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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Italy

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Italy

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1. INTRODUCTION

Italy submitted its Draft Budgetary Plan (for 2020 on 16 October 2019 in compliance with Regulation (EU) No 473/2013. Italy is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective(MTO).

As the debt ratio was 134.8% of GDP in 2018, exceeding the 60% of GDP reference value of the Treaty, Italy also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn forecast. The following section presents the recent and planned fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 autumn forecast. In particular, it also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2019, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Italy's Draft Budgetary Plan expects real GDP to rise by 0.1% in 2019, marginally revised down from 0.2% in the Stability Programme. The projected growth rate for the second half of 2019 is significantly lower than estimated in the Stability Programme, given the worsening of the external outlook and a still weak industrial cycle reflected by subdued business confidence indicators. The Commission estimate for real GDP growth, which took into account the slight upward revision of growth in the most recent quarters, is in line with government projections. In terms of the composition of GDP growth, the Commission forecast and the Draft Budgetary Plan are broadly aligned with a sizeable contribution from net trade and a sharp drop in inventories. The projected GDP deflator, estimated at 0.9% in 2019, is somewhat higher than the Commission forecast.

For 2020, the Draft Budgetary Plan projects lower real GDP growth than the Stability Programme (0.6% vs. 0.8%), due to a lower carryover from the previous year and the growth-

reducing impact of further declining inventories. By contrast, the Commission predicts real output to increase only by 0.4% on the back of lower domestic demand. Both private consumption and gross fixed capital formation are forecast to expand at a more moderate rate and the growth contribution of net exports is expected to be zero. On balance, budgetary measures are likely to be broadly growth-neutral. Regarding price dynamics, the Draft Budgetary Plan revised down HICP headline inflation substantially (from 2.3% in the Stability Programme to 1.0% in the Draft Budgetary Plan), following the cancellation of the initially legislated Value Added Tax rise for 2020. The Draft Budgetary Plan estimate for the unemployment rate is in line with the Commission forecast.

Despite prevailing downside risks, the Draft Budgetary Plan macroeconomic assumptions for 2019 appear plausible, also given that the national statistical institute's (Istat's) recent revision of quarterly data draws a slightly more positive picture of the first half of this year. Growth projections for 2020 appear favourable, especially as regards nominal growth. Overall, planned policy measures might be less growth supporting than envisaged in the Draft Budgetary Plan and the budget, in the aggregate, might be broadly growth-neutral. In addition, the GDP deflator, in particular for private consumption, looks on the high side, given weak underlying price and wage developments. Furthermore, macroeconomic assumptions are subject to high uncertainty and sizeable downside risks. Italy is exposed to a further weakening of the global economy, with negative ramifications for exports and investment, and the potential worsening of financing conditions, given its high public debt.

Box 1: The macroeconomic forecast underpinning the budget in Italy

Italy's 2020 Draft Budgetary Plan is based on the macroeconomic scenario outlined in the update of the Economic and Financial Document of 30 September 2019. The Economic and Financial Document presents a trend scenario, based on the hypothesis of unchanged legislation, and a programme scenario, including the impact of the measures proposed in the Draft Budgetary Plan. Both macroeconomic scenarios have been prepared by the government. The Parliamentary Budget Office, Italy's independent fiscal monitoring institution, endorsed both the trend and the programme scenario observing that the estimates were inside the acceptable range given the information currently available. Compared to the trend scenario, the programme scenario presents a deficit target for 2020 of 2.2% of GDP (compared to 1.4%) and real GDP growth of 0.6% (compared to 0.4%).

The endorsement of the trend and programme scenario, mentioned in the Draft Budgetary Plan, took the form of two letters (dated 23 September and 8 October 2019, respectively) addressed to the Italian Minister of Economy and Finance and publicly available on the Parliamentary Budget Office's website. In its parliamentary hearing on the Economic and Financial Document, the Parliamentary Budget Office noted that the growth outlook for 2020 was subject to downside risks that might further amplify in the following years.

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	0.8	0.2	0.1	0.1	0.8	0.6	0.4
Private consumption (% change)	0.8	0.6	0.4	0.4	0.7	0.7	0.5
Gross fixed capital formation (% change)	3.2	1.4	2.1	2.7	2.0	2.2	1.5
Exports of goods and services (% change)	1.8	2.1	2.8	1.9	2.3	2.2	2.0
Imports of goods and services (% change)	3.0	2.2	0.7	0.7	2.7	2.3	2.2
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	1.1	0.5	0.6	0.8	0.9	0.8	0.6
- Change in inventories	-0.1	-0.2	-1.1	-1.1	0.0	-0.2	-0.1
- Net exports	-0.3	0.0	0.6	0.4	-0.1	0.1	0.0
Output gap ¹	0.2	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1
Employment (% change)	0.9	-0.3	0.5	0.5	0.2	0.3	0.1
Unemployment rate (%)	10.6	11.0	10.1	10.0	11.1	10.0	10.0
Labour productivity (% change)	0.0	0.6	-0.4	-0.5	0.6	0.3	0.3
HICP inflation (%)	1.2	1.0	0.8	0.6	2.3	1.0	0.8
GDP deflator (% change)	0.9	1.0	0.9	0.6	2.0	1.3	0.9
Comp. of employees (per head, % change)	2.2	1.2	1.3	1.0	1.5	1.3	1.1
Net lending/borrowing vis-à-vis the rest of	2.6	2.3	2.8	2.9	2.2	2.7	2.9

Note:

¹In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

Italy's Draft Budgetary Plan projects that the general government deficit will remain stable at 2.2% of GDP in 2019.¹ This is below the headline deficit projected by the Stability Programme (2.4% of GDP), but above the revised deficit target adopted by the Italian government with its mid-year budget² in July 2019 (2.0% of GDP). Compared to the Stability Programme, the Draft Budgetary Plan considers the better-than-expected developments presented in the mid-year budget, namely higher dividends from the Bank of Italy and the national promotional agency (*Cassa Depositi e Prestiti*), as well as extraordinary revenues from a tax settlement with the Kering Group and underspending for the new minimum income and early retirement schemes. Furthermore, the Draft Budgetary Plan assumes lower interest

¹ In October 2019, Istat revised the 2018 headline deficit to 2.2% of GDP, from 2.1% of GDP transmitted with the spring notification.

² D.L. n. 61/2019.

spending compared to the Stability Programme due to the downward shifts in sovereign yields observed in July and September 2019. At the same time, compared to the mid-year budget the Draft Budgetary Plan takes into account more recent data on revenue developments and budget execution, which point to a higher headline deficit in 2019. Based on the Draft Budgetary Plan, the structural balance³ is projected to improve by 0.3% of GDP in 2019. While projecting the same headline deficit in 2019, the Commission 2019 autumn forecast projects a smaller improvement of the structural balance of 0.2% of GDP, due to a different estimate of potential growth.

The Draft Budgetary Plan projects the general government deficit to remain stable at 2.2% of GDP also in 2020, while the Stability Programme projected a decline of 0.3 percentage points. The higher headline deficit projected in the Draft Budgetary Plan compared to the Stability Programme results from the following factors: (i) lower interest spending by around 0.4% of GDP; (ii) more pessimistic macroeconomic outlook; (iii) more expansionary fiscal policy, mainly due to the repeal of the Value Added Tax hike legislated as a budgetary safeguard clause in 2020, which is only partially compensated with alternative financing measures. As a result, the Draft Budgetary Plan expects both government expenditures and revenues to grow less than projected in the Stability Programme, with the largest difference being on the revenue side (both revenues and expenditures are projected to grow by 2% in the Draft Budgetary Plan, compared to 3.8% and 2.9% respectively in the Stability Programme). Based on the Draft Budgetary Plan, the (recalculated) structural balance is expected to deteriorate by 0.1% of GDP in 2020.

The Commission 2019 autumn forecast projects that Italy's general government deficit will slightly increase to 2.3% in 2020. The difference with the Draft Budgetary Plan is mainly due to lower nominal GDP growth (1.4% compared to 2.0%), reflected in lower projected revenues. Furthermore, the Commission forecast considers only part of the revenues expected by the government from the new measures against tax fraud (around 0.2% of GDP), based on an individual assessment of each measure. While these measures appear overall well specified and are expected to support revenues in a structural way, the precise yields of measures against tax fraud are intrinsically uncertain and warrant a prudent approach.

At the same time, the Commission forecast assumes the activation of the spending-freezing mechanism included in the 2020 draft budget law⁴ as a safeguard clause. According to the clause, ministries are allowed to spend part of the funds allocated by the budget (for a total of EUR 1 billion, 0.06% of GDP) only in case the headline deficit target is expected to be met based on a specific mid-year monitoring. A similar mechanism was introduced with the 2019 budget law for a total of EUR 2 billion and proved effective in reducing the difference between the actual deficit and the government target. In light of the higher deficit expected in 2020, the Commission forecast assumes that the frozen funds will not be spent, with a positive effect on public finances. Overall, the Commission 2019 autumn forecast expects both government revenues and expenditures to grow less than projected in the Draft Budgetary Plan, by 1.9% and 1.6% respectively as opposed to 2% in the Draft Budgetary Plan⁵. Based

³ Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

⁴ Submitted to the Parliament on 2 November 2019 and currently under discussion.

⁵ Despite lower growth rates and levels, both revenue and expenditure projections appear higher as a share of GDP in the Commission forecast compared to the DBP due to the different denominator, as the Commission forecast assumes lower nominal GDP growth in 2020 (see Section 2).

on the Commission 2019 autumn forecast, the structural balance is expected to deteriorate by 0.3% of GDP in 2020, to around -2.5% of GDP. Compared to the Draft Budgetary Plan, the stronger structural deterioration projected in the Commission forecast is due to the higher headline deficit and to a different assessment of one-off measures (see Section 3.3).

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018		2019			2020			Change: 2018-2020	
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP	
Revenue	46.2	46.2	46.5	46.5	46.7	47.1	46.5	46.8	0.3	
<i>of which:</i>										
- Taxes on production and imports	14.3	14.3	14.5	14.3	14.3	15.6	14.3	14.4	0.0	
- Current taxes on income, wealth,	14.1	14.1	14.0	14.0	14.1	13.7	14.1	14.2	0.0	
- Capital taxes	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	
- Social contributions	13.3	13.3	13.5	13.5	13.6	13.4	13.5	13.6	0.2	
- Other (residual)	4.4	4.4	4.4	4.6	4.6	4.3	4.5	4.6	0.1	
Expenditure	48.4	48.4	48.9	48.7	48.9	49.1	48.7	49.1	0.3	
<i>of which:</i>										
- Primary expenditure	44.7	44.7	45.3	45.3	45.4	45.5	45.4	45.8	0.7	
<i>of which:</i>										
Compensation of employees	9.8	9.8	9.7	9.7	9.8	9.5	9.6	9.8	-0.2	
Intermediate consumption	5.7	5.7	5.5	5.6	5.6	5.6	5.6	5.7	-0.1	
Social payments	22.4	22.4	23.1	23.0	23.0	23.2	23.3	23.5	0.9	
Subsidies	1.4	1.4	1.5	1.5	1.4	1.5	1.4	1.4	0.0	
Gross fixed capital formation	2.1	2.1	2.2	2.3	2.2	2.4	2.4	2.3	0.3	
Other (residual)	3.4	3.4	3.3	3.2	3.3	3.3	3.1	3.2	-0.2	
- Interest expenditure	3.7	3.7	3.6	3.4	3.5	3.6	3.3	3.3	-0.4	
General government balance (GGB)	-2.2	-2.2	-2.4	-2.2	-2.2	-2.1	-2.2	-2.3	0.0	
Primary balance	1.5	1.5	1.2	1.3	1.3	1.6	1.1	0.9	-0.4	
One-off and other temporary measures	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2	0.0	
GGB excl. one-offs	-2.3	-2.3	-2.5	-2.3	-2.3	-2.2	-2.3	-2.5	0.0	
Output gap ¹	0.2	0.2	-0.3	-0.3	-0.2	-0.2	-0.2	-0.1	-0.4	
Cyclically-adjusted balance ¹	-2.3	-2.3	-2.2	-2.0	-2.1	-2.0	-2.1	-2.3	0.2	
Structural balance (SB)²	-2.4	-2.4	-2.3	-2.1	-2.2	-2.1	-2.2	-2.5	0.2	
Structural primary balance²	1.3	1.3	1.3	1.3	1.3	1.5	1.1	0.8	-0.1	

Notes:

¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/Programme as recalculated by Commission on the basis of the DBP/Programme scenario using the commonly agreed methodology.

² Structural (primary) balance corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

Risks to both the Draft Budgetary Plan and the Commission deficit projections include worse-than-expected macroeconomic developments, lower yields from measures against tax fraud and higher spending for the new minimum income or early retirement schemes. Furthermore, any increase in sovereign risk premia compared to the relatively low level observed as of September 2019 would imply higher interest spending than projected by both the Draft Budgetary Plan and the Commission forecast. Conversely, higher-than expected yields from the measures against tax fraud represent an upward risk.

Euro area sovereign bond yields remain at historically low levels, despite an upward-level shift observed in Italy from mid-2018 until mid-2019. After peaking at 3.6% in November 2018 and declining in January, July and September 2019, 10-year rates in Italy currently stand at 1%⁶. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the Draft Budgetary Plan, interest expenditure in Italy is expected to fall from 3.7% of GDP in 2018 to 3.4% in 2019 and is projected to decrease further next year, to 3.3% of GDP, well below the 4.8% recorded in 2012 at the peak of the euro area sovereign debt crisis. The picture stemming from Italy's plans is broadly confirmed by the Commission forecast.

The Italian authorities indicated in the revised Draft Budgetary Plan for 2019 that the budgetary impact of the extraordinary maintenance programme for the road network following the collapse of the Morandi bridge in Genoa as well as of the preventive plan to limit hydrogeological risks following exceptionally adverse weather conditions that occurred in 2018 is significant and should be considered as an unusual event outside the control of the government, for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97. More specifically, this expenditure was estimated at 0.2% of GDP in 2019. In relation to this, Italy requested a temporary deviation from the adjustment path towards the medium-term budgetary objective of 0.2% of GDP in 2019. Italy's 2020 Draft Budgetary Plan revised this amount to 0.18% of GDP, and indicated that up to September 2019 around 50% of the corresponding funds had been spent. The Commission provisionally assessed Italy to be eligible for an allowance of 0.18 % of GDP in 2019 in relation to costs considered by the Commission to have a clear and direct link to the invoked unusual events. The Commission will make a final assessment, including on the eligible amounts, in spring 2020 based on observed data as provided by the authorities. In the 2020 Draft Budgetary Plan, the Italian authorities indicated that the budgetary impact of the preventive plan to limit hydrogeological risks will be significant also in 2020 and, in relation to this, Italy requested a temporary deviation from the adjustment path towards the medium-term budgetary objective amounting to 0.2% of GDP in 2020. As regards costs related to 2020, the Commission will make a final assessment, including on the eligible amounts, in spring 2021, on the basis of observed data as provided by the authorities.

3.2. Debt developments

Based on the Draft Budgetary Plan, Italy's debt-to GDP ratio is expected to increase by 0.9 percentage points, from 134.8% in 2018⁷ to 135.7%, mainly due to a worsening primary balance and the weak real GDP growth, which resulted in a still debt-increasing and widening snowball effect despite the lower interest spending. The increase of the debt ratio in 2019 is higher than projected in the Stability Programme (0.4 percentage points), as the Stability Programme assumed large privatisation proceeds which are not considered in the Draft Budgetary Plan, resulting in a different stock-flow adjustment. In 2020, the Draft Budgetary

⁶ 10-year bond yields as of 28 October 2019. Source: Bloomberg.

⁷ In September 2019, Istat and the Bank of Italy published revised data on Italy's public debt, which implied an upward level shift of the debt-to-GDP ratio over the past years. For 2018, the debt ratio was revised to 134.8% from 132.2% notified in spring 2019. The revision is mainly due to the reclassification of accrued interests on postal bonds (which amounted to around EUR 58 billion in 2018) within the Maastricht-relevant government debt following the updated "Manual on government deficit and debt" published by Eurostat on 2 August 2019.

Plan projects the debt-to-GDP ratio to decline by 0.5 percentage points to 135.2%, thanks to stronger real GDP growth, lower interest

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio¹	134.8	132.6	135.7	136.2	131.3	135.2	136.8
Change in the ratio	0.7	-2.2	0.9	1.4	-1.3	-0.5	0.6
Contributions ² :							
1. Primary balance	-1.5	-1.2	-1.3	-1.3	-1.6	-1.1	-0.9
2. “Snow-ball” effect	1.5	2.0	2.1	2.6	0.0	0.7	1.5
<i>Of which:</i>							
Interest expenditure	3.7	3.6	3.4	3.5	3.6	3.3	3.3
Real growth effect	-1.0	-0.3	-0.1	-0.1	-1.0	-0.8	-0.6
Inflation effect	-1.2	-1.3	-1.2	-0.8	-2.6	-1.8	-1.2
3. Stock-flow adjustment	0.7	-3.0	0.0	0.1	0.3	-0.1	0.1
<i>Of which:</i>							
Cash/accruals difference		0.4	0.1		0.0	0.3	
Net accumulation of financial		-0.7	0.3		0.0	0.0	
of which privatisation proceeds		-1.0	0.0		-0.3	-0.2	
Valuation effect & residual		-0.1	-0.3		0.2	-0.4	

Notes:

¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

spending, and a significantly higher GDP deflator, which results in a significantly smaller – although still debt-increasing – snowball effect. Furthermore, the Draft Budgetary Plan assumes a small debt-decreasing stock-flow adjustment, reflecting the government privatisation target of 0.2% of GDP in 2020. The Stability Programme projected a stronger decline of the debt ratio in 2020 (1.3 percentage points), due to the more ambitious deficit target and the higher GDP deflator, related to the activation of the Value Added Tax hike legislated as safeguard clause and included in the projections of the Stability Programme.

Compared to the Draft Budgetary Plan, the Commission 2019 autumn forecast projects a stronger increase of Italy’s debt ratio in 2019 to 136.2%, mainly due to the lower inflation projection. In 2020, the Commission forecast expects the debt ratio to further increase by 0.6 percentage points to 136.8% of GDP. Compared to the Draft Budgetary Plan, the difference is due to the larger deterioration of the primary balance as well as to the lower GDP deflator, which – together with slightly lower real GDP growth – results in a wider debt-increasing snowball effect. In addition, in light of the past track-record, the Commission forecast does not consider any proceed from privatisations, which results in a small debt-increasing stock-flow adjustment.

3.3. Measures underpinning the draft budgetary plan

The measures included in the Draft Budgetary Plan were further specified in two legislative proposals: the "fiscal decree"⁸, and the draft budget law, submitted to the Parliament on 2 November and currently under discussion.

In the government projections, the measures included in the Draft Budgetary Plan have a deficit-increasing impact of 0.9% of GDP in 2020 compared to the projections based on unchanged legislation, with most of the expansion planned on the revenue side (0.8% of GDP) rather than the spending side (0.1% of GDP). The main deficit-increasing measure included in the Draft Budgetary Plan is the repeal of the Value Added Tax hike legislated as a budgetary safeguard clause in 2020 and worth 1.3% of GDP, which is included in the government projections based on unchanged legislation. The repeal of the Value Added Tax hike legislated for 2020 and its replacement with alternative financing measures had been announced by the Italian authorities already in the Stability Programme, and correspond to the practice of recent years. In fact, the Value Added Tax hikes legislated as budgetary safeguard clauses in Italy are meant to secure the budgetary targets in the outer years of the government plans, and are normally repealed for the incoming year with the corresponding budget law. However, over the past years such Value Added Tax hikes tended to be compensated only partially with alternative financing measures, leading to a corresponding revision of fiscal targets. Without considering the repeal of the Value Added Tax hike in 2020, the measures included in the Draft Budgetary Plan have an overall deficit-reducing impact of 0.4% of GDP according to the government estimates, related to a corresponding revenue increase. Table 4 reports the overall budgetary impact of the measures included in the Draft Budgetary Plan by main ESA categories, as estimated by the national authorities (the budgetary impact is presented in levels).

Besides the abrogation of the Value Added Tax hike legislated as a "safeguard clause", the main deficit-increasing measure for 2020 on the revenue side is the introduction of a fund for reducing the tax wedge on labour (worth 0.2% of GDP in 2020), although the details of the tax cut are still to be determined. On the expenditure side, the main deficit increasing measures include the introduction of two additional funds for public investment at the central and the local level and additional spending for "unchanged policies", namely the refinancing of military missions abroad and other expenditure needed to keep current policies unchanged but requiring specific financing decisions.

At the same time, the Draft Budgetary Plan includes a spending review conducted at the ministerial level which is expected to reduce government expenditure by 0.1% of GDP in 2020. On the revenue side, deficit-reducing measures for 2020 include: (i) higher taxes on gambling (below 0.1% of GDP); (ii) higher environmental taxes, namely the reduction of tax advantages for the most polluting company cars and the introduction of a new tax on plastic packages (0.1% of GDP); (iii) further postponement of the tax deductibility of specific costs and budgetary losses for some categories of firms, especially banks (0.1% of GDP); (iv) modified provisions concerning the substitute tax on the revaluation of land assets and nontraded shares; (v) postponement to 2020 of the higher revenues expected in 2019 from the

⁸ Decreto Legge 124/2019, Disposizioni urgenti in materia fiscale e per esigenze indifferibili.

revised methodology for estimating ex ante taxpayers incomes for the purpose of tax audits⁹
(close to 0.1% of

⁹ The tax agency estimates ex ante the plausible yearly turnover of self-employed workers and firms by sector of activity, in order to target tax audits to taxpayers whose declared income falls short of ex ante estimates. As a consequence, taxpayers tend to align their declared turnover to the one estimated by the tax agency, in order to avoid tax audits. In 2019, the methodology for estimating plausible turnovers has been refined by including additional parameters, such as the number of employees, which can hardly be misreported. This led to more accurate estimates and reduced the possibility for taxpayers to forge their turnover. As a result, the first payments received following the new provisions pointed to higher revenues in 2019, estimated by the government at EUR 1.5 billion. As part of the measures included in the DBP, the main part of related payments is postponed to 2020, increasing revenues next year.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan**A. Discretionary measures taken by General Government - revenue side**

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2020	2021	2022
Taxes on production and imports	-1.0	-0.1	0.2
Current taxes on income, wealth, etc.	0.0	-0.2	-0.3
Capital taxes			
Social contributions			
Property Income			
Other	0.2	0.0	0.1
Total	-0.8	-0.3	0.0

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2020	2021	2022
Compensation of employees			
Intermediate consumption	0.1	0.1	0.1
Social payments	0.0	0.1	0.1
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0.0	0.0	0.1
Capital transfers	0.0	0.1	0.1
Other	-0.1	0.1	0.1
Total	0.1	0.4	0.5

Note:

The budgetary impact in the table is the aggregated impact of measures as reported by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source:

Draft Budgetary Plan for 2020

GDP); (vi) additional measures against tax fraud (0.2% of GDP), including disincentives to the undue compensation of tax credits, the shift to the main contractor of the subcontractors' tax liabilities ("reverse charge") and several measures against fraud in the fuel sector. In addition, the Draft Budgetary Plan mentions several measures to encourage electronic payments and includes a dedicated fund worth 0.2% of GDP from 2021.

Compared to the Draft Budgetary Plan, the Commission forecast considers only part of the revenues expected from some of the measures against tax fraud in 2020, in light of the related uncertainty. In particular, this concerns the additional revenues expected from the measures against fraud in the fuel sector and from smaller measures, such as the stronger controls against Value Added Tax fraud on vehicles imported from the rest of the EU. At the same time, expected yields from the disincentives to the undue compensation of tax credits and from the shift to the main contractor of the subcontractors' tax liabilities are considered in full, given the precedent of similar measures which raised substantial revenues in the past. Overall, the Commission forecast considers around two thirds of the additional revenues expected by the government from the new measures against tax fraud. Furthermore, the yields expected from the modified substitute tax on the revaluation of land assets and nontraded shares are considered as a one-off revenue in the Commission forecast but not in the Draft Budgetary Plan, leading to a different estimate of the total impact from one-off measures in 2020.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Italy is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective . Box 2 reports the latest country specific recommendations in the area of public finances. Italy is also subject to the debt reduction benchmark.

Box 2. Council recommendations addressed to Italy

On 9 July 2019, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended Italy to ensure a nominal reduction of net primary government expenditure of 0.1% in 2020, corresponding to an annual structural adjustment of 0.6% of GDP. Italy was also recommended to use windfall gains to accelerate the reduction of the general government debt ratio.

4.1. Compliance with the debt criterion

As the debt ratio was 134.8% of GDP in 2018 Italy needs to comply with the debt reduction benchmark.

On 5 June 2019, the Commission issued a report under Article 126(3) TFEU, as Italy did not comply with the debt reduction benchmark in 2018. The report concluded that, after the assessment of all relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as not complied with and that the opening of a debt-based excessive deficit procedure was warranted. On 1 July 2019, the Italian government adopted, via its mid-year budget for 2019, a fiscal correction for 2019 amounting overall to 0.42% of GDP in nominal terms and 0.45% of GDP in structural terms. In its communication of 3 July 2019, the Commission concluded that this package was material enough not to propose to the Council the opening of an excessive deficit procedure for Italy's lack of compliance with the debt criterion in 2018 at that stage.

Based on the Draft Budgetary Plan, Italy is not projected to comply with the debt reduction benchmark either in 2019 (gap to the debt benchmark of 5.4% of GDP) or in 2020 (gap to the debt benchmark of 3.9% of GDP). This conclusion is confirmed based on the Commission forecast (gap to the debt benchmark of 8.8% and 8.6% of GDP in 2019 and 2020 respectively).

Based on an overall assessment of the Draft Budgetary Plan, the debt reduction benchmark is expected not to be met in both 2019 and 2020.

Table 5. Compliance with the debt criterion*

	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	134.8	132.6	135.7	136.2	131.3	135.2	136.8
Gap to the debt benchmark ^{1,2}	7.4	5.1	5.4	8.8	4.5	3.9	8.6
Structural adjustment ³	-0.2	-0.2	0.3	0.2	0.2	-0.1	-0.3
<i>To be compared to:</i>							
Required adjustment⁴							

Notes:

¹ Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

² Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

³ Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

⁴ Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the Medium Term Budgetary Objective

In 2019, for Italy to comply with the requirements of the preventive arm, the nominal growth rate of government expenditure, net of discretionary revenue measures and one-offs, should not exceed 0.1 %, corresponding to an annual structural adjustment of 0.6 % of GDP. Based on the Draft Budgetary Plan, the expenditure benchmark points to a risk of a significant deviation both in 2019 (gap of 0.7 % of GDP) and over 2018 and 2019 taken together (gap of 0.7 % of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed that recommended by the Council. The structural balance pillar points to a risk of some deviation over one year (gap of 0.3 % of GDP) and to a risk of a significant deviation over 2018 and 2019 taken together (gap of 0.3 % per year, on average). An overall assessment based on the government plans points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council in 2019. In case the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019, the expenditure benchmark would point to the risk of significant deviation and the structural balance to the

risk of some deviation from the adjustment path towards the medium-term budgetary objective in 2019. Based on the Commission forecast, the expenditure benchmark points to a risk of a significant deviation both in 2019 (gap of 0.7 % of GDP) and over 2018 and 2019 taken together (gap of 0.7 % of GDP per year, on average). The structural balance pillar points to a risk of some deviation over one year (gap of 0.4 % of GDP) and to a risk of a significant deviation over 2018 and 2019 taken together (gap of 0.4 % per year, on average). An overall assessment based on the Commission forecast points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council in 2019. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019.

In 2020, for Italy to comply with the requirements of the preventive arm, the nominal rate of reduction of government expenditure, net of discretionary revenue measures and one-offs, should be at least 0.1 %, corresponding to an annual structural adjustment of 0.6 % of GDP. Based on the Draft Budgetary Plan, the expenditure benchmark points to a risk of a significant deviation both in 2020 (gap of 1.0 % of GDP) and over 2019 and 2020 taken together (gap of 0.8 % of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed that recommended by the Council. The structural balance pillar also points to a risk of significant deviation both over one year (gap of 0.7 % of GDP) and over 2019 and 2020 taken together (gap of 0.5 % per year, on average). An overall assessment based on the government plans points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective in 2020. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019 and for 2020. Based on the Commission forecast, the expenditure benchmark points to a risk of a significant deviation both in 2020 (gap of 1.0 % of GDP) and over 2019 and 2020 taken together (gap of 0.9 % of GDP per year, on average). The structural balance pillar points to a risk of significant deviation both over one year (gap of 0.9 % of GDP) and over 2019 and 2020 taken together (gap of 0.6 % per year, on average). An overall assessment based on the Commission forecast points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council in 2020. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019 and for 2020.

In summary, an overall assessment based both on the Draft Budgetary Plan and the Commission 2019 autumn forecast points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective both in 2019 and 2020. Based on the Commission forecast, that conclusion would not change in case the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019 and 2020. Based on the Draft Budgetary Plan, in case that budgetary impact were taken into account for 2019, the expenditure benchmark would point to the risk of significant deviation and the structural balance to the risk of some deviation from the adjustment path towards the medium-term budgetary objective in 2019.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2018	2019		2020	
Initial position¹					
Medium-term budgetary objective (MTO)	0.0	0.0		0.5	
Structural balance ² (COM)	-2.4	-2.2		-2.5	
Structural balance based on freezing (COM)	-1.7	-2.2		-	
Position vis-a -vis the MTO ³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2018	2019		2020	
	COM	DBP	COM	DBP	COM
Structural balance pillar					
Required adjustment ⁴	0.3	0.6		0.6	
Required adjustment corrected ⁵	0.3	0.6		0.6	
Change in structural balance ⁶	-0.1	0.3	0.2	-0.1	-0.3
<i>One-year deviation from the required adjustment⁷</i>	-0.4	-0.3	-0.4	-0.7	-0.9
<i>Two-year average deviation from the required</i>	-0.4	-0.3	-0.4	-0.5	-0.6
Expenditure benchmark pillar					
Applicable reference rate ⁸	0.5	0.1		-0.1	
<i>One-year deviation adjusted for one-offs⁹</i>	-0.7	-0.7	-0.7	-1.0	-1.0
<i>Two-year average deviation adjusted for one-offs⁹</i>	-0.5	-0.7	-0.7	-0.8	-0.9
<i>Notes</i>					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.					
² Structural balance corresponds to cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact ed. 2018, page 38.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2018) was carried out on the basis of Commission 2019 spring forecast.					
⁷ The difference of the change in the structural balance and the corrected required adjustment.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i> Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.					

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

Based on the Draft Budgetary Plan, both government expenditures and revenues are expected to increase as a share of GDP in 2019 and to remain stable in 2020. In 2019, this is the result of higher social transfers related to the introduction of a new minimum income and early retirement scheme implemented with the 2019 budget law, which was financed through several measures which temporarily supported revenues. In 2020, the decline in revenue collection related to the projected slow-down in the labour market is set to be broadly offset by the effect of past measures against tax fraud and by the revenue-increasing measures included in the Draft Budgetary Plan. Expenditure is expected to grow broadly in line with nominal GDP in 2020, as a result of several factors including, on the one hand, the additional

spending for the minimum income and early retirement scheme and, on the other hand, declining interest spending and the planned spending review.

Spending for public investment continued declining in 2018 to 2.1% of GDP, from 2.2% of GDP in 2017. However, since the end of 2018 data on the number of projects and investment-related payments from local administrations present a different trend. The 2019 budget law increased funds for public investment for the period 2019-2021, and planned the creation of two public agencies for supporting local administrations, which are not yet operative. The Draft Budgetary Plan further increased funds for public investment over 2020-2021. Overall, public investment is expected to recover as a share of GDP from 2.1% in 2018 to 2.4% in 2020 based on the Draft Budgetary Plan projections.

The Draft Budgetary Plan includes an ambitious spending review for 2020, targeting EUR 2.7 billion in savings. Since 2017, spending reviews are conducted every year among all ministries as an integrated part of the budgetary process. The ex-post assessment of the first spending review conducted in this framework, carried-out in 2017 for the budgetary year 2018, highlighted that, while the overall targeted savings had been reached, ministries achieved them only partially through efficiency gains, while the rest was implemented by cutting or postponing spending programmes. It should also be considered that the spending review planned for 2020 only affects the central level of government. While regional and local governments are subject to national fiscal rules, no systematic spending reviews to improve the efficiency of public spending are conducted at those levels.

Italy's budgetary framework is very advanced concerning environmental sustainability, as detailed indicators and forecasts on the environmental impact of fiscal policies are updated every year with the Stability Programme. Regarding fiscal plans, the Draft Budgetary Plan includes several measures aimed at raising additional revenues while providing incentives to sustainable behaviours, such as a review of environmentally harmful tax expenditures (see Section 3.3).

As concerns the overall growth-friendliness of the tax structure, the Draft Budgetary Plan contributes to reducing taxes on labour (see Box 4) and lowering tax expenditures, but a comprehensive tax reform is still pending. Concerning tax expenditures, the Draft Budgetary Plan introduces a limit on tax deductions on personal income taxes, with the exception of mortgage interests, which is expected to produce a small positive budgetary impact. However, a comprehensive review of tax expenditures, notably encompassing consumption taxes, is still pending. Furthermore, there are no plans yet for reforming the outdated cadastral system.

Regarding tax compliance, the Draft Budgetary Plan includes several measures against tax evasion, which build on the measures already adopted in recent years, such as compulsory electronic invoicing and electronic transmission of receipts. In particular, the Draft Budgetary Plan includes several measures aimed at encouraging electronic payments, as well as numerous other measures targeting specific areas, such as the undue compensation of tax credits and frauds in the fuel sector.

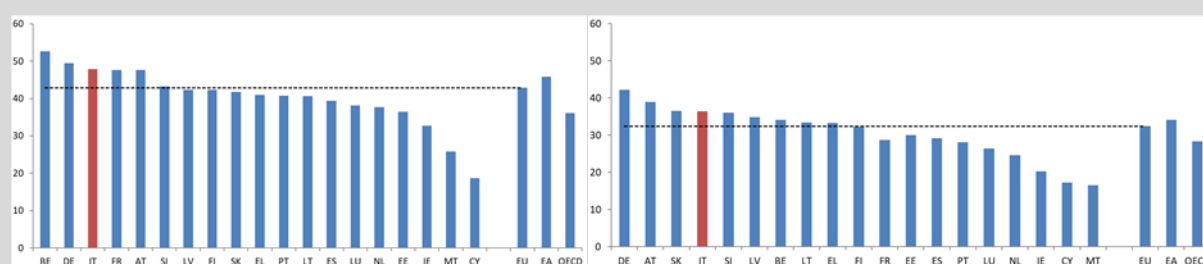
Overall, while the 2019 budget law had increased social transfers, including pensions, by temporarily raising the tax burden on firms at an aggregate level, the Draft Budgetary Plan takes a more growth-friendly approach, by earmarking resources to reduce the tax wedge on labour and further stepping up the fight against tax evasion, while also reducing the fiscal deterioration implied by the additional cost of past measures.

Box 3 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Italy for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Italy at the average wage and a low wage (2018)



Notes: EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2019 European Semester, Italy was issued the recommendations to shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values.

Italy's Draft Budgetary Plan contains one main measure that affects the tax wedge on labour, namely a fund for reducing the tax wedge on labour of around 0.2% of GDP in 2020 and 0.3% of GDP from 2021. However, the design of the tax reduction is not yet determined and will be specified in future decrees.

6. OVERALL CONCLUSION

Based on the Draft Budgetary Plan and the Commission 2019 autumn forecast, Italy is not projected to comply with the debt reduction benchmark in 2019 and 2020. An overall assessment based on both the Draft Budgetary Plan and the Commission 2019 autumn forecast points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective both in 2019 and in 2020. Based on the Commission forecast, that conclusion would not change in case the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were taken into account for 2019 and for 2020.