MEF Dipartimento del Tesoro

Relevant Factors Influencing Public Debt Developments in Italy

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INDEX

Executive summary 5
I. Introduction 6
II. Fiscal policy has responded to extraordinary events 6
III. Key inclusion and economic revitalisation policies enacted 8
III. Economy has responded very positively to fiscal stimulus 10
IV. Deficit was sharply lower than the official projections 11
VI. Public sector has borne the brunt of the Covid-19 shock 12
VII. Stability Program 2022 reaffirms debt-reduction plan 14
VIII. Higher GDP growth and gradual fiscal consolidation to improve public debt sustainability 16

EXECUTIVE SUMMARY

- The Italian economy recovered strongly in 2021, posting a 6.6 percent increase in real GDP following the unprecedented 9.0 percent drop recorded in 2020.
- Still, new waves of the Covid-19 epidemic required the adoption of additional economic relief measures. Furthermore, around mid-year natural gas prices soared, also driving up electricity prices. The government promptly responded to this new shock by cutting the fixed component of gas and electricity bills.
- Against this backdrop, the decline in the general government deficit to 7.2 percent of GDP in 2021, from 9.6 percent in 2020, is a positive result and is way better than the projection of last year's Stability Program (11.8 percent of GDP).
- In addition, high nominal GDP growth (7.5 percent), a low average funding cost and a smaller primary deficit drove the general government debt ratio down to 150.8 percent of GDP in 2021, from 155.3 percent in 2020.
- The General Escape Clause of the Stability and Growth Pact (SGP) remains in effect. Even so, the Commission is required to draft a Report ex article 126.3 of the Treaty on the Functioning of the European Union (TFEU) given that Italy's deficit and debt ratio in 2021 were both higher than the Treaty reference values.
- Prior to the pandemic Italy accomplished a meaningful reduction in the budget deficit (to 1.5 percent of GDP in 2019) but was less successful at revitalizing its economic growth: the average real GDP growth rate in the 2010-2019 decade was 0.3 percent, and the best performance in recent years was 1.7 percent in 2017.
- Consequently, when the current government took office in February 2021 its overriding goal was to minimize permanent scarring effects from the Covid-19 crisis and to set in motion a new phase of higher, more sustainable, and inclusive economic growth. Hence, the government focused its efforts on vaccinating at least 80 percent of the adult population, supporting households and firms most affected by the pandemic, and finalizing the Recovery and Resilience Plan (RRP).
- This pro-growth agenda has been coupled with a strengthening of social inclusion policies and a strong commitment to reducing the budget deficit and to bringing the debt ratio back to the precrisis level by the end of this decade.
- The energy crisis, recently aggravated by the war in Ukraine, has required the adoption of additional expansionary measures. However, in the recently adopted Stability Program 2022, the government reaffirmed the existing nominal budget deficit targets for 2022-2024 and set a deficit goal for 2025 of 2.8 percent of GDP. Testament to the government's commitment to fiscal discipline, recent relief packages were partly funded via a tax on the extra profits of energy firms.
- Higher inflation and the ongoing recovery in employment are boosting tax revenues, while the dynamic of primary noninterest expenditure remains moderate. Going forward, a further reduction of the tax gap and a comprehensive spending review will help reduce the deficit without stifling growth.
- The public sector has borne the brunt of the adjustment during the pandemic and energy crises. Looking through the current energy and geopolitical crisis, continuing fiscal discipline and the implementation of reforms and investments foreseen in the RRP will underpin the sustainability of government debt.

I. INTRODUCTION

At the request of the European Commission, in accordance with Article 126(3) of the TFEU and as foreseen by Art. 2(3) of Regulation (EC) 1467/97, this short report discusses factors that the Italian government deems “relevant in order to comprehensively assess compliance with deficit and debt criteria in 2021.” The report also summarizes Italy’s Stability Program for 2022-2025 and reiterates the government’s commitment to a long-term debt-reduction program.

The Commission’s request rests on the fact that Italy’s general government deficit in 2021 was 7.2 percent of GDP, down from 9.6 percent of GDP in 2020 but still above the Treaty reference value of 3 percent of GDP. In addition, the gross general government debt ratio in 2021 declined to 150.8 percent of GDP, from 155.3 percent of GDP in 2020, but exceeded the 60 percent Treaty reference value.

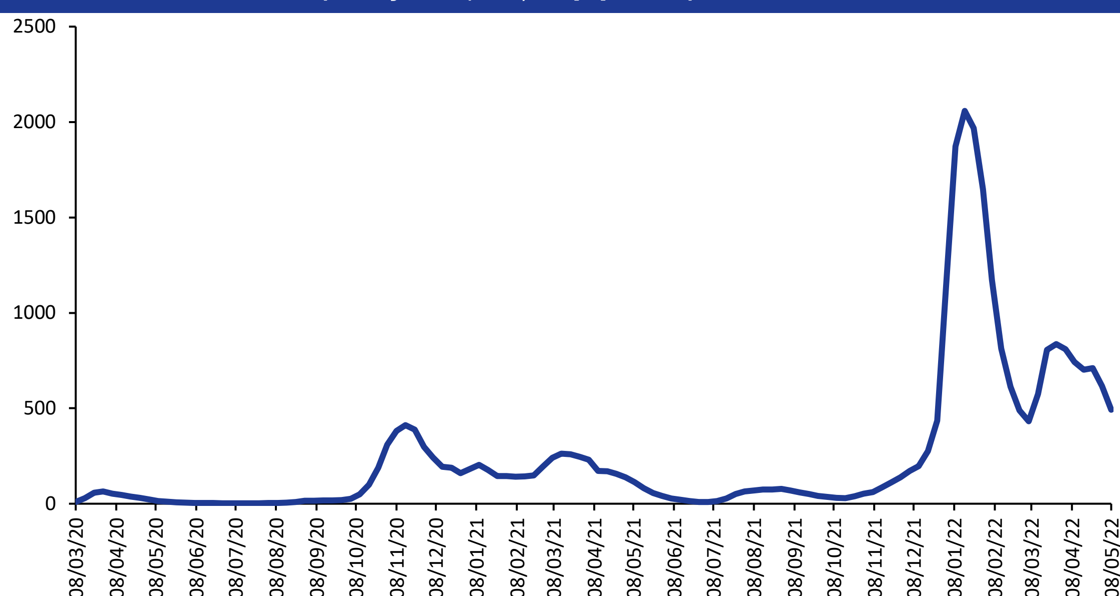
The General Escape Clause envisaged by Regulations 1466/97 (preventive arm) and 1467/97 (corrective arm) remains in effect. Furthermore, in its 2 March 2022 Communication on ‘Fiscal Policy Guidance for 2023,’ the European Commission announced that it would not propose the opening of new excessive deficit procedures in the spring of 2022. Indeed, the macroeconomic performance of the European economy continues to be negatively affected by the Covid-19 pandemic and its repercussions on global demand and value chains. Together with the geopolitical situation, and in particular the war in Ukraine, this creates an exceptional degree of uncertainty, including for designing a detailed budgetary adjustment path.

II. FISCAL POLICY HAS RESPONDED TO EXTRAORDINARY EVENTS

The conduct of fiscal policy in 2021 continued to be heavily influenced by the pandemic. A second wave of Covid-19 infections hit Italy and other European countries in the autumn of 2020, requiring the implementation of new restrictive measures and economic relief packages. New infections declined around the turn of the year but then rose again in the first quarter of 2021, as the vaccination campaign was just beginning. The evolution of the epidemic became more favorable in the spring of last year even though the diffusion of the Delta variant caused a moderate increase in new infections in the early summer.

The government achieved the goal of vaccinating at least 80 percent of the population over the age of 12 by the early autumn of 2021. However, in the final weeks of 2021 Covid-19 infections rose sharply, reaching a new high in January 2022, as the Omicron variant became prevalent. Although the fourth wave of the epidemic has receded since then, new infections remain relatively high. Even so, thanks to a reduced morbidity of the virus and to a high share of the population having received at least one dose of anti-Covid vaccines (91.5 percent of the over-12 and 38 percent of the under-12), the government decided to end the state of emergency on 31 March 2022. Most of the remaining anti-Covid restrictions were lifted at the beginning of May.

FIGURE 1: COVID INFECTIONS (weekly cases/100,000 population)



Source: Protezione Civile.

Economic relief packages in response to the Covid-19 crisis totaled 108.1 billion (6.5 percent of GDP) in 2020 and 71.0 billion (4.0 percent of GDP) in 2021. Their actual impact on the public finances was lower than the *ex-ante* estimates because the safety net created by the support measures helped cushion the economic impact of the lockdown and social distancing measures. In addition, economic activity rebounded very quickly as soon as restrictions were lifted, first in the summer of 2020 and then again in the spring of 2021.

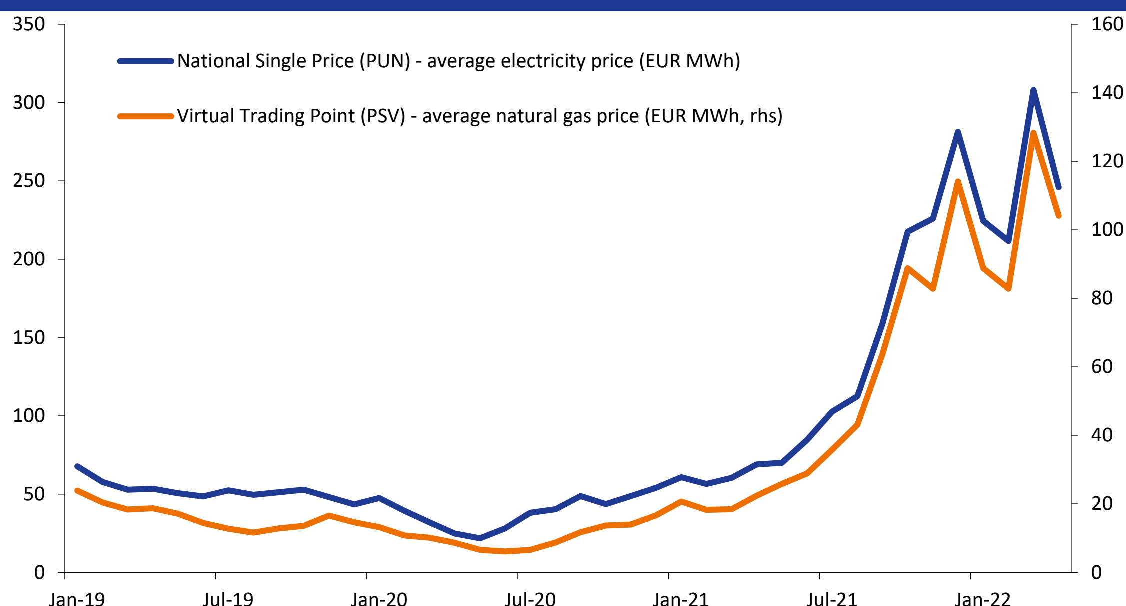
Since the late spring of 2021, the Covid-19 emergency has been compounded by a sharp rise in energy prices and growing geopolitical tensions, which burst out on 24 February 2022 with Russia's attack against Ukraine. The government intervened with fiscal measures aimed at cushioning the impact of the spike in natural gas and electricity prices on households and SMEs, with a special focus on families at risk of energy poverty (via the 'social bonus'). Total interventions carried out in 2021 totaled 5.3 billion (0.3 percent of GDP).

With natural gas prices reaching new highs in December and again in early March of this year following the Russian attack against Ukraine, a larger volume of resources has been devoted to mitigating the rise in energy prices not only for households, but also for firms (including energy-intensive ones). In late March, the government also cut the excise taxes on fuels. Taken together, the three decree-laws issued during the first quarter of this year have provided total support worth 10.9 billion (0.6 percent of GDP), largely but not exclusively to mitigate the increase in energy prices (incentives on sales of low emission vehicles, other industrial policy measures and support for Ukrainian refugees were also included in the package).[1]

[1] The 2022 Budget provided 3.8 billion of funding for cuts in fixed charges on utility bills. Including that amounts, the overall support package already enacted is worth 0.8 percent of GDP.

On 2 May the government approved two additional decree-laws, the first of which prolongs the cut in fuel taxes until 8 July while the second finances a series of measures, from a further cut in the fixed charges of gas and electricity bills in the third quarter of this year, to additional funding for public works in response to the rise in construction costs. Including the two new decree-laws, overall support measures adopted so far this year in response to the rise in energy prices and the Ukraine war, plus the above-mentioned industrial policy measures, are worth 1.1 percent of GDP.

FIGURE 2: NATURAL GAS AND ELECTRICITY PRICES



Source: GME

III. KEY INCLUSION AND ECONOMIC REVITALISATION POLICIES ENACTED

Consistent with the activation of the General Escape Clause, fiscal policy in 2021 remained expansionary. Indeed, the 2021 Budget involved a fiscal expansion worth 1.4 percent of GDP (and 0.6 percent for 2022) relative to the existing legislation.

The expansionary measures were for the most part temporary and consisted of selective support measures for sectors of the economy that were severely affected by the Covid-19 crisis. Among these, there was the extension of various income support schemes and an exemption from the payment of social security contributions for firms that took back employees previously laid off under the wage supplementation fund.

However, the 2021 Budget also included structural measures, such as the reduction of the tax wedge from 1 January 2021, for which the Budget allocated 3 billion, the financing of the entry into force of the first stage of the universal child benefit, and the introduction of a new fund to finance the personal income tax reform.

The 2022 Budget implemented the fiscal policy plans outlined in the 2021 Stability Program, which were based on the premise that the revival of the Italian economy after years of slow growth and the unprecedented slump in 2020 required a supportive

fiscal policy stance in the short run, in the expectation that in the following years the RRP would raise Italy’s potential GDP growth.

According to the approach adopted in the 2022 Budget, Italy's fiscal policy shall remain expansionary until the GDP gap, with respect to the pre-crisis trend, is closed. A gradually less expansionary stance of fiscal policy will lead to a decline in the deficit, a significant reduction in the debt-to-GDP ratio, an improvement in the quality of public spending, and strong revenue growth, thanks also to a shrinking tax gap.

The fiscal space obtained by adopting a more gradual deficit reduction path, compared to the baseline (roughly 1.3 percent of GDP on average in the period 2022-2024), has been allocated to a reform of the Personal Income Tax (IRPEF), the Regional Tax on Production (*Imposta regionale sulle attività produttive*, IRAP) and of social benefits, as well as raising the resources for the Citizenship Income scheme, funding credit guarantees and increasing public investment. In addition, funding for health and pandemic response has been increased, and as already mentioned, a substantial reduction in energy costs for households and businesses has been implemented. The universal child benefit has been fully implemented.

The personal income tax cut and the introduction of the universal child benefit are part of a plan to increase the overall equity and efficiency of the tax and benefit system. On the one hand, the IRPEF reform reduced the tax wedge on labor and the marginal tax rate for middle incomes, thus providing an incentive to participate in the regular labor market and supporting household disposable income. Tax expenditures have been streamlined, including via the elimination of the 100-euro monthly benefit (previously 80-euro bonus) for salaried workers. The universal child benefit replaces a set of family support tools (primarily income tax deductions for dependent children and the allowance for families), which did not guarantee adequate protection for low-income households.

The increase in the resources for Citizenship Income was motivated by the increase in poverty, and in the number of eligible individuals and families, caused by the pandemic crisis. However, eligibility criteria have been modified to combat fraud and strengthen the labor market activation component of the scheme.

The reform of social safety net implemented via the 2022 Budget has the dual objective to create a broad universal and inclusive safety net that protects workers in all enterprises, and to promote their employability. It provides for the extension of the existing instruments (CIGS, CIGO, Wage Integration Fund, etc.) and the easing of eligibility criteria for the unemployment benefit (NASPI).

Among others, tax credits referring to the Transition 4.0 program are extended and reinforced, with the aim to promote the technological and environmental transition of firms. Allocations for guarantees in favor of SMEs have been increased, in line with the extension of the State-aid temporary framework, to counteract any liquidity crunch for firms due to the Covid-19 crisis.

Finally, national resources of the Complementary Investment Fund and the Fund for Development and Cohesion (FSC) were increased to provide an additional boost to public investment spending, which is expected to be mainly supported by loans and grants from the Recovery and Resilience Facility in the coming years.

IV. ECONOMY HAS RESPONDED VERY POSITIVELY TO FISCAL STIMULUS

Following a fall in real GDP of 9.0 percent in 2020, the Italian economy last year grew by 6.6 percent. Eurostat data show that Italy's Q4/Q4 real GDP growth rate in 2021 (6.2 percent) was among the highest in the EU and outperformed the other large euro area economies. Growth in the Italian economy in 2021 was driven by investment, which increased by 17.0 percent, more than offsetting the 9.1 percent drop recorded in 2020. Exports were also very dynamic, rising by 13.3 percent following a 13.4 percent drop in 2020. Household consumption grew by a more moderate 5.2 percent, recouping less than half of the 10.5 percent drop suffered in 2020 as the saving ratio remained higher than before the crisis (13.1 percent of disposable income, down from 15.6 percent in 2020 but still way above the 8.0 percent ratio posted in 2019).

Counterfactual analyses of the impact of support packages suggest that fiscal support measures were very effective at containing the depth and duration of recession in 2020 and promoting a strong recovery in 2021. A recent study carried out at the Economy and Finance Ministry[2] based on detailed information on the full set of fiscal measures adopted in 2020 (including public guarantees) shows that real GDP would have fallen by an additional 4.4 p.p. in 2020 in the absence of emergency fiscal measures. Investment would have dropped by more than twice the fall recorded in that year. A similar analysis[3] focusing on the decrees adopted by the Italian government from March to May 2020 finds that policies reduced the impact of the Covid-19 crisis on GDP by 25 percent at the peak of the crisis. Fiscal measures were also key in supporting employment during the pandemic. A recent study[4] using Italian firms' data shows that short-time work schemes, liquidity support for firms, and the layoff ban extended during the pandemic crisis prevented more than 400,000 redundancies in 2020. Finally, internal MEF estimates based on the Italian Treasury Econometric Model (ITEM) indicate that emergency fiscal support measures adopted in 2021 boosted GDP growth by about 1.4 p.p.

Italy has made good progress on the implementation of the RRP: indeed, the first instalment of the Plan was completed at the end of 2021, leading to the disbursement of the associated payment from the EU in April of this year. Work is under way to complete the second instalment by mid-year. However, so far, the economic impact of the Plan has been limited. At the end of February of this year, realized spending on the Plan's projects stood at 5.2 billion[5], versus a total RRF endowment of 191.5 billion for the 2021-2026 period. This suggests that it was mostly the other policies implemented by the government and the reopening of social and economic activity that led to the strong economic recovery of 2021. Furthermore, with most of the resources of the RRP still to hit the ground, the growth outlook for the coming years looks quite promising if external factors become less of a drag.

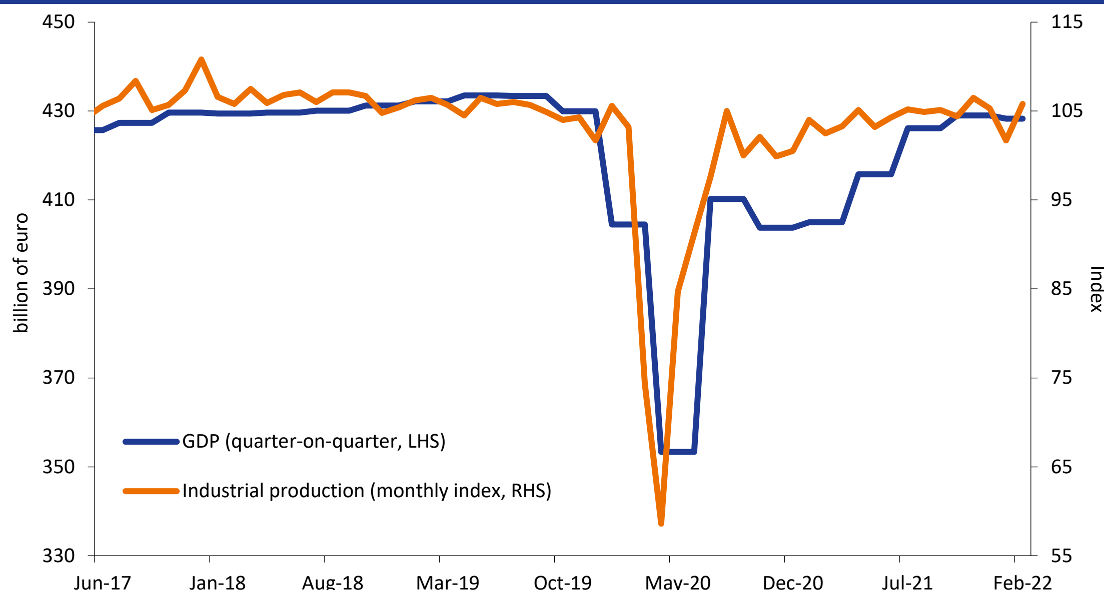
[2] Di Bartolomeo, G., D'Imperio, P., Felici, F. (2021), "The fiscal response to the Italian Covid-19 crisis: A counterfactual analysis", Government of the Italian Republic, Ministry of Economy and Finance, Department of the Treasury, Working Paper No. 1 (2021).

[3] Di Pietro, M., Marattin, L., Minetti, R. (2020), "Fiscal policies amid a pandemic: The response of Italy to the Covid-19 crisis", National Tax Journal, 73(3), 927-950.

[4] Viviano, E. (2021), "The impact of employment protection measures in 2020", Economia Italiana, 2021/1.

[5] Data on realized RRF spending are still provisional.

FIGURE 3: REAL GDP AND INDUSTRIAL PRODUCTION



V. 2021 DEFICIT WAS SHARPLY LOWER THAN OFFICIAL PROJECTIONS

In 2021 the general government deficit fell more sharply than expected, to 7.2 percent, from 9.6 percent in 2020. The outturn was 2.2 percentage points lower than the 9.4 percent estimate published last September in the Update of the Stability Program and 4.6 pp lower than the 11.8 percent forecast in the 2021 Stability Program. The lower deficit reflects higher-than-expected revenues from taxes and social security contributions, as well as lower expenditure.

A similar outcome was already observed in 2020, when the deficit was almost one percentage point lower than the official forecast of 10.5 percent of GDP in the Draft Budgetary Plan 2021. This is in line with the above-mentioned simulation results suggesting that countercyclical fiscal policy interventions have been effective in stabilizing the economy, also leading to a lower-than-expected deficit.

Following the exceptional drop in government revenues caused by the 2020 recession, government revenues in 2021 grew by 9.2 percent. The annual increase in indirect taxes was 13.8 percent, those of social contributions and direct taxes were, respectively, 6.7 percent and 6.5 percent.

Among indirect taxes, VAT revenues on internal trade showed the greatest dynamism due to rising inflation and the rebound in domestic demand. VAT revenues on imports recorded strongly positive rates of change thanks to the recovery in import volumes and a sharp rise in import prices. The increase in social contributions and personal income tax revenues reflected the improvement in labor market conditions. Finally, in 2021 other types of taxes, such as excise duties, withholding taxes, car taxes, and taxes on lotteries, also posted strong growth rates.

On the expenditure side, pensions expenditure in 2021 increased by 2.0 percent. As far as interest payments are concerned, thanks to still accommodative monetary

conditions, the average cost of issuing government bonds reached an all-time low of 0.10 percent, from 0.59 percent in 2020. However, the pickup in inflation led to higher interest payments on inflation-linked government bonds. Due also to the higher debt stock, interest expenditure in 2021 increased by 5.5 billion, reaching a level of 62.9 billion. Even so, interest expenditure relative to GDP remained stable at 3.5 percent.

Lower-than expected public expenditure was mainly due to a lower take-up of discretionary measures adopted to counter the economic and social impact of the pandemic crisis. Also, public spending for social transfers other than in-kind was stable compared to the 2020 level. The increase in pension expenditure was offset by a 4.7 percent decrease in expenditure for the wage supplementation fund and unemployment benefits.

In 2021 the annual growth rate of current primary expenditure was 2.2 percent, compared to a nominal growth of the economy of 7.2 percent. As a result, the ratio of this expenditure component to GDP fell by 2.2 percentage points, to 46.0 percent, from a peak of 48.2 percent recorded in 2020. By contrast, public investment grew by 19.5 percent, reaching a level of 2.9 percent of GDP, up from 2.6 percent in 2020.

VI. PUBLIC SECTOR HAS BORNE THE BRUNT OF THE COVID-19 SHOCK

During the pandemic, public policies relied primarily on leveraging the balance sheet of the general government. This is clearly borne out by the latest financial accounts data (third quarter of 2021), which show that general government liabilities rose from 2,265 billion euros (128 percent of GDP) at the end of 2019 to 2,571 billion (145 percent of GDP), while during the same period the financial position of the private sector improved markedly.

Indeed, households enjoyed a sizeable increase in net financial assets, which in Q3 2021 rose to 4,998 billion, 334 billion higher than at the end of 2019, as gross assets were boosted by higher savings and financial asset prices while liabilities grew by a mere 15 billion, to 979 billion. Non-financial corporations experienced a marginal decrease in net financial debt, from 1,982 billion to 1,952 billion, as assets grew by 76 billion and liabilities by €46 billion.

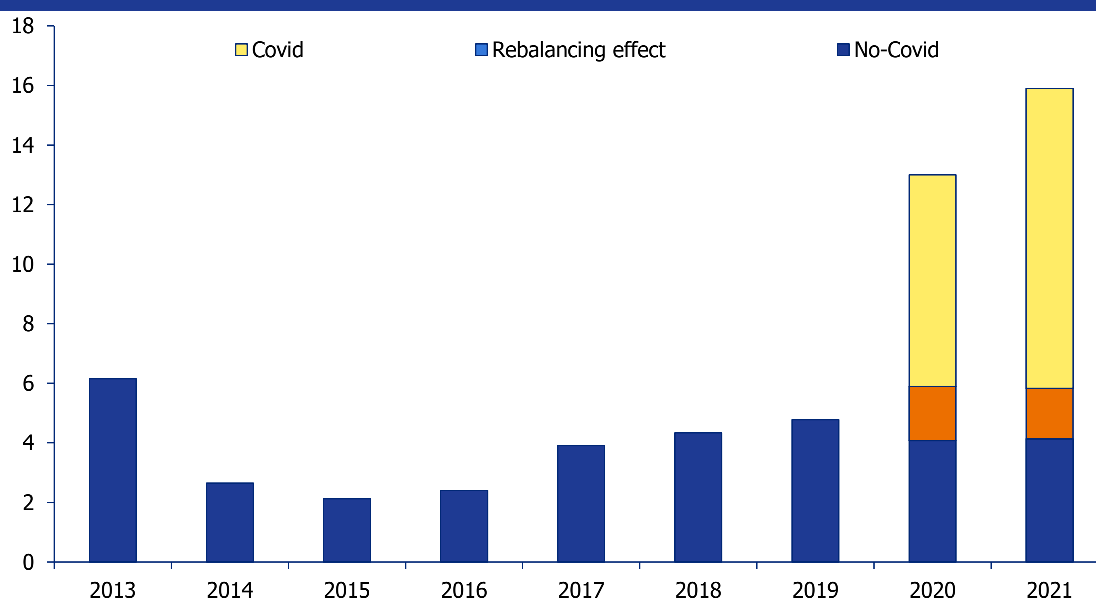
Banks and financial corporations too have come out of the 2020-2021 crisis relatively unscathed if not stronger. As the Bank of Italy notes in its latest Financial Stability Report, in 2021 the quality of the assets of the banking system remained good on average, thanks to the economic recovery and to the measures in support of households and businesses adopted by the government. Loan growth was boosted by state guarantees in 2020 and then slowed to a more moderate rate in 2021. The rate of loan deterioration remained low through to end-2021, while the sale of impaired loans continued. The profitability of banks has improved, thanks also to a decrease in value adjustments on credits, while their capitalization has remained stable.

As for the latest developments, the war in Ukraine will affect banks through financial and economic channels. However, overall direct exposure vis-à-vis Russian counterparts is limited. The two largest Italian banking groups are relatively more

exposed to Russia, but the potential impact on their capital ratios appears manageable[6].

The relief packages implemented by the government also relied importantly on public guarantees. By the end of 2021 the stock had increased to 15.9 percent of GDP, from 13.0 percent of GDP in 2020 and 4.8 percent in 2019. The increase is mainly due to guarantees related to the Covid-19 crisis, which rose from 7.1 percent in 2020 to 10.1 percent in 2021, whereas other state guarantees remained stable at 5.8 percent of GDP (4.1 percent excluding the reclassification of guarantees issued by SACE[7]). In particular, the State exposure towards the financial sector remained unchanged at 0.8 percent of GDP.

FIGURE 4: STOCK OF PUBLIC GUARANTEES (% of GDP)



Note: The rebalancing effect refers to the reform provided for the D.L. No. 23/2020, that shifts from 10% to 90% the share reassured by the State of the financing granted by SACE to support export and internationalization, with consequent increase of the State exposure.

Source: MEF analysis on ISTAT and Eurostat data.

In 2021, Covid guarantees were reinforced by several measures introduced by decree-law No. 73 of 25 May 2021. The expiry of the two main Covid-19 guarantees schemes, the Central Guarantee Fund for SMEs and SACE's 'Garanzia Italia', initially foreseen for 30 June 2021, was extended to 31 December 2021, given the protracted pandemic emergency and in line with the extension of the EU Temporary Framework on State aid. For the former, the Decree provided for a lower coverage ratio of the guarantees and extended the guarantees on medium- to long-term funding for research and development projects and investment programs. Also, the Decree denied the access to the Central Fund to the medium-sized firms, which can access to the 'Garanzia Italia' scheme, without the constraints imposed on large companies.

[6] Bank of Italy, Financial Stability Report, No. 1 2022, 29 April 2022.

[7] SACE is the Italy's Export Credit Agency.

Consequently, the stock of the two funds increased, respectively, to 8.3 percent of GDP in the case of the Central Fund (+2.5 p.p. compared to 2020) and to 1.6 percent of GDP for 'Garanzia Italia' (+0.4 p.p. respect to 2020).

More recently, the 2022 Budget further postponed the deadline for the Central Fund to 30 June 2022 while modifying the methods of disbursement of these guarantees (80 percent for transactions up to 30,000 euro and a one-off fee). Nonetheless, some types of guarantees are still exempt from the fee, such as those in favor of women's businesses and for businesses in the South.

The so-called Energy Decree (decree-law No. 21 of 21 March 2022) provided that until 30 June 2022 the fee is not due for guarantees relating to loans in support of firms' liquidity needs, resulting from higher energy prices. Moreover, it provided for additional SACE guarantees for financial transactions relating to strategic industrial sites.

Finally, the decree-law currently in the works provides for further temporary guarantees on loans granted until 31 December 2022, to support the liquidity of companies hit by the economic fallout of the Ukraine war. They include guarantees provided by SACE (market guarantees) aimed at supporting imports of commodities or production factors whose supply chain has been interrupted or has experienced price increases as a result of the crisis; guarantees provided by the Central Fund of Guarantees for SMEs on loans aimed at achieving objectives of efficiency or diversification of energy production or consumption, subject to requirements on turnover and energy costs; guarantees granted by ISMEA to SMEs operating in the agricultural and fishing sectors that have experienced a sharp increase in energy costs.

VII. STABILITY PROGRAM 2022 REAFFIRMS DEBT-REDUCTION PLAN

In last month's Stability Program, the Government confirmed the nominal deficit targets announced in the 2022 Draft Budget Plan while extending the planning horizon to the year 2025. The new projections entail a deficit path starting from 5.6 percent of GDP this year and declining to 2.8 percent in 2025, below the 3 percent Treaty reference value.

Some room for measures aimed at counteracting the effects of the Ukrainian crisis was also created; the leeway was worth 0.5 percentage points of GDP this year, 0.2 in 2023 and 0.1 in 2024 and 2025. The above mentioned 0.5 percentage points of GDP margin is being used to finance the new relief package described above.

As already mentioned, the two new decree-laws supplement the resources intended to compensate for the increase in the cost of public works due to higher energy and building materials prices and prolongs the cut in fuel taxes and fixed charges of gas and electricity bills. New measures will also support the companies most affected by the sanctions vis-à-vis Russia. To this end, the guarantee fund for SMEs will also be refinanced. Finally, additional resources will be made available for the care of Ukrainian refugees.

Over the 2020-2022 period, with the General Escape Clause having been activated, fiscal policy was mostly aimed at sustaining economic activity in the face of the severe

challenges posed by the Covid-19 pandemic crisis. Accordingly, several temporary emergency measures, described in the previous section, were introduced. In the Stability Program it was argued that their identification and quantification are extremely complicated especially when assessing their impact on public finance on an ex-post basis. This makes quite difficult to gauge the public finance performance if relying on the indicators traditionally used for fiscal surveillance, such as the structural balance rule. Clearly, the task is made even more complex when considering the correction of the budget balance for the cyclical component, which is large and subject to considerable uncertainty.

All the above difficulties become less compelling starting from the year 2023, when temporary measures are projected to be phased out. Indeed, from that year onwards projected changes in the structural balance are broadly in line with the corrections required by the adjustment matrix of the SGP. In 2023 a significant structural budgetary improvement is expected, while in the following years the adjustment envisaged in the Stability Program is of 0.5 pp of GDP, broadly in line with the requirement of the preventive arm of the SGP, and the deficit-reduction path converges to the Medium-Term Objective (MTO). Projections for the expenditure aggregate also show that it would be close to the benchmark established by the existing rule.

Italy's Stability Program 2022 is compliant with the fiscal policy guidance for 2023 issued by the Commission in early March. In its communication, the Commission recommends expanding current expenditure at a slower pace than potential output from 2023, while relying on the expansion of public investment spending to sustain the economic recovery[8]. This is even more reassuring, considering that the benchmark, based on a moving average of the estimated potential output, is particularly conservative.

In 2021, the debt-to-GDP ratio fell by about 4.4 percentage points of GDP, reaching 150.8 percent, from a peak of 155.3 percent in 2020[9]. The preliminary estimate for 2021 is also significantly lower (-2.7 percentage points) than the level envisaged in the Update of the Stability Program 2021 and in last October's Draft Budgetary Plan, which projected a debt-to-GDP ratio of 153.5 percent.

The improvement was driven by the economic recovery as the snow-ball effect contributed to the reduction of the debt-to-GDP ratio, whose significant downward impulse more than offset the primary deficit.

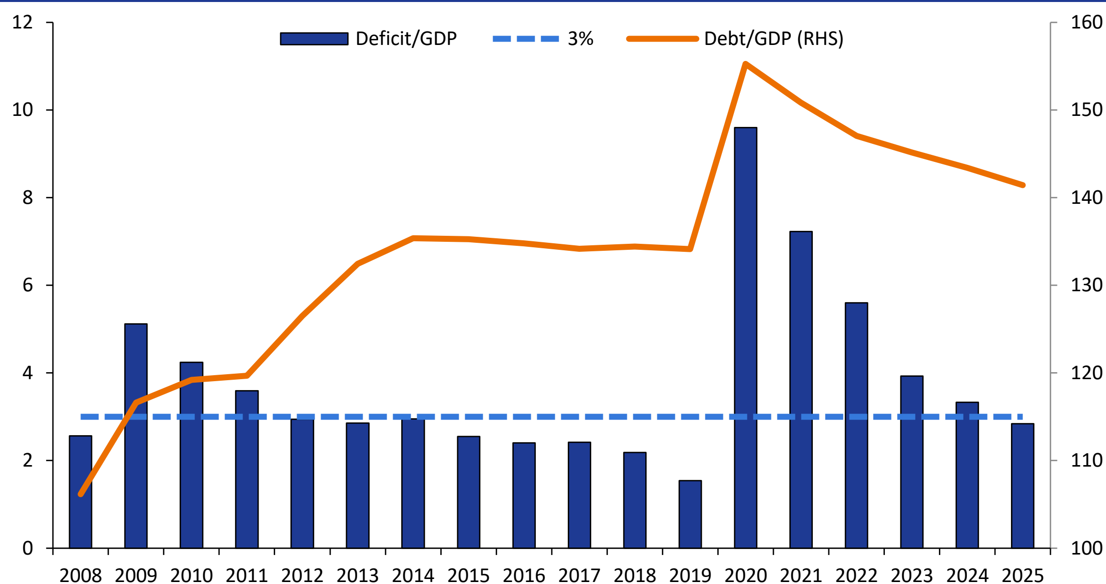
The reduction in the debt-to-GDP ratio is expected to continue in the current and the next three years, during which the public deficit will gradually shrink while economic growth and a sustained GDP deflator dynamics will continue to deliver a favorable snow-ball effect. Accordingly, in 2022, the debt-to-GDP ratio is projected at 147.0 percent, while the new debt-to-GDP ratio target for 2025 is set at 141.4 percent.

[8] See Table III.10 of the Italian version of the Stability Program, pg. 74, where the growth rate of the primary expenditure financed by national resources is expected to be lower than the nominal benchmark.

[9] As a result of the revisions to the debt stock and the level of nominal GDP, the 2020 debt-to-GDP ratio slightly declined to 155.3 percent from the previous estimate of 155.6 percent, while the 2019 debt-to-GDP ratio declined to 134.1 percent from 134.3 percent in September.

While strict adherence to the debt-reduction rule would require an even sharper reduction in the debt ratio, the Government is committed to a multi-year consolidation strategy that, combined with the investments and structural reforms defined in the RRP, aims at raising potential GDP growth and improving the sustainability of public debt.

FIGURE 5: DEFCIT AND DEBT-TO-GDP RATIOS IN THE POLICY SCENARIO (% OF GDP)



VIII. HIGHER GDP GROWTH AND GRADUAL FISCAL CONSOLIDATION TO IMPROVE PUBLIC DEBT SUSTAINABILITY

The Italian Stability Program contains a comprehensive risk analysis involving both deterministic debt-to-GDP projections (consistent with alterative scenarios related to geopolitical and macroeconomic and financial risks) and stochastic simulations.

In the stochastic simulation, the results are predominantly driven by the degree of uncertainty surrounding the median projection; if the volatility observed over the last two years is assumed to be the new norm, then there is a significant probability that at the end of the forecast horizon (2025) the debt ratio will be higher than the current level. Otherwise, if the magnitude of the shocks is restricted to the volatility recorded in the historical series preceding the pandemic (*limited-volatility shock scenario*), the results of the analysis are clustered around the baseline scenario.

The stochastic simulations show that the downward trend in the debt-to-GDP ratio over the next few years would be facilitated by a context of renewed stability. On the other hand, in the event of prolonged instability, the decline in the debt-to-GDP ratio could come to a temporary halt and fiscal policy would have to respond appropriately, including actions at the EU level.

The Stability Program also includes public debt projections on a ten-year horizon, adopting the Debt Sustainability Analysis approach followed by the European Commission in its Fiscal Sustainability Report (FSR). Unlike the FSR (in which the projection starts in 2024), the baseline scenario – called “scenario A” – starts in 2026,

as the 2022-2025 values coincide with the official projections. In this scenario, the projected structural budget from year 2026 onwards is kept constant at its 2025 value. The budget outcome, however, is allowed to deteriorate in line with the projected values of ageing costs.

In addition, the Stability Program section includes two alternative scenarios. In scenario B, the nominal deficit-to-GDP ratio gradually improves in the years after 2025, reaching a structural budget balance in 2033. In scenario C, potential growth is higher thanks to the implementation of structural reforms envisioned in the Recovery and Resilience Plan, whose impact was estimated with the Quest DSGE model.

Figure 6 shows the evolution of the debt-to-GDP ratio in the three scenarios. In scenario A, which does not envisage any fiscal correction beyond 2025 nor a full evaluation of the positive impact of reforms, the debt-to-GDP ratio declines until 2026 and then rises again to 150 percent in 2033. This finding is in line with the projections recently published in the FSR and is strongly influenced by estimated ageing costs.

In scenario B, the continuing fiscal adjustment produces a downward all the way to 2033, when the debt ratio reaches 130.4 percent. In scenario C, the full implementation of reforms improves the growth performance, leading to a decline in the debt-to-GDP ratio compared to scenario A over the entire simulation period. However, the debt-to-GDP ratio rises in the final years of the decade, reaching 137.5 percent in 2033.

The reference or baseline scenario (scenario A) should not be interpreted as the most likely outcome. First, it rests on an unchanged (fiscal) policy assumption, whereas a further adjustment after 2025 is envisaged by the official plans. Secondly, the potential growth projection does not incorporate the positive impact of reforms.

Combining the effects of the two alternative scenarios, scenario B+C shows how quickly the debt ratio would decline if reforms led to an increase in potential output growth and the structural budget gradually moves towards balance.

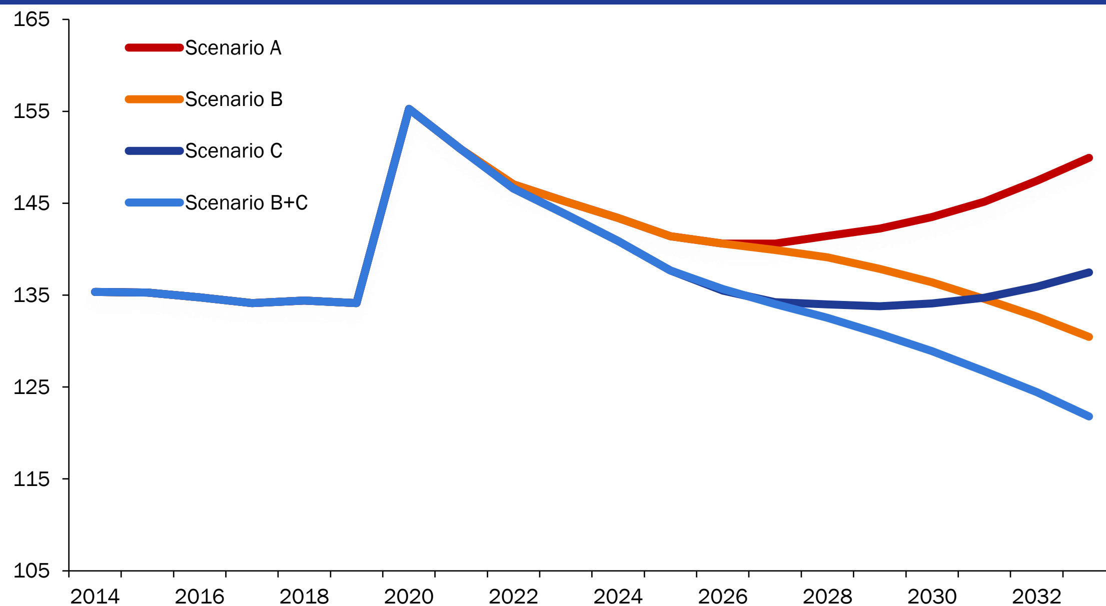
The Stability Program also includes long-term projections of the debt-to-GDP ratio, spanning to the year 2070. Such projections rely on trends of the main expenditure items that are sensitive to population ageing and are computed using the approach adopted by the Ageing Working Group. The dynamic of public debt in the long run is very sensitive to the primary balance level used as the starting value for the simulation. Like in the case of ten-year projections, it is shown that a smaller deficit can lead to a very different dynamic and to a remarkably different end-of-horizon (2070) debt ratio.

In addition to the customary sensitivity analysis, a small simulation set provides some examples of the favorable effects that given policies may have on the debt-to-GDP ratio in the long-term. The first analysis concerns the impact of structural reforms contained in the RRP, alongside the alternative simulation made while assessing debt sustainability over the medium term.

The RRP includes a series of reforms that are aimed at improving the tax collection system, encouraging tax compliance, and combating tax evasion. The envisaged reforms would reduce tax evasion by approximately EUR 12 billion, or 0.67 percent of GDP in 2024 compared to 2019. Such an outcome is currently not included in the

government budget projections. An alternative simulation incorporates a permanent improvement of 0.67 percent of GDP in the budget balance, leading to a sizable decline in the debt ratio.

FIGURE 6: MEDIUM-TERM PROJECTION OF THE DEBT-TO-GDP RATIO



Source: MEF projections.

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