the coming months, in preparation for the 2020 Budget Act.[17] At the same time, the EFD expressed the intention to continue the reform of income tax (with the introduction of a flat tax system) and the general simplification of the tax system in the Budget Bill for next year, easing the tax burden on the middle class, with the specific indication that this must be accomplished in compliance with the public finance objectives set out in the EFD.[18]

Table 2.4 illustrates developments in the structural balance (i.e. net of cyclical effects and one-off measures) for the forecast period. The policy scenario envisages a deterioration of one-tenth of a point in the structural balance in 2019, followed by improvements over the entire 2020-2022 period (two-tenths of a point in 2020 and three-tenths annually in 2021-2022). The structural deficit, forecast at 1.5 per cent of GDP in 2019, is expected to gradually decline to 0.8 per cent in 2022 (see also section 4.3). In consideration of the characteristics of the exceptional and urgent nature of certain planned measures, for 2019 the Government has asked the European Commission to grant budget flexibility of just under 0.2 per cent of GDP. Taking account of the multi-year horizon of the extraordinary plan of interventions, the Government confirms its intention to request budget flexibility for the next few years for exceptional expenditures that it will face after 2019. To this end, the Government plans to use resources of €2.6 billion in 2019, €3.7 billion in 2020 and €4.2 billion in 2021.

Figure 2.1 shows changes in policy net borrowing, broken down into its components:

– the change in the structural primary surplus is the component that best identifies the discretionary (and permanent, i.e. net of one-offs) stance of the budget policy in each year compared with the previous one. This stance is moderately expansionary for 2019, with a worsening of the primary structural surplus by 2 tenths of a percentage point of GDP, more than recovered in the following three-year period with improvements of 2 tenths in 2020 and 4 tenths in both 2021 and 2022, made possible by the presence of safeguard clauses on indirect taxes;

[14] See page 14, Section III of the EFD.
[15] See page 6, Section III of the EFD.
[16] See page 14, Section III of the EFD.
[17] See pages VI and VII, Section I of the EFD.
[18] See page VI, Section I of the EFD.

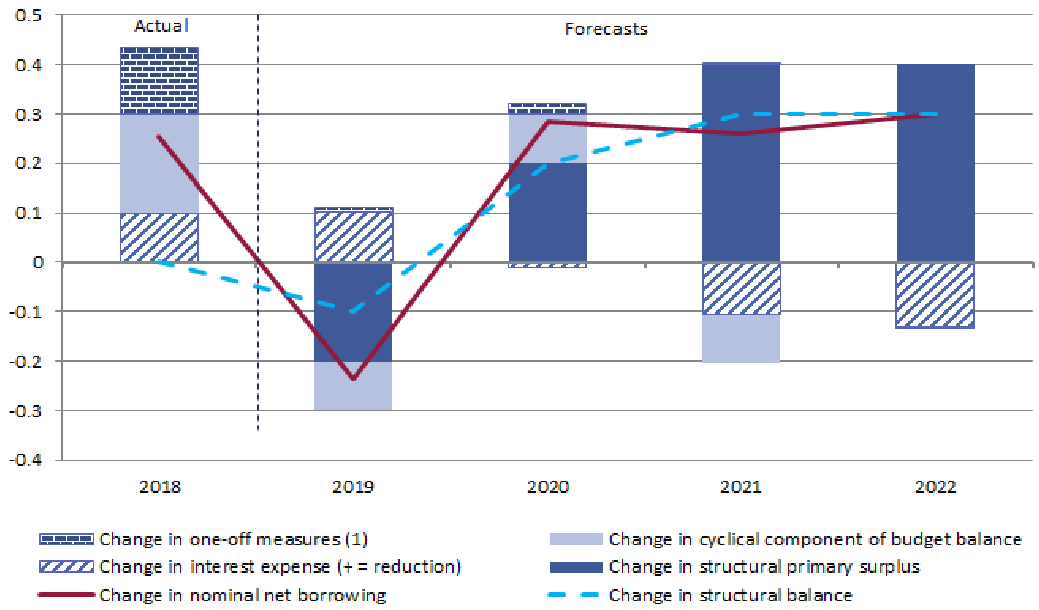
– interest expenditure, which from 2013 to 2018 contributed to the improvement in the balance each year, continues to have a positive impact of one-tenth of a point in 2019 as well, is unchanged in 2020 and has an unfavourable impact of about one-tenth of a point per year in 2021-2022, reflecting an increase in interest rates;

– the cyclical component of balance is negative and remains essentially constant with minimal changes (a negative one-tenth of a point in 2019 and 2021 and a positive one-tenth in 2020) or no variation (in 2022), reflecting the persistence of a prolonged negative phase of the cycle for the entire forecast period, according to the projections in the EFD;

– the developments in the one-off component of the balance, equal to 0.1 points for the entire forecast period, does not give rise to changes in policy net borrowing.

In summary (Table 2.5), the EFD shows that the deficit on an unchanged policy basis with no VAT increase would rise as a percentage of GDP from 2.4 per cent in 2019 (€42 billion) to 3.4 per cent in 2020, 3.6 per cent in 2021 and 3.8 per cent in 2022 (€73 billion). The resources that need to be found to ensure a gradual decline of the policy deficit in the EFD are: i) alternatives to the VAT increases, which amount to €23.1 billion in 2020 and €28.8 billion starting from 2021; ii) resources to finance unchanged policies, amounting to €2.7 billion in 2020, €5.2 billion in 2021 and €7.8 billion in 2022 and to increase investment (about €2 billion a year); and iii) those necessary for a further correction of the deficit in order to achieve the policy objectives, amounting to €6.5 billion in 2022 (conversely, in 2020 and 2021 the policy objective consists in an increase in the trend figure and therefore in a reduction in funding needs of €2.5 billion and €0.1 billion respectively).

Figure 2.1 – Change in the components of the policy budget balance
(percentage change)



Source: based on data from Table 2.1.
(1) A plus sign indicates one-off deficit reduction measures.

Ultimately, if the VAT increase clauses are to be neutralised, unchanged policies are to be retained and the targets set in the EFD are to be met, resources of about €25 billion need to be identified for 2020, rising to about €36 billion in 2021 and €45 billion at the end of the period. The financing measures (Table 2.5) have yet to be specified: the only indications offered by the EFD are those, mentioned above, concerning the spending review (generating up to €8 billion in 2022) and revenue increases (0.4 of GDP in the 2022).

Thus, after the interruption of the deficit reduction path expected for this year, the resumption of a downward trajectory in the deficit, needed for stabilising the debt/GDP ratio, requires the identification of substantial resources. The additional initiatives announced in the EFD, such as the plan to continue the process of reforming income taxes (the flat tax mechanism) and the general simplification of the tax system, to be implemented "in compliance with the public finance objectives specified in the document", would require the identification of further compensatory measures. The actual specification of the public finance in 2020-2022 therefore resembles a complex puzzle, which will require the clear identification of policy priorities. As already noted, this uncertainty over the design of budgetary policy is an important risk factor for the country's economic prospects.

2.3 A number of risks associated with the deficit reduction measures announced in the EFD

On the basis of the few indications provided in the EFD on the budget measures, procuring the resources needed to achieve the policy objectives will be based on three main pillars, in addition to increases in indirect taxes: the reduction and rationalisation of tax expenditures, countering tax evasion and the spending review. Each of these approaches has problems.

Tax expenditures

Tax expenditures have received particular attention both in legislation and in the policy debate for some time now. Among the former, various initiatives have been undertaken to analyse and monitor tax expenditures, with a view to reorganising and rationalising them in order to increase the transparency of tax and spending policies and to minimise the distortions of the tax system, in line with various recommendations from both the European Commission and the OECD. In the context of policy discussions, the reorganisation of tax expenditures is often mentioned as a possible source of resources for new measures.

Tax expenditures represent the cost in terms of lower revenue of measures that grant taxpayers any form of exemption, exclusion or reduction in the tax base or tax liability, or otherwise grant favourable tax treatment. Quantifying these expenditures inevitably depends on identifying of the theoretical tax model with respect to which the reduction in revenue is assessed and on the scope of taxation considered (State taxes only or including other levels of taxation).

Legislation[19] provides for a specific commission to draw up an annual report containing a review of tax expenditures, indicating their impact in terms of forgone revenue, number of beneficiaries and scope of application, which serves as the basis for the preparation of the annex to the revenue part of the State budget. A comparison shall also be made between tax expenditures and expenditure programmes intended for the same purposes

[19] Article 1 of Legislative Decree 160 of 24 September 2015, in implementation of Law 23 of 11 March 2014. For more details, see Ufficio parlamentare di bilancio (2015), "Audizione del Presidente dell'Ufficio parlamentare di bilancio sullo Schema di decreto legislativo recante norme in materia di stima e monitoraggio dell'evasione fiscale e in materia di monitoraggio e riordino delle disposizioni in materia di erosione fiscale" before the Finance and Treasury Committee of the Senate, 21 July 2015.

in order to rationalise the entire system. The reports[20] provide a detailed picture of tax expenditures in Italy, identified on the basis of the "legal benchmark" principle, under which the tax relief is measured as the difference in tax compared with the general system defined by applicable legislation.[21] Compared with similar past attempts to identify tax expenditures, the use of this principle has resulted in the exclusion of some of the most significant items,[22] which are considered structural under the current tax system. These include, for example, tax credits to ensure the progressivity of taxation, those for dependents and reduced VAT rates. Overall, the most recent report, that for 2018 attached to the notes of the revenue part of the State budget, identifies 513 tax expenditure measures concerning State taxes, corresponding to an estimated revenue loss of about €61 billion,[23] a significantly lower total than previously indicated (for example, the annex to the 2015 State budget quantified the impact of tax relief measures at around €161 billion). It should also be borne in mind that the list given in the Commission report does not clearly include tax expenditures introduced after the autumn of 2018, such as, for example, those connected with the recent extension of the simplified mechanism for certain categories of low-turnover self-employed workers and professionals.

The main items identified in the 2018 Report concern personal income tax (IRPEF).[24] In particular, these include the so-called "€80 bonus" tax credit (around €9.4 billion), tax credits for building renovations (€6.8 billion) and the exclusion of primary residences from income tax (€3.6 billion), the tax credit for healthcare expenditures (€3.3 billion), the exemption of certain types of pensions (€2.4 billion) (Table 2.6).

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[20] See "*Rapporto annuale sulle spese fiscali 2016*" and "*Rapporto annuale sulle spese fiscali 2017*" of the Commission for Tax Expenditures. The 2018 Report is annexed to the notes to the State revenue part of the State budget (page 800 et seq.) and can be found at http://www.rgs.mef.gov.it/_Documenti/VERSIONE-I/attivita_istituzionali/formazione_e_gestione_del_bilancio/bilancio_di_previsione/bilancio_finanziario/2019-2021/allegato-tecnico-per-capitoli/DLB_2019_DLB-04-AT-000-Entrata.pdf.

[21] In identifying tax relief measures, the Commission felt it advisable to not refer to a theoretical or ideal tax regime found in the literature, partly to avoid the formulation of value judgements, and instead to make exclusive reference to the provisions of law. As a result, it does not consider as tax relief measures those representing, in the intent of lawmakers, a structural characteristic of the tax.

[22] See Gruppo di lavoro sull'erosione fiscale (2011), *Relazione finale*, Allegati ai bilanci di previsione 2012-16.

[23] it should be borne in mind that for just under a third of the measures it was not possible to quantify the impact on revenue.

[24] In the 2018 Report, tax expenditures connected with IRPEF represent 27.7 per cent of the total, with a total estimated value of 64.3 per cent.

Table 2.6 – The twenty largest tax expenditures

	Measure	Tax	Financial effects for 2019 *(billions of euros)*
1	€80 bonus	Irpef	-9.4
2	Tax credit for building renovations	Irpef	-6.8
3	IRPEF exemption for primary residence	Irpef	-3.6
4	Tax credit for healthcare expenses	Irpef	-3.3
5	Exemption for war pensions, disability benefits, etc.	Irpef	-2.4
6	Deduction for supplementary pensions	Irpef	-2.1
7	In lieu tax for banking sector	Registration fees, stamp duty, mortgage registration and property transfer taxes	-2.0
8	Super-depreciation	Irpef\Ires	-1.9
9	Tax credit for energy efficiency upgrading	Irpef\Ires	-1.8
10	Exemption of family allowances	Irpef	-1.8
11	Tax in lieu on rental income	Irpef	-1.8
12	Preferential registration fee for purchase of primary residence	Registration fees, stamp duty, mortgage registration and property transfer taxes	-1.7
13	Reduction of diesel excise tax for lorry transport	Excise	-1.6
14	Tax credit for R&D investment	Tax credit (firms)	-1.3
15	Mortgage interest deduction for primary residence	Irpef	-1.0
16	Agricultural fuel tax relief	Excise	-0.9
17	Tax credit for investment in southern Italy	Tax credit (firms)	-0.8
18	Preferential property transfer tax	Registration fees, stamp duty, mortgage registration and property transfer taxes	-0.7
19	Exemption of lunch vouchers	Irpef	-0.6
20	50% tax credit for building upgrades in seismic areas	Irpef	-0.6
	Total 20 largest items		**-46.2**

Source: *Rapporto annuale sulle spese fiscali 2018 allegato alla Nota integrativa allo stato di previsione dell'entrata* (pages 800 et seq.).

Tax expenditures related to other taxes include those arising from the application, for the banking sector, of a tax in lieu of registration fees, stamp duty, mortgage registration fees and property transfer taxes and the tax on government concessions (€2 billion) as well as the super-depreciation mechanism (€1.9 billion). Overall, the twenty largest items make up about 75 per cent of the total foregone revenue associated with tax expenditures.

The legislation establishes that the Government shall draft a policy report, attached to the Update to the EFD, indicating the general outline of the measures intended to reduce, eliminate or reform tax expenditures. The 2018 policy report, while reaffirming the need to reform tax expenditures, underscores the complexity of the task and identifies, with a certain degree of generality, two possible reform approaches: one approach could be to link the review of preferential tax measures and the consequent expansion of the tax base with a targeted strengthening of deductions and credits for families and workers; another approach, pending a linkage of the tax expenditure review with a more structural tax reform, could instead be to implement horizontal measures. Nevertheless, the report confirms the priority of safeguarding, in any reorganisation, the protection of the income from payroll employment and self-employment, the incomes of smaller firms and incomes from pensions, of households, of health, of economically or socially disadvantaged persons, of the artistic and cultural heritage, of research and education, as well as the environment and technological innovation. The intention indicated in the National Reform Programme to introduce a flat tax to reduce the tax wedge on labour, financing it with the reduction of tax expenditures, appears to be consistent with the first of the approaches highlighted in the policy report.

However, the revision and rationalisation of tax expenditures raises a number of issues that need to be addressed. First, as they are important tools for transferring resources to individuals and firms, their elimination should be preceded not only by a quantification of the overall financial impact and the beneficiaries involved, but above all by an *ex post* analysis of the redistributive effects that the elimination of each subsidy mechanism would generate. It is also necessary to have a clear picture of the specific purposes of the tax expenditures (support for families, productive sectors, environmental goals, etc.) and to verify whether they are still valid or necessary within the context of policy priorities in order to rationalise them. For example, an across-the-board cut of existing preferential mechanisms would not serve this purpose.

Furthermore, some tax relief measures spread out over multiple years (for example, those for building renovations or for mortgage interest on primary-residences) would continue to cause revenue losses in future years until they expire, and would therefore not immediately make resources available to fund other measures.

Fighting tax evasion

Achievement of the net borrowing targets for 2021 and 2022 is conditional on implementing revenue increases of 0.1 and 0.4 per cent of GDP, respectively, which on the basis of the indication sin the EFD would mainly be generated by measures to fight tax evasion. In particular, the EFD states that this would be pursued by enhancing the tools available to the tax authorities and, above all, exploiting the use of new technologies to carry out targeted controls.

The tools introduced in the last few years and most recently with the 2019 Budget Act (including the split payment mechanism, quarterly VAT reports, periodic VAT settlements, electronic invoicing and mandatory transmission of data on proceeds of the sale of goods and services) have had and will continue to have a significant role on the fight against tax evasion connected with failure to file VAT returns, but still do not substantially address tax evasion deriving from seller-buyer accord and in some cases could encourage it.

Nevertheless, all of these tools, which increase the supply and timeliness of information, will help increase tax authorities' capacity for analysis and preventive control, improve the relationship between tax authorities and taxpayers and increase voluntary compliance. At the international level, these data are supplemented by those generated by the automatic exchange of data on financial assets held by taxpayers abroad. The systematic and integrated use of this information, facilitated by the push towards digitalisation of the whole country, as announced in the National Reform Programme, can boost the efficiency and effectiveness of administrative controls as well as provide an incentive for the virtuous behaviour on the part of taxpayers. Working against these innovations has been the repeated introduction of various forms of facilitated settlement of tax arrears and pending disputes, which reward the less deserving taxpayers and weaken the sense of tax compliance, and compromise future revenue.

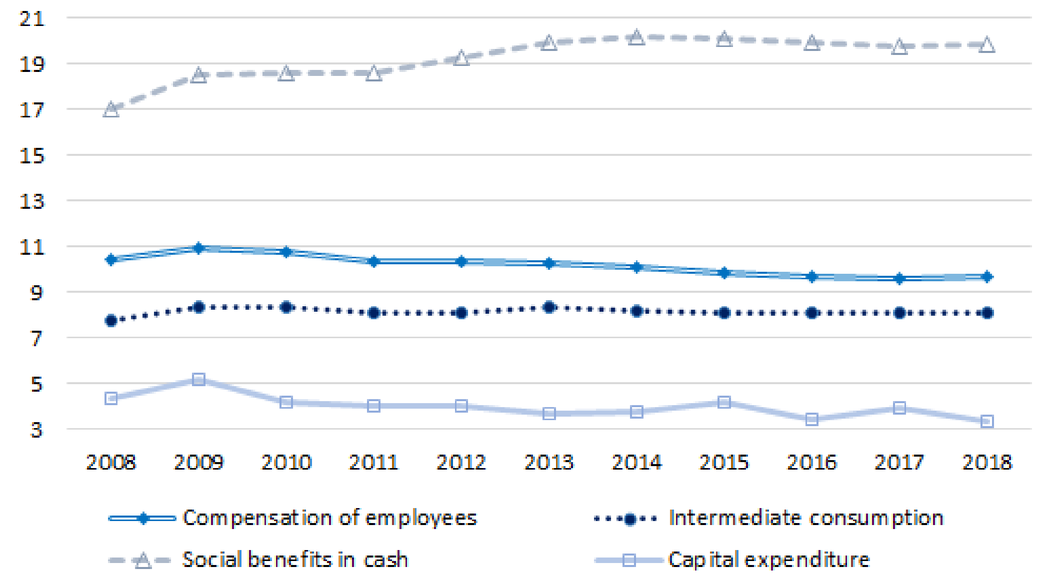
Overall, the magnitude of the increase in revenue expected from the fight against tax evasion in 2022 (most of the 0.4 percentage points of GDP indicated in the EFD, or about €8 billion) seems rather ambitious when assessed in the light of the results currently achieved by the Revenue Agency. More specifically, just over €19 billion were collected in 2018, of which €16 billion deriving from "ordinary" control activities (i.e. as a result of assessments issued by the Revenue Agency, promotion of compliance and enforced collection) and the remaining €3 billion from "extraordinary" recovery measures (for example, the facilitated settlement of tax disputes and outstanding assessments, voluntary disclosure, etc.). It would therefore be a question of significantly increasing (by up to 50 per cent or so) the amount of revenue recovered from "ordinary" collection activity. Moreover, these additional resources would have to be permanent in order to effectively contribute to the adjustment of the public accounts and their medium-term sustainability.

From a methodological standpoint, predicting the increase in revenue that would be generated by this activity is a very complex challenge, both because the effectiveness of the available tools used is uncertain and because the results depend strictly on the behaviour of economic agents. This is the main reason why such revenue should not be earmarked to fund measures whose effects are certainly permanent, as has often happened in the past, or even as a guarantee for the adjustment of the public accounts. This revenue must be quantified *ex post* by a specifically appointed Commission and only if the Commission determines that it is permanent it can be used as actual resources to reduce net borrowing.

Spending review and spending cuts

Raising financial resources by reviewing and cutting spending is now more challenging than previously in the wake of the corrective expenditure cuts implemented in the last decade. The main components of general government primary expenditure (i.e. spending excluding interest expenditure) have decreased gradually since 2010 as a proportion of GDP, with the exception of social benefits in cash (Figure 2.2).

Figure 2.2 – Main components of primary expenditure between 2008 and 2018 *(percentage of GDP)*



Source: based on Istat data.

This has reflected small nominal increases in spending and, in some cases, reductions in absolute value. Only since 2016 have the growth rates of all expenditure components turned positive, although at a rate close to or lower than GDP growth, thus giving rise to the stabilisation or contraction in expenditure as a percentage of GDP.

From 2010 to 2018, primary expenditure increased by a total of €50.4 billion in nominal terms (6.9 per cent), while it decreased by €14.7 billion (-2 per cent) in real terms (corrected for inflation measured by the GDP deflator). As a ratio to GDP, primary spending contracted by 2 percentage points to 44.8 per cent. Excluding expenditure for social benefits in cash, primary spending decreased by €6.9 billion in nominal terms (-1.6 per cent) and by €43.2 billion in real terms (-9.7 per cent). This aggregate fell by over 3 percentage points of GDP, to 24.9 per cent. Social benefits in cash have slowed the contraction in primary spending, mainly due to demographic dynamics, automatic mechanisms for indexing benefits and new income support measures (the €80 bonus) and to unemployment.

Further reductions in expenditure could be challenging to implement precisely because of the impact of past policies, including those implemented most recently. In the public sector, for example, measures to contain expenditure such as a new freeze on turnover would run up against the already reduced number of staff and the ageing of employees. These factors have inevitable repercussions for the overall efficiency of government administration and the use of technological innovation. Further cuts in health spending would risk affecting the quality of services delivered or the scope of public involvement in this sector. The growth of investment spending is the main fiscal policy instrument for supporting growth. Finally, social benefits have been increased by the measures introduced with the 2019 Budget Act and the decree issued last February. More specifically, the trend forecasts of the EFD show this expenditure rising by €15.2 billion between 2018 and 2019 and by another €33 billion in 2020-2022, largely due to the Citizenship Income and the *quota 100*.

Looking forward, spending review measures should be implemented through more targeted interventions, possibly aimed at channelling spending towards strategic and more innovative areas rather than merely cutting resources. In any case, such measures would require the clear identification of public policy priorities and the time required for analysis and implementation would be incompatible with the urgency of finding financial resources for the budget package. In this regard, moreover, it should be noted that the process of reviewing spending within the budgetary planning cycle (pursuant to Article 22-bis of Law 196/2009) was not initiated for 2019. The failure to identify, in the EFD, the expenditure objectives for ministries prevents their full involvement in the rationalisation of expenditure, thus limiting the implementation of the innovations contained in the Public Accounting Act (Law 196/2009) that could help improve the policy-setting and planning capacity of budgetary policy.[25]

[25] See the hearing of Chiara Goretti, member of the Board of the PBO, as part of the fact-finding inquiry into the results of the initial implementation of Article 22-bis of Law 196/2009 on public financial planning and agreement between ministries, held on 13 March 2019 before the Budget Committee of the Chamber of Deputies.

2.4 Developments in the policy debt/GDP ratio

Compared with the *Documento di aggiornamento del quadro macroeconomico* (Update of the macroeconomic scenario) published by the Government at the beginning of January, the policy scenario in the EFD postpones the start of a stable decline in the public debt as a proportion of GDP from 2019 to 2020, lowering the debt/GDP ratio from the peak forecast for 2019 (132.6 per cent) to the target of 128.9 per cent set for 2022. It should be borne in mind that this trajectory reflects an increase in revenue deriving from the raising of indirect taxes provided for in the safeguard clauses, quantified at around 1.3 percentage points of GDP for 2020 and 1.5 points of GDP in subsequent years.

The increase in the level of the debt/GDP ratio over the entire forecast horizon compared with the profile envisaged in the policy scenario in the 2019 Budget Act can be attributed to various factors, first and foremost significantly weaker growth in the denominator (especially for 2019, for which the nominal growth rate has been revised downwards from 2.3 to 1.2 per cent), which gives rise both to the purely arithmetical impact on the value of the ratio and to most of the deterioration in the forecast for the deficit. Moreover, Istat's downward revisions of GDP for previous years also have an impact, as does – by about one-tenth of a point per year – the upward revision of the nominal stock of debt at the beginning of April by the Bank of Italy to reflect changes in the list of institutions considered in the general government sector (notably, the inclusion of RFI – the railway infrastructure operator).

In the EFD's policy scenario, the debt/GDP ratio should increase by close to 0.5 percentage points in 2019 compared with 2018, before falling by a total of 3.7 percentage points in the following three years (Table 2.7), thus representing a net reduction of 3.2 percentage points in 2022 compared to 2018.

Table 2.7 – Determinants of the change in the debt/GDP ratio (1)
(percentage of GDP and rate of change)

	2018	2019	2020	2021	2022
Level	*132.2*	*132.6*	*131.3*	*130.2*	*128.9*
Change on previous year	0.8	0.5	-1.3	-1.1	-1.3
Determinants of the change in the public debt:					
Primary surplus	**-1.6**	**-1.2**	**-1.5**	**-1.9**	**-2.3**
Snow-ball effect, of which:	**1.5**	**2.0**	**0.0**	**0.4**	**0.9**
Interest expenditure	*3.7*	*3.6*	*3.6*	*3.7*	*3.8*
Contribution of growth in nominal GDP	*-2.2*	*-1.6*	*-3.6*	*-3.3*	*-2.9*
Stock-flow adjustments, of which:	**0.9**	**-0.3**	**0.2**	**0.4**	**0.1**
Differences in cash and accrual accounting	*0.2*	*0.4*	*0.0*	*0.0*	*-0.8*
Net accumulation of financial assets, of which:	*0.2*	*-0.7*	*0.0*	*0.3*	*0.5*
Privatisation receipts	*0.0*	*-1.0*	*-0.3*	*0.0*	*0.0*
Debt valuation effects	*0.2*	*-0.1*	*0.2*	*0.2*	*0.3*
Other (2)	*0.3*	*0.0*	*0.0*	*-0.1*	*0.0*
memo: Implicit interest rate on the debt	2.9	2.8	2.8	2.9	3.0

(1) Totals may not match due to rounding. – (2) "Other", a residual resulting from the previous items, includes: changes in the liquidity holdings of the MEF, statistical discrepancies, Eurostat reclassifications and assistance supporting the euro area provided under the EFSF.

Breaking down these developments into their various components, we find that the primary surplus always provides a positive and growing contribution over time, totalling almost 7 points of GDP. Of these, around 4.3 points are attributable to the safeguard clauses for indirect taxes provided for under current legislation, the effective activation of which would therefore be crucial in starting the downward path in the debt/GDP ratio.

Conversely, the stock-flow adjustment and the snow-ball effect contribute to increasing the debt. More specifically, the latter is expected to increase the debt/GDP ratio by a total of 3.3 points. Most of this rise would be concentrated in 2019 due to the sharp slowdown in nominal growth, despite the 0.1 per cent reduction in interest expenditure as a proportion of GDP. In 2020, the snow-ball effect should become nil thanks to unchanged interest expenditure and a significant acceleration in nominal GDP (+2.8 per cent). In the following two years, the contribution of this component would return negative (for a total of 1.3 points of GDP) due to the gradual increase in interest expenditure (equal to one-tenth of a point in each year), combined with a reduction in the nominal growth rate (+2.6 per cent in 2021 and +2.3 per cent in 2022).

The stock-flow adjustment has a total adverse impact of 0.4 percentage points. In the final two years, this item is affected by the effects of the measurement of the level of the debt (which is influenced, among other things, by debt-issue spreads and the revaluation of indexed government bonds) and the cash/accruals difference, which makes favourable contribution of no less than 0.8 points of GDP in 2022: this value is mainly attributable to the cash proceeds from the award of rights to use radio and television frequencies and other frequency bands (including those for the development of the 5G network), which were allocated through a competitive procedure completed in October 2018. In the general government revenue and expenditure account, these proceeds are recognised on a pro-rated basis in the years in which they accrue, under other current revenue.

The privatisation component drives the developments in the stock-flow adjustment in the previous two years, forecasting revenue equal to 1 percentage point of GDP in 2019 and 0.3 points in 2020.

The privatisation programme

The debt forecasts contained in the 2019 EFD confirm the assumption, adopted in the 2019 DBP,[26] of privatisation receipts equal to 1 percentage point of GDP in 2019 and 0.3 points in 2020, equal to about €17.8 billion and €5.5 billion, respectively.

In this regard, note that in recent years policy documents have regularly included forecasts for privatisation receipts that in reality have proven to be well below expectations, with rare exceptions.

[26] See the revised version of 13 November 2018, available on the website of the European Commission.

Table 2.8 illustrates a comparison between disposals envisaged in the 2015-2018 EDFs and the corresponding final figures. In that period, the only year in which the results met expectations is 2015, when the disposals implemented (€6.6 billion) had already been included in the plans drawn up the previous year. In the years before 2015, disposals of more than €10 billion were recorded on only three occasions (1997, 1999 and 2003). In the years following 2015, the results obtained were significantly below expectations: in 2017-2018, with forecast disposals of 0.3 points of GDP per year, actual receipts amounted to €58 million in 2017 and €2 million in 2018.[27]

In the EFD, the forecast for 2019 is more than three times greater than that for the previous two years, without providing the information necessary to assess its feasibility.

In light of the increase in the forecast for privatisation receipts, the PBO therefore reiterates even more strongly its previously expressed conclusion that the public finance policy scenario is exposed to the real risk that the privatisation programme may prove to be totally or partially unworkable.

The risk referred to above has a number of aspects. First, the quantitative aspect: the EFD does not indicate which of the listed and unlisted equity investments[28] would be included in the privatisation programme, thus preventing a complete evaluation of the feasibility of the operation.

Table 2.8 – Privatisation receipts: forecasts and actual results
(percentage of GDP; billions of euros)

	EFD forecast by reference year (1)		Actual receipts	**Difference**
	% of GDP (a)	Billions of euros (b = a * policy GDP)	Billions of euros (c)	**Billions of euros (d = c - b)**
2015	0.4	6.6	6.6	**0.0**
2016	0.5	8.4	0.9	**-7.5**
2017	0.3	5.3	0.1	**-5.2**
2018	0.3	5.3	0.0	**-5.3**
2019	1.0	17.8	-	**-**
2020	0.3	5.5	-	**-**

Source: MEF, Economic and Financial Documents for 2015-2019; Bank of Italy, The Public Finances: Borrowing Requirement and Debt 2016-2018.
(1) The forecasts in the various EFDs, expressed as a percentage of GDP, are applied to the corresponding figures for nominal GDP in the policy scenario. For each EFD, the forecast figure for the year of publication are considered, with the exception of the 2019 EFD, which also considers the forecast figure for 2020.

[27] For 2017-2018, see Bank of Italy, *The Public Finances: Borrowing Requirement and Debt*, 15 March 2019, Table 1 (Formation of the central government borrowing requirement). For more detailed information on privatisations carried out in each year until September 2016, see MEF, Relazione al Parlamento sulle privatizzazioni, November 2016.
[28] The website of the Treasury Department of the MEF provides monthly updates of a chart of the equity investments of the MEF, indicating listed companies separately.

For example, an estimate of the market value of the MEF's direct holdings in listed companies would amount to around €23.6 billion at current prices, substantially equal to the expected privatisation receipts indicated by the EFD for the 2019-2020 period.

Of course, disposals could also involve equity participations in other companies. Among the latter, the EFD mentions INVIMIT Sgr, a real estate investment fund to which €1.4 billion in public properties have been transferred. The market placement of the units of this fund relating to real estate owned by the State would generate receipts to be used for debt reduction. It should be noted, however, that these receipts would not contribute to improving the general government account (as they are financial items) and would therefore be additional to the revenue from the real estate disposals included as a one-off item in the general government account, which amount to about €1.8 billion for 2019. The overall value of public real estate potentially involved in disposals for 2019, to be implemented with different instruments, would therefore be €3.2 billion.

It is also necessary to avoid the risk that the privatisation transactions might not comply with the accounting rules set out in ESA 2010. This risk would be significant if the process involved purchasers linked, even indirectly, to the public sector (for example, Cassa Depositi e Prestiti).

In this case, multiple aspects of the privatisations would be subject to careful scrutiny by national and European statistical authorities (appropriateness of the prices compared with market valuations, the retention of a controlling position by the public entity, profitability of the purchase for the buyer). These aspects should therefore be considered in advance, in order to exclude the risk of subsequent reclassification of the transactions, with the consequent risk of having to reverse the resulting decrease in the debt.

Finally, it should be clarified whether the policy forecasts, which include the reduction in interest expenditure deriving from the decline of the debt attainable thanks to privatisations, also include the resulting reduction in dividends. This information, which cannot be deduced from the "other current income" aggregate reported in the general government account, is necessary to eliminate any possible element of inconsistency in the policy scenario. It should also be recalled that, in the case of disposals of equity investments whose return is greater than the interest expenditure on the public debt, the short-term reduction in the stock of debt may not necessarily improve the sustainability of the residual debt in the medium term.

More generally, the EFD lacks a comprehensive picture of the Government's industrial policy regarding equity investments. It should be clarified whether, in addition to the policy of divesting holdings in order to reduce the debt, the policy developments reflect an extension of public intervention in other sectors of economic activity, such as, for example, air transport or public management of water resources, both of which are mentioned in the NRP.[29]

[29] In particular, it cites the bill on the public management of the integrated water cycle, currently being examined in the Chamber of Deputies (A.C. no. 773). The EFD also refers to the revival of the air transport sector and other sectors that have been experiencing crises for some time now.

Local government debt

Local government debt is very low compared with total general government debt, but it nevertheless has a role in achieving the policy reduction in the debt/GDP ratio: the trend in the local component of debt is sharply decreasing, falling by about €2.4 billion a year and from 7.2 per cent of GDP in 2018 to 6.1 per cent in 2022.

In the EFD, local government debt is reported gross of liabilities to other subsectors.[30] Since it is not consolidated debt, the sum of the components by subsector is greater than total general government debt and, in particular, the size of the local component of the debt indicated above (which includes the liabilities in respect of the MEF) is overestimated with respect to the corresponding consolidated component. Despite this caveat, the progressive reduction of local government debt assumed by the EFD over the forecast horizon appears significant.

The EFD forecast of a decline in the local component of the debt appears to be linked to two factors:

- the projection over the forecast horizon of the trend observed in the last decade, a period during which local government debt progressively decreased (-24 per cent in 2018 compared with 2007);

- the circumstance that the new balanced budget rules, applicable from October 2018, have, in allowing government to use accumulated surpluses, reduced the need to resort to borrowing to finance investment.

It is not clear whether, in addition to these two factors, the policy debt forecasts are also affected by any transfer of part of local government debt to the State.

In this regard, a possible risk could arise if local government borrowing should be greater than that expected in the EFD forecasts. It should be remembered that the decline recorded since 2008 also reflects the constraints of the domestic stability pact and, subsequently, the budget balance rule under Law 243/2012, which discouraged new borrowing. Instead, the new accounting rules not only allow the carry forward of surpluses from previous years (*avanzi di* amministrazione) but also the use of new borrowing to finance investment. This possibility could be exploited by local governments that do not have spendable surpluses, as the latter are not evenly distributed around the country.[31] Accordingly, it does not seem possible to rule out a recovery in the pace of local borrowing over time.

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30 See Table III.11 of the DEF, Section I.

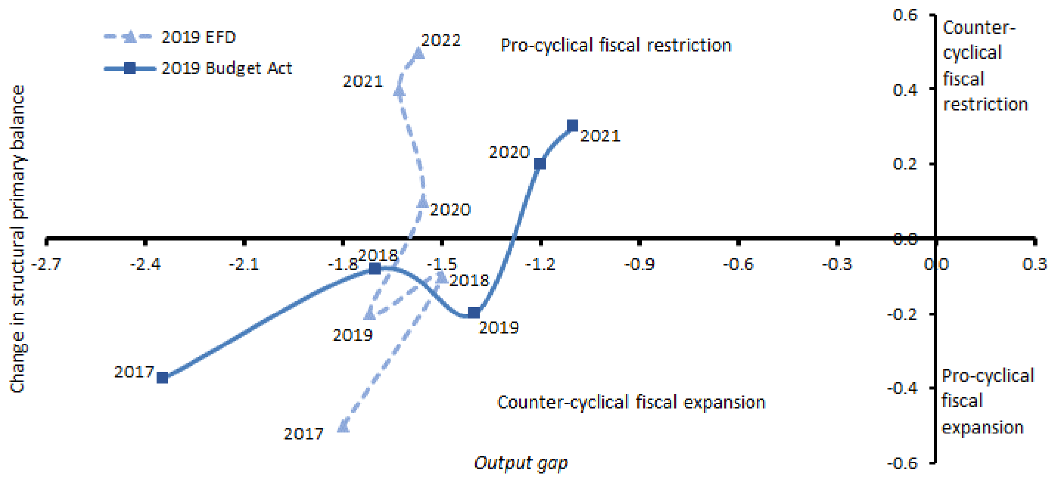
31 See Ufficio parlamentare di bilancio (2019), "Spendable surpluses of local authorities under the new budget balance rules", Focus Paper no. 3, April (text in Italian), which shows that many local authorities, especially in the Centre and South, do not have spendable surpluses.

2.5 *Analysis of the fiscal stance*

The analysis of the fiscal stance assesses the orientation of fiscal policy in relation to cyclical conditions in the economy. The latter is generally determined using the output gap (the difference between actual output and potential output, expressed in relation to the latter), while a summary indicator of the type of impulse (expansionary or restrictive) provided by fiscal policy and its intensity is given by the change in the structural primary balance (which measures the correction of public finance balances net of the cyclical component, temporary measures and interest expenditure). Comparing these two indicators therefore enables us to describe an expansionary budget (a decrease in the primary balance) as counter-cyclical or pro-cyclical depending on whether it occurs, respectively, during a contraction (a negative output gap) or an expansion (positive output gap) of the economy (the opposite holds for a restrictive budget).

The 2019 EFD does not significantly change the public finance scenario from that outlined by the 2019 Budget Act, but – based on the estimates it contains – places it within a significantly different cyclical context (Figure 2.3). If in the macroeconomic scenario underlying the Budget Act the output gap improved slowly from year to year until it reached just above 1 per cent in 2021, in the current scenario its value deteriorates by more than two-tenths of a point in 2019, and then remains at around 1.6 points in the following three years. As discussed in section 1.3.1, the developments in the output gap estimated by the PBO using five different models are qualitatively similar to that of the EFD for 2019-2020 (although the difference of actual output from potential output is smaller on average), while they differ more significantly in 2021 and 2022. In the PBO estimates, the output gap continues to improve in 2021-2022, and in fact turns positive. In these two years, the structural restriction planned in the EFD would therefore be counter-cyclical.

Figure 2.3 – Changes in the structural primary balance and the output gap
(percentage of GDP)



Source: based on data from the 2019 Budget Act and the 2019 EFD.

With the further deterioration in the EFD estimates of the cyclical phase, the expansionary measures for 2019 contained in the Budget Act would have a more markedly counter-cyclical stance (taking effect when there is greater divergence between actual output and potential). On the other hand, the policy scenario for the following three years envisages an increasingly stringent pro-cyclical restriction.

The increase in the structural primary balance in 2020-2021 remains cumulatively equal to half a percentage point, but compared with the 2019 Budget Act the correction envisaged for the first year is smaller (from 0.2 to 0.1 points of GDP, leaving fiscal policy substantially neutral in next year), while that for the second year increases (from 0.3 to 0.4 points of GDP). Finally, for 2022 the balance is expected to improve by a further 0.5 percentage points.

It is worth bearing in mind that, while the fiscal impulse that the policy scenario of the EFD implies for 2022 would be the result almost entirely of new corrective measures (such as to improve net borrowing by 0.4 percentage points compared with the trend scenario), the increase in the primary balance forecast for the next two years incorporates the activation of the safeguard clauses, and therefore of the increase in indirect taxes already provided for under current legislation (equal to 1.3 per cent of GDP in 2020 and about 1.5 per cent from 2021).

3 THE SHORT-TO-MEDIUM-TERM SUSTAINABILITY OF THE PUBLIC FINANCES

This section assesses the sustainability of the public finance policy scenario published in the EFD. The European Commission and the International Monetary Fund define the sustainability of public finances as the ability to maintain current fiscal policy in the future without causing a continuous and potentially explosive increase in debt relative to GDP.

In the baseline scenario, the fiscal policy stance corresponds to the strategy outlined in the EFD for 2019-2022, which is extended to the following years assuming an adjustment path that ensures the achievement of the medium-term objective (MTO) by the end of the simulation horizon (2028), which is currently specified as a structural surplus of 0.5 per cent of GDP (see section 4.5). Sustainability is also assessed using scenarios of the trajectory of the debt/GDP over the medium term based on alternative assumptions.

More specifically, the analysis of medium-term sustainability[32] is divided into two parts: 1) a deterministic analysis with the formulation of a baseline scenario, in which the policy path of the debt/GDP ratio presented in the EFD is extended to 2028 with ad hoc assumptions and is compared with alternative scenarios; in addition, sensitivity analyses are conducted for the time horizon of the EFD only; and 2) a stochastic analysis, in which the variables that influence the dynamics of the debt/GDP ratio are subjected to temporary and permanent shocks in order to obtain a large number of scenarios of the relationship over the next decade and determine the probability intervals.

The ad hoc assumptions to extend the policy path of the EFD debt/GDP ratio from 2023 to 2028 are the following: 1) the gradual convergence of real growth to 0.5 per cent, based on the new European Commission projections[33] of potential GDP growth for Italy; 2) the gradual convergence of the inflation rate 2 per cent, as the ECB's medium-term monetary policy target; 3) the gradual convergence of the short-term interest rate to 3 per cent; 4) the gradual convergence of the long-term interest rate to 4.5 per cent, given as the sum of the short-term interest rate and a risk premium of 150 basis points, consistent with the average for Italy since its entry into the euro area until 2018; 5) a primary structural balance that enables the gradual achievement of the MTO in 2028; and 6) an output gap that closes in three years and a value of zero for the stock-flow adjustment and one-off measures. The extrapolation is performed using a methodology similar to that of the European Commission for analysing the sustainability of public debt.[34]

32 Consistent with the analyses of the European Commission, the medium-term scenarios do not consider developments in pension spending connected with population ageing.
33 See European Commission (2017), *Debt Sustainability Monitor*.
34 See also Ufficio parlamentare di bilancio (2016), "2017 Budgetary Policy Report", Appendix 3.3.

Deterministic analysis

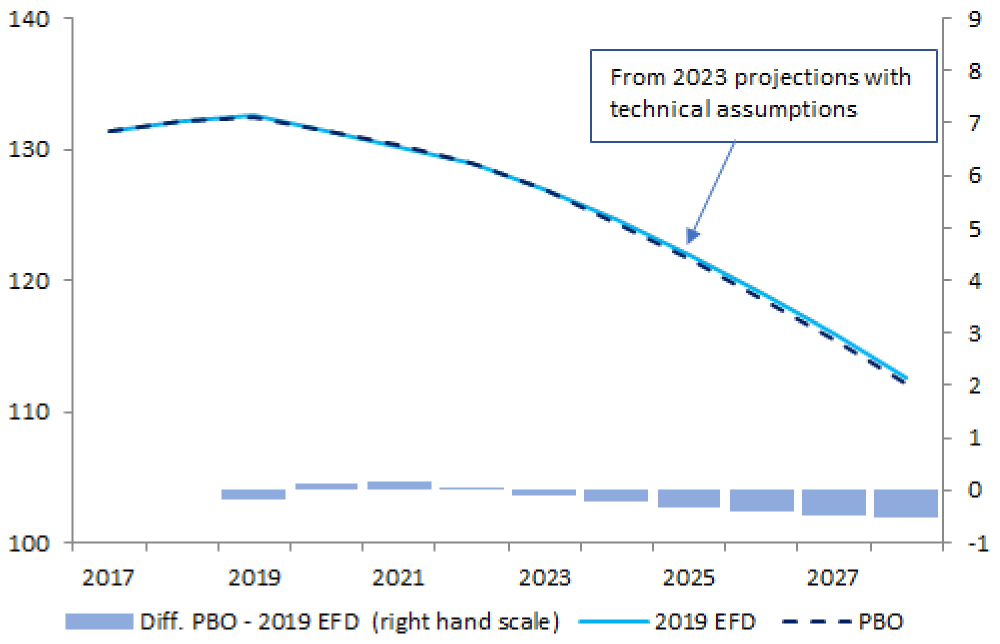
In the baseline scenario, by applying these assumptions the debt/GDP ratio continues to decline even beyond 2022. However, by the end of the medium-term forecast period, in 2028, it would still be 112.7 per cent of GDP (Figure 3.1).

This trajectory is compared with that of the debt/GDP ratio consistent with the real GDP growth and GDP deflator forecasts prepared by the PBO.

After 2022 the same assumptions used in the baseline scenario are retained for developments in the rate of real GDP growth and the inflation rate. For the entire 2019-2028 period, however, the ratio between the primary surplus and GDP is calculated by applying a semi-elasticity for this balance of 0.544[35] to the real growth differential between the PBO scenario and the EFD scenario. Furthermore, it is assumed that the inflation differential is partially translated onto interest rates. The stock-flow adjustment remains unchanged from the policy scenario in the EFD.

Considering that the PBO's forecasts for nominal GDP growth differ only slightly from those of the EFD, the developments in the debt/GDP ratio in the PBO scenario are substantially the same as those forecast in the EFD, with marginal downward deviations in the medium-term projections.

Figure 3.1 – Developments in the debt/GDP ratio in selected macroeconomic scenarios *(percentage points)*



Source: based on 2019 EFD data.

[35] In line with the update of the estimates recently released by the European Commission. See European Commission (2019), "Public finances in EMU 2018", pages 39-51, January.

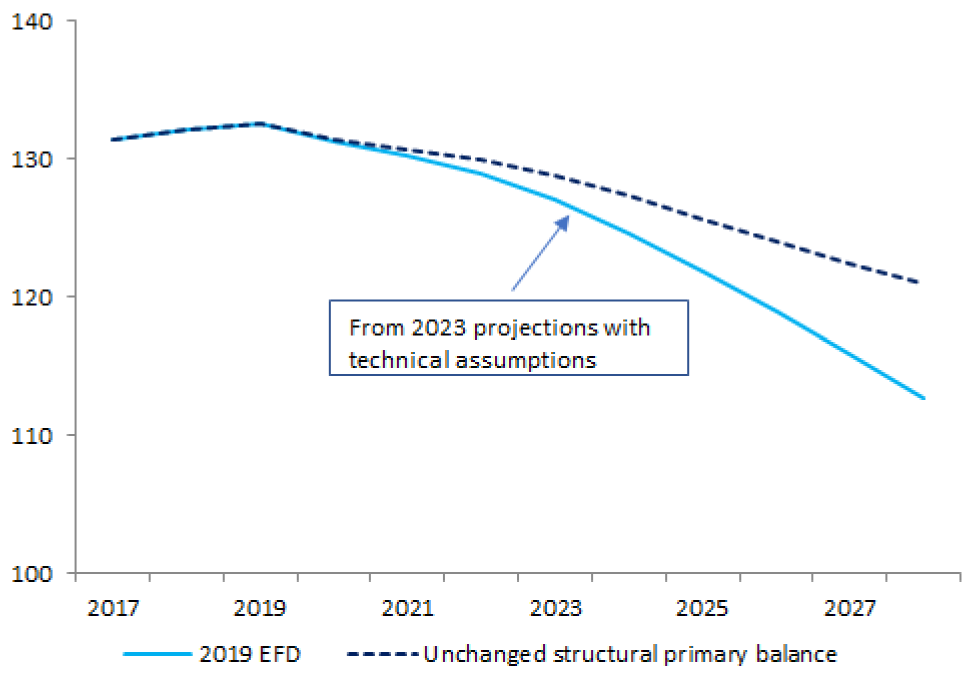
The scenario presented in the EFD is also compared with a scenario in which the structural primary balance remains constant at the level envisaged in the policy scenario for 2019 (2.1 per cent) over the entire simulation horizon.

The impact on the real growth rate of the greater deficit generated by this assumption is estimated using the average multiplier of the PBO model and measuring the fiscal policy impulses with the difference between the level of the alternative structural primary balance and that for the reference scenario. Consequently, the value of the nominal primary balance is recalculated, as in the case of the PBO scenario, by applying the estimated semi-elasticity of the balance (0.544) to the real growth differential between the two scenarios. It is assumed that the inflation rate remains unchanged from that in the reference scenario.

In this alternative scenario, the deterioration in the public finance balances would dominate the associated expansionary effects, especially in the medium term: the debt/GDP ratio would be about one percentage point higher in 2022 and more than 8 points higher in 2028 (Figure 3.2).

With regard to compliance with the debt rule with the backward-looking criterion (see section 4.4), the baseline scenario would imply a debt/GDP ratio below the benchmark only in 2028. In the PBO scenario, the same criterion would be satisfied one year earlier, while in the "unchanged policies" scenario, the debt would always remain above the benchmark (by 3.2 percentage points in 2028).

Figure 3.2 – Developments in the debt with structural primary balance unchanged at 2019 level
(percentage points)



Source: based on 2019 EFD data.

Sensitivity analysis of developments in the public debt

This section analyses the sensitivity of the debt/GDP ratio in the EFD's policy scenario with respect to alternative scenarios based on different assumptions.

a) *Impact of suspension of increases in indirect taxes, failure to achieve privatisation receipts and financing of unchanged policies*

In the first sensitivity exercise, it is assumed that the safeguard clauses, which are currently still part of the EFD policy scenario (about €23 billion in 2020 and almost €29 billion from 2021), will not be activated in 2020-2022. Note that is the assumption adopted by the European Commission and leading forecasters.

The exercise assumes an expansionary impulse equal to the amount of the safeguard clauses estimated in the Technical Report to the 2019 Budget Act, whose effects on real GDP growth are determined through the indirect tax multiplier of the PBO model. The effect on inflation is also considered, applying the elasticity of the GDP deflator to a fiscal impulse through indirect taxes, also estimated by the PBO model. It is also assumed that a change in the growth of the GDP deflator is partially (50 per cent) passed through to interest rates.

This exercise found that the debt/GDP ratio would rise slightly until 2021 and remain substantially constant around 133 per cent in 2022 (Figure 3.3).

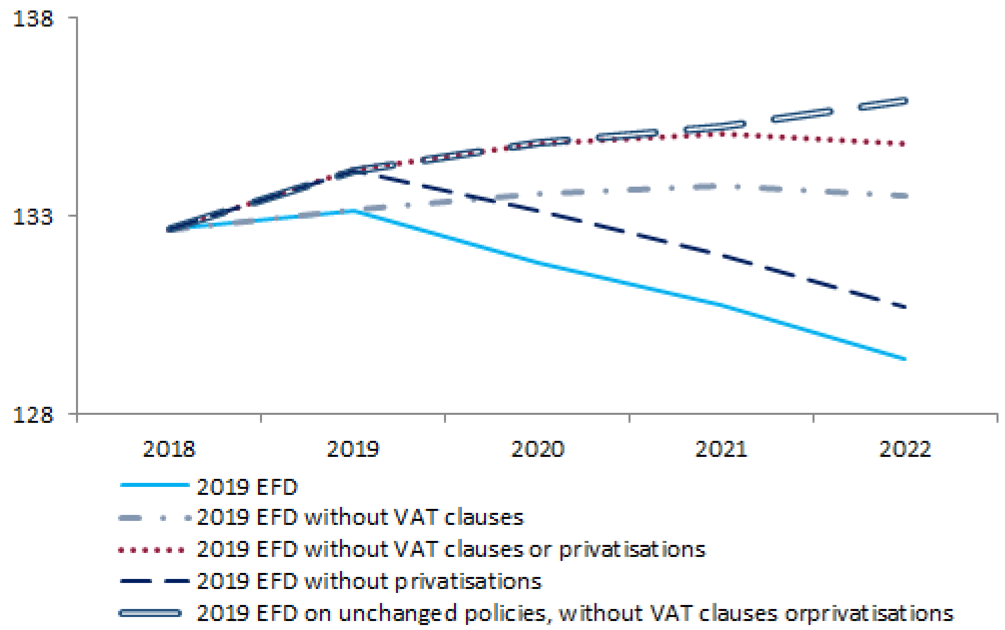
The change in the debt/GDP ratio that would be produced in three other alternative scenarios is also illustrated. In the first, the difference with respect to the policy scenario presented in the EFD consists in the failure to achieve the forecast privatisation receipts in 2019 and 2020 (equal, respectively, to 1 and 0.3 per cent of GDP).

This only produces a more unfavourable contribution of the stock-flow adjustment to debt developments in 2019-2020 compared with the baseline scenario, in an amount equal to the privatisation receipts envisaged therein.

In this simulation, the descending trajectory of the ratio from 2020 is confirmed, although it would exceed the level envisaged in the EFD by about 1.3 points, reaching 130.2 per cent of GDP in 2022.

The second simulation assumes no receipts from privatisations and deactivation of the indirect tax increases with the shortfall financed through the deficit. In this exercise, in 2019-2020, the debt/GDP ratio increases (by a total of 1.3 percentage points) compared with the ratio that would result from solely deactivating the safeguard clauses, before then paralleling it in the following two years. As a result, by 2022 the debt would reach 134.3 per cent of GDP.

Figure 3.3 – Alternative scenarios: impact of unchanged policies, no activation of indirect tax increases and failure to implement privatisations
(percentage points)



Source: based on 2019 EFD data.

Finally, the third simulation assumes that, in addition to the suspension of the safeguard clauses and the lack of privatisation receipts, the budget correction net of unchanged policies assumed in the EFD for 2020-2022 is not implemented. This would entail a further deterioration in the budget balances of 0.3 percentage points of GDP in 2021 and 0.8 points in 2022. This simulation is therefore equivalent to a public finance scenario with unchanged policies, which excludes both the activation of the safeguard clauses and the achievement of forecast privatisation receipts. In this scenario, the debt increases even further, rising to 134.7 per cent in 2021 and 135.4 per cent in 2022.

b) The debt/GDP ratio in alternative scenarios for the differential between interest rates and GDP growth ("i-g")

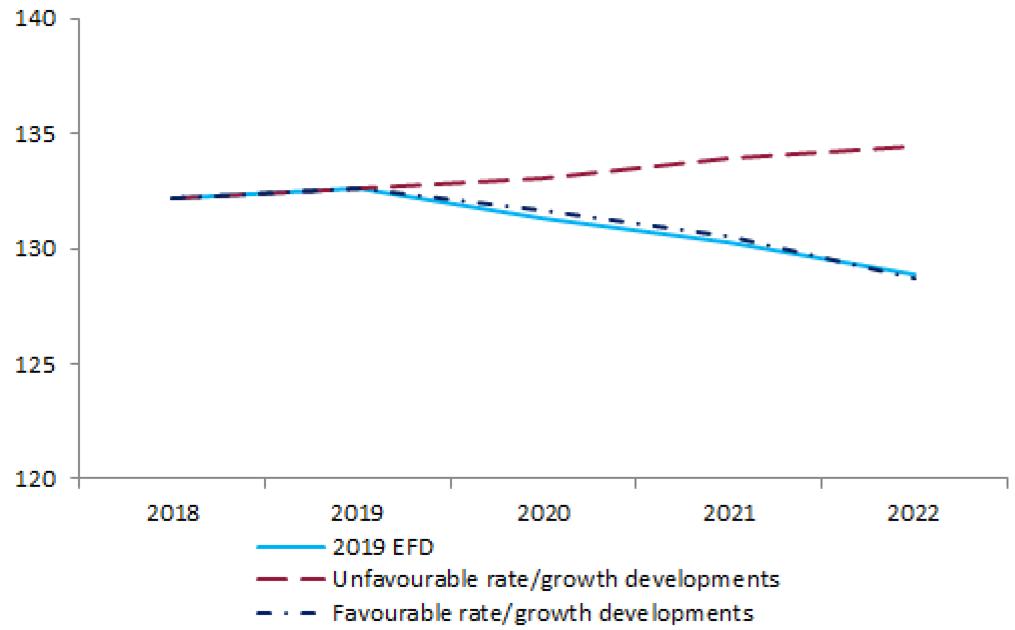
In this exercise, two different scenarios for the yield curve are developed: one scenario in which the differential between interest rates (i) and nominal GDP growth (g) is particularly unfavourable in 2019-2022 (corresponding to the seventy-fifth percentile of the distribution of this variable observed in the last 18 years, i.e. the fifth most unfavourable year) and one scenario in which the differential is particularly favourable (corresponding to the twenty-fifth percentile, or the fifth most favourable year).[36]

[36] The 75th percentile (unfavourable tail) of the distribution of the differential between the interest rate and the nominal GDP growth rate was registered in 2011 (when the differential was 1.7 percentage points); the 25th percentile (favourable tail) occurred in 2000 (-0.9 percentage points).

The results of the simulations show that especially adverse developments in interest rates with respect to the nominal GDP growth rate would put the debt/GDP ratio on a rising trajectory over the EFD forecast horizon, reaching 134.4 per cent of GDP in 2022 (Figure 3.4). In the opposite case (a favourable trend in the differential between interest rates and growth), the debt/GDP ratio would decline to 128.7 per cent in 2022. It is important to note that the EFD scenario is very similar to this second scenario. This is due in particular to the EFD scenario's particularly favourable forecast for the differential between interest rates and the growth rate in 2020, which places this value in the second decile of the distribution.

The results of these exercises suggest that, given the growth outlook envisaged in the policy macroeconomic scenario for the coming years, the (descending) trajectory of the debt/GDP ratio delineated in the EFD is likely to be achieved only if the evolution in the cost of debt service is consistent with the Government's expectations, which are in line with the current market expectations but appear especially favourable in the light of the experience of the last two decades. Faster interest rate growth would require higher primary balance targets to achieve the same amount of debt reduction relative to GDP.

Figure 3.4 – Alternative scenarios: impact of favourable or unfavourable developments in differential between interest rates and GDP growth ("i-g")
(percentage points)



Source: based on 2019 EFD data.

Stochastic analysis

To take account of uncertainties in the estimates, the EFD's policy scenario is compared with probability intervals obtained using statistical techniques in line with those used by the European Commission and the International Monetary Fund.[37] More specifically, we estimated 5,000 possible trajectories for the debt/GDP ratio, considering developments in the ratio that are consistent with the PBO macroeconomic forecasts (real GDP growth and GDP deflator). This enabled the construction of a probability fan chart under an assumption of temporary and permanent shocks to the variables that affect the behaviour of the debt.[38]

Using the equation describing debt dynamics, alternative debt/GDP ratio scenarios are obtained by shocking the variables that characterise the equation itself: the real GDP growth rate, the GDP deflator growth rate, the short-term interest rate and spreads between short- and long-term interest rates.

Considering that the macroeconomic forecasts developed by the PBO do not differ significantly from those of the EFD, the distribution obtained in the case of temporary shocks puts the ratio between the debt and the policy GDP in the EFD just below the median: in other words, in just over half of the scenarios generated with random shocks the debt/GDP ratio would be higher than projected by the EFD (Figure 3.5).

The assumption of permanent shocks produces a slightly wider distribution of the values for the debt/GDP ratio (Figure 3.6). More specifically, at the end of the period (2028) the difference between the ninetieth and tenth percentiles is equal to 53 percentage points in the case of temporary shocks, while it rises to 60 points in the case of permanent shocks; all of the deciles in the distribution have a lower value in the case of permanent shocks.

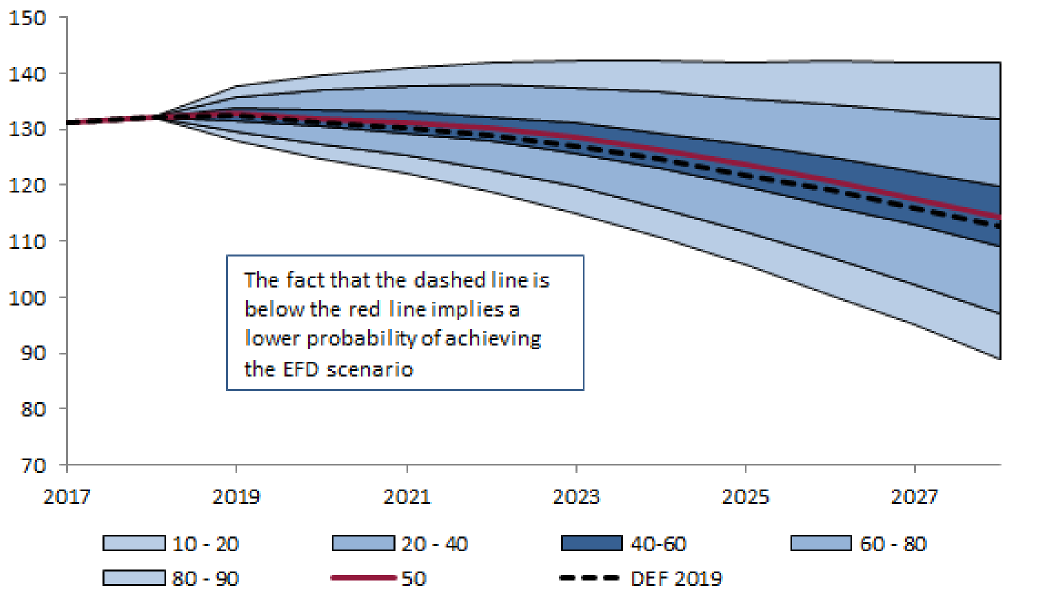
In this case, the trajectory of the debt/GDP ratio in the EFD overlaps the median in the first part of the simulation interval (until 2023), before rising above it in the following years. This is explained by the fact that the interest rate shocks accumulate, as their basis is the value of the short-term interest rate in the first year of the forecast (2019), which – although increasing compared with more recent years – is still at a low level from a historical perspective and by the assumptions of the EFD itself for 2019-2022, whose forecasts use

[37] See Berti K. (2013), "*Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries*", European Commission, *Economic Papers 480*, April.

[38] The assumption of temporary shocks provides for changes in the variables that determine developments in the debt/GDP ratio whose effects are limited to the year of the shock. The assumption of permanent shocks provides for persistent shocks over time with regard to interest rates.

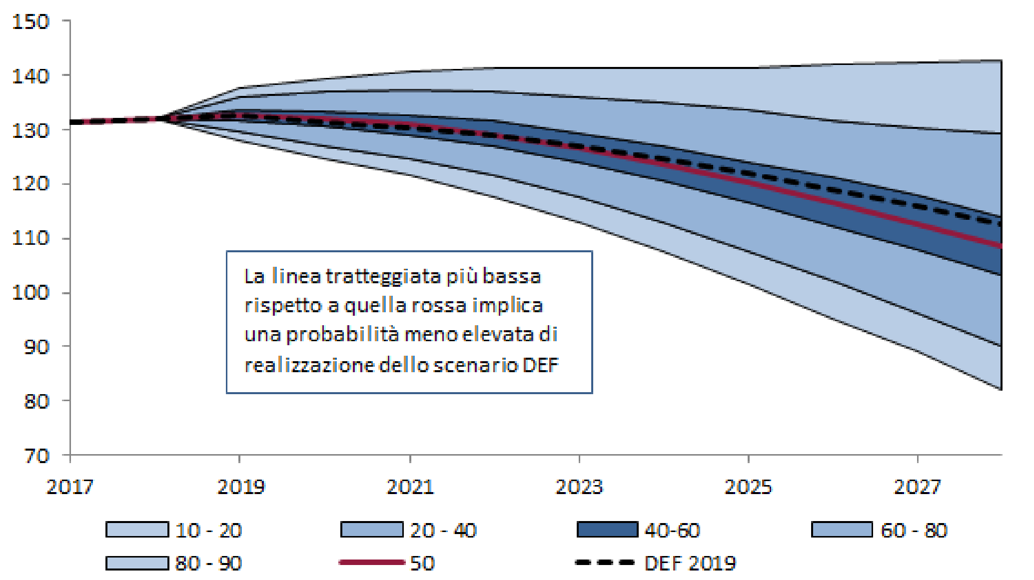
the forward curves updated in the period the document was prepared, which are less favourable.

Figure 3.5 – Stochastic analysis with temporary shocks: EFD policy scenario compared with the PBO scenario
(percentage points)



Source: based on 2019 EFD data.

Figure 3.6 – Stochastic analysis with permanent shocks: EFD policy scenario compared with the PBO scenario
(percentage points)



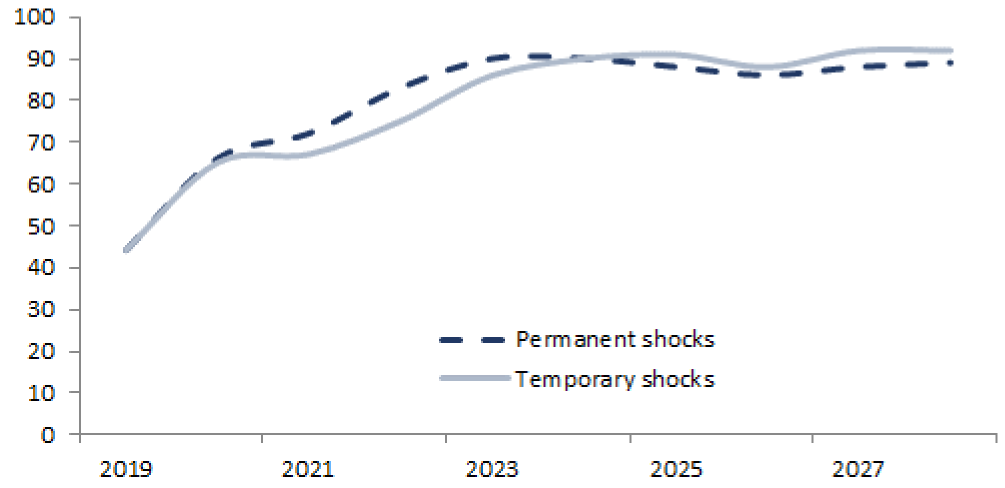
Source: based on 2019 EFD data.

Figure 3.7 reports the likelihood of a decline in the debt for each year compared with the previous year (panel A) and compliance with the debt rule on a backward-looking basis (panel B) under temporary and permanent shocks.

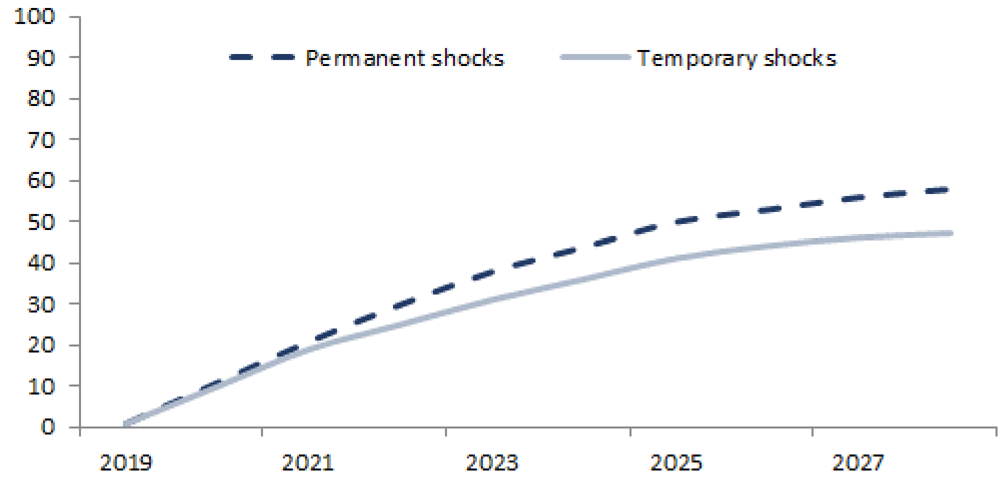
With temporary shocks, the probability of the debt/GDP ratio decreasing compared with the previous year is around 45 per cent in 2019 (the year in which the debt is expected to grow in both the EFD and PBO scenarios) and rises until the end of the period, reaching around 90 per cent from 2024 onwards. In the case of permanent shocks, the dynamic is fairly similar, with marginally higher values between 2021 and 2023.

Figure 3.7 – Stochastic analysis of temporary and permanent shocks: implicit probabilities
(percentage points)

a) Debt declines with respect to previous year



b) Compliance with the debt rule



Source: based on 2019 EFD data.

For the debt rule with the backward-looking criterion, the results indicate that the probability of compliance with the rule in the last year of the EFD forecast (2022) is around 30 per cent in case of permanent shocks and just below that (25 per cent) with temporary shocks. In the subsequent years, these probabilities rise steadily, but still remain below 60 per cent in the first case and 50 per cent in the second.

4 THE PUBLIC FINANCE OBJECTIVES IN THE LIGHT OF THE FISCAL RULES

4.1 *Overview of the assessment of compliance with the rules*

Despite the more unfavourable than expected nominal deficit targets, the policy scenario in the 2019 EFD envisages, due to more pessimistic macroeconomic assumptions, a slightly more ambitious structural adjustment path towards the MTO compared with the policy scenario in the *Aggiornamento del Quadro Macroeconomico e di Finanza pubblica* (Update of the macroeconomic and public finance scenario) published in December 2018. Nevertheless, deviations from the required adjustments persist for almost the entire planning horizon.

For 2018, which will be evaluated *ex post* by the European Commission on the basis of its spring 2019 estimates, the structural adjustment is zero and is not adequate according to the fiscal rules, as this is less than the required 0.3 percentage points, which had been halved due to the application of the "margin of appreciation" by the European Commission. In addition, the growth in the expenditure aggregate is greater than the maximum target, confirming the inadequacy of the adjustment. The EFD provides some explanation, albeit a partial one, of the estimated deviation, as required by Italian legislation, but does not indicate whether this deviation will impact the results for subsequent years or whether the 2020 policy objectives already achieve the requirements of the correction mechanism. Therefore, the procedures of the "correction mechanism" provided for by Italian law were only partially implemented.

For 2019, the EFD forecasts a structural deterioration of 0.1 percentage points. On the basis of the EFD estimates for the structural balance rule, there is the risk of a non-significant deviation in annual terms and a close to significant deviation in two-year terms, also considering the flexibility of 0.18 percentage points for exceptional events granted by the Commission in December. Considering instead last year's Commission estimates, as provided for in the Vademecum of the Stability and Growth Pact, the required adjustment would be larger and, therefore, there would be a risk of a significant deviation in annual terms as well. However, the required adjustment could be revised downwards in the spring of next year should the 2019 data indicate a recession or very bad economic conditions. For the expenditure benchmark, the EFD foresees the risk of a non-significant deviation in annual terms and a significant deviation in two-year terms. However, according to the estimates of the Commission, as envisaged by the Vademecum, there would be the risk of a deviation close to significance in annual terms and a significant deviation in two-year terms.

As regards the subsequent three years, for the structural balance rule the EFD forecasts indicate a risk of a non-significant deviation from the structural adjustment in annual terms in 2020, the possibility of compliance with the rule in 2021 and the risk of a non-significant deviation in 2022. In two-year terms there is the risk of a deviation close to significance in 2020 and a non-significant deviation in 2021 and 2022. For the expenditure benchmark, for 2020 the EFD forecasts no deviation and, therefore, full compliance with the rule in annual terms and the risk of a non-significant deviation in two-year terms.

Finally, there is no compliance with the numerical debt reduction rule either in 2018 or in the forecast period, despite the Government's forecast for a decline in the debt/GDP ratio in 2020-2022.

Considering the deviations from both the structural balance rule and the expenditure rule for 2018, the Commission, using its spring 2019 estimates, will conduct an overall assessment to establish whether Italy is compliant with the preventive arm of the Stability and Growth Pact and determine whether opening a significant deviation procedure is warranted. The findings of this overall assessment should also have an impact on the analysis that the Commission should perform as a result of the non-compliance with the debt rule in 2018. In the spring of 2019, the Commission should prepare a new Report pursuant to Article 126(3) of the TFEU to evaluate the possible opening of an excessive deficit procedure (EDP) for non-compliance with the debt criterion.

Italy's new medium-term objective (balanced budget under Italian legislation) is indicated in the EFD starting from 2020. It is equal to a structural surplus of 0.5 percentage points of GDP, compared with the previous objective of zero structural balance. The revision of the Italian MTO recently decided at EU level is due both to the deterioration in the public finance scenario and to the increase in the forecast for long-term developments in public expenditure linked to the ageing of the population (ageing cost), which require a more ambitious budget balance objective to ensure the sustainability of the public finances. The recent measures impacting the social security system could lead to a request for an even higher MTO on the occasion of the review procedure scheduled for 2021 if pension expenditure savings after 2040 do not offset previous increases.

4.2 The structural balance rule

Despite the deterioration in the nominal budget balances, the policy scenario of the EFD provides for a slightly better structural adjustment towards the MTO compared with the policy scenario outlined in the "*Aggiornamento del quadro macroeconomico e di finanza pubblica*" published last December.[39] Nevertheless, deviations from the adjustments required by the fiscal rules remain for almost the entire planning horizon.

The assessment of compliance with the fiscal rules in the spring is structured into an *ex post* analysis for 2018, an in-year analysis for 2019 and an *ex ante* analysis for 2020 and the following two years. The evaluation by the European Commission will be based on the 2019 Stability Program contained in the 2019 EFD.

Table 4.1 reports the values published in the EFD for the assessment of compliance with the structural balance rule, and – when they differ – those determined on the basis of EFD data taking into account the Vademecum on the Stability and Growth Pact prepared by the European Commission.[40] In particular, it sets out the main elements to be considered in evaluating compliance with the structural balance adjustment requirement and the conclusions to be drawn on the estimated deviations (on an annual and two-year basis) from the required adjustment.

As regards 2018, in the EU Council Recommendations of July 2017, the Commission announced that in assessing the 2018 DBP and the outcomes for 2018, it would take account of the need for Italy to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of the public finances.[41]

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39 http://www.mef.gov.it/inevidenza/article_0385.html.

40 See *Vade Mecum on the Stability and Growth Pact – 2019 Edition* (COM), available at https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_en.

41 https://eur-lex.europa.eu/legal-content/IT/TXT/PDF/?uri=CELEX per cent3A32017H0809 per cent2811 per cent29.

Table 4.1 – Assessment of compliance with the structural balance rule (1)
(percentage of potential GDP)

Structural balance rule	2018 (2)		2019		2020	2021	2022
	2019 EFD	Vademecum	2019 EFD	Vademecum	2019 EFD	2019 EFD	2019 EFD
Structural balance adjustment required excluding clauses (a) (3)	0,5	0,6	0,25	0,6	0,5	0,25	0,5
Flexibility for exceptional events (road transport and hydrogeological risk 2019) (b)	0,0	0,0	0,18	0,18	0,0	0,0	0,0
Flexibility for margin of appreciation (c)	0,3	0,3	0,0	0,0	0,0	0,0	0,0
Adjustment required including clauses, exceptional events and margin of appreciation (e=a-b-c)	**0,3**	**0,3**	**0,07**	**0,42**	**0,5**	**0,25**	**0,5**
Annual structural adjustment (f)	**0,0**	**0,0**	**-0,14**	**-0,14**	**0,2**	**0,3**	**0,3**
Deviation from required adjustment on one-year basis (g=f-e) (4)	**-0,3**	**-0,3**	**-0,2**	**-0,6**	**-0,3**	**0,0**	**-0,2**
Compliance on one-year basis	***Adj. not adeq.***	***Adj. not adeq.***	***Dev. not sign.***	***Sign. dev.***	***Dev. not sign.***	***Yes***	***Dev. not sign.***
Deviation from required adjustment on two-year basis (4)			**-0,27**	**-0,44**	**-0,27**	**-0,14**	**-0,08**
Compliance on two-year basis			***Dev. close to sign.***	***Sign. dev.***	***Dev. close to sign.***	***Dev. not sign.***	***Dev. not sign.***

Source: based on 2019 EFD data and European Commission estimates.
(1) Totals may not match due to rounding of decimals. – (2) The deviation for 2018 on a two-year basis is not reported as, following application of its "margin of appreciation", the European Commission will assess that year only with regard to full compliance (i.e. with no scope for deviation) with the rule on a one-year basis. – (3) According to the Vademecum of the SGP, the required adjustment for a given year is established in the spring of the previous year on the basis of the spring forecasts of the European Commission. – (4) Compliance is achieved if the deviation of the structural adjustment from the required effort is nil or positive. If the one-year deviation is negative and between 0 and -0.5 (0 and -0.25 for the deviation over two years taken together), then the deviation is not significant. If the one-year deviation is negative and greater than -0.5 (-0.25 for the deviation over two years taken together), then the deviation is significant. For 2018, following application of the margin of appreciation, a smaller adjustment than that required is not considered adequate.

In the 2018 DBP, the Government had planned an improvement in the structural balance of 0.3 points of GDP in 2018, instead of the 0.6 points indicated by the direct application of the matrix which determines – in accordance with cyclical conditions – the adjustment under the preventive arm.[42] In the opinion on the 2018 DBP,[43] the European Commission announced that it had conducted a qualitative assessment of the economic recovery in Italy while giving due consideration to the sustainability of the public finances. The Commission concluded that the economic recovery was still fragile, while the estimated output gap was subject to

[42] European Commission (2019), "*Vade Mecum on the Stability and Growth Pact*", 2019 Edition, https://ec.europa.eu/info/publications/vade-mecum-stability-and-growth-pact-2019-edition_en
[43] https://ec.europa.eu/info/sites/info/files/economy-finance/c-2017-8019-en.pdf

uncertainty. For these reasons, a structural effort of 0.3 points GDP, rather than 0.6 points, seemed appropriate to the Commission for 2018, thus deciding to apply the "margin of appreciation".[44] The Commission specified, however, that the reduction of the structural effort would leave the Member State "without any additional margin of deviation over one year". This position was reaffirmed in the Recommendations of the EU Council of July 2018.[45]

It should be noted, however, that already in the EFD 2018, which only contained the trend scenario, the expected improvement in the structural balance was equal to one-tenth of a point, below the adjustment required by the fiscal rules, while the change in the structural balance in the 2018 Update to the EFD was equal to two-tenths of a point, still smaller than the requirement. This structural improvement of two-tenths was confirmed in the *Aggiornamento del Quadro Macroeconomico e di Finanza pubblica*" of last December, which finalised the agreement between the Italian Government and the Commission to avoid the opening of an EDP for non-compliance with the debt criterion.

In the 2019 EFD, the final estimate of the change in the structural balance in 2018 is zero, thus indicating a smaller adjustment effort than that required by the fiscal rules.

In this context, Law 243/2012, Article 8, provides that the Government, on the basis of the final outturn, shall verify whether, with reference to the outcome of the previous financial year, there has been a deterioration in the structural balance compared with the policy objective equal or superior to the deviation considered significant under the EU rules. If it estimates that this deviation will be reflected in the results expected for the years covered by the planning period, the Government must highlight the scale and causes of the deviation and must take corrective measures (the so-called correction mechanism).

In the 2019 EFD, the MEF only provides a partial explanation of the deviation of three-tenths of a point from the required adjustment under the fiscal rules. Half of the failure to achieve the structural correction of two-tenths of a point envisaged in the December

[44] According to Commission's 2017 estimate of the output gap, Italy was in normal times in 2018 and, under the fiscal rules, should have made an structural effort of 0.6 percentage points. According to the estimated output gap in the 2019 EFD, cyclical conditions in 2018 were bad, and therefore the required structural adjustment should have been 0.5 points. These different assessments explain the differences for 2018 in line (a) of Table 4.1 between the columns "2019 DEF " and "Vademecum". Note that according to the Vademecum assessments of compliance with the fiscal rules must use the estimates formulated by the Commission. In this case, the differences did not have an impact as the application of the margin of appreciation meant that in both cases the required adjustment was equal to 0.3 percentage points with no additional margin of deviation.

[45] https://eur-lex.europa.eu/legal-content/IT/TXT/PDF/?uri=CELEX:32018H0910(11)&from=EN

2018 document is attributed to the revision of potential GDP, while the other half is ascribed to capital expenditures exceeding forecasts, presumably linked to a greater than expected use of tax credits for research and development expenditure. No explanation is provided for the additional correction of a tenth of a point required under the fiscal rules that did not materialise. Furthermore, the MEF does not clarify whether the failure to adjust in 2018 is reflected in the policy path for the following years and whether the policy objectives for 2020-2022 already comply with the provisions of the correction mechanism, i.e. a return to the structural policy objective.

Examining the application of the law since its entry into force, the criteria that should guide the implementation of the corrective mechanism set out in Article 8 remain uncertain. In the spirit of the law, the MTO was to be the benchmark for demonstrating the return to the policy objective. The continual updating of the plans for adjustment towards the MTO forces to find another parameter, possibly policy structural balance for the reference year (2020 for the actual deviation recorded for 2018), which was indicated in the most recent plan for returning to the path of adjustment approved by Parliament. In this specific case, the most recent plan approved by Parliament was amended (without a new vote) on the basis of the December 2018 agreement with the European institutions.

Moreover, requiring a return towards the structural objectives specified in previous years is likely to be difficult to implement, given that they have in practice proved to be highly sensitive to the technical parameters used to estimate potential output.

In actual experience, the change in the structural balance has proved more stable, making it a candidate for use as a benchmark for the correction mechanism. Note that the policy structural correction for 2019-2021 incorporated in the 2019 EFD is one-tenth of a point better than that provided for in the Government's December document in each of the three years. It would be helpful if the Government would clarify whether this policy profile corresponds to the commitment, for the purposes of the correction mechanism, to recoup in subsequent years the correction not achieved in 2018.

As regards 2019, the EFD forecasts a structural deterioration of 0.1 percentage points. Based on estimates of the output gap, real GDP growth and potential growth contained in the EFD, the required adjustment for 2019 would be 0.25 percentage points, reduced to 0.07 percentage points after considering the requested flexibility of 0.18 percentage points for exceptional events, included in the 2019 EFD, for expenditure connected with initiatives to counter hydrogeological instability and work on the road network. Considering last year's Commission estimates, as provided for in the Vademecum, the adjustment required before flexibility would be 0.6 percentage points. The required adjustment would fall 0.42 percentage points as a result of the flexibility request of 0.18 percentage points.

The required adjustment given in the 2019 EFD is based on the MEF estimates of the output gap, real GDP growth and potential GDP growth. However, according to the Vademecum, the required adjustment for 2019 was established and "frozen" in the spring of 2018 based on the European Commission's estimates of the output gap, real GDP growth and potential GDP growth. According to the Vademecum, in order to avoid unwarranted consequences arising from fluctuations in the output gap and the structural balance, the required adjustment can be "unfrozen" if the Member State is in recession (negative growth) or in very bad times (output gap less than -3). This "unfreezing" can take place in two specific moments: in the autumn of 2018 (and on this occasion this did not occur for Italy) and in the spring of 2020, again based on the estimates of the European Commission, when the *ex post* assessment of compliance is conducted by the Commission.

Therefore, using the estimates of the EFD, there is a risk of a deviation of -0.2 percentage points of GDP in annual terms and -0.27 points of GDP in two-year terms, the first not being significant and the second close to significance. However, according to last year's Commission estimates, there is a risk of a deviation of around -0.6 percentage points of GDP in annual terms and a deviation of -0.44 points on a two-year basis, both of which are significant.

As regards the subsequent three years, the scenario contained in the 2019 EFD shows a structural adjustment of 0.2 percentage points of GDP in 2020, and 0.3 points in 2021 and 2022. Since the required adjustment – according to the estimates contained in the EFD – is equal to 0.5 points of GDP in 2020, 0.25 points in 2021 and 0.5 points in 2022, there is the risk of a deviation on a one-year basis of -0.3 points of GDP in 2020, which is not significant, compliance with the rule in 2021 and the risk of a deviation of -0.2 points of GDP in 2022, which is not significant. In two-year terms, there is also the risk of a deviation close to significance in 2020 and a non-significant deviation in 2021 and 2022.

4.3 The expenditure benchmark

Under the expenditure benchmark, the values given in the 2019 EFD point to an inadequate adjustment in annual terms in 2018 despite the degree of discretion granted by the Commission. Accordingly, there is a risk of non-compliance with this rule as well. For 2018, the estimates of the EFD imply an increase in the expenditure aggregate (1.8 per cent), net of one-off and discretionary revenue measures (DRM) that exceeds the maximum target (0.5 per cent), as shown in Table 4.2. The difference is equal to 0.6 percentage points of GDP, indicating a significant deviation.

For 2019, the EFD forecasts an increase of 1.7 per cent in the expenditure aggregate, greater than the maximum target (1.3 per cent), representing the risk of a deviation of -0.2 points of GDP in annual terms, which is not significant, and a risk of deviation of -0.37 points of GDP in two-year terms, which is significant. The maximum expenditure target reported in the EFD was calculated on the basis of the required structural adjustment estimated in that document, equal to 0.07 percentage points, including the requested flexibility. However, the required structural adjustment established last year by the European Commission, in accordance with the Vademecum but with the possibility of revision under certain circumstances in the spring of 2020, would be 0.42 percentage points, including the requested flexibility. The required adjustment produces a lower maximum growth target than that indicated in the EFD (0.5 per cent), and therefore a greater risk of deviation, equal to -0.5 points of GDP in annual terms, or close to significance, and a risk of deviation of -0.55 points of GDP in two-year terms, which would be significant.

For 2020, on the other hand, the EFD reports an expansion in the expenditure aggregate equal to the maximum target (0.5 per cent), indicating compliance with the rule in annual terms (zero deviation) and a risk of deviation of -0.10 points in two-year terms, which would not be significant.

Given the deviations for 2018 from both the structural balance rules and the expenditure benchmark, the Commission is expected to conduct an overall evaluation in May, using its spring 2019 estimates on the occasion of its assessment of stability programmes, to determine if Italy has complied with the preventive arm of the Stability and Growth Pact and whether a procedure for significant deviation should be opened. The result of this evaluation will also have an impact on the analysis that the Commission should conduct as a result of the failure to comply with the numerical debt rule in 2018 as well. In past evaluations, compliance with preventive arm of the Pact has been considered as one of the main relevant factors for avoiding the opening of an EDP for non-compliance with the debt reduction criterion.

Table 4.2 – Deviations and compliance with the expenditure benchmark (1)
(percentage points)

Expenditure benchmark	2018 (2)	2019		2020
	2019 EFD	2019 EFD	Vademecum	2019 EFD
Corrected nominal expenditure growth net of one-offs and DRMs	1.8	1.7	1.7	0.5
Maximum annual expenditure growth target	0.5	1.3	0.5	0.5
Deviation from annual target (% GDP) (3)	**-0.6**	**-0.2**	**-0.5**	**0.0**
Compliance with expenditure benchmark (annual)	***Adj. not adeq.***	***Dev. not sign.***	***Dev. close to sign.***	***Yes***
Two-year deviation (% GDP)		**-0.37**	**-0.55**	**-0.10**
Compliance with expenditure benchmark (two-year average)		***Sign. dev.***	***Sign. dev.***	***Dev. not sign.***

Source: based on 2019 EFD data and European Commission estimates.
(1) Totals may not match due to rounding of decimals. – (2) The deviation for 2018 on a two-year basis is not reported as, following application of its "margin of appreciation", the European Commission will assess that year only with regard to full compliance (i.e. with no scope for deviation) with the rule on a one-year basis. – (3) Compliance is achieved if the deviation of net expenditure growth from the required effort is nil or positive. If the one-year deviation is negative and between 0 and -0.5 (0 and -0.25 for the deviation over two years taken together), then the deviation is not significant. If the one-year deviation is negative and greater than -0.5 (-0.25 for the deviation over two years taken together), then the deviation is significant. For 2018, following application of the margin of appreciation, a smaller adjustment than that required is not considered adequate.

The excessive deficit procedure (EDP) is part of the corrective arm and can be invoked for failure to comply *ex post* with the debt criterion, i.e. a debt/GDP ratio of at most 60 per cent or – if greater than this threshold – an annual reduction in the ratio of one twentieth of the portion exceeding the ceiling. It may also be invoked for failure to comply *ex ante* or *ex post* with the nominal deficit criterion, i.e. a maximum nominal deficit/GDP ratio of 3 per cent. The significant deviation procedure (SDP) is part of the preventive arm and can be invoked for significant *ex post* deviation as assessed by the Commission in the spring of the following year based on the deviation in the adjustment of the structural balance from the required adjustment or the deviation of growth in net expenditure from the maximum growth target.

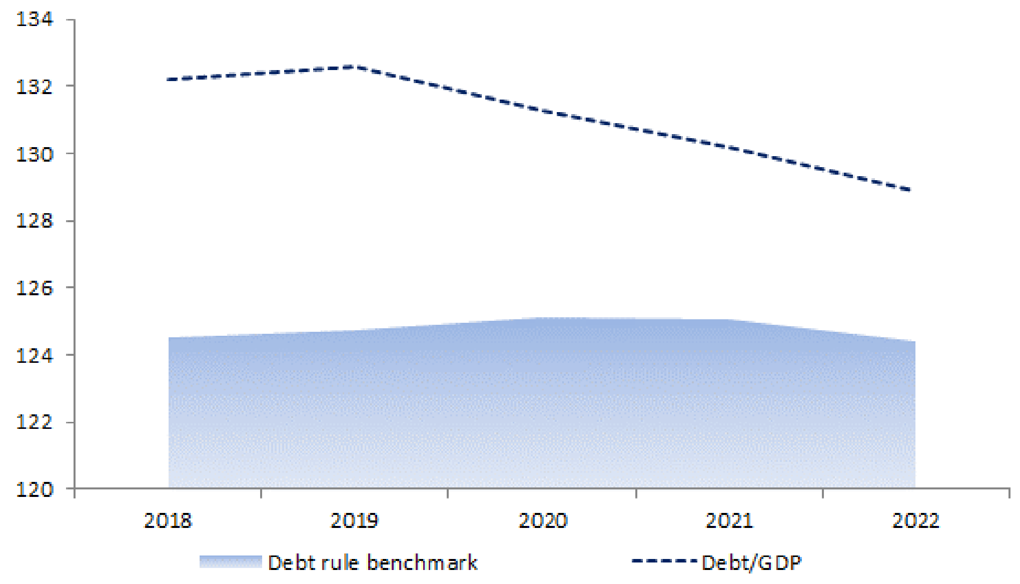
4.4 The debt reduction rule

The profile of the policy debt/GDP ratio described in the EFD is less favourable than that presented in the "Aggiornamento del quadro macroeconomico e di finanza pubblica" last December, with an increase of 0.5 points of GDP in 2018, rising to an estimated difference of 2 points of GDP in 2021, accompanied by an increase in the ratio in 2019 in place of the previously forecast reduction. The trend in the debt/GDP ratio given in the EFD shows a slight increase in 2018 (from 131.4 to 132.2 points of GDP) and 2019 (to 132.6 points of GDP), a decline in 2020 (to 131.3 per cent) followed by further reductions to 130.2 per cent in 2021 and 128.9 per cent in 2022.

Despite the decline in the debt in 2020-2022 envisaged by the Government, Italy does not comply with the numerical debt reduction rule in the programming period, either with the backward-looking criterion until 2022 (Figure 4.1) or the forward-looking criterion until 2020, nor with the cyclically-adjusted criterion.

As noted in previous PBO publications, compliance with the rule using the forward-looking method in a given year is the equivalent of complying with the rule using the backward-looking approach two years after the reference year. For example, not complying with the rule using the backward-looking approach in 2022 implies non-compliance with the rule in 2020 using the forward-looking criterion. This also means that given the current state of information it is not possible to assess compliance with the rule using the forward-looking approach for 2021-2022, because that would require projections for the debt/GDP ratio for 2023-2024.

Figure 4.1 – Compliance with the debt/GDP reduction rule
(percentage of GDP)



Source: based on 2019 EFD data for the backward-looking rule.

Recall that the European Commission, considering the failure to comply with the rule in 2017, prepared a report under Article 126(3) of the TFEU in May 2018 that concluded that the rule had been complied with, postponing preparation of a new report to the spring of 2019. However, due to the material changes reported in the 2019 DBP, the Commission prepared the report earlier, in November 2018, recommending the opening of an excessive deficit procedure for non-compliance with the debt criterion in 2017 because of the "particularly serious non-compliance" with the Stability and Growth Pact. The objectives and measures set out in the *Aggiornamento del Quadro Macroeconomico e di Finanza pubblica* would eliminate this "particularly serious non-compliance", making it possible for the Commission to avoid recommending the opening of an EDP against Italy for failure to comply with the debt criterion in 2017. However, given the failure to comply with the debt reduction criterion in 2018 as well, in the spring of 2019 the Commission should prepare a new report under Article 126(3) of the TFEU based on the outturn for 2018.

4.5 *Modification of the medium-term objective (balanced budget) as from 2020*

The EFD indicates Italy's new MTO valid from 2020. It is equal to a structural surplus of 0.5 percentage points of GDP, a more stringent target than that declared in previous policy documents, which called for a zero structural budget balance. Note that previous documents, in specifying zero structural balance as the MTO, set a more ambitious MTO than the minimum determined using the EU methodology, which until the recent revision produced an MTO for Italy equal to a structural deficit of 0.5 per cent of GDP. The revision of the MTO under the European method is therefore equal to 1 percentage point of GDP.

At the national level, Law 243/2012 (art. 3, paragraph 1) establishes that general government entities shall contribute to ensuring a balanced budget pursuant to Article 97, paragraph 1 of the Constitution. The same law (Article 3, paragraph 2) defines a balanced budget as corresponding to the MTO, in turn understood as the value of the structural balance identified on the basis of the criteria established under European Union regulations. Note that as a result of the referral in the Italian legislation to European law, the adjustment of the MTO does not require a legislative modification of the definition of balanced budget.

The MTO is calculated at the EU level on the basis of a procedure set out in the Code of Conduct[46] of the Stability and Growth Pact (PSC) and is reviewed every three years, following the publication of the Commission report on the ageing of the population, to which it is linked in view of the medium/long-term projections that it contains for expenditure connected with the ageing of the population.

Under the European methodology, the MTO is given by the most stringent of three different indicators: 1) the minimum value of the structural balance which ensures, with a high degree of probability, that in the event of a recession the nominal deficit would not exceed the threshold of 3 per cent of GDP (the minimum benchmark); 2) the structural budget balance that ensures the sustainability of the public finances in the light of the effort required to stabilise the debt at 60 per cent of GDP in the long term, of the supplemental debt-reduction effort necessary for countries that have a debt to GDP ratio above this threshold and that necessary to cover a fraction (33 per cent) of ageing costs,[47] i.e. the increase in expenditure connected with the ageing of the population (medium-term objective implicit liabilities and debt); and 3) net structural borrowing not exceeding

[46] Economic and Financial Committee (2017), "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes", http://data.consilium.europa.eu/doc/document/ST-9344-2017-INIT/en/pdf.

[47] The change in the structural primary balance needed to offset, for an infinite horizon, the increase in age-related expenditure with respect to the base year. Beyond the final forecast year (2070), it is assumed that age-related expenditure remains constant at its final value as a ratio to GDP. More specifically, the present value of all changes (positive and negative) in the ratio of the expenditure to GDP with respect to the base year must be offset by the present value of an increase in the structural primary balance (the objective) to be achieved over the infinite horizon.

1 per cent of GDP for the Euro-area countries (0.5 per cent for countries that have signed the Fiscal Compact).

In the case of Italy, the MTO is based on the indicators included in point 2), i.e. it depends crucially on both the level of public debt as a ratio to GDP and the implicit liabilities connected with the ageing of the population: the higher the public debt to GDP ratio and the estimated impact of population ageing on public spending, the more stringent the MTO must be in order to ensure the sustainability of the public finances. The revision of the Italian MTO is due in almost equal measure to both of these components. In particular, the deficit component consistent with the stabilisation of the public debt at the 60 per cent threshold in the long term deteriorated by 0.4 percentage points (from -2.1 to -1.7 per cent), the effort required to address the worsening of the estimated growth in long-term public expenditure linked to the ageing of the population increased by 0.5 points (from a positive contribution of 0.1 points to a negative contribution of almost 0.4 points). The estimated additional effort required for countries with high debt loads remained unchanged at 1.9 points.

The greater effort required to stabilise the debt derives from the deterioration in the European Commission's Autumn Forecasts of the debt to GDP ratio forecast for 2020 and from less favourable projections for long-term nominal growth. The impact of population ageing on public spending is estimated on the basis of a common methodology agreed within the Ageing Working Group (AWG), whose members consist of representatives of the European Commission and the Member States. The projections are calculated over a time horizon of 50 years.

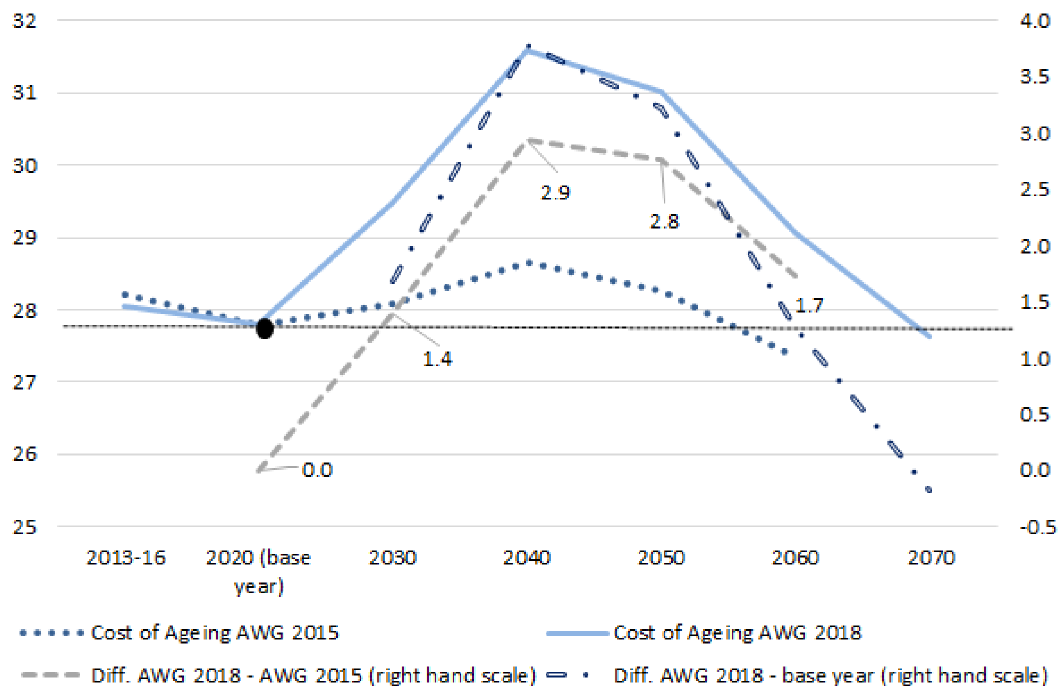
The components of public spending that are especially dependent on demographic variables are pensions, healthcare, long-term care, education and unemployment benefits (passive labour market policies). While the first three of these expenditure components increase as a percentage of GDP in relation to the ageing of the population, spending on education and unemployment benefits typically tend to fall, ceteris paribus, as an older population implies both fewer individuals of school age or working age (and therefore exposed to the risk of unemployment). The Commission reports contain forecasts for the growth in each of these five components of public expenditure, based on projections for demographic dynamics and the main macroeconomic variables.

The increase in ageing costs for Italy is highlighted in the Commission's 2018 report (AWG 2018),[48] whose conclusions were adopted by ECOFIN in May 2018. Compared with the previous report in 2015 (AWG 2015),[49] in the 2018 edition, public spending in Italy affected by population ageing changed from 28.1 to 29.5 per cent in 2030, from 28.6 to 31.6 per cent in 2040, from 28.3 to 31 per cent in 2050 and from 27.3 to 29.1 per cent in 2060 (Figure 4.2). Finally, the new report, which extends the forecast horizon with respect

48 European Commission (2018), "*The 2018 Ageing Report*".
49 European Commission (2015), "*The 2015 Ageing Report*".

to the previous report, estimates that public expenditure linked to the ageing of the population will be equal to 27.6 per cent in 2070 (Table 4.3).[50]

Figure 4.2 – Medium/long-term projections of expenditure connected with population ageing
(percentage of GDP)



Source: European Commission (2015), "The 2015 Ageing Report" and European Commission (2018), "The 2018 Ageing Report".

Table 4.3 – Medium/long-term projections of the components of expenditure connected with population ageing
(percentage of GDP)

Components of expenditure	2020	2030	2040	2050	2060	2070
Pensions (2018)	15.6	17.2	18.7	17.3	15.1	13.9
Pensions (2015)	15.3	15.7	15.8	14.8	13.8	
Healthcare (2018)	6.2	6.5	6.9	7.2	7.1	7.0
Healthcare (2015)	6.2	6.4	6.6	6.8	6.7	
Long-term care (2018)	1.8	2.0	2.3	2.8	3.1	3.0
Long-term care (2015)	1.9	2.0	2.2	2.5	2.7	
Education (2018)	3.4	3.1	3.1	3.3	3.3	3.3
Education (2015)	3.5	3.3	3.4	3.6	3.5	
Unemployment benefits (2018)	0.8	0.6	0.6	0.5	0.5	0.5
Unemployment benefits (2015)	0.9	0.7	0.6	0.6	0.6	
Total age-related expenditure (2018)	**27.8**	**29.5**	**31.6**	**31.0**	**29.1**	**27.6**
Total age-related expenditure (2015)	**27.8**	**28.1**	**28.6**	**28.3**	**27.3**	

Source: European Commission (2015), "The 2015 Ageing Report" and European Commission (2018), "The 2018 Ageing Report".

[50] The values are drawn from the report's baseline scenario.

It should also be borne in mind that the ageing costs that affect the MTO are assessed over an infinite horizon, maintaining the various expenditure components as a proportion of GDP in the last forecast year (respectively 2060 in the 2015 Report and 2070 in the 2018 Report) constant over time. Comparing the two reports, we note that until 2070 the deterioration is mainly attributable to pension expenditure, while subsequently it is mainly attributable to spending on healthcare and long-term care.[51]

On the pension front, the deterioration does not depend so much on the legislative changes made after 2015[52] (the extension of the so-called fourteenth month additional pension payment, the eighth safeguard measure for those who left work under an early retirement scheme but are no longer eligible for a pension following pension reform,[53] specific measures for early career starters and for the retirement of workers in physically demanding occupations and the early retirement programme for hardship categories[54]), which have contributed to a relatively modest increase in future pension expenditure,[55] but rather on the changes in the assumptions for demographic and economic variables, which also involve the other expenditure categories. In the most recent demographic projections underlying the 2018 round, the ageing of the population is more marked and faster.[56] Furthermore, the persistence of the effects of the economic crisis is assumed to be longer and more pervasive: between 2020 and 2040, the growth rate of total factor productivity (TFP) is on average three-tenths of a percentage point lower, the

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[51] European Commission (2018), "Fiscal Sustainability Report 2018", vol. 2 (page 68): "*It is in particular the projected increase in health care […] and long-term care […] expenditure that drives up ageing costs*".

[52] The 2018 Report considers pension legislation in force in each EU country at 30 November 2017.

[53] See Ufficio parlamentare di bilancio (2016), "The problem of 'early leavers' and safeguards from the impact of the Fornero reform", Focus Paper no. 2 (text in Italian).

[54] See the *Country fiche* for Italy, attached to the 2018 Ageing Report of the Commission, https://ec.europa.eu/info/sites/info/files/economy-finance/final_country_fiche_it.pdf.

[55] Some of these measures are also temporary. The early retirement programme for hardship categories is experimental until 31 December 2019, while the deadline for participation in the eighth safeguard measure has expired.

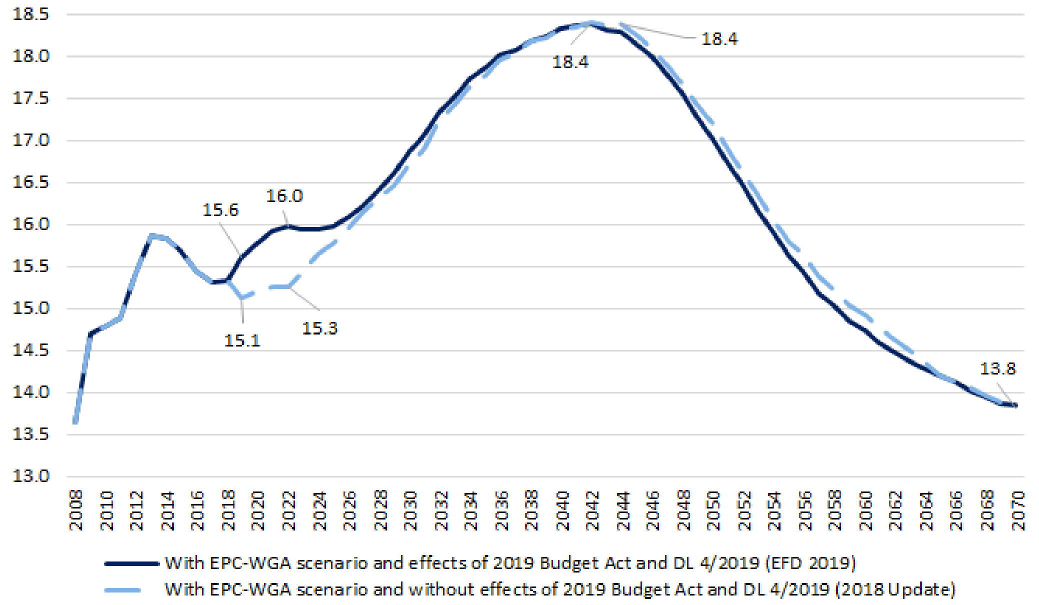
[56] The old-age dependency ratio rises from about 36 per cent in 2020 to more than 60 per cent in 2060, nearly 10 percentage points higher than in the previous Eurostat projections. Between 2020 and 2060, net migration flows decline by 100 thousand per year. The total population fall by just under 4 million between 2020 and 2060, while in the previous forecasts it had risen by more than 4 million.

employment rate is about half a percentage point lower and potential GDP growth almost one percentage point lower.[57]

The 2018 AWG projections do not include the effects of the package of pension measures adopted with the 2019 Budget Act and Decree Law 4/2019, notably, on the one hand, the *quota 100* mechanism (sum of age and years of contributions) and the suspension until 2026 of the linking of pension eligibility requirements to changes in life expectancy – which will enable people to retire earlier compared with the provisions of previous legislation, albeit with lower benefits – and, on the other, the limitation of pension indexation for 2019-2021, which permanently decreases the amount of pension benefits. Taken as a whole, these measures, as seen in a comparison between the 2019 EFD and the 2018 Update,[58] would produce a further increase in pension expenditure up to 2040 (with a peak of over 0.7 percentage points of GDP in 2022) and a slight but prolonged reduction in that spending (on average about one-tenth of a point of GDP) in the following years until 2070, the last year of the forecast horizon (Figure 4.3).[59] Until 2040, the effect of the greater pension expenditure associated with the larger number of retired people under the *quota 100* mechanism and the suspension of the adjustment of age and contribution requirements to life expectancy prevails. Subsequently, however, the reduction in retirement benefits connected with the limitation of indexing and fewer years of contributions prevails.

[57] The persistence of the effects of the crisis is obtained by applying the "t+10" methodology. See Ufficio parlamentare di bilancio (2018), "Medium-long term projections of pension spending", Focus Paper no. 8 (text in Italian).
[58] The medium/long-term effect of the recent pension reforms is clear in a comparison of the projections in the 2018 Update, which did not include those changes, and those in the 2019 EFD. The two documents enable us to refer to the forecasting exercise based on the AWG 2018 scenario and that based on the national scenario. In the description, attention focused on the former. The latter, while differing in terms of the level of expenditure, produces similar results in terms of the change in spending.
[59] These differences also reflect the changes in the trend macroeconomic scenario in the 2019 EFD compared with the 2018 Update for 2019-2022 as well as the new outturns for 2017 and 2018 released by Istat on 9 April.

Figure 4.3 – Medium/long-term projections of expenditure connected with population ageing with and without the effects of the measures in the 2019 Budget Act and Decree Law 4/2019
(percentage of GDP)



Source: based on data drawn from the 2018 Update and the 2019 EFD.

If the increase in pension expenditure expected until 2040 is not offset by a subsequent reduction in that spending, the results of the 2021 AWG exercise could imply a further upward revision of the MTO for Italy.

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