Hearing as part of the consideration of the 2023 EFD

Summary

The Chair of the Parliamentary Budget Office (PBO), Lilia Cavallari, spoke today at a hearing before a joint session of the Budget Committees of the Chamber of Deputies and the Senate as part of the preliminary examination of the 2023 Economic and Financial Document (EFD). Cavallari discussed the reasons that prompted the PBO to **endorse the macroeconomic policy scenario in the EFD,** (the trend scenario had already been endorsed), and then analysed the economic outlook, the strategy outlined in the EFD, and the developments in the main public finance aggregates.

The analysis of the EFD reveals **overall acceptable forecasts, albeit with downside risks on growth beyond the short term, and a prudent public finance plan, albeit with some critical issues.** Both forecasts depend on the **full and efficient use of European resources under the National Recovery and Resilience Plan (NRRP).** On this front, the EFD is seen as a "bridge document" awaiting greater clarity on the time profile of expenditure, given the announced redrafting of the Plan.

The policy objectives contained in the EFD for 2023-26 appear consistent with the directions of the proposed reform of the EU fiscal framework. Consolidation may, however, have to extend beyond the EFD planning period in view of the objective of maintaining a declining debt-to-GDP ratio and the need to finance the higher expenditures planned in the medium-to-long term arising from population ageing.

Below are the main points from the memorandum delivered to the Committees.

The general situation of the Italian economy. − In 2022 Italian GDP continued its recovery phase begun the previous year after the contraction caused by the pandemic. The economy grew by 3.7 per cent, more than in the other leading European countries, driven in particular by consumption and export demand. After the marginal downturn in the final quarter of 2022, according to PBO estimates in the first three months of this year GDP resumed its moderate cyclical expansion; the uncertainty surrounding these estimates is high, but the range is nevertheless balanced. Despite the weak performance in the first months of the year, the manufacturing sector is expected to recover due to the easing of energy cost pressures, while the services sector should continue to benefit from significant tourism flows; on the contrary, the recent growth of the construction sector should slow down in the future, also due to the revision of the incentives for the residential sector.

Endorsement of macroeconomic forecasts. − On 7 April the PBO announced the endorsement of the trend macroeconomic forecasts contained in the EFD, which had been drafted by the MEF taking into account the Office's remarks. Although it was close to the limit, the macroeconomic policy scenario was also endorsed: the policy forecasts of the EFD

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are on the whole consistent with those of the PBO panel (comprising CER, Oxford Economics, Prometeia and REF.ricerche, as well as the PBO itself), although they lie close to the upper bound of the forecast interval. The rate of change of real GDP does not exceed the upper bound of the PBO panel forecast, except marginally in 2024. Nominal GDP growth is below the median of the panel, except in the last year, during which it is still similar to the PBO forecast. The impact of the public finance measures on GDP growth is similar to that estimated by the panel forecasters and equals that of the PBO.

The macroeconomic scenario for the Italian economy appears to be exposed to risks, which are primarily international and are mainly tilted on the downside for growth beyond the short term. Major ones include the risk associated with Italy's full, timely and efficient use of the Next Generation EU European funds for the implementation of the projects set up under the NRRP, the war in Ukraine, global financial tensions, the persistence of inflation, and climate and environmental risks. The adverse factors for the next years affect the most recent forecasts by other private and institutional analysts, which are characterised by lower growth prospects, especially for GDP in 2024, than those foreseen by the Government.

NRRP: opportunities and risks. − Given its economic and strategic relevance, the NRRP is a key element to be taken into account in the assessment of macroeconomic and public finance forecasts. According to PBO analyses based on the MeMo-It model, its macroeconomic impact would amount to about three percentage points of GDP at the end of the period (2026), assuming full and timely implementation of the projects envisaged so far. The estimate is slightly lower than the one contained in the EFD (3.4 per cent) but the discrepancy is mainly due to the different econometric tool adopted for the simulation. In the first two years of the programme the activation of public investment was moderate, so a strong catch-up in spending capacity is needed over the EFD forecast period to make up for any delay. The redrafting of the NRRP envisaged by the Government needs to be carried out without delays and should be oriented towards supporting potential economic growth.

The redrafting of the Plan may also change the timeframe of public spending. Therefore, in this respect the EFD appears to be a "bridge document" awaiting greater clarity, which will necessarily have to be provided by autumn at the latest, with the publication of the Update to the EFD and the definition of the budget law for 2024.

Lastly, to date the main source of official information on the state of implementation of the Plan, ReGiS, shows limitations in terms of completeness and timeliness of information. For these reasons, ReGiS appears not yet able to provide adequate information for a solid assessment of the degree of implementation of the NRRP and its future prospects, nor of the actual and possible expenditure.

Public finance developments and objectives − After a deficit in 2022 that turned out to be much higher than expected due to the new accounting classification rules of the effects

of the Superbonus and Façade Bonus incentives, the trend balance course outlined in the EFD appears − for the two-year period 2023-24 − to be slightly more favourable than the one reported in last autumn's Update to the EFD. Forecasts for the following years point to a steadily decreasing public deficit, again at or below 3 per cent of GDP from 2025. From 2024, after four years, a return to a primary surplus is also expected.

The public deficit is expected to fall sharply this year, from 8 per cent to 4.4 per cent of GDP, also due to the significantly smaller impact of building bonuses and the substantial cutback in measures against high energy prices, before falling more gradually to 3.5 per cent in 2024, 3 per cent in 2025 and 2.5 per cent in 2026, also in line with the unchanged legislation nature of the forecast. The primary balance is projected to remain negative in 2023 at 0.6 per cent of GDP, although well below the level of 2022, and to turn positive and grow from the following year, reaching 0.5 per cent in 2024, 1.2 in 2025 and 2 in 2026. This improvement in the balance appears to be attributable to the primary expenditure, which is expected to fall in terms of GDP (down by 7.3 percentage points, from 52.4 per cent in 2022 to 45.1 in 2026) much more than revenues (down by 1.7 percentage points, from 48.8 per cent in 2022 to 47.1 in 2026). The drop in revenues will be due to a decrease in the tax burden from 43.5 per cent to 42.7 per cent and, in particular, to direct taxes, which are affected by already enacted changes to personal taxation, changes to the pension indexation mechanism, and the discontinuation from 2024 of the extraordinary levy on companies operating in the energy sector. Interest expenditure is projected to fall to 3.7 per cent of GDP this year due to the sharp decline in prices − which affects inflation-indexed securities − but then to gradually rise to 4.1 in 2024, 4.2 in 2025 and 4.5 in 2026 due to the increase in current and expected short-term and long-term rates.

For 2023-24, the 2023 EFD policy scenario confirms the deficit-to-GDP targets set in the 2022 Update and the DBP of November 2023. The deficit thus remains projected at 4.5 per cent of GDP in 2023, 3.7 per cent in 2024 and 3 per cent in 2025; a target of 2.5 per cent is set for 2026.

The difference between policy and trend balances in the two-year period 2023-24 will be allocated to finance in 2023 a cut in the tax wedge on medium-to-low incomes of more than EUR 3 billion and to increase in 2024 the Fund to reduce the tax burden (by more than EUR 4 billion). In order to provide for the refinancing of the so-called unchanged policies from 2024 and to continue reducing the tax burden in the two-year period 2025-26, as well as, in general, to finance the new measures that the Government will decide to adopt as part of the end-of-year measures, funding will have to come from within the public budget, according to the EFD, including by strengthening the spending review aimed at identifying savings that grow over time, and through greater cooperation between the tax authorities and taxpayers.

The public finance strategy: general remarks. − The public finance policy scenario confirms the objectives set in the previous policy document, in continuity with the recent past. These choices point towards affirming a more stable medium-term planning that

envisages a reduction in the debt-to-GDP ratio, as proposed by the European Commission in the context of the reforms of EU rules. However, in 2024, the year in which the general escape clause will be removed, the deficit is still expected to exceed 3 per cent of GDP, and the path for reducing the debt-to-GDP ratio envisages decreases in the three-year period 2024-26 averaging about 0.6 percentage points, lower than previously projected.

This budgetary stance is set in a context of uncertainty both in terms of the macroeconomic scenario and the public finance prospects. In addition to the uncertainty linked to the NRRP and its pending reformulation, the EFD contains generic information on the resources to be devoted to unchanged policies and the measures that will contribute to their coverage.

Within the unchanged policies, usually the most relevant component is the renewal of civil service contracts and, in this regard, it should be noted that there is a strong risk of facing significant increases due to cumulative inflation; the resources allocated in the budget law to renew contracts cover only central government and similar resources have to be found for local governments, whose budgets are unlikely to be sufficient to cover the renewals; looking ahead, these elements will be particularly relevant considering that both the economic three-year negotiation period (2022-24) for all public sectors and two-thirds of the following period (2025-27) fall under the EFD timeframe.

Additionally, it is not clear how the reduction of the tax wedge for low- and medium-income earners, described as temporary, fits in with the structural measures envisaged in the draft enabling law on the tax reform. As regards the possibility of a reduction in taxation over the legislature, the EFD points out that one of the possible options is to increase collaboration between the tax authorities and taxpayers. Interventions aimed at increasing compliance are worthy but their financial effects are difficult to measure in advance and may emerge only gradually over time; for the sake of prudence, it is advisable that they are not used to cover structural interventions to reduce the tax burden.

With regard to healthcare spending, although EFD trend forecasts may have adopted more realistic assumptions than the previous estimates on the actual need for future funding, it should be noted that Italy has a lower level of spending than the European average − which has a negative impact on the quality of the services offered − and that there may be the need to refinance the national health service.

Lastly, a number of the measures linked to the budgetary decision listed in the EFD − such as the one on pension regulation − may require additional resources, for which adequate funding has to be identified.

Therefore, it would seem that substantial resources are needed overall, which are difficult to find, given the period of recovery in the recent past, while maintaining current levels of service provision and social policies.

In light of the recent measures concerning the freeze on the transferability of building bonuses, it is plausible that the statistical authorities may decide that they should be reclassified as non-payable credits on the basis of the actual tax deduction profile. This would lead to lower budget deficits in the three-year period 2023-25 but would aggravate those in the following years. Any use of budget margins as a result of the possible reclassification would necessarily lead to an increase in public debt.

The evolution of debt between higher rates and lower ECB purchases. – After falling in 2022 (from 149.9 per cent to 144.4 per cent of GDP), the debt-to-GDP ratio is expected to fall further in the following years, from 142.1 per cent in 2023 to 140.4 per cent in 2026. This decline is less pronounced than that projected in the Update to the EFD: at the end of the projection period, the debt-to-GDP ratio is expected to be about 15 percentage points lower than the peak in 2020 (154.9 per cent) but more than 6 percentage points higher than the pre-pandemic level of 2019, when debt amounted to 134.1 per cent of output. Reaching this level by the end of the decade would require an additional reduction in the ratio over the four-year period 2027-2030 averaging about 1.6 percentage points of GDP per year, higher than the reductions currently planned for 2024-26.

Starting last July, the Governing Council of the European Central Bank (ECB) started to tighten monetary policy, first by terminating the net purchases of financial assets under the Asset Purchase Programme (APP) as of 1 July, and then by raising key policy interest rates. Overall, between July 2022 and the first months of 2023, the increase in key interest rates amounted to 3.5 percentage points. In addition, the portfolio of the APP has been reduced by an average of EUR 15 billion per month since last March, due to the only partial reinvestment of the repaid capital on maturing securities, a process that will continue at least until June.

In 2023, interest expenditure is projected to fall to 3.7 per cent of GDP, consistent with the gradual decline in the Italian and European inflation rate; in the following three years, however, interest expenditure is expected to rise again to 4.1 per cent of GDP in 2024, 4.2 per cent in 2025 and 4.5 per cent in 2026. This is mainly due to the following factors: 1) the upward shift in the yield curve on government bonds for the entire forecast period, which implies a gradually more significant burden, as the effects of issues with a higher cost accumulate over the years; 2) the still high level of the inflation rate, which in the EFD is assumed to converge towards values close to 2 per cent only starting from 2025 in Italy and 2026 in Europe; 3) the relatively high level of the state sector's requirement (also due to the cash impact of tax credits linked to the Superbonus and the Façade Bonus incentives).

Following the ECB's decisions, it is possible to estimate the impact of the Eurosystem's programmes on the Italian government bond market for 2023 and thus assess the amount of net flows of remaining bonds to be absorbed by private investors. According to these estimates, gross issues of government bonds (redemptions of maturing bonds and new issues) net of Eurosystem purchases on the secondary market should amount to EUR 424

billion, about EUR 107 billion more than in 2022. Net issues of government bonds (new issues) again net of Eurosystem secondary market purchases are expected to be positive at 104 billion, a marked increase from the 2 billion estimated for 2022. Private investors will therefore have to absorb a significant amount of Italian government debt compared to the past years.

EFD objectives between old and new regulations. – With the termination of the general escape clause at the end of 2023 the European Commission confirmed that, pending the reform of the EU fiscal framework, the current version of the Stability and Growth Pact (SGP) will continue to be in force for 2024. Based on the current rules, it is possible to briefly assess the objectives of the EFD for 2024 and, with regard to the deficit rule, also for 2023.

This assessment shows that the EFD policy scenario envisages a structural adjustment objective in 2024 consistent with the SGP structural balance rule; as regards the expenditure rule, it is not possible to verify its compliance since the detailed values of the components needed to calculate the net expenditure aggregate are not reported in the 2023 EFD.

As for the nominal deficit rule, in the EFD it is projected at 4.5 per cent of GDP in 2023 and 3.7 per cent in 2024. The deficit as a ratio of GDP in 2023 is therefore higher than and not close to 3 per cent and the breach of the threshold is not temporary. If the interpretation of the rule were to remain unchanged with respect to the current legislation of the Stability and Growth Pact, there would be a risk that the European Commission could propose to open an excessive deficit procedure for Italy in spring 2024 for non-compliance with the deficit rule should there be a net borrowing significantly higher than 3 per cent of GDP in 2023 and should the Government confirm a violation of the 3 per cent threshold in 2024.

However, according to the directions given in the Commission Communication on fiscal policy guidance for 2024, during the transition period to the reformed EU fiscal framework the old rules will also be interpreted taking into account the new framework proposed by the Commission itself, i.e. with a focus on medium-term debt developments. From this point of view, the primary balance and net borrowing objectives contained in the EFD for the period 2023-26 appear consistent with the indications available on the proposed reform of the EU fiscal rules, assuming that the medium-term macro-financial framework is in line with the pre-pandemic scenario. The analysis also shows that it may be necessary to maintain the consolidation strategy beyond the EFD horizon to reach a primary surplus of around 2.5-3 per cent of GDP so as to have a high probability of debt-to-GDP reduction, even in unfavourable scenarios, and at the same time to finance the projected increase in age-related expenditure.