# Hearing as part of the examination of the 2024 EFD (Economic and Financial Document)

## Summary

22 April 2024 | **The Parliamentary Budget Office (PBO) has endorsed the macroeconomic forecasts of the 2024 EFD.** The President of the PBO, Lilia Cavallari, spoke today before the Joint Budget Committees of the Senate and the Chamber of Deputies and announced the positive outcome. The hearing revolved around the 2024 Economic and Financial Document (EFD).

The President Cavallari discussed the reasons that led to the positive endorsement of the trend macroeconomic scenario (QMT) related to the EFD (the policy scenario had not been presented), and then analysed the economic trends, the strategy outlined in the EFD, and the developments in the main public finance aggregates. Below are the main issues addressed.

***The global economy and the geopolitical tensions*** − The extended conflicts in Ukraine and in the Middle East cause instability in the international panorama. The consequences of such instability can be seen in the volatility of oil prices and the bottlenecks in intercontinental transports; the passage of ships in Suez is undermined by the Houthis' attacks, resulting in slower and more expensive trade exchanges at the international level. Monetary authorities are keeping the communication of future monetary policies at a more prudent level, as they will strongly rely on the macroeconomic data that will be released in the coming months.

**Forecasts for EFD exogenous variables** − The assumptions about the EFD exogenous variables are consistent with those made one month and a half ago. However, uncertainty and risks have increased due to the possible extension of the Middle Eastern conflict to other countries of the region, which would result in a cascade of relevant consequences. Moreover, uncertainty is felt in connection to the timing of the expected loosening of monetary policies in Europe and the US, which, if not occurring simultaneously, might affect currency market volatility.

***The Italian economy*** − Italy's GDP slowed to 0.9 per cent last year. However, it recorded a growth higher than that of the euro area for the third consecutive year. In 2023, the activity was mainly supported by internal demand, mostly represented by services and constructions in terms of sector. According to the PBO's estimates, GDP during the first quarter of 2024 continued to increase by a couple of tenths of a percentage point quarter-on-quarter, in line with the two previous periods; the uncertainty around these estimates is large but balanced. The manufacturing industry is currently weak; however, according to qualitative indicators, a strengthening is expected; the construction sector is affected by considerable uncertainty, mainly attributable to the reduction of incentives in the residential sector.

***Construction business and the Superbonus incentive*** − Italy recorded more robust growth in the construction sector than in the euro area. Over the last three years, the construction business in Italy has been strongly relaunched by the Superbonus incentive, albeit with a recourse that became gradually more pronounced as the cyclical phase strengthened. This resulted in a marked recovery in terms of employment in the construction sector; however, it was accompanied by a strong unbalance between the labour demand and supply. It is difficult to assess the impacts of the Superbonus incentive on the aggregated demand given the lack of an official and detailed reconstruction of some of the incentives adopted in the residential sector over the last three years and the need to wait for the national accounting data on investments to stabilise.

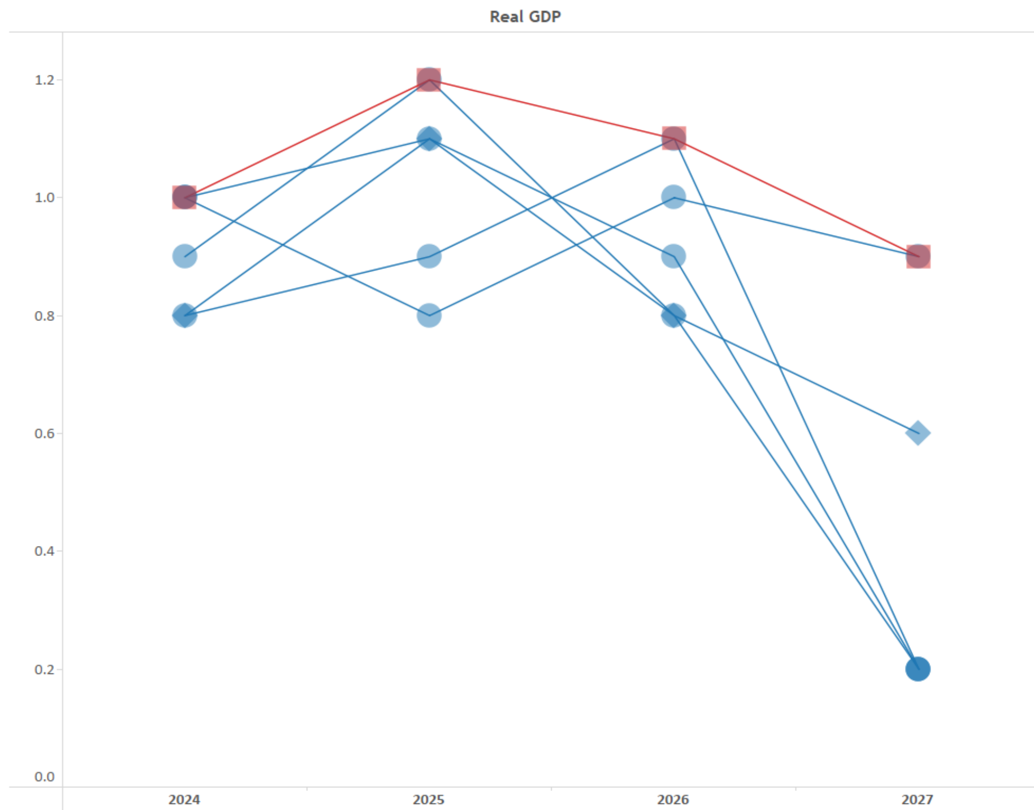
***Endorsement of macroeconomic forecasts*** − The PBO announced the endorsement of the trend of macroeconomic forecasts contained in the EFD, which had been drafted by the MEF (Ministry of Economy and Finance), taking into account the Office's remarks. The endorsement process of the 2024 EFD forecasts had a positive outcome: the trend EFD forecasts are overall acceptable if compared with those drafted by the PBO panel (CER, Oxford Economics, Prometeia and REF Ricerche, and the PBO itself). However, it should be noted that real and nominal GDP growth forecasts - which are relevant in terms of public finance estimates - are close to the higher value estimated by the panel across the whole forecasting horizon (Figure 1). This is important in perspective, given the risks connected to the forecasts.

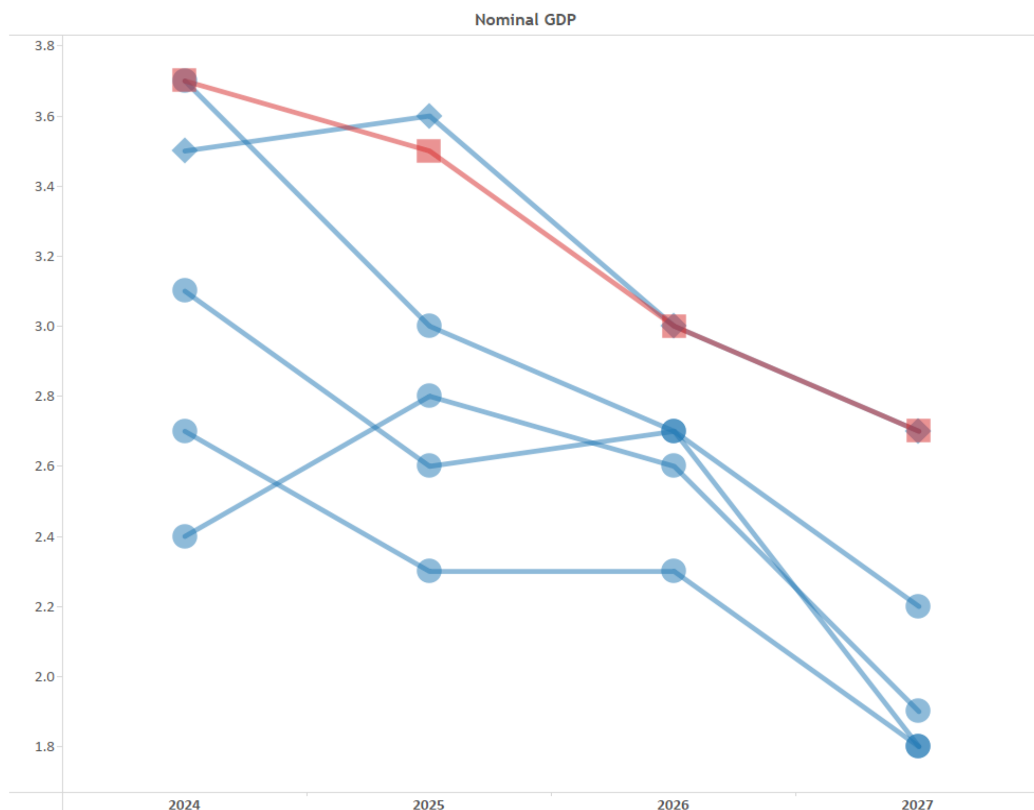
***Risk factors for the Italian economy*** − The macroeconomic forecasts are exposed to exogenous and external risks, mostly of an international nature, but sometimes also domestic. **Overall, risks to economic activity appear balanced in the short term, but in the medium term they are mainly tilted to the downside,** especially at the end of the trend macroeconomic scenario.

***Geopolitical tensions, volatile commodity markets and world trade*** − The wars in Ukraine and the Middle East, which already have tangible repercussions on international trade and commodity prices, could further deteriorate over the EFD forecast period. Assumptions on world trade are crucial, although its strengthening is currently not fully widespread, thus possibly appearing less robust than expected.

***Investments and the NRRP*** − It is difficult to make prospects about the economic effects of the legislative changes to the Superbonus incentive. In the medium term, some criticality might emerge on the NRRP as the small activation of investments over the first years and the changes agreed with the EU require accelerating interventions. However, the works concentration in the next two years could lead to bottlenecks in supply.

***Figure 1*** – Real and nominal GDP, trend developments




Government estimates Estimates of other PBO panel forecasters PBO estimates

***Market risk aversion and monetary policies*** − Market operators' risk aversion is low at the moment, but it could change over the EFD forecasting horizon. Upcoming central bank decisions may not reflect market expectations; moreover, the large number of elections this year could have an impact on the economic policies, which in turn could affect investors' sentiment.

***Climate and environmental risks*** − In addition to affecting food and energy prices, climate change can directly damage the productive and social fabric of the country if extreme weather events occur. In 2023, CO2 emissions for energy production have reached a historical peak, thus narrowing the path towards reducing GHG emissions.

***Public finance trend scenario*** − Following a 2023 deficit far above expectations, primarily due to the effects of the Superbonus incentive, the public finance trend scenario for the 2024-2027 period shows a lower deficit resulting from the reduction and reclassification of the Superbonus incentive, the lifting of measures to tackle high energy prices and the disappearance of specific measures which will expire in 2024, including the cut of social security contributions on employee labour.

The trend scenario provided in the EFD is similar to the policy scenario of the 2023 EFD Update (NADEF). The EFD deficit for 2024 is estimated to be equal to that reported in the NADEF of last autumn (4.3 per cent of GDP), while the EFD forecasts for the two following years show a slightly higher public deficit: 3.7 per cent of GDP in 2025 vs. 3.6 per cent reported in the NADEF, 3 per cent in 2026 vs. the foreseen percentage of 2.9 per cent. The forecasts for year 2027 show a deficit of 2.2 per cent of GDP.

From 2025, there is also expected to be a return to a primary surplus, i.e. a positive balance net of interest expenditure, after five years, increasing in the following years, as already projected in the NADEF, albeit with values now revised downwards. More specifically, the primary balance, although showing a marked improvement compared to the year 2023, is expected to remain negative in 2024 (-0.4 per cent of GDP), to grow and become increasingly positive in 2025 (0.3 per cent), 2026 (1.1 per cent) and 2027 (2.2 per cent). The weight of interest expenditure on GDP would grow from 3.9 per cent in 2024 to 4.4 per cent in 2027.

Primary expenditure is expected to drop in relation to GDP (by 7.2 percentage points, from 51.2 per cent in 2023 to 44 per cent in 2027) much more than revenues (which are expected to fall by 1.6 percentage points, from 47.8 per cent in 2023 to 46.2 per cent in 2027). Given the decline in Superbonus expenditure and -- in 2027 -- the running out of spending related to the NRRP interventions, capital expenditure would reduce even more. Current primary expenditure as a ratio of GDP also shows a decline, due to the trending nature of the forecasts that, for example, do not consider costs of contractual renewals for public employees after 2022-2024. However, social benefits would keep the weight of GDP basically unchanged in the 2025-2027 period, as also in relation to the automatic inflation indexation of pensions. In the four-year forecast period, the expenditure for

investments would be equal to 3.2 per cent on average, in line with the figures recorded in the previous year and far higher than the previous years' final figures, supported until 2026 by the impact of the additional programmes related to the NRRP.

Interest expenditure is expected to gradually increase already from the current year, when it would be equal to 3.9 per cent of GDP, until 2026, when it would reach 4.1 per cent, rising more sharply in 2027 to 4.4 per cent. Such a trend reflects higher issue volumes especially in 2024, the transmission of past interest rate hikes to an increasing share of government debt and the rise of long-term rates.

From 2023 to 2027, a fall in revenue as a ratio of GDP (equal to 1.6 percentage points) is also expected, attributable to the downsizing of all revenue components other than social contributions. These contributions, instead, show an increase in relation to GDP (equal to 0.5 percentage points), mostly following the elimination of several contribution relief measures on employed labour which is assumed in the current- legislation scenario. Direct and indirect taxes equally contribute to the fall in tax revenue in relation to GDP, while capital taxes remain stable. The decline in the ratio of other current and capital revenues to GDP at the end of the forecasting period is linked to the fact that subsidies from the EU to finance the NRRP interventions were no longer accounted for. The tax burden slightly decreases, from 42.5 per cent in 2023 to 42.3 per cent in 2027. A further slight decline in the tax burden will emerge when the "Fund for the implementation of the tax enabling law" (*Fondo per l'attuazione della delega fiscal*) is used, currently included in the current expenditure.

***Some general remarks on the public finance trend scenario*** – The EFD does not include the policy scenario, which is a content required by Law 196/2009. According to the EFD, the preparation of a new policy framework in line with the new European rules and the five-year horizon to be adopted, was deferred to the presentation of the medium-term Structural-Fiscal Plan, which should take place in the coming months.

The Government's choice to defer the presentation of the policy scenario is justified by the transition to the new European rules. In this context, the Government should pursue its commitment to fully involve Parliament in preparing the Plan as soon as the framework is further defined.

Should the NADEF 2023 objectives be confirmed, it will be necessary to identify adequate sources of financing within the next budgetary manoeuvre for the unchanged policies to be adopted and for possible new interventions. The EFD shows that in the unchanged-policy forecast, the deficit would increase to 4.6 per cent in 2025, 4 per cent in 2026 and 3.2 per cent in 2027. In this context, it is stated that priority will be given to refinancing the labour tax wedge cut. In this regard, as already observed in the assessment of NADEF 2023, it should be made clear whether it is intended to make the measure structural by

fixing its distorting features and identifying structural financing resources. From a medium-long term planning perspective, structural resources should also be identified for other interventions, including those required for the renewal of public employment contracts. The EFD specifies that the interventions deemed necessary by the Government will be subject to evaluation (both in terms of size and of economic-social sectors involved) during the preparation of the public finance policy framework.

The public finance framework shows some uncertain elements linked to the macroeconomic scenario and the implementation of the NRRP by the end of 2026. The expected profile of the privatisation plan remains ambitious but has been, more realistically, reprogrammed over time.

As for the Superbonus incentive, although Law-Decree no. 39/2024 envisaged interventions to contain costs for the coming years by introducing further restrictions on invoice discounts and the transferability of tax credits, unexpected effects cannot be ruled out, in light of what has happened in past years and should these restrictions be relaxed when the decree is converted into law.

Finally, a lack of information should be noted related to three fundamental areas for public finance and for the macroeconomic scenario: NRRP, unchanged policies and building renovation bonuses. As for the NRRP, the new yearly profile of EU-funded expenditure within the NGEU instrument, broken down by economic category, type and kind of financing should have been reported in the EFD, considering the review and remodulation of the Plan. As for the forecasts with unchanged policies, only the overall impact on the net borrowing for their refinancing was indicated without providing any information on the measures considered to define such amounts. The EFD should report at least the information required by Law 196/2009 concerning the main aggregates of general government accounts in the unchanged-policies scenario. Finally, as for the Superbonus and the Façade Bonus, the amounts considered in the final data were not reported in the documents published by ISTAT and the MEF. This is relevant information, given that it results from provisional preliminary estimates that can be reviewed based on updates on information avavliable with a delay, after the closing dates for the preliminary estimates. Providing more information related to the amounts allocated to the 2024-2027 period within the policy documents would also be important.

***The debt evolution and the impact of the Eurosystem programme on the Italian government bond market*** − After three years of decline in the public debt-to-GDP ratio, the EFD trend scenario shows an increase from 2024 to 2026, for a total of 2.5 percentage points and a slight reduction in 2027, equal to 0.2 percentage points, when it would reach 139.6 per cent. At the end of the forecast period the debt/GDP ratio is projected to be about 15 percentage points lower than the peak in 2020 (155 per cent) but over 5 percentage points higher than the pre-pandemic level in 2019, when the debt was equal to 134.2 per cent of output. To reach this level by the end of the decade, further

reductions in the ratio should be achieved over the 2028-2030 period, averaging about 1.8 per cent of GDP per year.

Up to 2026, debt was affected by considerable tax offsets connected to the tax incentives of the previous years. Most of the items accounted in the 2020-2023 four-year period net borrowing in terms of accruals relating to the Superbonus and Façade Bonus incentives will mainly affect the debt (in cash terms) over the 2024-2026 three-year period. In particular, the amount inferred from the 1 March ISTAT data on the general government accounts, which amounts to approximately EUR 170 billion over the period 2020-2023, will lead to an average annual increase in debt of approximately 1.8 percentage points of GDP over the three years 2024-26, higher than the 0.5 percentage points over the three years 2021-23.

The implementation of the privatisation plan, launched at the end of 2023 and expected to continue until 2027, contributes to the break in the path of debt-to-GDP increase in 2027. Inflows from equity divestments amount to a cumulative value of close to 1 per cent of GDP over the period. Thus, the receipts of the Plan, as assumed in NADEF 2023 for the same amount in the 2024-2026 three-year period, have been reprogrammed in the EFD until 2027.

The reduction of the securities portfolio held by the Eurosystem for monetary policy purposes continues. During 2023, the Italian government bonds held by the Eurosystem have been reduced by 30 billion compared to the end of 2022. In 2024, the Eurosystem will continue reducing the financial assets held in the portfolio.

Gross issues of government bonds are estimated at EUR 525 billion in 2024, higher than in 2023, due both to an increase in the state sector's borrowing requirement and to higher amounts of bonds to be redeemed in the year. Gross issues of government bonds net of Eurosystem secondary market purchases in 2024 are projected at EUR 492 billion, some EUR 44 billion higher than in 2023. During the current year, the secondary market purchases of Italian government bonds by the Eurosystem should only involve complete reinvestment of the repaid capital on maturing securities included in the Pandemic Emergency Purchase Programme until June, while the following reinvestment will be partial. The net flows of bonds that private investors should absorb, equal to the net issue of government bonds net of secondary market purchases of the Eurosystem, are estimated to increase in 2024 up to approximately 166 billion.

***Debt Sensitivity Analysis*** – A sensitivity analysis on some assumptions of the debt-to-GDP ratio foreseen in the EFD trend scenario was carried out. As for the 2024-2027 period, by using the spread between the PBO forecasts and the EFD forecasts on GDP growth and on GDP and private-consumption deflator growth rates, it is possible to re-determine the primary fiscal balance and interest expenditure as a ratio of GDP. In this alternative scenario, the debt-to-GDP ratio would be always higher compared to the EFD. In 2024, the debt-to-GDP ratio would reach 138.2 per cent, approximately 0.3 percentage points

higher compared to the same figure in the EFD, while in the period 2025-2026, the debt would continue to increase at a faster pace compared to the trajectory envisaged by the EFD, to be equal to 140.3 per cent of GDP in 2026, about 0.5 percentage points higher than the forecast made by the Government under the current legislation scenario. In 2027, contrary to the reduction envisaged by the EFD, the debt-to-GDP ratio of the PBO's scenario would, instead, continue to increase compared to the previous year, reaching 140.5 per cent, about 0.9 percentage points higher than the government's forecast.

The privatisation programme envisaged by the Government will contribute to reducing the debt-to-GDP ratio between 2026 and 2027. Should the privatisations assumed by the Government for 2025-2027, equal to a total of 0.7 percentage GDP points, not occur, debt as a ratio of GDP would rise even more sharply. In this case, the debt-to-GDP ratio would increase by 0.5 percentage points in 2025 and 1 percentage point in 2026 compared to the figures reported in EFD. In the last forecast year, the ratio would be equal to 141.2 per cent, about 1.6 GDP percentage points higher than the EFD forecast, and slightly higher than the 2022 level.

***The deficit rule*** – By the end of 2023, the general escape clause envisaged by the Stability and Growth Pact was de-activated. Over the coming months, the European Commission will assess the possibility of launching excessive deficit procedures based on the deficit criterion for Member States. As for Italy, based on the final data published by ISTAT, the deficit as a ratio of GDP is higher than the 3 per cent ceiling in 2023, and, based on the EFD estimates, the excess over 3 per cent is not temporary. Therefore, the Commission will likely recommend to the Council of the EU the opening of an excessive deficit procedure for Italy.

The path to correcting the excess deficit should take into account the agreement on the new European economic governance reached in February, which will enter into force in the second half of the year. The new rules prescribe a minimum reduction of the overall structural balance of at least 0.5 GDP percentage points per year. However, during the transitional regime, in the 2025-2027 period, the adjustment will not take into account the increased costs connected to the rise of interest expenditure. The correction path should be, in any case, consistent with the plausible reduction of the debt ratio in the medium term and ensure that, once out of the procedure, the numerical safeguard of debt reduction in the remaining years of the adjustment period is respected: this could imply annual required adjustments of more than 0.5 percentage points of GDP.

***EU Recommendations for 2023 and 2024*** – The EU recommendations for 2024 require Italy to: i) keep a prudent budgetary policy by limiting the nominal growth of net primary expenditure financed from national resources below the 1.3 per cent threshold; ii) eliminate, in 2023 and 2024, the measures to tackle high energy prices and use savings to reduce the budget deficit; iii) protect nationally funded investment. The country-specific recommendations made to Italy in 2023 were to guarantee a prudent budgetary policy by keeping the growth of the current primary net expenditure financed from national

resources below the medium-term potential GDP growth, and to expand public investment.

Based on the estimates used to prepare the EFD forecasts, in 2024, Italy would comply with the ceiling on net primary expenditure financed from national resources. However, due the upward expenditure revision linked to the Superbonus incentive in 2023 - the so-called "base effect"-, the 2024 growth in primary net expenditure might be assessed as "not fully in line" with the recommendation. Italy would comply with the recommendation for the reduction of measures to tackle high energy prices, as it envisages to almost eliminate such measures by 2024 and to use the relevant savings to reduce net borrowing. Italy would have increased public investments in 2023 and seems to be preserving such investments in 2024, both overall and nationally funded ones. Finally, as for 2023, Italy would be in line with the recommendation on limiting the current net primary expenditure financed from national resources below medium-term potential growth.

***Medium-term debt projections in the context of the new EU fiscal rule framework*** – The new EU economic governance framework, which will be implemented in June, provides for Member States to prepare medium-term Structural-Budgetary Plans with a legislature horizon (4 or 5 years) to be submitted to the European Commission for evaluation and to the Council for approval.

Such Structural-Budgetary Plans should define a programme of structural reforms and public investments and outline, through a net primary expenditure trend, a multi-annual budgetary adjustment over 4 years, possibly extending it up to 7 years In case of commitments to implement specific reforms and investments. Budgetary adjustment should be in line with the corrective and preventive requirements provided in the Stability and Growth Pact and allow, in particular, to "plausibly" reduce the debt-to-GDP ratio in the medium term and keep the deficit below 3 per cent of GDP.

Before submitting its Structural-Budgetary Plans, the European Commission will provide a "reference trajectory" for the net primary expenditure funded from national resources to countries with a debt higher than 60 per cent of GDP or with a deficit higher than 3 per cent of GDP. Along with guaranteeing a "plausible" reduction of the debt-to-GDP ratio and being in line with the corrective recommendations, such a technical trajectory should comply with a series of safeguards applying to all EU members, such as the average yearly reduction of the debt-to-GDP ratio of 1 percentage point during the adjustment period, provided that the country is not in excessive deficit procedure, and convergence towards a resilience margin of a structural deficit of 1.5 per cent of GDP after the adjustment period.

According to the methodology developed by the PBO, several medium-term scenarios have been prepared to describe an evolution of the debt-to-GDP ratio and of the main

public finance variables that are broadly consistent with the approach outlined in the legislative proposals on the new EU governance.

The analysis shows that in a scenario where potential growth aligns with pre-pandemic values ("historical trend" scenario, with potential growth equal to about 1.1 per cent), the minimum consolidation required by the new rules might be equal to 0.5 GDP percentage points per year over seven years (2025-2031). In case of potential GDP growth that gradually converges to medium-term Consensus growth ("Consensus trend" scenario, where potential growth gradually reduces from 1.1 per cent to 0.7 per cent), the annual budgetary adjustment in the 2025-2031 period should instead be more ambitious and equal to 0.6 GDP percentage points each year.

To achieve a plausible reduction of the debt-to-GDP ratio in the "historical trend" scenario, the deficit should drop below 3 per cent of GDP from 2029, and reach 2.1 per cent in 2031, at the end of the seven-year adjustment plan. More pessimistic growth assumptions ("Consensus trend" scenario) suggest the deficit would drop below 3 per cent in 2028 and reach 1.7 per cent of GDP at the end of the consolidation plan.

The current legislation forecast of the net borrowing-to-GDP ratio reported in the EFD for the 2024-2027 period appears consistent with the indications of the final agreement on the EU fiscal rule framework in the case of a seven-year budgetary adjustment in both scenarios.