2021 Budgetary Policy Report

Summary

The 2021 Budgetary Policy Report extends and supplements with specific assessments and sectoral analysis the testimony given at the hearings on the Update to the Economic and Financial Document (EFD Update) and on the budget package by the PBO Chairman, Giuseppe Pisauro, before the Budget Committees of the Chamber of Deputies and the Senate on 12 October and 24 November.

The first of the three chapters of the Report examines **the macroeconomic scenario, taking due account of the most recent economic indicators**. In 2020, GDP is expected to have contracted by around 9 per cent, in line with the projections of the Ministry for the Economy and Finance (MEF) given in the EFD Update and the Draft Budgetary Plan (DBP), as the negative surprise in the fourth quarter would essentially offset the rebound in the summer. Moreover, the worsening economic situation undermines the outlook for 2021: even in the event of a rapid recovery beginning in the spring, thanks in part to the improvement in the economic climate following the launch of the vaccination campaign, the Government's policy forecast for GDP growth of 6.0 per cent seems difficult to achieve. On the occasion of the endorsement exercise for the macroeconomic scenario in the EFD Update, the PBO had forecast a pace of GDP growth in 2021 similar to that indicated by the Government. However, the slowdown emerging for this quarter will reduce the carry-over impulse into next year – and therefore the outlook for growth – by at least one percentage point.

The second chapter is devoted to a detailed reconstruction of **developments in the public finance aggregates in 2020 and** the measures implemented by the Government **in response to the health emergency, an exposition of the fiscal forecasts for the 2021-2023 period and an analysis of the Budget Bill for 2021 in the context of the use of EU funds**.

In 2020, the impact of the pandemic on the economy and the public finances interrupted the gradual improvement in the public accounts over the past few years, strongly influencing their performance. According to official estimates, the general government deficit, which was 1.6 per cent of GDP in 2019, is expected to rise to slightly over 10.8 per cent in 2020, while the debt should increase from 134.7 per cent of 2019 GDP to 158 per cent. During the year, the Government submitted four Reports to Parliament to request authorisation for an increase in deficit compared to previous adjustment path. The total estimated impact on general government net borrowing in 2020 following the various Decree Laws presented is equal to €113.6 billion, although the effective increase comes to €108.2 billion net of €5.4 billion in savings on deviations authorised by Parliament. Of the total deterioration in the balance, €90.1 billion is attributable to an increase in net

expenditure – mainly on current account (€74.2 billion) – and €23.4 billion to a decrease in net revenue.

According to the forecasts in the EFD Update for 2021-2023, policy net borrowing should amount to 7.0 per cent of GDP in 2021 before decreasing to 4.7 per cent in 2022 and below the 3 per cent threshold in 2023, thus improving with respect with the 3.3 per cent forecast on a trend basis. Developments in the debt/GDP ratio should be more favourable than the trend scenario in each year of the planning period, with an accentuation of its reduction. The budget contains expansionary measures of substantially similar size in terms of GDP over the three-year period: 1.8 per cent in 2021, 1.9 per cent in 2022 and 1.7 per cent in 2023, with the policy budget balances showing a progressive improvement attributable to resources that for 2022-2023 are largely linked to the tax feedback from growth created with the expansionary measures; such tax feedback is estimated by the Government at 0.7 per cent in 2022 and 1.1 per cent of GDP in 2023. The inclusion of revenue produced by fiscal feedback effects reflects the use of European funds from the NGEU programme in the policy scenario, which would have an expansionary impact on GDP and a consequent favourable feedback impact on the public finances.

However, the estimates of resources produced by the expected increase in tax revenue from expansionary measures appear to have been calculated in a scenario that still presents uncertainty concerning the timing of the use of European funds and that is based on trend developments in GDP and the public finances, that are affected by great uncertainty. Assuming that the composition and timing of the use of European funds are similar to those that could be inferred from the EFD Update, simulations performed using the models of the PBO panel forecasters indicate that the estimate of the increase in tax revenue contained in the Budget Bill appears optimistic, especially for 2023, when the estimate in the Budget Bill is overestimated by at least a quarter. Furthermore, the evolution of the public finances over the next three years depends on forecasts in the macroeconomic scenario that are still exposed to downside risks. The Government has in fact already announced its intention to assess the need for further deviations next January in light of developments in the pandemic.

The greatest risk for the deficit and developments in the debt derives from the fact that it has been decided to use these estimated amounts to finance measures permanently increasing expenditure or reducing revenue, which require structural funding in the long term.

The Budget Bill and the related documentation contain some information on the criteria for the use of the NGEU funds available to Italy, which are estimated to total €209.7 billion. In particular, the Government has elected to use €121.2 billion of the funds for new measures (to be financed using the full amount of grants available, which total €82.1 billion, and “additional” loans of €39.1 billion) and to use the remaining €88.5 billion for measures already envisaged under current legislation, to be financed with “replacement” loans.

According to the policy scenario in the EFD Update, which was confirmed in the DBP, the debt/GDP ratio is expected to decrease starting from 2021, falling from the 155.6 per cent expected for next year to 153.4 per cent in 2022 and 151.5 per cent in 2023.

The PBO has assessed the sensitivity of the policy trajectory of the ratio to an alternative scenario, based on the forecasts for real GDP growth and the GDP deflator developed by the PBO through 2023. Using standard assumptions for the impact of these variables on public finance aggregates, in the PBO scenario the debt/GDP ratio would exceed that in the EFD Update scenario over the entire period. After an initial decline in 2021, the debt/GDP ratio would start to rise again as early as 2022. The outcome of the sensitivity exercise must also be considered in light of the uncertainty about the evolution of the pandemic and the subsequent economic recovery, as well as the possible risk of a downward revision of the macroeconomic forecasts underlying these estimates.

The Report re-examines the analysis of the implications of the Eurosystem's purchase programme on the secondary market. Using a number of specific assumptions, the impact of the Eurosystem purchase programme is assessed, in particular the volume of securities net of Eurosystem purchases that will have to be absorbed by private investors. For 2020, Eurosystem purchases of Italian securities would amount to approximately 39 per cent of expected gross Treasury issues on the primary market. In this scenario, gross issues of government securities net of Eurosystem purchases would amount to €335 billion, which is less than the volume registered in 2019, when estimated purchases amounted to €384 billion. For 2021, including the recently decided expansion of the ECB's purchase programme, the total volume of Eurosystem purchases would fall to 33 per cent of total gross Treasury issues, with gross issues net of Eurosystem purchases equal to an estimated €358 billion, an increase compared with 2020, but still lower than those estimated for 2019. Net issues of government securities net of Eurosystem purchases would be negligible: a marginally positive €3 billion for 2020 and a negative €3 billion for 2021. In both 2020 and 2021, the share of government securities held by the private sector would decline at the end of the year.

The third chapter contains **qualitative and quantitative assessments of the main measures contained in the budget package and their effects on the categories and sectors concerned**.

In the context of the great uncertainty over the evolution of the pandemic and macroeconomic conditions, the budget package appears to be an amalgam of measures targeted at a variety of worthy goals but without a well-defined underlying budget policy design. More specifically, it is composed of a series of measures part of which follow in the wake of those launched previously to support the labour market and firms and part are intended to foster recovery in the coming years. In addition, it includes interventions to support households, measures regarding public employment, measures concerning pensions, healthcare and education, measures for the South and others combatting tax evasion and providing incentives for the use of traceable means of payment.

The emergency measures include the extension to the early months of 2021 of the extraordinary package of anti-crisis programmes for the labour market (COVID-19 wage supplementation or, alternatively, contribution relief; the moratorium on layoffs for financial reasons; the renewability of fixed-term contracts), a further extension of liquidity support for firms (public guarantees and the extraordinary moratorium on loan repayments), aid for industries most severely affected by the crisis, as well as a series of measures supporting the areas of public intervention directly affected by the pandemic, such as healthcare, education, security and local public transport.

The most structural measures involve a variety of major areas. First, considerable attention is devoted to investment, both public (supported both by national resources and NGEU funds), and corporate. On this latter front, the budget package extends and broadens the scope of application of the incentives already adopted in previous years through the tax credit for spending on new capital goods, investment in research and development, technological innovation and other innovative activities, and industry 4.0 training costs. An analysis of the financial statements of corporations shows that the enhanced tax credit proposed for 2021 is in any case more generous than the existing incentives. For 2022, the attractiveness of the mechanism depends on the type of asset involved: for high-tech equipment, the new tax credit is enhanced with respect to both the existing credit and the increased depreciation for investments exceeding €2.5 million.

Measures are also envisaged for the rebalancing of the financial structure of firms, encouraging their recapitalisation to compensate for the increased leverage on their balance sheets as a result of the crisis and to ensure more favourable conditions for the resumption of investment. To this end, the Budget Bill extends certain measures introduced with the May decree to incentivise the contribution of equity capital for small and medium-sized firms (those that have seen their revenues decline by more than a third compared with 2019), allows the SME Capital Fund to subscribe securities issued by certain companies benefiting from the tax credits and introduces tax incentives for business combinations carried out through a merger, spin-off or other transfer of a business.

Other substantial measures have been envisaged to support employment in the South, and in general of young people and women. In particular, the budget package extends the contribution relief previously introduced with the August decree for all employers with employees in the South until 2029. The contribution relief, which declines over the years (from 30 per cent until 2025 to 10 per cent in 2028-2029), is available for all employees in the South, not only new hires or those whose fixed-term contracts are made permanent, thus representing a reduction in the labour costs of firms operating in the South.

The package of measures for households first makes the 100 euro tax credit for payroll employees (*bonus* Irpef), introduced with Decree Law 3/2020 but financed only for the second half of 2020, a permanent benefit. But above all, the announced reform of the tax system is being launched, for now only in terms of the appropriation of financial resources. In particular, additional resources have been allocated for 2021 to the fund for the universal allowance and family services (€3 billion), while a new fund of €8 billion in 2021 and €7 billion from 2022 has been established to finance the reform. Of these resources, an annual amount of between €5 billion and €6 billion is specifically allocated to finance the universal allowance for dependent children.

While the details of the tax reform have yet to be defined, those for family support are at a more advanced stage: implementation has been delegated to a bill under discussion in Parliament that sets general criteria for the overall reorganisation of programmes to support dependent children. The resources allocated so far for the revision of family benefits, including those provided for in the Budget Bill, amount to approximately €4 billion for 2021 and between €6.2 billion and €7.2 billion as from 2022.

However, the bill does not specify the specific criteria for the design of the children allowance with regard to both its amount and the relationship with the equivalent economic status indicator (ISEE), which is to be used in determining eligibility for the new instrument. It is therefore difficult to assess both the congruity of the appropriations with respect to costs and the distributive effects of the new measure. Analyses recently conducted by the PBO, in which different possible configurations of the universal allowance are considered, show that the greatest benefits would be concentrated among taxpayers with low incomes and zero tax who do not benefit from personal income tax credits for dependent children under the current system (so called *incapienti*) and self-employed workers (who are not eligible for family allowances under the current system, which are reserved for households in which income from payroll employment represents at least 70 per cent of the couple's income). The average net benefit (the balance between the new allowance and the programmes that would be abolished) would be around €1 thousand per household. However, there is a risk that for non-negligible share of households, the benefits they receive under the current system may be greater than those under the new universal allowance. This would be most likely for families with adult children, who would receive a reduced universal allowance, but the change could also penalise other types of household due to the different mechanism for calculating the new universal allowance compared with current programmes.